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Creating the value of organization in the restructuring process of a holding company

Provided in Cooperation with:

Czech journal of social sciences, business and economics

Reference: Białowas, Piotr J. (2016). Creating the value of organization in the restructuring process of a holding company.

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Article history: Received 6 March 2016; last revision 2 June 2016; accepted 12 June 2016

CREATING THE VALUE OF ORGANIZATION IN THE RESTRUCTURING PROCESS OF A HOLDING COMPANY: A CASE STUDY

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Abstract

The article represents a kind of a case study dealing with concentration of the processes taking place in the holding company. These processes in question are not connected with the core business of the company and are conducted and/or executed with the sole purpose of selling the company as a subsidiary with the assumption of maximizing the costs value of revenues from this sale.

We include references to a practical example as well as to the economic theory, particularly to the theory of transactional costs. Therefore, the article has both theoretical and practical layers and might be relevant for business managers and economic theorists.

Keywords: business organization, holding, restructuring, transactional costs, economic theory

JEL classification: D20, D82, L22

Introduction

Before the economic transformation in 1989, it was characteristic for Polish businesses to own assets serving social purposes. In case of most businesses in the first years of the transformation these processes were eliminated. This was typical for many business enterprises both in Poland and in other countries (Abrahám et al., 2015; or Korski et al., 2016).

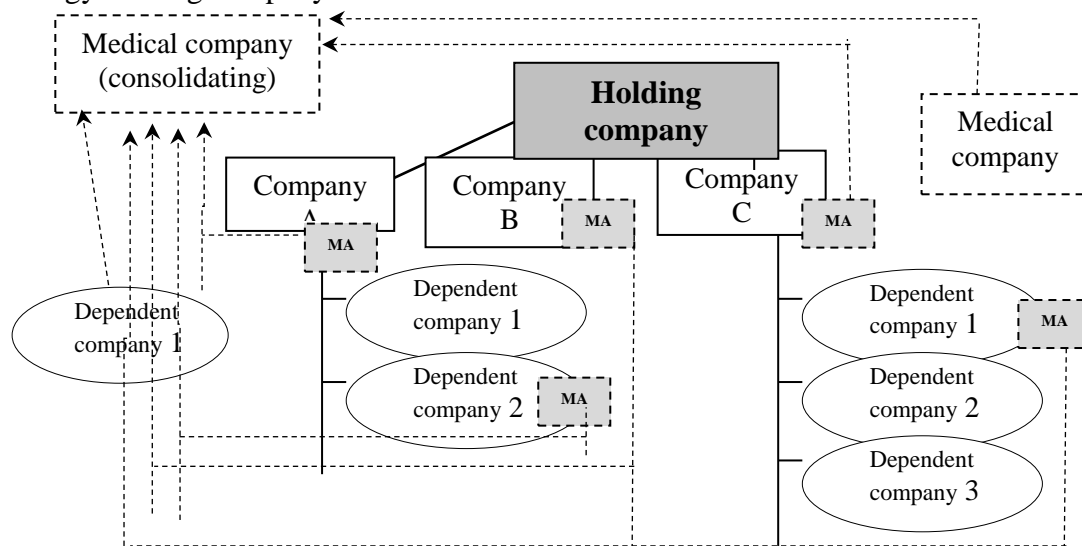
The main value added and the major purpose of this article is to present the problem of forming the value of the processes, which are selected from multi-stakeholder organizations and often comprise a vital value as private limited companies. This issue will be presented in the context of restructuring processes in a singled out energy sector entity having characteristics of a holding company, taking into consideration selecting and then selling a medical services entity.

The course of concentration of the processes

The vast concentration and restructuring processes conducted in the 1990s for the entities of energy sector were one of the reasons of limiting support processes (see e.g. Balitskiy et al., 2014). In many cases these processes were not associated with organizational potential. One of the most commonly occurring processes in many companies before the structural transformation were medical care processes which occurred both in Poland and abroad (Janušauskas, 2015). The intensely continued processes of capital concentration among companies in the energy sector led to emerging organizationally scattered processes and medical companies within the created energy holding companies. In the example further discussed this situation is to be considered as a starting state before the restructuring processes. Within the structure of a holding company there functioned both medical companies and

medical assets, which resulted from historical facts. The first stage of the process of building the values of non-core assets (assets not connected to core business) was consolidating within one company. The consolidating company was one selected medical company which had medical assets of particular companies brought by contribution in kind. The process of incorporating medical companies within holding structure was also conducted which is illustrated in Figure 1 that follows.

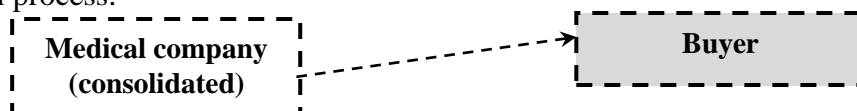
Figure 1: Schematic presentation of concentration processes of medical assets within the energy holding company

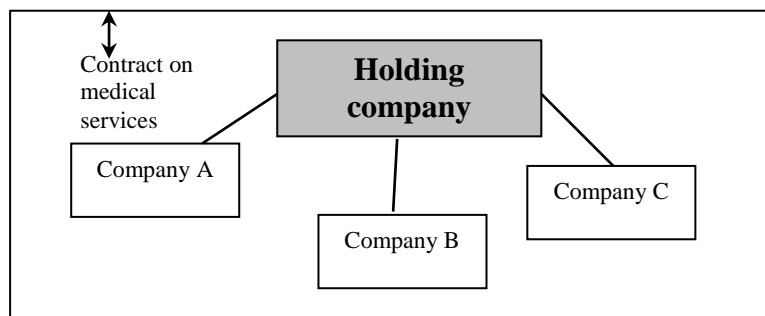


Source: Own results. Note: MA – medical assets.

After the process of concentrating medical assets (consolidation of a separate company) but still before the official decision of selling the company, a consolidated restructuring process was started. Its aim was to sell the consolidated medical business entity. Before announcing the tender to sell the company, a restructuring process had been conducted, which concentrated on such activities as; increasing the range of services of a medical company for business entities of energy group (which influenced the value of sales returns), standardizing the range of services in terms of scope and value, and restructuring employment. The result of this activity was doubling the company’s net profit and a double increase in sales efficiency rate in a three-year period. The effect on the market was a big interest of investors in a medical business entity, which after the capital-organizational consolidation and restructuring process had a flow of 30 million zlotys with a few per cent efficiency flow and employment on the level of a few hundred. It must be pointed out that the reorganizational process was not performed in full scope due to, among other factors, social and political limitations resulting from ownership affiliations to significant energy business entity. It meant that there was a significant potential of further increase in effectiveness as well as the value of the company. The setting of medical assets after reorganization processes is presented in the Figure 2 below.

Figure 2: A scheme presenting the place of a medical entity after the capital-organizational consolidation process.



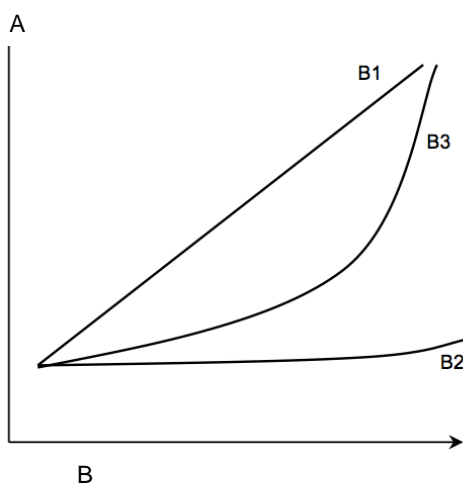


Source: Own results

Eliminating assets – shaping the value

The process of selling the consolidated medical company was performed in a form of a tender in one price criterion without obliging the investor to certain activity. There was a substantial market interest (Polish and foreign medical companies significant on the market and international investment funds). The final selling price was unprecedented on the market. It had a level of a dozen or so of EBITDA (total amount of net profit and the value of depreciation) rate value of the purchased medical company, and its buyer was the investment fund of a stock holding company PZU SA – TFI PZU. Practical experience shows that the initial estimate of the company's value in the process of purchasing the entity is easy to determine. The value is estimated roughly as a multiplier of EBITDA value of the purchased company being in activity in the sector concerned. Specific economic-financial and organizational situation as well as specific risks of the entity cause the increase or decrease in the price. It does not mean, however, that commonly available methods of valuation are not used

Figure 3: Parameters of a transaction vs its value in the divestment process.



Note: A – transaction value B1 – level of contract marketization B2 – value of contracts linked to the company owner B3 – duration of contract with company owner

Source: Own results

To quote an example, at that time the multiplier of EBITDA value for Polish transactions in the medical sector was 7-12. An example of a significant transaction of a medical company in Poland in 2013 was purchasing LUX-MED entity by the British investment fund BUPA for 1.6 billion zlotys. Going back to the discussed case it is worth considering the source of the value of such transactions. The vital elements which influenced the value were such parameters as

the level of medical assets concentration, the level of marketization of a consolidated medical company understood as share of contacts not resulting from ownership dependencies, as well as the fact of their occurrences taking into consideration the value and timing. The former, being the level of medical assets concentration, is a derivative of restructuring processes and is correlated to the generally understood efficiency of the company. The diagnosed correlations between the parameters between the transaction parameters and the value of transaction are presented in Figure 3.

The correlation between the level of contracts in privatization (B1) and the value of transaction is obvious and results from becoming independent from one contractor of services, which is the former owner of the company. In the discussed example, the share of the market revenue value (from outside the energy company) was predominant, which influenced the rating value in a positive way. Naturally, the contracts with the owner themselves influence the value of the entity positively. However, the parameters don't serve as classic stimulants. It must be noticed that maximizing the value of contract (B2) has little influence on increasing the value of transaction, on condition that the value of transaction (A) is treated as a value in the company purchase contract reduced by the value which the selling company will incur in the following year for the benefit of the former owner of the medical company. Such attitude is vital in evaluating the real value of the entity. According to the author, it would be justified to introduce *transactional gross value and transactional net value* in this type of transactions. It would reflect the value of the company without the participation of its owner in creating this value. During the selling process a simple correlation was noticed, which referred to the duration of the contract (B3) and its influence on the value of transaction (A) – implicitly the transactional net value. It takes place when there is an assumption of occurring values of market contracts and the binding nature of medical contracts occurring each year of activity of the energy company. In this case, there were obligatory contracts concerning providing occupational medicine services and contracts regarding commercial medical services for employees, which were co-financed by the employer

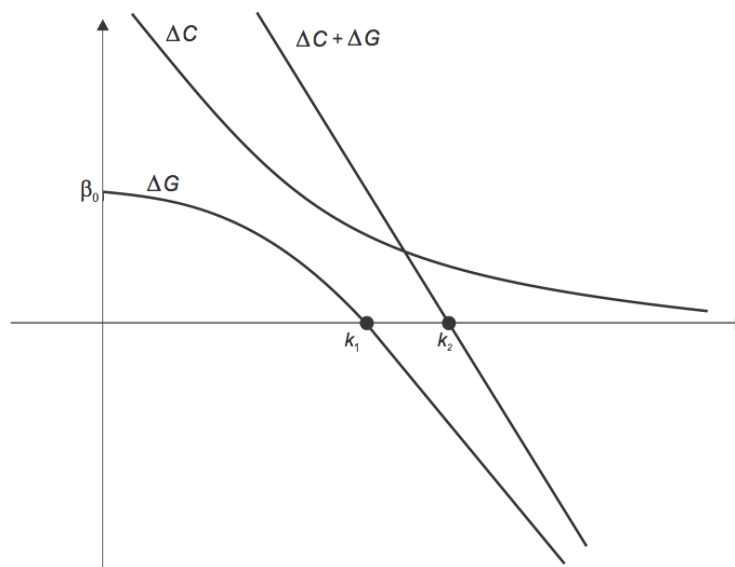
Maximizing the selling value of the company, as could be predicted in this case, was possible regarding the specific strategy of the buyer, which wanted to purchase PZU SA (Williamson, 1986). PZU SA, using its capital surplus, was looking for investment possibilities outside its existing core business line. Independently, the market of medical services should be considered attractive in most countries of the world, which is a result of increasing expenditures on health care. It should be also noticed that the assets sale process by the energy company had an effect in radical organization of the processes and which is not obvious, limiting the supervision costs and the service of processes connected with owning medical assets, with particular reference to labor costs (Ehrenberger et al., 2015).

Outsourcing and a theory of transactional costs

Trying to place the concept of outsourcing (leaving aside the issue of illustrating the possibilities of developing the value of a medical entity selected in the outsourcing process and the legitimacy of selecting it from the energy entity) in the theory of economics it is worth noticing its connection to the concept of transactional costs introduced by Coase (1937). The concept deals with choosing an optimal way of transaction regulation. This choice in the market economy, especially in case of high “flexibility” of organizational structures, is one of the basic problems of company functioning. It should be distinguished which transactions are to be performed on the market (between the company and its contractors) and which inside the organization. A transaction occurs when a product is transferred between the selected organizational units (Williamson, 1985). A practical example of applying Coase's theorem is becoming increasingly commonly used concept of outsourcing as an element of a company

property restructuring process. There is an increasing liberty in deciding which processes should be performed within one structure and which could be outsourced. It does not mean that the question is easy. The author claims that in the last decades, especially in case of privatized organizations taken over by foreign entities or consolidated within big economic entities, we can observe certain model solutions. It could be claimed, however, that implementation of these models is not often preceded by a thorough financial analysis, including the analysis of risk, which is difficult to quantify due to its character. Keeping the process of physical protection within one production company is difficult to undermine. However, when it deals with production of an extremely innovative character or military production, the answer to the question of outsourcing the protection process is not so obvious (the process executed within the service of external company is supervising some airports. Security incidents connected with such form of executing processes cause decisions of resignation from such cooperation). The previously mentioned theory of transactional costs deals with the choice of optimal method to regulate transaction taking into consideration such parameters as ‘market’ and ‘hierarchy’. These are two extreme solutions, whose choice is determined by the level of transaction costs concerning the performing of transaction (Williamson, 1986).

Figure 4: Comparative costs of production and transactional costs



Source: Gorynia (2007)

The price mechanism (market self-regulation) and organization through managerial control (hierarchy) constitute alternative ways of allocating resources. Market coordination is executed through transactions within independent organizational units, hierarchic coordination is executed through organization, planning, giving instructions, control etc. Obviously, the allocation of resources is executed by the management of the organization within vertical integration. When coordination costs through prices are higher than coordination costs through the company, its own execution of the process (creating a company) is economically justified. When the costs of market coordination are lower or comparable to the managerial costs, there is no economic justification for execution of the processes (creating an organization) (Urbanek, 2011). It is important to consider the structure of production costs, transactional costs as well as the sum of these costs including the increase in specific resources. It has been outlined by Williamson in Figure 4 above.

Assuming that the size of production is constant, ΔC is the difference between production costs within an organizational unit and production costs of the supplier. This is a parameter connected to the level of specificity of the resources – the higher the specificity the bigger the decrease of ΔC , which will asymptotically fall to zero. In case of a low level of specificity of the resources we may infer that the choice of the supplier from the market is a better solution. An external provider might have lower costs in comparison to its own production, which might result, for instance, from the economies of scale. Parameter ΔG is the difference between transactional costs in the hierarchical solution and transactional costs of the market solution. Taking into consideration the high specificity, hierarchical solution is worse than the market solution. If we take into consideration the level of specificity marked by parameter k_1 , ΔG has a zero value, which means equivalence of the two regulation concepts due to transactional costs. The increase of the k parameter makes the production within an organizational unit more rational due to the lower level of transactional costs. The analysis of $\Delta C + \Delta G$ value is essential because in case of specificity of the resources lower than k_2 the cumulative value of production costs and transactional costs is lower for the external supply, and with the specificity level higher than k_2 it is lower for its own production: $k_2 > k_1$ (Gorynia, 2007).

It is worth noticing that with the analysis of forming transactional costs, the specialists' writings mention such determinants of their levels as uncertainty – connected with human behavior (uncertainty of the future makes it difficult to formulate precisely the contract between economic) and the frequency of transaction considered in correlation with the level of specificity of the resources. The structures with a higher level of specificity are more expensive and therefore it must be decided if it is justified to bear additional costs (Williamson, 1985). The matter is therefore connected to the issue of scale effects and the break-even point. Empirical researches, which refer to the theory of transactional costs, were conducted by, among others, Walker and Weber. They examined whether to produce or to divide in an American car company. They distinguish two kinds of uncertainty. One of them is connected with the volume of component supply. With a high uncertainty about the scale of the order suppliers bear unpredictable production costs or experience overcapacity. As a result, the payer may experience supply shortages or increasing stock, which increases the value of costs

Not making further vast description of the concept in the context of transactional costs, the author wants to point out one aspect, which seems to be overlooked in the management theory as well as practice. It is an objective evaluation of the product quality or services within the outsourcing concept. This issue is indicated in specialists' writings (e.g. Wawak and Soltysik, 2015; Bugdol, 2011; or Swietla, 2014), yet, in a limited scope. Effective implementation of the concept, which is implementation having a positive influence on the efficiency of the organization, is easier to achieve in case of accounting and IT processes. The parameters of quality evaluation of the service, which are present here, are easier to quantify - in case of accountancy services, which are codified to a great extent in law regulations of certain countries. Therefore, it should not be surprising that these are the most commonly outsourced processes, which additionally influences the ease of relocating them. According to the author, the popularity of applying the outsourcing concept within the processes of organizational transformations of companies (as it has been already pointed out, reorganizational processes are strongly connected with consolidating processes of an organization, especially within fusion and take-over processes) is caused by two factors. One of them results from the general worldwide tendency concerning concentration of a company on its core processes. The other one is connected to the fact that it is relatively easy to produce the effect of cutting costs, which is one of the main goals of restructuring. According to the author, this effect results mostly from the lack of providing comparability of the quality of processes before and after separating from the main organization. It mainly concerns processes which are difficult to quantify and have no reference to legal codifying. It seems, however, that a substantial number of selected processes

have a different level of quality than initially assumed, which is a common source of budgeting. An example is the common selection of processes such as cleaning, security, supplying food to hospitals etc. It results in limiting the level of salaries, economizing by using low quality cleaning products or producing food with low quality products. These examples seem trivial, but it is worth noting that they often concern substantial financial levels. A yearly cost of cleaning services in a bigger holding company in a certain country might be as high as a dozen or so million zlotys. For instance, a three-year contract for Chopin Airport security in Warsaw is about 120 million zlotys.

It should be safe to assume that we can observe a certain segmentation of the processes. A part of them, which is not subjected to market verification, at least in a short period of time, is less important from the point of view of quality (an example is providing food for hospitals in Poland). The processes which are subjected to market verification have, according to the author, a higher quality control – the example could be ordering components for car manufacturing, whose flaws would cause the risk of bearing servicing costs and so called low quality costs connected, if only, with deterioration of the make image. Referring to the example of outsourcing medical services by taking over the medical company together with medical staff it is worth noticing that one of easy to use financial reserves is verification of contracts with employees and a possible replacement of the staff with people who have lower financial requirements without assessing their competences. It allows keeping the contract to perform the services for the payer and increasing the margin of the service, which is common practice on the market. The author omits ethical questions of these activities, trying only to stress the complexity of the problem.

Evaluating the described situation, a conclusion can be drawn that the problem of restructuring a company is complex. Not questioning the legitimacy of such practice, multiple aspects of evaluating these processes should be taken into consideration. Given the practical aspect of the consideration, commonly observed occurrences which take place during the described form of restructuring should be pointed out. They decrease its effectiveness (the remarks result from practical experience of the author during restructuring processes of multi-stakeholder organizations). Each one has a certain level of inertia in adapting to the changeable conditions of the environment. The inertia produces, at the same time, protection of the arrangements used for years, in this case keeping the status quo of the current processes. It results in lack of full elimination in organizing these functions, which are transferred to another company within the outsourcing concept. Economic practice also points out to the phenomenon of recreating functions in a short time after selecting them to another organization. These phenomena are pathological from the point of view of praxeology and they lead to limiting the effectiveness of the described restructuring concept, yet frequently occurring in economic practice during implementation.

Conclusions

It should be pointed out that the procedure of selecting processes from the existing structures of the organization is one of the most commonly executed concepts of reorganization. Companies implementing such changes have been described above. However, if we look at other companies in recent years, it is clearly seen that they take action in selecting accountancy services, IT, operational support services etc. It must be also noticed that there is higher dynamics of such changes in case of privatized companies and definitely lower dynamics in which the main owner is the State Treasury. It results from the fact that privatized companies are more involved (forced by market) in development changes leading to cost-benefit despite many formal limitations, which have been mentioned. In such type of companies it is easier to transfer certain solutions, which worked well in other entities of a certain group (in case of

transnational companies). While evaluating the benefits of the outsourcing process it should be taken into consideration that it does not bring expected results in all organizations. It depends to a great extent on the specificity of the company and the considered concept of changes. As the experience of the first described company shows, the concept which is not always fair in its assumptions will work in practice. Referring to both theory and practice of management, a question about the boundaries of outsourcing of company processes could be asked. In the author's opinion, they are determined to great extent by technique and technology development as well as the efficiency of supervision of the processes. Currently outsourcing concepts are common practice in most companies to support processes not connected to their core business. However, the perception of outsourcing and its acceptance in the employee group selected outside the company is changing significantly.

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