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What If the Enterprise Value Doesn't Grow? Evidence from Romanian Steelmaking Companies

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Abstract
The question investigated in this paper's is what happens to a company that doesn't grow its value? The analysis focuses on Romanian steelmaking companies in insolvency or incurring losses for many years. The basic methodology used is the analysis of the indicators (working capital, total assets, retained earnings, book value, total liabilities, and net sales) from the corporate income and balance sheet and to measure the Z1-score for predicting bankruptcy and for the financial distress status of privately held manufacturing companies. The major findings include the results for the financial health of a Romanian steelmaking company with tradition such as COS TARGOVISTE S.A., in insolvency, suspended from trading on the Bucharest Stock Exchange in 2013. The key quantitative results show high likelihood of bankruptcy in 2018 and how the company value decreased. The discussion raised is how companies can avoid destroying their value? If the companies fail to increase their value, they should find the ways to avoid destroying it, else they will not be able to resist in the actual competitive environment and go bankrupt. In the conclusion, planning for and acting on emerging technologies and trends is the key for the companies' survival.

Keywords: capital, assets, earnings, enterprise value, Z1-score.

JEL classification: G32, G33, G34, D46.

1. Introduction

Businesses are undergoing rapid and multi-dimensional changes, in the context of the emergence of new technologies, Internet, and the globalization of production and consumption and they should be able to capture opportunities and make full use of them by a very good knowledge of the market. However, companies with tradition like COS TARGOVISTE S.A. in insolvency, and ARCELORMITTAL GALAŢI S.A. are facing difficulties because of the obsolete materials, and production techniques and technology, being forced to find the resources for restructuring.

Value management supports value maximization for shareholders and stakeholders. In figure 1, the investments are presented as a necessary step in obtaining growth. With this purpose, the company should analyze its revenue growth (for the growth from new investments) and operating margin (for the improved efficiency). In order to find out how much new capital will the firm have to invest to deliver growth, the return on invested capital should be aanalyzed. (Damodaran, 2012)

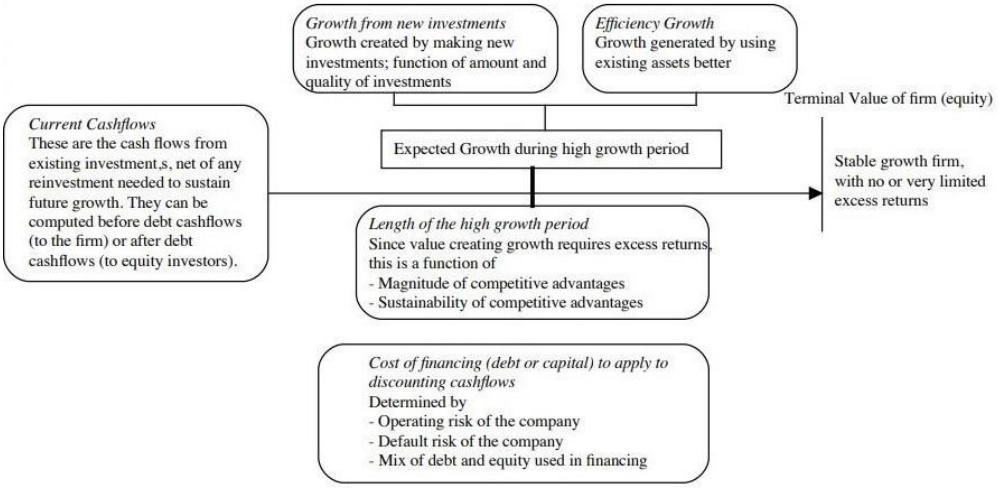

Figure 1. Drivers of company value

Source: (Damodaran, 2012)

Company value can be determined in three ways: (i) intrinsic or DCF valuation (by forecasting out expected cash flows and discounting them); (ii) relative valuation (using a multiple and comparable firms, to make a judgment on value); (iii) Contingent claim valuation (value a business as an option). (Damodaran, 2012)

Fabozzi (2017) argued that financial asset prices are equal to the sum of the discounted values of expected future cash flows, determined as the sum of the risk-free rates and a risk premium; it is exogenous and cannot be determined by purely financial considerations.

Fundamental (intrinsic) value can still be used as an effective tool to outperform the market, but only for investors that have a sufficiently long time horizon, i.e. five years, as the stock price returns may be driven at least as much by factors such as momentum, flow of funds, and investor sentiment within periods of less than five years.

The estimation of the intrinsic value requires research and time. Thus, in order for this process to turn profitable, market prices have to be far from intrinsic values, and this is most likely when large information asymmetries exist and major nonanticipated shocks in supply and demand happen. (Fabozzi, 2017)

Value management supports value maximization for shareholders and stakeholders, providing the appropriate owners / managers with appropriate indicators (EPS), EVA (Economic Value Added), MVA - Market Value Added, TSR - Engl. Total Shareholder Return, CVA - Cash Flow Return on Investment (CFROI), etc. MVA maximization is followed by the growing of the firm's value, yet there are cases when this leads to the reduction of the firm's value, as a result of some inefficient investment projects:

1. RIR< C_k, where RIR = rate of internal return, C_k= capital's cost, or
2. NPV<0, where NPV=net present value.
3. increasing sales through extending distribution networks, appropriate promotion of the products, improving the quality of the products or extending the market quote do not always increase firm's value. So

MVA is majored only if supplementary invested capital generates a higher return then the present cost of the capital. (Vasilescu & et.al., 2018)

2. Method

In order to understand the difficulties the Romanian companies are encountering, in figure 2, we can see the situation in comparison with other countries; Romania records an incidence of insolvencies more than 4 times the recorded average in Central and Southeast Europe, where

the local average is 45 insolvencies per 1,000 active companies, the first position from this point of view. (Guda, 2016)

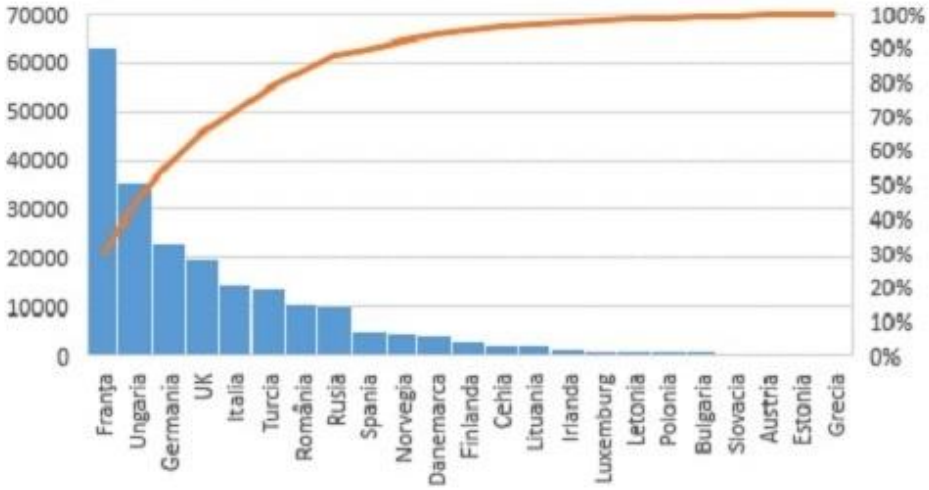

Figure 2.Country-wise status of procedures in 2015

Source: adapted from (GODÎNCĂ-HERLEA, 2015)

In figure 3, the Pareto (or sorted) histogram chart represents the cumulative total percentage, highlighting the biggest factors in 2018. The number of insolvencies opened in 2015 is down by about 51% over the previous year. (Guda, 2016)

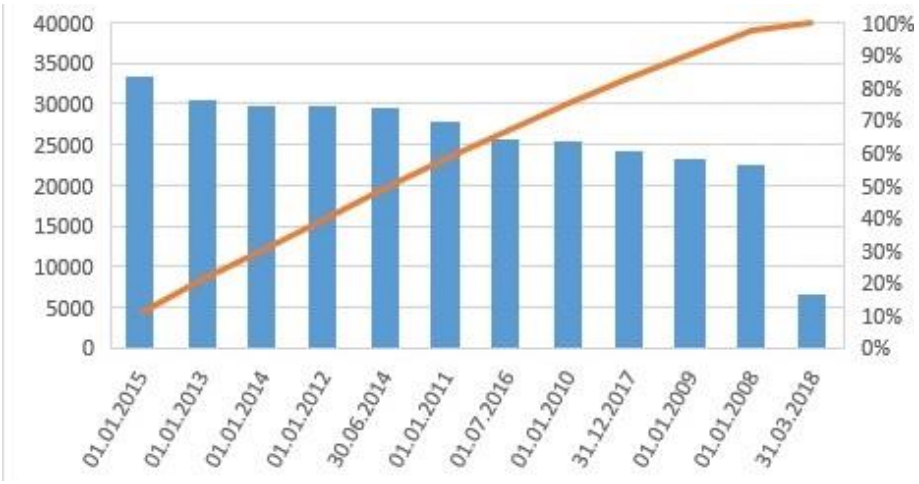

Figure 3. The number of insolvency files between 2015-2018

Source: (BPI, 2018)

With respect to the Romanian steelmaker in difficulty [Another steel producing company, ARCELORMITTAL GALAŢI S.A. is for sale now, as part of a divestment package, according to company's announcements], in table 1 and 2 there are presented the published information.

Table 1. COS economic and financial indicators (IFRS) in mil.lei

Balance sheet items	**31-Mar-17**	**31-Dec-17**	**30-Mar-18**
Total fixed assets	152,402	144,421	144,220
Total curent assets	156,006	185,026	215,288
Total assets	**308,408**	**329,447**	**359,508**
Total equity	**-336,839**	**-330,485**	**-329,259**

Source: (COS TARGOVISTE S.A., 2018)

Table 2. COS Financial results

Financial results	**01.01-31.03.2017 (1Q 2017)**	**01.01-31.03.2018 (1Q 2018)**
Turnover	141.568.960	154.182.261
Total revenues	134.142.990	172.144.899
Total expenses	141.441.660	170.919.602
Gross profit (loss)	(7.298.670)	1.225.297
Net profit (loss)	(7.298.670)	1.225.297

Source: (COS TARGOVISTE S.A., 2018)

Companies reported negative net results (32%), with a quarter of these companies incurring losses for the third year in a row according to the semi-annual financial statements. (NBR, 2016). In figure 5, there were 44 % of non-performing loans in local banks' portfolios in December 2016 and 72 % of total loans past due for more than 90 days, and the NPL ratio stood at 19.3 % in December 2016, down from 26.2 percent at end-2015.

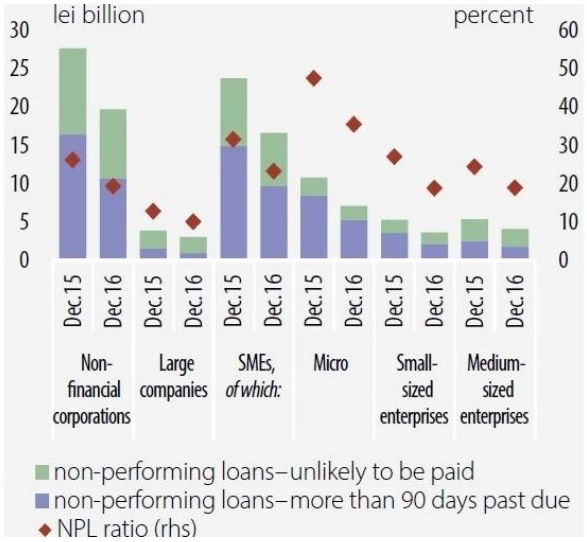

Figure 4. Non-performing loan ratio by company size

Source: (NBR, 2016)

In Table 1, 75 % of firms with negative equity at end-2015 were in this situation in 3 out of the past 5 years and the persistence of this issue is also revealed by the fact that nearly half of the firms (48.5 %) with negative equity in 2015 were in this circumstance in each of the past 5 years. This indicates that the sector has been facing a chronic problem and the developments in the liability structure of firms are not sustainable. This evolution cannot be solely accounted for by challenges encountered during economic recession, as the resumption of economic growth did not come with a solution to this problem or even help reduce its magnitude. (NBR, 2016)

Table 3. Persistent structural vulnerabilities in 2015

Indicators	Value (in 2015)	No. of firms (thousand)	% of firms (of total)
Equity/share capital	<50%	275.5	45
Equity	<0	268.7	75
PD			

Source: (NBR, 2016)

The probability of default [failure to meet the legal obligations (or conditions) of a loan, e.g. the biggest private default in history is Lehman Brothers (over $600 billion when it filed for bankruptcy in 2008); the biggest sovereign default is Greece ($138 billion in March 2012)] (PD) - calculated on a 12-month horizon for companies with outstanding bank loans reporting no payments overdue for more than 90 days over the last 12 months - at end-2016 on a 12-month horizon reveals a notable increase in the default rate up to 4.9 percent in 2016. (NBR, 2016)

There are several financial models for analyzing default risk, such as the Jarrow-Turnbull model, Edward Altman's Z-score model, or the structural model of default by Robert C. Merton (Merton Model).

Initially, the Altman Z-Score was found to be 72% accurate in predicting bankruptcy two years before the event, with a Type II error (false negatives) of 6% (Altman, 1968). In a series of subsequent tests covering three periods over the next 31 years (up until 1999), the model was found to be approximately 80%–90% accurate in predicting bankruptcy one year before the event, with a Type II error (classifying the firm as bankrupt when it does not go bankrupt) of approximately 15%–20% (Altman, 2000).[2]

From about 1985 onwards, the Z-scores gained wide acceptance by auditors, management accountants, courts, and database systems used for loan evaluation (Eidleman). The formula's approach has been used in a variety of contexts and countries, although it was designed originally for publicly held manufacturing companies with assets of more than $1 million. Later variations by Altman were designed to be applicable to privately held companies (the Altman Z'-Score) and non-manufacturing companies (the Altman Z"-Score).

Neither the Altman models nor other balance sheet-based models are recommended for use with financial companies. This is because of the opacity of financial companies' balance sheets and their frequent use of off-balance sheet items. There are market-based formulas used to predict the default of financial firms (such as the Merton Model), but these have limited predictive value because they rely on market data (fluctuations of share and options prices to imply fluctuations in asset values) to predict a market event (default, i.e., the decline in asset values below the value of a firm's liabilities).

Default: a debtor has passed the payment deadline on a debt they were due to pay. and can be of two types: Debt service default occurs when the borrower has not made a scheduled payment of interest or principal; Technical default occurs when an affirmative or a negative covenant is violated.

Results

The first 100 companies in terms of net profit accounted for 42 percent of total, while companies' involvement in high-tech and knowledge-intensive activities can be enhanced. Other challenges facing the corporate sector in the period ahead stem from pressures on wage costs and from the availability of labor force. (NBR, 2016)

A large number of undercapitalized companies (that pass through the difficulties they are facing to both credit institutions and other trading partners) are responsible for a significant share of banks' non-performing loans and the overdue payments to other economic agents. In addition, the materialization of a potential adverse economic scenario will substantially reduce the survival chances of these firms, given their precarious situation.

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