A NOTE ON FINANCIAL DISTRESS

We can divide the sources of financial distress into three categories:

a - Firm level causes of financial distress

b- Industry level causes

c- Macro level factors causing financial distress

a. Firm Level Causes

These factors are specific to a particular firm and include i) ownership and governance, b) operating risk and c) leverage.

For example, agency costs connected with managerial discretion and debt, depending on the extent that they are not mitigated through contracting devices can affect a firm's operational efficiency, leverage, profitability and risk. However, if a firm is observed to be in financial distress, and even if the cause of the distress can be traced explicitly to bad decisions by management, it may be difficult to distinguish whether the decisions that contributed to distress are due to management's self-serving behavior or to incompetence.

b. Industry Level Causes Competition:

Five forces of industry competition are useful for identifying possible industry level causes of financial distress. These forces are 1) entry / exit barriers, 2) bargaining power of vendors 3) bargaining power of buyer 4) threat of substitute products and 5) rivalry among competing firms.

A negative shock to an industry's product demand or costs especially if it is sustained over time, will eventually force a shakeout of firms in the industry. The weakest firm will be forced into liquidation or must consider being acquired by a stronger firm in the industry.

The leverage helps boost a firm's sales growth relative to that of its industry rivals because the firm commits to aggressive competitions in the product markets, which leads less aggressive competitors to yields part of their market share. The firm may deliberately choose low leverage so as to be able to pursue predatory market strategies to squeeze a high-levered rival, perhaps to the point of bankruptcy.

The industry shocks contribute to the frequency of takeover and restructuring activity. Shocks included regulation, changes in input costs, and innovations in financing technology that induce or enable alterations in industry structure. The inter-industry patterns in the rate of takeovers and restructurings are directly related to the economic shocks borne by the sample industries.

Financial researchers and thinkers have investigated the effect of a bankruptcy announcement by one firm on the values of other firms in the industry. There are two conflicting effects. On one hand, there may be contagion effect. The market may lower the value of other firms in the industry because the bankruptcy announcement reveals new negative information about the status of the industry as a whole. On the other hand, the market may raise the values of other firms in the industry because on of their rival has failed.

The deregulation of an industry can induce financial distress in many firms within the industry as the economic structure of the industry changes. Over the last decade, Pakistan has deregulated the transportation industry (airline and rail), communication industry and several public sector giant industries including Pakistan Steel.

c. Macro-Level Causes

Recessions create financial distress by narrowing the margin between cash flow and debt service. When the flow constraint is relevant, a principal effect of drop in current income is the reduction of expenditure on illiquid and long-lied assets. There are two reasons for this. First, lower current income increases the short run probability that the flow constraint will have to be satisfied through costly means, for example, the distress sales of assets, borrowing at unfavorable terms, sever reduction in current living standard, or as the last resort, bankruptcy. Secondly, a drop in current income typically has ambiguous implications for the consumers' estimates of future income flows and, hence, for the level of durables holdings consistent with maintenance of solvency in the long run. Because durables are illiquid, it is more costly to correct an over purchase than an under purchase. Assuming that waiting for new information will tend to resolve the ambiguity created by the initial income fall even a risk neutral consumer will be motivated to defer durables purchases until the uncertainty is resolved.