



The Impact of Debt Restructuring on Debt Maturity, Cost of Capital and Cash Holding of Non-Financial Institutions in Developing Countries: A Conceptual Framework

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ABSTRACT

This paper delves into the integral role of debt restructuring in shaping the financial architecture of non-financial firms, particularly within developing nations. In volatile economic environments, understanding the nuances of debt restructuring becomes paramount for these entities. Key findings indicate that smaller non-financial enterprises, often constrained by financial limitations, rely on debt as a tool for operational continuity, with a marked preference for long-term maturity. The research further elucidates the broader repercussions of debt restructuring on a firm's cost of capital. For nascent enterprises, immediate capital for new ventures is challenging to procure. Debt restructuring, especially with extended debt periods, emerges as a strategic fulcrum, enabling these firms to navigate fiscal challenges and capitalize on future growth prospects. The nexus between debt restructuring and a firm's cash reserves is accentuated during economic downturns. Effective liquidity management becomes vital, as companies balance between expenditure and savings. The technological disparity between firms in developed versus developing nations further complicates this dynamic. While advanced entities harness cutting-edge technologies, their counterparts in developing regions grapple with outdated infrastructures and, at times, lax corporate governance. This study underscores that for many firms in developing nations, debt restructuring transcends its role as a mere financial tool, evolving into a critical lifeline that facilitates economic resilience and growth.

Keywords: Debt Restructuring, Debt Maturity, Cost of Capital, Cash Holding Non-Financial Institutions, and Developing Countries.

INTRODUCTION

Debt restructuring is commonly seen as a mechanism for firms under financial strain to adjust their obligations. This involves a negotiation between the debtor and creditor to change the

initial debt service terms [1]. The process might include changes to the type or setup of financial arrangements, or even transitioning to completely different facilities. While it provides companies a crucial reprieve during tough periods, it brings with it certain administrative and legal expenses [2]. Beyond being a vital tool for companies grappling with pressing financial issues, the ramifications of debt restructuring are expansive. Specifically, choices regarding debt maturity can significantly influence a company's capital composition and its overall fiscal well-being. Diamnd and HE [3] highlighted the potential dangers of extended-term debts, which can result in elevated debt burdens. On the other hand, while short-term debts can be riskier due to renewal concerns, they often align better with market shifts, reducing debt burden issues.

According to Diamnd and HE [3] long-term debt ties to higher debt overhang. Hence, reducing maturity can increase or decrease overhang even when shorter term debt's value depends less on firm value. In this regard, Wahab, Nassir [4] found Malaysian listed companies hold around 39.6% long-term debt of its total debt, compared to 51% in the case of India Kalsie and Nagpal [5], 14% in China Zhang and Xu [6], 53.3% in Saudi Arabia Hasan, Asad [7], 41.6% in the UAE, and 44.8% in Kuwait [8].

As Paladino and Pradelli [9] noted, private debt in non-financial corporate sectors of Asian nations like Malaysia, India, China, Saudi Arabia, the UAE, and Kuwait reached an average of approximately 74.5% of GDP in 2020. Non-financial entities in these regions lean more towards debt as a financing means compared to other regional groupings. Consequently, these nations face an increased likelihood of resorting to debt restructuring to meet both their immediate and future obligations.

The trajectory of non-financial corporate debt relative to GDP across different Asian nations between 2015 and 2020, as presented by the International Monetary Fund (IMF, 2022), reveals captivating patterns concerning the financial vitality, tactics, and obstacles these countries encountered. For instance, Malaysia saw its corporate debt grow, rising from 74.2% of its GDP in 2015 to 79.6% in 2020. Such growth is linked to the nation's aggressive developmental initiatives, which are often debt-funded, combined with the general economic hurdles it encountered during that timeframe [10].

LITERATURE REVIEW

Debt Maturity

Debt maturity is often realized by well-structured smaller firms that have vigilant shareholders who oversee and define the limits of the debt maturity allotted to them. Debt restructuring significantly benefits debt maturity, particularly for small investment enterprises that qualify to obtain loans and adjust their debt maturity as per agreements with their lenders. Such enterprises often opt for long-term debt to sustain their core operations. Conversely, firms that commit to long-term debts can sometimes find themselves at a disadvantage [11].

Disagreements between the involved parties can hinder a firm's operations, especially in less developed nations grappling with management challenges. Short-term debts prove beneficial for non-financial companies as they bolster resilience and foster robust relationships between

shareholders and debtors, especially concerning growth opportunities and addressing underinvestment concerns [12].

Past research suggests that companies exhibiting substantial growth rates tend to lean towards shorter debt maturity options. Decisions regarding suboptimal investments aren't derived from debt maturity preceding the execution of investment alternatives. In the long run, long-term debts can hamper a firm's performance because prolonged underinvestment can gradually diminish profitability. In contrast, short-term debts can serve as an effective managerial check, pressuring them to refinance and shift control from shareholders to creditors, more so than long-term debts [13].

Various studies have shown that short-term debt maturity can influence loans and the overall structure of a firm's debt maturity, impacting its performance. This is evident in Chinese listed companies where leverage and its corresponding maturity duration play a pivotal role in determining their performance. Such studies further suggest that long-term debt maturity can influence firm performance[14]. Empirical research indicates that a higher proportion of short-term debt benefits German companies' efficiency, a trend not observed in US companies. Several scholars argue in favor of a positive correlation between short-term debt and profitability[15].

When contrasting small and large firms, distinctions emerge in areas like tax implications, ownership, adaptability, industry sector, economies of scale, financial market accessibility, and the extent of information asymmetry. The researcher pinpointed various factors influencing smaller firms' decisions related to debt maturity structure. The study further identified several crucial elements that sway debt maturity decisions [16].

Cost of Capital

The cost of capital, a pivotal metric in capital budgeting decisions, serves as the benchmark discount rate for gauging the viability of investment opportunities. A project with a positive net present value indicates its potential profitability and is typically greenlit [17]. Additionally, the weighted average cost of capital offers insights into the efficacy of a firm's financial strategies. The overarching aim, when deciding the debt-equity ratio in a firm's capital composition, is to diminish the aggregate cost of capital [17]. Routinely, the cost of capital aids in discerning the most financially efficient funding avenue. It significantly informs dividend distribution decisions and plays a paramount role in determining investments in working capital [17].

The cost of capital, fundamental in financial decision-making for capital investments, represents the baseline return a company must achieve to create value. Essentially, a firm should generate enough revenue to surpass its capital financing expenses to realize profitability. This cost comprises both debt and equity expenses, contingent on the firm's financing decisions. The cost hinges largely on a company's chosen financing model – its capital structure, which might be an amalgamation of equity, debt, or both. Given its determinant role in shaping a firm's capital structure, the cost of capital emerges as a pivotal element. Consequently, businesses strive for an ideal financing blend that simultaneously ensures adequate funds and curtails capital costs [18].

Cash Holding

As described by Damodaran [19], a company's cash encompasses readily available funds and investments that either don't yield interest or do so at below-market rates. Businesses maintain such reserves primarily for handling routine transactions and for seizing new commercial opportunities. Gill and Shah [20] describe cash holding as the money immediately available for investments in tangible assets or for disbursement to stakeholders. Cash is the lifeline for every transaction, underscoring its paramount importance to global businesses. This liquidity enables organizations to stay agile even when no "ideal" cash balance exists. In times of crisis, this liquidity ensures that companies can fulfill their obligations. Cash serves as a cushion, bridging the gap between retained profits and investment aspirations. For improved revenues and sales, companies must optimize their cash reserves, ensuring timely cash flows to create a favorable cash flow scenario [20]. Moreover, having immediate cash access lets businesses invest opportunistically and bypass asset undervaluation [21]. Nevertheless, hoarding excessive cash can backfire if not utilized efficiently. Hence, finance experts should be attuned to the dynamics governing cash reserves.

Cash holdings are essentially readily available funds and assets convertible into cash within a short span, usually less than three months. Decisions regarding cash holdings should be prudent, comprehensive, and astute to prevent the pitfalls of possessing too much idle cash [22, 23]. Research indicates that firm cash represents the money on hand and investments with subpar or no interest. Companies retain this for routine business activities and to chase fresh ventures. This research defines cash holdings as assets either instantly on hand or effortlessly accessible for tangible asset ventures and payouts to creditors [24].

Debt Restructuring

Debt restructuring allows countries to fulfil their obligations to lenders prior to securing another loan. Non-financial entities in certain developing nations often face financial challenges, prompting them to borrow from financial institutions within those nations. Additionally, they may seek to reschedule repayments of prior loans. The author highlighted the case of the Hanjin shipping company, which benefitted from cross-border insolvency reforms. These reforms facilitated the recognition of foreign insolvency procedures, providing a lifeline for the company, which was already grappling with substantial debt burdens [25].

Debt restructuring emerges as a vital aid for smaller, emerging firms that encounter challenges in procuring funds to sustain their operations. By opting for debt restructuring, these firms can navigate and potentially resolve existing financial constraints [25-27].

Many developing nations in Asia grapple with economic challenges due to insufficient funds, hampering their ability to execute certain activities. As a workaround, these nations consider debt restructuring, often sourced from more developed European countries. Given that many of these nations are already saddled with debts, instead of facing bankruptcy, they explore options for insolvency and debt rescheduling. Research suggests that several lesser-developed Asian countries encounter financial hurdles, leading to the necessity for debt restructuring [28]. The population surge in Asian nations has left many underdeveloped countries struggling to gather sufficient resources for their populations while also fostering economic growth. Consequently, many resort to debt restructuring. This scenario prompted researchers, like

Areri [29], to investigate the effectiveness of current sovereign debt restructuring mechanisms and to discern if the debt profiles of less-developed Asian countries differed from others.

This inquiry was steered by two theoretical frameworks: the creditor bargain theory and the value-based theory. A detailed analysis of the debt dynamics in the Philippines and Singapore was conducted, focusing on their historical economic trajectories and contemporary concerns. The study concluded that the debt profiles of less-developed Asian nations, such as the Philippines, are indeed distinct from those of other global regions. The existing debt restructuring approaches were found lacking in efficiency, particularly when applied to Asian countries' debts [29].

Trade-off Theory of Debt Restructuring

Debt restructuring involves companies, particularly those facing financial shortfalls, procuring funds through borrowed means. Two primary theories, the trade-off theory and the pecking order theory, are believed to shape debt restructuring decisions. Research into the theory of sovereign debt indicates that there can be delays between a company and its creditor, with both sides possibly withholding funds until an agreement is reached that ensures more substantial payments from the borrowing entity [30].

The trade-off theory closely relates to debt restructuring. It emphasizes the tax benefits since interest expenses are subtracted from the company's revenue. Additionally, as the debt amount rises, so do the anticipated costs of default. This connection between the trade-off theory and a firm's capital structure has been highlighted in studies by experts in the field [31].

Pecking Order Theory of Debt Restructuring

The pecking order theory is a framework many businesses use to decide their debt preferences. This theory examines company behaviour and its ability to source debt either internally or from external avenues. According to this perspective, smaller companies lean towards external debt because they often don't have sufficient internal funds, unlike larger entities [32].

However, the applicability of the theory can be debated when assessing the financial sources, both internal and external, for firms with varying leverage levels. Firms with lower leverage tend to seek external financing, usually due to internal financial shortfalls. On the other hand, highly leveraged firms are more likely to lean towards equity funding when their internal finances don't meet their operational expenses [33]. In essence, the pecking order theory is a cornerstone for a firm's capital structure decisions, especially when contemplating debt restructuring strategies.

CONCEPTUAL FRAMEWORK

Non-financial firms can employ a capital structure model wherein shareholders play a pivotal role in evaluating the firm's finances. The author proposed a model ensuring that the firm's liabilities mature simultaneously. This means that when principal repayments are due, shareholders control the entirety of the firm's cash flow, allowing them to recalibrate the capital structure. Such flexibility in reshaping the capital structure at its maturity empowers shareholders to determine the debt's duration and facilitates an in-depth examination of the firm's choice of leveraged financing [13]

Emerging economies often grapple with challenges in procuring funds, particularly from external sources. Research, focusing on how international reserves impact the debt maturity structure in these countries, suggests a direct correlation. Data from 66 such countries revealed that increasing reserves amplify long-term external borrowing. The researcher posits that bolstering financial stability can effectively mitigate the mounting international reserve maturity debt in these nations [34].

The cost of debt stands out as a paramount factor in managerial deliberations, often guiding the assessment of a firm's advantages. Further research depicted the interrelation between the cost of debt across two countries, contending that this relationship is influenced by the geographical distance and anticipated shifts in institutional landscapes which, in turn, affect pre-investment financing rates [15]. Notably, the cost of capital is deemed a vital resource for non-financial entities, especially when launching new ventures.

When enterprises contemplate introducing novel revenue streams, they evaluate the capital cost and the prospective profitability. Firm leadership must innovate ways to fuel this new capital influx without depleting internal funds, prompting shareholders to seek external financing for these new initiatives [35-38].

Debt restructuring is perceived to profoundly impact cash reserves. It paves the way for collaborative agreements between shareholders and debt holders, enabling smaller investment companies to secure funds that bolster their operational budgets, subsequently amplifying their cash reserves.

A general observation indicates that higher liquidity in a firm corresponds to increased cash reserves. Scholarly insights reveal that as firms, whether financial or non-financial, elevate their cash savings and consumption, they exhibit a heightened response to uncertainties and external fiscal constraints. Conversely, when consumption outpaces savings, the firm's cash reserves diminish. Entities navigating specific financial limitations often witness elevated cash expenditures. Such patterns provide invaluable insights for managers and shareholders, offering a clearer understanding of a firm's liquidity management dynamics [39].

Furthermore, the current paper has come up to conclude this study by proposing the following conceptual framework as shown in Fig. 1.

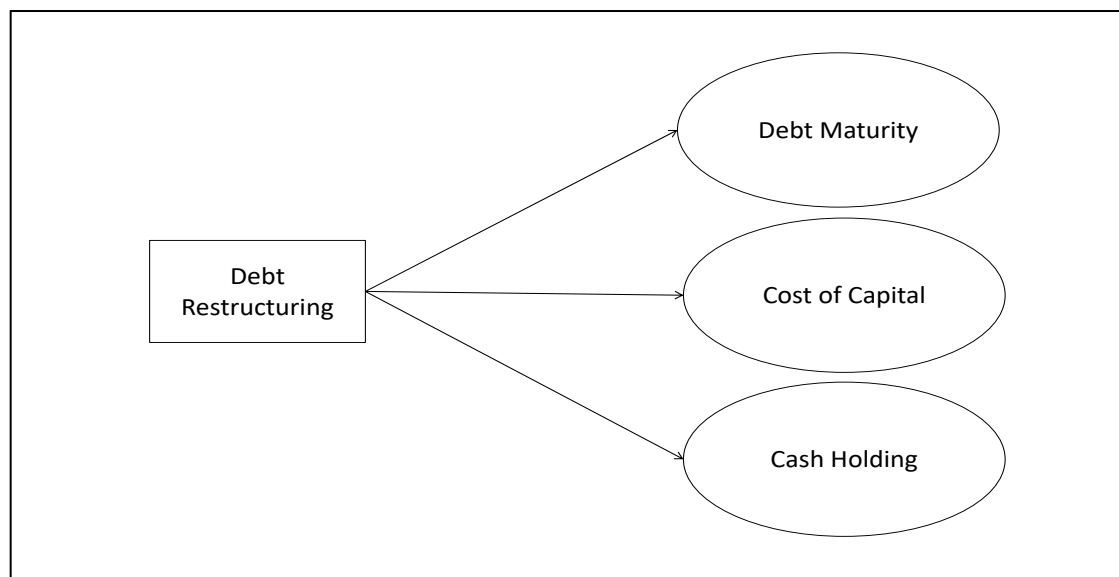


Figure 1: Research Conceptual Framework

CONCLUSION

Debt restructuring stands as a beacon of hope for many non-financial institutions in developing countries, offering them a lifeline in challenging financial waters. The implications of restructuring, as this paper has comprehensively highlighted, are vast, touching on debt maturity, the cost of capital, and cash holding. The interplay of the trade-off and pecking order theories provides a nuanced understanding of the decisions firms make around debt and restructuring. For practitioners and policymakers alike, this paper offers a blueprint for understanding the broader impacts of debt restructuring. It emphasizes the need for balanced financial management, strategic foresight, and a deep understanding of both internal and external financial landscapes.

The role of debt restructuring in shaping a company's financial dynamics, especially within developing nations, is of paramount importance. These countries frequently contend with volatile financial scenarios, making it crucial to decipher this intricate relationship. Notably, for smaller non-financial entities in these nations, which often face fiscal limitations, debt becomes an essential tool to maintain uninterrupted operations. The decision between short-term or long-term debt is a key strategic consideration, with the latter often being more favorable. It grants them an extended timeframe to judiciously utilize resources and foster expansion.

Furthermore, the repercussions of debt restructuring extend to the cost of capital for a firm. For smaller non-financial enterprises, launching new ventures without ready capital can be a daunting task. Here, debt restructuring, especially when it includes options for extended debt periods, offers a saving grace. This enables these entities to kickstart and maintain ventures that promise future returns and potential debt settlement opportunities. This discourse also sheds light on the intertwined nature of debt restructuring and a company's cash reserves. This relationship is particularly evident during fiscal downturns. Companies, cautious of unforeseeable challenges and external limitations, often enhance their liquidity. However, increased expenditure coupled with dwindling savings can detrimentally affect an entity's cash reserves, underscoring the need for adept liquidity management.

Against this backdrop, the pivotal role of debt restructuring in determining a company's liquidity position is clear. While expansive corporations, benefiting from diverse income channels, might have the advantage of lesser debt dependence, smaller companies frequently lean on external funds to keep their operations running. It's also pertinent to highlight the technological gap that exists between entities in developed and developing regions. While the former can harness cutting-edge technology to refine processes and amplify revenues, the latter may be encumbered by obsolete systems, resulting in operational inefficiencies and financial hurdles. When combined with sometimes inadequate corporate governance in several developing regions, these companies encounter multifaceted challenges, amplifying their dependence on debt and its subsequent restructuring. In a nutshell, while advanced economies may possess the tools and resources to adeptly manage financial hurdles, their counterparts in developing regions face a plethora of challenges. For these entities, debt restructuring becomes more than just a fiscal strategy; it's a crucial support system, enabling them to navigate economic uncertainties and chart a course toward sustainable growth.

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