SME Restructuring
Financial Strategies for Turnaround and Growth

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Abstract

Financial losses and inability to obtain affordable financing are primary reasons for SME failure and low growth. The literature suggests that these challenges may be resolved by changing asset composition, capital structure and terms of debt repayment. However, there is need for more information about how to choose from among these strategies to suit specific situations.This article reports results from statistical analysis of an opinion survey of 127 SME owner/managers in Jamaica.The findings are presented as a framework for deciding financial restructuring strategies based on SME performance objective and business strategy.

Introduction

SMEs are important for economic growth and job creation [1, 2].However, they have a relatively high rate of discontinuance.[3] In Jamaica, the number of small firms filing General Consumption Tax returns declined42% from 18,142 in 2005 to just 10,438in 2011 [4, 5].Financial hardship is a primary reason for SME discontinuance [6, 7, 8, 9].This adversity arises from financial losses and inability to obtain affordable financing [10, 11].

Firms canuse financialrestructuring toincrease liquidityandreduce the cost of capital [e.g. 12]. This process involves changes in asset composition, capital structure orterms of terms of debt repayment. Yet, the information available on financial restructuring of large corporationsfar outweighs similar research on SMEs [10]. A keyword search of corporate financial restructuring, by the authors using ABI Inform/Global electronic database, returned 22,793 scholarly journal articles compared to only1,115 (or 5%) for SME financial restructuring. Welsh and Whitenoted that "a small business is not a little big business" because of resource poverty and limited revenue streams that make them more vulnerable to environmental jolts [13].Furthermore, SMEs have a different financing pattern from large firms [14]. Understanding this pattern is important for SME turnaround or growth [15].

SMEs often lack the financial information needed to make successful decisions [10]. Also, firms in a small open economy, such as Jamaica, must cope with the adverse consequences of macroeconomic challenges of high interest rates, local currency depreciation and tight liquidity [4].

Studies have observed the effect of various financial strategies on SME performance. Debt restructuring can facilitate recovery of distressed SMEs from declining performance [e.g. 15].High cost of capital can have a negative effect on SME growth [e.g. 17].Low debt and effective liquidity management are among the factors promoting profitability and growth of SMEs [16].However, there is no systematic evidence about what financial restructuring

strategies to choose to fit different business situations.The literature also overlooks the extent to which SME owner/managers are inclined to embrace these strategies in the first place.Small business decision-making is often intuitive, informal and invisible [18].SME owner/managers have a strong influence on decision-making in their firms including whether or not strategies for financial restructuring are adopted. For example, since 2009, the Government of Jamaica has provided substantial tax incentives for SMEs to become listed on the Jamaica Stock Exchange. After four years, only 16 SMEs have taken up this opportunity.

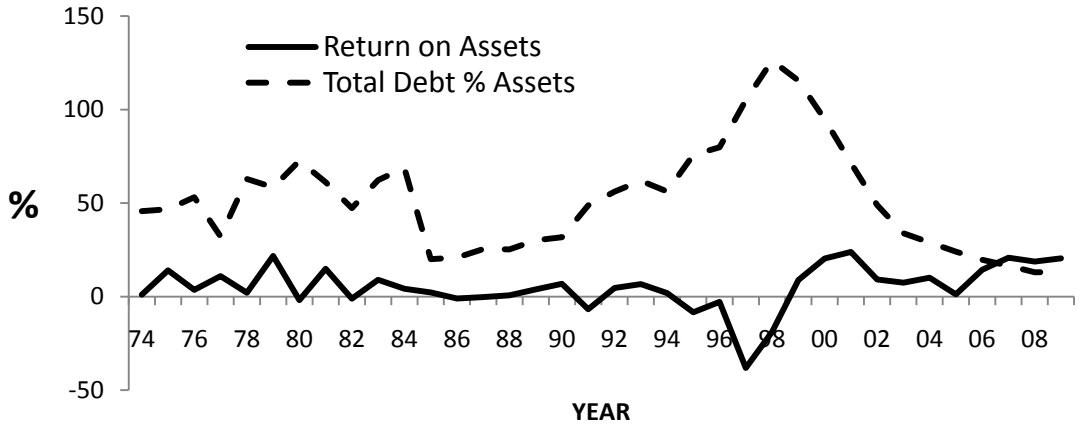
The purpose of this study was to obtain the views of owner/managers in Jamaica about the importance and choice of financial restructuringstrategies for SME turnaround and growth.Thenext section of this article provides theoretical foundation, develops testable hypotheses, and describes the methodology. Finally, the findings are presented and discussed.

Literature Review and Hypotheses

Viable firms in profit trouble can take deliberate actions for sustainable recovery from the decline [e.g. 19, 20].The turnaround process unfolds in two overlapping phases called declining stemming and performance recovery [21]. The decline stemming phaseinvolves actions to halt erosion of company profit and liquidity. This may require asset reconfiguration to increaseworking capitalor changes in capital structure to reduce the cost of capital [22, 23, 24].

The experience of Salada Foods, a Jamaican producer of instant coffee,illustrates how financial restructuring can be part of SME turnaround from losses and insolvency. This company suffered from the adverse effects of hyperinflation and a failed project overseas. To stem decline, management rescheduled debt, sold the loss making project and negotiated with creditors to refinance debt at a lower rate of interest. Salada Foods also used proceeds from a rights issue of ordinary shares to finance sales growth during its recovery phase of the turnaround cycle. Figure I shows that the debt burden of this company increased substantially, when its profitability was declining, and then the level of debt was reduced during recovery or turnaround.

Figure I. Salada Foods leveraged financial restructuring for business turnaround



Data source: Jamaica Stock Exchange Yearbooks

Firms use different strategies for turnaround depending on the cause of decline [25]. The choice between growth and cutback as turnaround strategy is contingent on the SME owner/managers' perceptions of resource availability [26].The theory of the growth of the firm, put forward by Edith Penrose, posited that the firm achieves growth by pursuing opportunities for productive utilization of its resources [27]. Competitive advantage arises from superior skills in combining resources. Capital structure has a substantial effect on the ability of SMEs to innovate and grow [28]. High cost of capital constrains SME growth [17].For sustainable growth, firms need either keep the level of sales within the constraints of existing working capital or obtain additional financing by strategies such as sale of equity [29].

The performance objective ofthe SME, in terms of turnaround or growth, and its business strategy has important implications for the firm's choice of financing. Firms engaged in cutback or contraction may wish to sell assets to get financing for refocusing on core competitive strengths [e.g. 16]. In contrast, firms in pursuit of expansion defer debt repayment through rescheduling or refinancing to boost liquidity [e.g. 15].

The strategy required for successful financial restructuring depends on the nature of the situation. Contingency theory posits that the organization is an open system operating in a state of dynamic equilibrium with the external environment by the exchange of goods, services, information and resources [30].The system works best when the organization is in harmony with its environment. An adverse shift in the environment exerts pressure on the organization that can disrupt its equilibrium and induce declining performance. For survival and growth, the organization must choose and execute the correct response for reestablishing equilibrium. However, there is no universal approach that is applicable to all situations.

A behavioral theory put forward by Cyert and March argues that the firm adapts to its environment by making decisions about price, output and internal resource allocation [31]. Imperfections in decision-making generate a resource surplus, called organizational slack, which provides a buffer against environmental pressures or internal weaknesses and enables search for solutions to problems. SMEs have a limited range of output and little control over market prices. They rely on resource allocation, on a contingency basis, to support both the performance objective and business strategy.Of course, these actions presume that SMEs perceive that financial restructuring is important. Thus:

Hypothesis H1: Owner/managers perceive that strategies for financial restructuring areimportant for SME turnaround and growth.

Hypothesis H2: There is a significant difference, between owner/managers of SMEs in need of turnaround and those in pursuit of growth, about the level of importance of strategies for financial restructuring.

Hypothesis H3: SME owner/managers perceive that the required strategies for financial restructuring are contingent on the firm's performance objective, turnaround or growth and its choice of business strategy,contraction or expansion.

Methodology

Research Design and Sample

Similar to prior research on SME financing, the study adopted a one sample, cross-sectional survey research design [32, 33]. This design is appropriate for describing the attitudes, opinions behaviors or characteristics of the population of interest [34]. Data was obtained by way

of face to face interviews conducted over a period of four weeks using a survey questionnaire pre-tested with responses from five SME owner/managers.The sample consisted of responses from 127 SME owner/managers who agreed to participate in the survey from a sampling frame of 436 SMEs listed as active members with the Small Business Association of Jamaica in May 2012. This sample size is just over one percent of small firms filing General Consumption Tax returns in Jamaica [4].

Data Collection and Measures

Demographic data was collected on SME parish location, business activity,age of business (Age), number of employees (Employees) and gender of the respondent.The survey also captured SME owner/manager opinions on the need of their firms to cope withrising business debt.This variable was used to split the sample into two sub-groups: (1) SMEs in need of turnaround rated the importance of rising debtat a high score of 4 or 5 on a five-point numeric scale and (2) the other SMEs in the sample, called growth, rated rising debtas being of low or moderate importance.

Respondents rated the importance of four financial restructuring strategies for improving SME performance: debt rescheduling (ReschedDebt), sale of assets (SellAssets), sale of equity (SellEquity) and debt refinancing (Refinance).They also rated the importance of three strategies: addition of new products (NewProd), enter new markets (NewMkt)and cutback product offerings (CutProd).Michael and Robbins (1998) found, from a study of turnaround strategy at 164 small manufacturing firms, that cost and asset retrenchment helped the firms to recover from decline. SMEs can also grow by entering new markets [e.g. 35].

Resource allocation is also contingent on the stage of SME life cycle. The appropriate capital structure for the firm depends on its stage of life: birth, growth, maturity and decline [33]. Therefore,SME Age was adopted as a control variable. SME size, measured as the number of employees, was also adopted as a control variable. All variables were measured using a five-point numeric scale ranging from a score of 1 (unimportant) to 5 (very important).

Data Analysis

The data was coded and inspected for means, standard deviation, skewness and kurtosis. The possibility of data bias, in respect of gender or business, was examined using Wilcoxon (Mann Whitney U) tests to compare independence of means between male and female respondents and also goods-oriented firms and service providers. Survey research methodologies often correlate variables to learn about the populations under study [34]. The results for Hypothesis H1 were assessed on the basis of the sample means. Wilcoxon (Mann-Whitney) tests were used to investigate hypothesis H2. Hypothesis H3was tested by way of Spearman bivariate correlation coefficients to signal whether or not SME owner/managers were inclined to take a contingency approach to selection of financial restructuring strategies.These tests were conducted at .10 level of significance because non-parametric tests carry a greater probability of not rejecting a false null hypothesis or a Type II error.

Results

Statistics for skewness and kurtosis revealed that the data distribution of the sample was normal.With respect to SME location, the responses spanned 11 of the 14 Parishes in Jamaica.The profile of the sample was similar to the population distribution of SMEs filing GCT returns (Planning Institute of Jamaica 2012). Retailing was the largest business activity

accounting for 34.6% of the SMEs. Manufacturing (9.4%), construction (8.7), transportation (5.5%) and restaurants (4.7%) were the largest categories in the rest of the sample.

Male respondents were 63% of the sample.There was no significant difference based on either gender or business activity (goods versus services) in respect of any variable. 41% of the SMEs were less than 10 years old. 65.4% had less than 10 employees. 48.9% of respondents were of the view that intensifying competition was an important issue (scored at least 4 out of 5 on the rating scale). 42.5% of respondents believed that rising debt was an important issue. 59% of respondents stated that increasing cost was an important issue.

Results of testing hypotheses

The data was split into two sub-groups based on the perceived importance of rising debt:The Turnaroundgroup (scoring rising debt at either 4 or 5 on the five point numeric scale) and the Growthgroup (scoring rising debt at 1, 2 or 3 on the scale).The mean values of all variables in the Turnaround group were higher than corresponding values in the Growth group. Hypothesis H1waspartially supported by statistical evidence (Table 1). SME owner/managers, of firms in need of turnaround, perceived that debt rescheduling and debt refinancing were of moderate importance. Sale of assets and equity were of low importance by this group. All four strategies for financial restructuring were of low importance for the Growth group.

Table I. Summary descriptive statistics and results of tests of independent means

Variable	**Turnaround** (N = 54)		**Growth** (N = 73)	
	Mean	std. dev.	Mean	std. dev.
NewProd **	3.78	1.34	3.24	1.30
NewMkt	3.67	1.36	3.41	1.41
CutProd **	215	1.19	1.67	0.99
ReschedDebt **	3.33	1.43	2.02	1.13
SellAssets *	1.87	1.21	1.54	1.05
SellEquity	1.76	0.97	1.49	1.03
Refinance **	3.20	1.55	1.76	1.14

Significant difference between the two groups (* $p < .10$, ** $p < .05$, two-tailed Mann Whitney U tests)

Hypothesis H2was partially supported by statistical evidence. There is a significant difference, between the Turnaround and Growth groups, in respect of adding new products (Mann Whitney U = 1473.0, p = .012), product cutback (U = 1523.0, p = .017), debt rescheduling (U = 1114.5, p = .000), sale of assets (U = 1680.0, p = .099) and debt refinancing (U = 1115.0, p = .000). SME owner/managers of firms in the Turnaround group place more emphasis on strategies for debt rescheduling, sale of assets and debt refinancing than SME owner/managers of firms in the Growth group.

Table II. Descriptive Statistics and Correlation Coefficients for SMEsfocusing on turnaround

		Mean	s.d.	1	2	3	4	5	6	7	8
1	NewMkt	3.67	1.36								
2	NewProd	3.78	1.34	.19							
3	CutProd	2.15	1.89	.19	.07						
4	ReschedDebt	3.33	1.43	.18	.35**	-.11					
5	SellAssets	1.87	1.21	.01	.18	.31**	.25*				
6	SellEquity	1.76	0.97	.26*	.13	.27*	.23	.63**			
7	Refinance	3.20	1.55	.08	.28**	.14	.48**	.41**	.34**		
8	Age	3.23	1.53	-.23*	-.00**	-.30**	.08	-.05	-.29**	-.24	
9	Employees	2.33	1.06	-.12	-.16	-.03	-.36**	.01	-.12	-.33**	.48**

* p < .10, ** p < .05, two-tailed Spearman tests, N =54, s.d. refers to standard deviation

Table III. Descriptive statistics and correlation coefficients for SMEs focusing on growth

		Mean	s.d.	1	2	3	4	5	6	7	8
1	NewMkt	3.41	1.41								
2	NewProd	3.25	1.30	.61**							
3	CutProd	1.67	0.99	.02	-.06						
4	ReschedDebt	2.37	1.27	.23*	.11	.32**					
5	SellAssets	1.55	1.00	.11	.05	.29**	.08				
6	SellEquity	1.62	1.04	.12	.02	.40**	.20	.65**			
7	Refinance	2.01	1.31	.02	.06	.28**	.46**	.16	.33**		
8	Age	2.89	1.53	-.03	-.14	-.14	-.33**	-.18	-.30**	-.13	
9	Employees	1.82	0.89	.10	-.09	.30**	-.00	.16	.23*	-.26**	.22*

* p < .10, ** p < .05, two-tailed Spearman tests, N =73, s.d. refers to standard deviation

Hypothesis H3 received partial support from the statistical evidence (Tables 2 and 3). For SMEs following a business strategy of contraction in the Turnaround group, the required

strategies for financial restructuring are debt rescheduling, sale of assets and sale of equity. SMEs attempting turnaround by way of expansion should refinance debt and sell equity. SMEs in pursuit of revenue growth by way of cutbacks should adopt all four strategies for financial restructuring. SMEs using expansion strategies for revenue growth should reschedule debt.

Discussion and Conclusion

This study was an empirical investigation of the views of SME owner/managers about strategies for financial restructuring.The literature suggests that SMEs can benefit from these strategies but there is a need to provide information for making this choice. The findings support our hypothesis that the required strategies for financial restructuring are contingent on performance objective and business strategy. Figure II shows these findings in a framework that can be used to decide strategies for financial restructuring.

FigureII. A framework for deciding SME strategies for financial restructuring

		SME Strategy	
		Contraction	**Expansion**
SME Performance Objective	**Turnaround**	**A** Sell assets Sell equity	**B** Reschedule debt Sell equity Refinance debt
	Growth	**C** Reschedule debt Sell assets Sell equity Refinance debt	**D** Reschedule debt

SME owner/managers perceive that sale of assets and sale of equity are appropriate strategies for firms attempting turnaround by way of contraction (Quadrant A in Figure II). These actions can solve debt repayment problems even under conditions of impending insolvency. Firms in Quadrant B should reschedule debt, sell equity and refinance debt. These actions help SMEs to boost cash flow for sales growth. SMEs in Quadrant C require all four strategies to refocus on core strengths and build competitive advantage. Firms in Quadrant D are in good financial heath and only need breathing space by way of debt rescheduling to expand for sales growth.

This study has limitations that serve as opportunities for future research. Industry context was not examined. Do the perceptions of SME owner/managers also depend on industry type and stage of life cycle? The nature of declining performance was beyond the scope of the study.

Do the cause and speed of performance decline influence choice of strategy for financial restructuring?There is need for more education of SME owner/managers.

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