DEBT TO EQUITY SWAPS AS ALTERNATIVE OF FINANCIAL RESTRUCTURING IN SERBIAN ECONOMY[1]

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Abstract:
The goal of this paper is to analyze debt to equity swaps as potential alternative of financial restructuring in Serbian economy. We got motivation for making this paper on review of current situation of financial structure of large number of Serbian companies burdened with debts. High level of indebtedness and illiquidity limit business operations and decrease possibility for financing growth and development. Without intensification of investment activity of business entities there will be no dynamic economic growth and necessary structural changes. Traditional measures from the arsenal of restructuring of debts - postponement of repayment, extending dead-lines, write-off, changes in calculation of interest rate etc. can have but limited effect in existing conditions, when fast recuperation of many companies is required. For this reason, a massive application of debt to equity swaps, with increased role of the public and transparency in business operations and reaffirming the efficient and effective management, can pose a reasonable solution for faster alleviation from heavy indebtedness and increased illiquidity of Serbian companies.

Key words*: Debt to Equity Swap, Financial Restructuring, Debt Restructuring, Corporate Restructuring, Financial Institutions*

1. INTRODUCTION

In this paper we will try to analyze debt to equity swap as alternative of financial restructuring in Serbian economy. Business entities in the Republic of Serbia have

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been burdened by heavy indebtedness and aggravated illiquidity for many years now. In 2014, creators of economic policy tried to catch the ‘voice of economy’ in order to try to help businessmen in increasing production, with the aim to make fast economic growth. In several meetings it could be heard how leading Serbian businessmen suggest some of the following measures to the Government: assistance in reducing high level of indebtedness, extending payment dead-lines, write-off (or pardon) of part of debt in some cases, transferring part of non-performing loans (NPL) to special legal entity, reducing interest rates, extending new loans in the aim of increasing liquidity, etc. Just on those ground we found a basic motive for writing this paper. It consists of the attempt to help in expanding alternatives in the domain of financial restructuring by detailed analysis of mechanisms of debt to equity swaps.

Debt to Equity Swap is technique of financial restructuring from the domain of debt restructuring. It is usually applies in cases when a company is faced with financial problems, when it is over-endebted, cannot repay existing loans on time, has decreased liquidity and when there is no possibility for additional endebtedness. Key point is to replace the existing debt for ownership share, by what the previous creditors (creditors or owners of security instruments of debt - bank notes or bills of exchange) become new co-owners of the company. Some time ago, this strategy was applied only to large companies, but as of late, it has been present as an option of financial restructuring for medium-sized and small companies too.

In order to show possibilities of application of debt to equity swaps, we divided the paper in three basic parts. After introductory notes, we will try to indicate the proportions of basic problem of many companies in Serbia - heavy indebtedness. In the following part we will analyze the specific nature of debt to equity swap as potential solution of the basic problem and research various international experiences in its application. Finally, in the conclusive part we will indicate the possibilities, limitations and potential advantages of application of this mechanism in our circumstances.

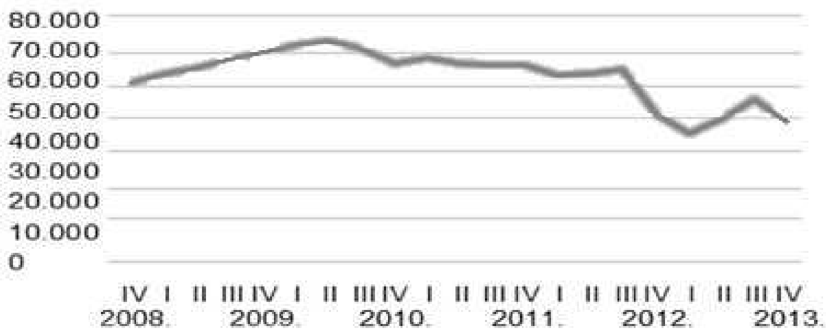
2. BASIC PROBLEM – DIAGNOSTICS OF CURRENT SITUATION

Basic problem that we are focusing our attention on is heavy indebtedness of Serbian business entities. As Serbian economy has been facing with negative consequences of global crisis for some years now, we are dealing with the problem which has significant influence not only on individual companies, but on macro level leads to slower growth and development of national economy and in keeping with this, on the over-necessary changes. Number of companies facing crisis has been growing year after year, which is manifested mainly in reduced liquidity and increased indebtedness.

According to data of the National bank of Serbia (NBS), in the period from 2009 to the middle of this year, between 30,000 and 50,000 business entities had blocked accounts (*Annual report on stability of financial system for year 2013, p. 42*).

Bearing in mind that total number of companies and entrepreneurs who do business in our country ranges from 130 - 140,000 (in the year of 2013 there were 115,613 active business organizations and 19,066 entrepreneurs who kept their ledgers applying dual accounting and thus sent financial reports to the Business registers Agency (*Report on business operation of the economy in the Republic of Serbia in the year of 2013, enc. 1, p. 46*), we can conclude that in the last five years, parallel with the increase of negative influences of global crisis, in the Republic of Serbia between 20 and 35% of all business entities was in the situation of chronic illiquidity.

Graph 1: Rate of movement of the number of companies with blocked accounts in the period from 2008 - 2013



Source: Annual report on stability of financial system for year 2013, p. 42, www.nbs.rs

It is plain to see in the graph that number of blocked business entities is on a decline from the second quarter of 2012. It is the result of application of Article 91 of Company law, which prescribes that entrepreneur stops operation if his business account has been in blockade for more than 2 years.

We should point out the fact that in the observed period, the state itself very often was late with payment of its obligations and that deadlines and payments in certain areas (e.g. commerce) are rather long. so we can conclude that in our country there is a ‘magic circle’ of illiquidity. In order to overcome this somehow, many companies were simply forced to take new loans, which resulted in further aggravation of parameters of their indebtedness. Hence, problems of illiquidity and over-indebtedness cannot be observed separately.

At this point we could ask several questions, such as:

1. How many companies are faced with heavy indebtedness?
2. What is the structure of balance sheets of our companies?
3. How much are banks burdened with bad credit - what is the level of NPL in economy sector?

In reply to first two questions we reached for the data from the Business registers Agency, on financial reports of domestic business organizations for year 2013 (*Report on business operation of the economy in the Republic of Serbia in the year of 2013*). According to data from financial reports for year 2013, in the structure of total source of funds of business organizations in the Republic of Serbia, capital has largest participation (42.1%), followed by short-term liabilities (40.5%) and long-term liabilities (15.3%).

Own sources of financing i.e. capital of Serbian economy is expressed in the amount of 5,663,849 million dinars or 2.8% more than last year. In the end of 2013, capital of business organizations is mostly comprised of initial capital in the amount of 3,967,853 million dinars, then reserves and revalued reserves of 1,654,887 million dinars i.e. retained earnings of 1,760,052 million dinars and unpaid registered capital of 26,264 million dinars. Loss up to the level of capital is expressed in the amount of 1,704,139 million dinars, while unperformed loss and unperformed profit on the basis of securities available for sale amounted to 22,346 million dinars i.e. 7,889 million dinars.

Long piling-up of cumulative losses is reflected in decrease of own capital of business organizations, so that security of business operation of companies has been endangered. This is another chronic illness that affects business operation of domestic business entities. At that, steadily high rate of lost capital additionally increased from 35.9% to 38.9% in 2013.

In 2013 decrease of participation of equity capital was registered in ration of total sources of financing (from 34.3% in 2012 to 33.4% in 2013). It indicates that heavy indebtedness that Serbian economy has been faced with for several years, resumes its growing trend. Total amount of debts of the economy of Serbia ranges from cca. 20 bill. euros, which in relative amount makes approximately 60% GNP (*Annual report on stability of financial system for year 2013, p. 39*). On weakened financial capacities of business organizations and increased risks in their business operations indicate worsening of already adverse ratio between borrowed and own capital, as business organizations on 1 dinar of borrowed capital in 2013 used 0.58 dinars of equity capital, while in 2012 that ratio was 1 to 0.59 dinars.

Shifting the burden on business operations on other participants, business organizations are in default in defraying their liabilities, so that their operational liabilities are increased, while simultaneously they additionally reach for short-term loans as well, thus triggering the spiral of illiquidity.

Possibilities for acquiring capital of business organizations through additional borrowing were narrowed in 2013, so that total number of credits extended to the economy in the amount of 3,113,416 million dinars slightly increased (4.2%) compared to previous year. At the same time, participation of total credits in total sources of financing slightly increased, from 22.9% to 23.2%.

Limited availability of long-term sources for financing the existing scope of business operation and aggravated servicing of current liabilities inspired greater use of short-term forms of financing, so that short-term credits were increased by 10.2%, while long-term credits showed decrease of 2.5%. That way, high participation of short-term credits, expressed in the amount of 1,747,047 million dinars, which were used for overcoming illiquidity problems, was strengthened in the structure of total credits, compared to previous year.

Continued financing of part of fixed assets by short-term resources, as deeply rooted disbalance in financial structure of Serbian economy was especially noticeable in 2013, when business organizations lacked twice as much long-term capital for financing fixed assets, compared to last year. Negative net working capital was expressed in the amount of 599,357 million dinars, and as supplies amounted to 1,305,578 million dinars, for accomplishing the level of business operations of the economy on the whole, 1,904,935 million dinars were required or 14.2% more than last year, which resulted in further worsening of already poor liquidity.

In searching for answer to the question how much the banks were burdened with bad credits, i.e. what was the level of NPL in economy sector, we turned to data published by national central bank. According to NBS data in the report Quarterly review of movement of indicators of financial stability of republic of Serbia for 2nd quarter of 2014, participation of problematic credits in total number of extended credits amounted to 23.0%.

Movements per year can be seen in the table below:

Table 1: NPL shares in total loans in Serbian banking system

Year	2008	2009	2010	2011	2012	2013	Q1 2014	Q2 2014	Q3 2014
NPL %	11.3	15.7	16.9	19.0	18.6	21.4	22.3	23.0	???

Source: NBS - *www.nbs.rs/export/sites/default/internet/latinica/18/pregled_grafikona.pdf*

On review of data given in Table 1, we can notice how NPL level has been growing year after year in the Republic of Serbia, starting from 2008. The only exception is year 2012, when there was slight drop, in comparison to previous year 2011. According to these data, it can be concluded that one in four extended loans in the Republic of Serbia is problematic. Special problem is, that according to the same source, more than 50% of loans were connected with companies in industry sector, which indicates that one of potentially most-prosperous sectors is faced with serious problems in financing its business operations.

As a comparison, NPL level in the surrounding countries in 2013 was: Albania 23.5%, Bosnia Herzegovina 15.3%, Bulgaria 16.6%, Croatia 15.4%, Macedonia 10.9% Slovenia 18.0%, Romania 21.6%, Hungaria 17.6% (*Bank nonperforming loans to total gross loans, World Bank).*

Data given are frightening, bearing in mind that financial system of the Republic of Serbia is among bank-centric systems in which greatest participation in financing have the banks. According to NBS data, as much as 92.3% of total financial assets are in the hands of banks (*www.nbs.rs*). It has significant implications in terms of diversification of resources of financing for the economy sector, which is by definition forced to refer to banking sector.

Bearing in mind everything said so far, one question is raised logically: What are the possibilities of further financing of growth and development with bad financial structure? The answer is not optimistic. So it is required to search for various methods for alleviating of the burden of credit indebtedness of domastic economy. One such solution could be debt to equity swap.

3. DEBT TO EQUITY SWAPS AS POTENTIAL SOLUTION

Bearing in mind that domestic companies are faced with serious problems in liquidity and over-indebtedness, the need for financial restructuring is a must. In case that restructuring of debts is not carried out, very realistic option for companies with problems is bankruptcy. Restructuring of debts can be various. Most often it is divided into court and out-of-court. Court restructuring means that the procedure of reorganization was initiated in keeping with the laws which regulate the sphere of bankruptcy. In recent times, in many countries there is increased number of out of court arrangements, also known as workout or voluntary financial restructuring.

Before devising and implementation of debt to equity swap, other alternatives of debt restructuring are also analyzed. Some of them are rescheduling of liabilities, extension of payment dates, freezing repayment for certain period (standstill), write-off of part of claims, new negotiation of interest rate or asset swap. The last alternative is nearest to debt to equity swap. In case of asset swaps, debtor gives some form of assets (land, building, machine, equipment) in exchange for write-off of part of debts. The problem with this form of financial restructuring implies that assets and liabilities levels are decreased. Decrease of assets is specially frightening, as the company loses working assets which could bring proper income in the future.

Debt to equity swap does not imply reduction of company's assets: it is a method which strengthens the performance of the company by eliminating liabilities which are difficult to service. Level of assets and liabilities in the balance sheet remains the same, but structure of liabilities is changed, in terms of decrease of participation of debt and increase of participation of equity capital. That way, the level of indebtedness is reduced, which can be seen in improving of most important indicators of indebtedness (debt ratios) - P/E and P/A ratio. As a logical consequence of conversion, probability of bankruptcy decreases and new basis for improving company's liquidity is created.

It should be noted that there are view which point out that with debt equity swap, creditors sometimes are better-off than owners (*Myers, 1977*). Due to inadequate management, companies ran into indebtedness 'trap'. Conversion of debts and dilution of ownership is the price to pay for unsuccessful management. This way is sanctioned inefficient and ineffective management.

Technically, the transaction itself can be carried out in a simple way. Most important is the agreement of major stakeholders regarding swap of credit claims with ownership rights. Those are, first of all, two groups of entities - creditors (usually banks in a role of creditor or bond holders, where as investors other financial institutions, organizations, even individuals can appear), of one side and existing owners (of share in case of company such as limited liability companies, or equity securities in case of corporations) of the other side. The point is that instead of loan or bond which is written-off, i.e. annulled, proper number of shares is issued (ordinary or preferential, subject to agreement); this way, creditors are becoming new co-owners of the company which ran into financial problems. As new owners, previous creditors get all ownership rights contained by shares, such as voting rights, right to dividend, sale of shares and other rights. In designing the transaction conversion, the following issues should be considered:

a) Determine the company value correctly.
b) Identify adequate level of debt which should be converted into the equity.
c) Determine which type of equity instrument would be best-suited in given circumstances, i.e. whether to issue preferred or ordinary shares. Preferred shares give no voting right, but they would have priority in terms of payment of dividend. On the other hand, if ordinary shares are distributed, they would not provide privileged treatment of dividend, but owners would have right to vote, instead.

There are several options for implementation of debt to equity swaps, such as (*Erić and Stošić, 2013, pp. 160-164*):

I - *Stand Alone Debt to Equity Swap* – where clean exchange of debt is made for new share capital and where there is no additional investing of capital. Part of old debt that burdened the company is written-off and new structure of capital is created, which is adjusted to existing level of assets. In devising the instruments which are distributed to 'ex' creditors now new co-owners, several alternatives are defined, such as: convertible bonds (*Stein, 1992*), preferred or ordinary shares. In case of swap by means of convertible bond, there will not be immediate change of ownership structure, but in the case of issuing other equity instruments, ownership structure is changed in favour of ex creditors. Creditors who do not participate in conversion, still possess their claims, but total amount of debt is less with consequently greater probability to collect it.

II - *New Money/Funded Plan* – is combination of stand-alone debt to equity swap and investment of new funds. New funds can be invested in the company either in the form of loan or additional share capital. One part of newly-acquired funds is used for requirements of repayment of previous loans, which leads to company's relief of part of loan-related liabilities. Other part of funds is used for requirements of current financing of business operations, which provides infusion of fresh liquid funds.

III - Another option is *sale of part of assets* (also know as asset swap) or the whole company. This is the simplest transaction in which assets owned by 'problematic' company is sold for cash, and part of debt is written-off. A new investor can buy one part or all assets of the company which ran into difficulties and after that, make its own decision what to do next with them. Sometimes for requirements of implementation of this strategy of restructuring, special legal entity is created that has the role of buyer (*SPV – Special Purpose Vehicles*). Its purpose is purchase of property of certain business entity and very often it does not perform any other business activity.

Please note that in addition to three basic options of debt to equity swap, there are possibilities of combining different alternatives. Success of debt to equity swap depends on several factors, such as:

1. Does it lead to obtaining support of all creditors and owners - if there is no minimum consensus between key participants, there is no possibility of feasibility of this operation. At this point, there are two groups of problems - approval of all creditors, both those who possess old debt (senior) and owners of new (junior) debt. Sometimes, different interests can exist between them. On the other hand, approval of all shareholders is also required, as debt to equity swap implies change of existing ownership structure.

2. Regulatory issues which must be fulfilled before and during the conversion itself. As the transaction reaches issues connected with the sphere of loans and securities (bonds and shares), it is necessary to examine regulations from jurisdiction of the Commission for securities and Central bank. At least three types of institutions are involved - banks, securities regulators and Central bank. Of course, regarding devising the whole transaction, it is necessary to pay attention to taxation and accounting implications.

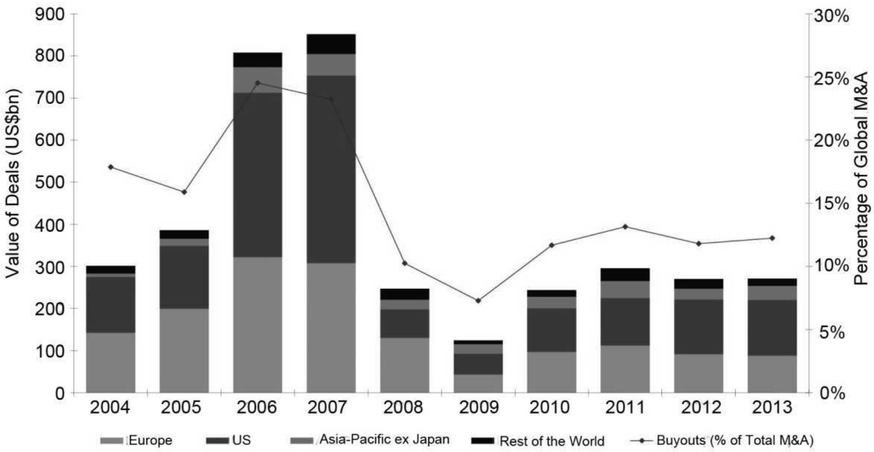
3. Resuming business operations of the company and ability to make business success. Key issue for success of debt to equity swaps is good management. If we continue with the 'old' practice and borrowing continues after the transaction, it is likely that the company will run into difficulties again and that this form of restructuring will not be successful. Success of these activities in certain developed countries, such as USA and UK support the fact that the very transaction was followed by changes in style of management in terms of its improvement (*Vygovskyy, pp. 2010*).

International experience regarding application of this technique of financial restructuring are various. In USA, debt-equity swaps are very popular method of financial restructuring, with high degree of efficiency. Large number of researches determined that more than 75% of programs were highly successful (*Gilson, 1990, James, 1995*).

According to German legislature, debt-equity swaps are treated as increase of capital of the company. Ipso facto, previous creditors become new co-owners of the company. In Germany it is applied to two most frequent forms of companies - the joint stock companies - corporations (*Aktiengesellschaft, AG*) and the limited liability company (*Gesellschaft mit beschränkter Haftung, GmbH*). In both cases, approval of at least 75% of existing owners is required in order to approve the transaction (*Sinhart, 2009*). This mechanism has gained popularity in the last couple of years, with intensification of global crisis, where companies tried to reduce the burden of debts and create basis for easier acquiring of additional capital. It proved to be faster and more efficient than classic court settlements. There are several cases of very successful transactions, such as *Conergy and Pfleiderer* companies (*Schwarz & Rosiak*, 2011). There were examples of successful debt to equity swaps in other countries too, such as Switzerland (example of UBS bank in 2008, *Landier & Ueda, 2009*), etc.

The total value of private equity buyouts during 2013 stood at US$ 271.1 bn. Buyout deals contributed 12.2% to global M&A activity (US$ 2.2 bn.), up from 11.8% in 2012, but lower than in 2011 (13.1%). The buyout activity increased in all regions and has highest share in USA (*Mergermarket M&A Trend Report: 2013*).

Graph 2: Private equity deals worldwide – 2004 - 2013



Source: Mergermarket M&A Trend Report: 2013

An extensive program of debt-equity swaps was applied in PR China in the period from 1999 - 2001. This was a forced measure due to very high level of NPL's which were made in the period from 1987 to 1995 and were connected with bad credit policy of two great state-owned banks. Basic intention was to eliminate the 'toxic assets' from the balance of the banks. It was done in such manner that special asset management companies (AMC) were created, which took over problematic credits from the banks. At first, several advantages were achieved: scope of NPL was reduced from 35% to 25%, banks improved financial structure without additional capitalization, so that financial position of large number of companies improved. However, results of massive use of debt-equity swaps in China are highly problematic (*Steinfeld, 2001*).

There is a similar situation in some other countries under transition. For example, in Ukraine, before the crisis, this mechanism was partly applied, but also with changing results. Main reasons can be found in legal problems and discrepancy in legal regulations (*Vygovskyy, 2010*). Namely, we should bear in mind that this mechanism of financial restructuring is basically neutral. Problematic companies are not a problem only for itself and for their owners, but for banks, other creditors and sometimes national economy. By implementation of debt-equity swap, financial structure is changed, so that part of debt is converted into share capital. But this does not mean automatic promotion of alocative efficiency. If companies continue to be run in the manner same as before running into difficulties, spectacular results cannot be expected from this activity. Hence, key issue connected with the success of these operations is connected with the quality of management. Change of habits, even replacement of complete management teams, with considerable increase of participation of the public and transparency of business operations are preconditions for success of these operations. The question is are we ready to go into such operations? Problem which occurred in China is that AMC's were not too active in promoting efficient management. That passivity guided the management of companies and here lies one of the causes of poor results of these activities.

4. CONCLUSIONS - OBSTACLES AND RECOMMENDATIONS

Debt to equity swap is rather unknown in these parts. It is known under legal terms of conversion of claims of creditors into debtor's shares and conditional increase of capital. Most important laws recognized it, such as laws regarding enterprises (i.e. business organizations nowadays) and laws regarding banks. There were several cases of conversion which are registered with competent regulatory body for securities - Commission for securities of the Republic of Serbia.

Relatively small number of cases of debt to equity swap pointed to one big problem - absence of transparency and existence of information asymmetry. Those are phenomena so typical in these parts, where you just don't know who makes decisions, on behalf of whom, what is 'hidden' behind something and things like that. Debt to equity swaps are different in their nature. They imply the public and openness. It is applied when the diagnosis is obvious - a business entity is in a condition of deep problems of financial nature and is under threat of liquidation. In such circumstances, successful recuperation requires openness and minimum of honesty among owners, managers, creditors, even the broader public.

For smaller, privately-owned companies - greater transparency means change of legal form from limited liability company into shareholding company and access to stock-exchange i.e. organized capital market(s). For larger state-owned companies - greater transparency means abandoning the party's 'loot' division after elections, corporatizing and clear pre-defined rules and procedures for operation. In both cases, change of management teams and mental attitudes are required. Instead of inclination towards loans as the only source of finance, instead of inclination towards 'pilfering' and extracting capital, inclination towards making and creation is required. The right question is: Do we have strength for such changes?

We appreciate as positive the fact that domestic Commission for securities has affirmative attitude towards this mechanism, i.e. it believes that it can bring about financial restructuring of companies. Subject of conversion can be debts at least 6 months old, information must be available to all shareholders and about this should be discussed at annual meeting of shareholders. Besides, it is required that information regarding making debt be delivered, as well as information regarding type of debt, reasons for making debt and persons responsible for making a decision on borrowing and regarding relative participation of debt in liabilities of the company. In the aim of protection of interests of all shareholders for making a decision on conversion, minimum 2/3 majority is required. Open question is how NBS looks on debt to equity swaps?!

In several cases, the state was on the side of creditor who converted debt into ownership (example: Simpo Vranje). Similar thing happened in some countries in the region, where for example, electrical company of Montenegro converted debt on the basis of contributions and value added taxes (VAT) into capital of the state of Montenegro. In case that the state performs debt to equity swap, there is a danger of political influence on the management. Bearing in mind our reality, where managers are still appointed on the basis of their party membership, it is a real danger. Unfortunately, the state of Serbia did not prove itself as a good businessman.

The problem we are aiming at is that in our country there is undeveloped mezzanine level of finance. It is a source of funds between classic loan and equity. Here we have in mind different types of corporate bonds, preferred shares etc. As such sources are not developed, the companies are left we two alternatives only - loans or equity. The first one is easier, but it leads into a trap that many companies fell in. On the other hand, equity financing is connected with changes of ownership structure, where in turn there is strong opposition to changes. How can we explain a simple terrifying fact? Even 25 years after formal start of transition and 14 years after so-called democratic changes, no one company in Serbia made initial public offer (IPO) of shares. Is it possible that no one entrepreneur felt the need to ask for additional source of capital in the form of loan at capital market in the form of issuing of shares, rather than in banking sector. Research was made about this in these parts (*Erić, 2013*), when as some of the reasons were stated avoiding 'big opening up' ('too big a step'), i.e. changing the type of limited liability company into shareholding company implies lack of trust in institutions of the system.

Debt to equity swap brings many advantages for companies involved, creditors, even for national economy on the whole. Basic advantages for the company are:

- strengthening of financial position - by eliminating part of problematic loan, leading to automatic improvement of balance sheet structure;
- increase of debt capacity, i.e. making a possibility for new borrowing, leading to increasing liquidity of the company and making a basis for further growth and development;
- assistance to managers in avoiding a phenomenon of moral hazard and responsibility for wrong business decisions.

Advantages for creditors involved:

- saving' part of outstanding claims which could be lost forever by bankruptcy of the client;
- reducing the level of indebtedness of the company, leading to making new basis for healthier growth in the future;
- they become co-owners, which way they can make influence on recuperation of the company and in certain cases getting a possibility to control the company;
- participation in future growth of the company;
- possibility of making bigger income through sale of ownership share at higher price, after certain period of time.

Advantage in using debt to equity swaps for national economy can be seen in:

- relief of part of economy from heavy burden of indebtedness;
- recuperation of real and financial sector;
- promotion of efficient and effective management;
- avoiding bankruptcy of great, especially state-owned companies, which leads to reducing the risk that losses should be covered by taxpayers.

In extreme circumstances it is necessary to apply extreme measures. Traditional measures from the arsenal of debt restructuring - postponement of repayment, extension of deadlines, write-off, changing calculation method of interest rate etc... can have but limited effect. Massive application of debt to equity swaps with increase of participation of the public and transparency in business operations and reaffirming efficient and effective management, can be realistic option for faster debt relief of Serbian companies. Are we ready and wise enough to do it?

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