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BUSINESS RESTRUCTURING AS A TOOL OF FINANCIAL STRATEGY OF A COMPANY

Inese Mavlutova[1], Andris Sarnovics[2], Gregory Olevsky[3]

[1,2] BA School of Business and Finance,
Kr. Valdemara str.161, LV-1013, Riga, Latvia
Email: inese.mavlutova@ba.lv; andris.sarnovics@ba.lv

[3] University of Latvia,
Raina bulv.19, LV-1586, Riga, Latvia
Email: grigol@lanet.lv

Abstract. The authors examined conceptual basics of the company's financial strategy, studied its development possibilities under inconsistent economic conditions, and developed methodological ground of organizing and enacting restructuring by using of a particular example. The actual restructuring target gains an additional effect (effect of synergy). The company's market value indicator concept can be used as the best quantitative indicator to evaluate the effect of synergy. The goal of research is to justify the attractiveness of business restructuring used to increase a company's market value and develop restructuring program. Upon examination of the implementation of a financial strategy mechanism in companies experiencing financial difficulties, the evaluating mechanism of the company restructuring effect was found to have been improved from the aspect of a company's financial performance and indicators of market value.

Keywords: restructuring, company's financial strategy, company's financial performance, company's market value, effect of synergy, capital assets pricing model (CAPM).

JEL classification: G340.

1. Introduction

On the ground of inconsistent economic environment consideration of ensuring market positions and future developmental possibilities is required of entrepreneurs. Restructuring is one of the most common scenarios in order to develop a company.

Essentially joining the European Union together with rapid growth of Latvian economy until the middle of 2007 incited the investors' interest about the region, which sequentially promoted an increasing amount of company restructuring cases. During and after recession a majority of companies experienced financial difficulties and one of the possibilities of a company's strategy implementation lies in the restructuring of the company.

The object of research is the company's management process.

Due to impact of inconsistent economic environment and processes of globalization the life cycle of companies has shrunk and business has become more dynamic, which has encouraged the restructuring of companies. Motives of restructuring vary significantly, albeit the target is one – an increase of the company's market value and raise of efficiency as a result of implementing a company's financial strategy.

The goal of research is to justify the attractiveness of business restructuring used to increase a company's market value and develop restructuring program, based on a study of methods used during financial strategy enactment and on an analysis of Latvian retail companies' financial position.

As a result of the research a conclusion has been made that restructuring is a process which is aimed at the maximization of a company's market value by implementing activities aimed at improving company's activity.

Generally accepted quantitative and qualitative methods of research in management science were used, including analysis and synthesis, logically constructive and statistical methods, economic mathematical simulation, description and display methods of numeral information.

2. Business restructuring as a tool of financial strategy

During research it was examined that in scientific literature the concept of strategy as a composite of conditions to make management decisions about future activities of the company formed during the early eighties of the 20th century. Enactment of strategically significant decisions is at first related to attracting monetary resources, respectively, to the quality of business financial management.

The main component of financial management on the other hand is financial strategy, which includes the establishment of a sustainable system of financial activity's targets and indicators, as well as the determination of priority tasks for a present perspective. In general financial strategy is defined as business policy in the matter of main directions of financial development (Porter 1998; Prahalad, Krishnan 2008; Wahl, Prause 2013). Aspects of financial strategy are described in publications of Van Horne, Vachowicz (2005), Brigham *et al.* (2008), Brigham, Ehrhardt (2010). After performing an analysis of scientific publications the authors concluded that the content of financial strategy may be displayed as provided in Figure 1:

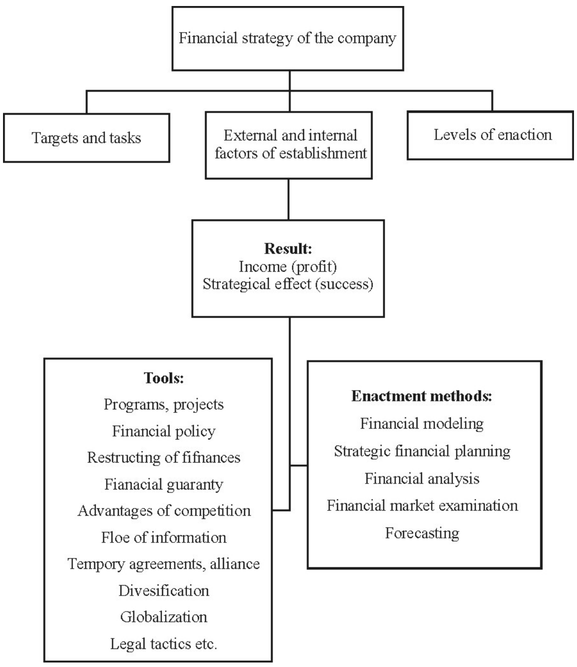

Fig. 1. Content of a company's financial strategy (source: compiled by authors)

A company's financial strategy is developed with consideration of different fixed conditions or their predictable development. Since they are not taken into consideration often, especially in long-term perspective, it is always possible that the set targets and planned strategic result will not be accomplished. A financial strategy's potential deviation from the objective is considered a consequence emerging from financial risk (Hitchner 2003).

The matter of the complicity of activities related to preventing the difficulties is dependent on the complicity of the problems – starting with technical insolvency and concluding with bankruptcy.

During the *stage of owner's crisis* financial performance of the company worsens, which initially does not influence the payments to creditors. The criterion chosen is the limitation of interests of the owner, respectively, the real loss of owners investing. Theoretical ground of offered criterion and numeral measurement is completely possible, despite of apparent abstractness. For owners the company is an object of investing financial resources, allowing increasing the value of the resources invested. In order to compare the effectiveness of investments, alternative investments with the same risk level can be used as the ground. Therefore, to determine the direct loss to owners, present market value and present initial investment value of the equity capital should be compared, considering that they will be used as alternative investments with the same risk level.

Thereby the following inequality can be used as the criterion of the first stage which is the owner's crisis:

$$\frac{TV_{pk} + D}{TV_{pam}} \langle 1 \quad (1)$$

where: TV_{pk} – company's market value; D – owner's dividends; TV_{pam} – present initial investment value of the equity capital with the possible alternative use of the resources invested with the same risk and liquidity level.

The insolvency of the company can be described both as episodic and chronic. In the latter case a huge possibility of bankruptcy may arise, which is understood as legally admitted or announced by debtor as inability to satisfy creditor's financial demands in full and/or inability to meet their obligatory payment.

Therefore to avoid situations of crisis, company's financial position has to be evaluated in a short time, so in case of instable situation composite of actions can be enacted in order to recover it. One of the key elements of the activity's system is *restructuring of the company* (Howson 2003).

Together with integration in the European Union the competition became more intense in several areas of entrepreneurship in the Baltic States, therefore new requests for entrepreneurship methods were brought forward. Restructuring as a method of increasing market value of the company is common in industrial countries (Vance 2010; Gilson, Altman 2010). However it is characteristic of the Baltic market that a bulk of small and medium size companies often uses irrational methods of financing. Therefore the structure of managing financial sources and financial flow is irrational in these companies.

Considering the company as a complicated system, dependent on external and internal factors, a company's restructuring is defined as changing the structure or the business units. Analysing the impact of both external and internal factors, restructuring includes improvement of the company's management systems, financial, economic and strategic activities, marketing systems, personnel management, quality management and innovation management. Low efficiency of the company's economic activity after the recession can be considered as the main cause of restructuring, which is reflected by poor financial indicators, scarcity of current assets, huge debtor and creditor debt amount and arriving at a situation of crisis (Howson 2003).

Matters of company's restructuring and their importance in the viability of companies in transition economies are studied by Dockery, Herbert (2000), Crum, Goldberg (1998). Scientists have united opinions about the relevance of the integration activities in overcoming different barriers (Mitchell, Marks 2011; Miller 2011). The speed of the activities is often mentioned as the key factor (Malhotra, Sarma 2013). In general scientists consider that the optimal speed of restructuring depends on the desires of employees, culture barriers and existence of competitors desiring for addition of the company (Mitchell *et al.* 2012). Taking strategic and tactical targets into account, the majority of motives for restructuring a company can be classified in following groups as provided in Figure 2.

A summary of the motives of restructuring brings forth a conclusion that managers and owners traditionally enact two targets: an increase of company's competitiveness and a further increase of the company's value. Depending on the targets and the company's strategy one of the types of restructuring is chosen – operative or strategic.

International practice nowadays and skills of restructure enactment in Latvia testifies that restructuring is one of the most complicated tasks of management. Restructuring does not lead to simultaneous changes in resource and capital structure or in the economic activity in general. Restructuring process can be enacted only when the targets have been made clear, the concept of restructuring is justified and all the stages and methods have been comprehended.

It is clear that the restructuring targets are set by the strategy, while financial resources provide the ground of enacting it and defines the effect of enactment (Weston *et al.* 2012). This means that in order to justify the targets of restructuring the use of integrated financial strategy's definition is the most appropriate, as well as choosing the type of restructuring by evaluating its results and effectiveness.

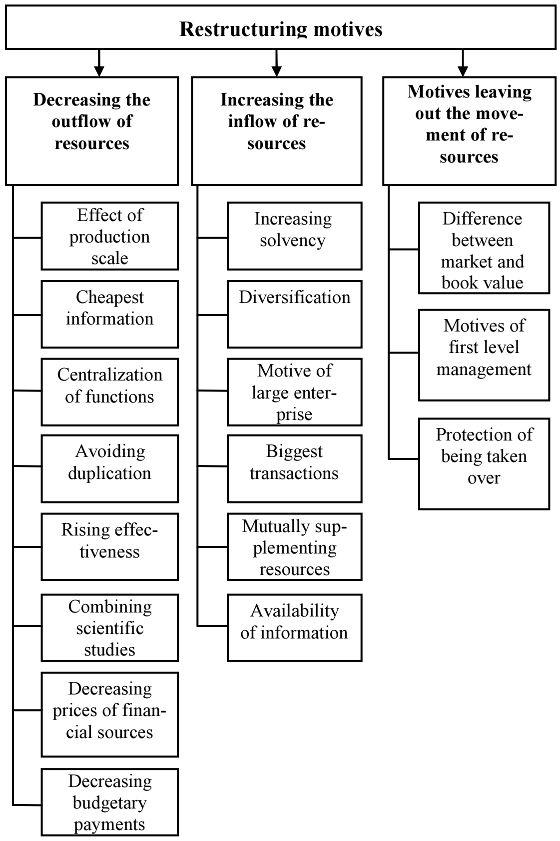

Fig. 2. Structure of main restructuring motives (source: compiled by authors)

The authors have concluded that an important part of a company's restructuring concept is the classification of the types, because restructuring leads to crucial changes in the company's organizational, asset and capital structure. There are several approaches of restructure enactment. The authors prefer the following types of restructuring: mergers of companies, acquisitions of companies, forming strategic alliances, restructuring of property, activities to eliminate financial difficulties. All types of restructuring are related to a company's financial strategy (Gaughan 2007).

Regardless of how formal the motives of a company's restructuring are, its real objective is to gain additional effect (effect of synergy) (Tomperi 2006).

During examination of several Latvian and foreign expert conclusions the authors have concluded that during the process of restructuring the most appropriate concept for examining whether a company's financial strategy is implemented is the evaluation of a company's market value with the income concept which includes two techniques: capitalization of income and discounting the future cash flow (Fernandez 2007; Damodaran 2009).

The most important indicator of a company's financial strategy is the increase of equity value Capital assets pricing model (CAPM) (Sharpe 2008); thereby the company's restructuring traditionally is performed in this direction. Company's market value indicator as a restructuring criterion is not chosen randomly (Damodaran 2012). As a result the owners are less interested in the sphere of the activity, the technology used, parameters and characteristics of the goods and services produced and the market. Investment efficiency criterion is constant growth of investment value, which defines the increase of the owner's personal prosperity and a steady development of the company as well (McTaggart *et al.*1994).

A company's value indicator calculated with the use of cash flow discounting method includes the achieved present value of cash flow during the stage of stabilization of the company (within a predictable calculating period) and the discounted value of the cash flow outside the predictable calculating period (Glen 2008). The cash flow is defined on the basis of net profit and depreciation deduction which is in hand of the company as target financial resources. The model of cash flow discounting method can be expressed in a formula:

$$V = \sum_{t=1}^{T} \frac{CF_t}{(1+r)^{(t-0,5)}} + \frac{V_{atl}}{(1+r)^T} \qquad (2)$$

where

t – year for predictions;

T – calculating horizon;

r – discount rate;

CF_t – cash flow during period t;

V_{atl} – terminal value outside the calculating period for predictions.

Development concept is managed by a defined methodology. In the first stage the company's market value before the restructuring must be calculated by the use of cash flow discounting method (DCF) (CFA Institute 2008). Afterwards different alternatives of restructuring economic, investment and financial activities have to be developed (management of current assets and optimization of labor capital; liabilities, increase in capacity, planning the capital investments and selling the assets; equity value, proportion of equity and borrowed capital, structure of the capital).

The developed activities should be inspected with the use of a company's evaluation model. One of the criterions for choosing alternatives is increasing the company's market value. The financial strategy aimed at increasing the company's market value is considered as a ground for restructuring alternative consideration described subsequently (Mavlutova 2011).

Restructuring strategies have to be reviewed "from the easiest to more complicated", respectively, from the alternatives anticipating minimal capital investment and external funding to the investment projects renewing the technologies of goods and services provided.

3. Company's restructuring enactment program and related risks

The restructuring model has to be developed on the basis of existing financial strategy of the company. Thereby the enactment of restructuring consists of following stages:

The first stage is the diagnosis of the company, performed in order to define its problems, strengths and weaknesses, and to clarify the development perspectives.

The second stage begins with development of restructuring strategy and program. On grounds of the results gained during the diagnosing process, several development alternatives were formed.

The third stage contains the enactment of the restructuring accordingly to the developed program. A set of specialists is formed and all the stages of the program are developed sequentially and carried out.

The fourth stage is the monitoring of the restructuring program and evaluation of its results.

In order to solve the problems authors offer a model (Figure 3) which contains a row of sequential activities with a feedback which enables correction of targets and tasks in order to improve the financial position and implement the financial strategy of the company. The starting point of the model development is a definition of the motivation and mission behind the company's restructuring.

The most significant risks with a negative impact on enacting the restructuring program are:

- wrong choice of restructuring method;
- prematurely evaluated restructuring results;
- insufficient qualification of the management;
- wrong evaluation of resources necessary to perform restructuring;
- insufficient motivation of the restructuring participants;
- emergence of negative social consequences during the enactment of restructuring;
- inadequate legal coverage of the restructuring project.

The large number of unsuccessful restructuring deals does not decrease the amount of performed restructuring deals because of their potential advantages when compared to the traditional methods of business extension.

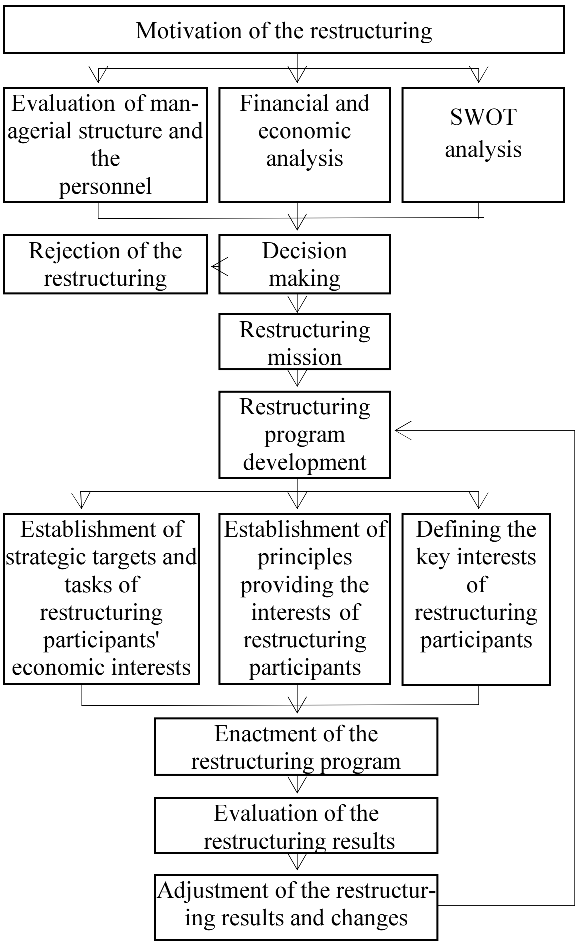

Fig. 3. Algorithm of establishing the company's restructuring model (source: compiled by authors)

Analysis of the failures is made and the factors are identified:

1. Increase of labor fluctuation.
2. Absence of strategy.
3. Insufficient evaluation of the costs.
4. Wilful non-objective evaluation.
5. Scarcity of necessary control.
6. Slow decision making and uncertainty of the competition limits.
7. Barriers of cultural differences.
8. Scarcity of managerial experience.

The performed researches enable to make conclusion that the company's restructuring is related to high risk level. Moreover the amount of unsuccessful transactions do not decrease, therefore the companies with negative experience should be more careful in the future, while the participating specialists and consultants have to obtain the necessary experience in order to succeed with consideration of the mistakes made. Unfortunately statistics does not confirm the assumption. One of the explanations could be that the external conditions change constantly, and consequently the experience obtained cannot be used because of the changes in general conditions. The second reason – the experience obtained previously is not being systematized and accumulated.

4. Rising the company's value as an objective of the restructuring

In order to explore the practical use of restructuring methods offered in the theoretical parts an empiric research was performed. As the ground of the research Limited Liability Company LLC RVP was taken – a grocery retail company with a chain of seven shops with a total space of 6700 m² (average space per unit – 957 m²). All the shops are located in Riga, mostly in the centres of residential areas, thereby becoming the most convenient and advantageous shopping place for the residents of the particular areas. The target customer is a resident with average or medium high income level.

Like global economy, Latvian economy experienced recession within 2008-2010. Net turnover increment rate of Latvian trading companies had an increasing tendency until 2005. Since 2007 till 2009 the increment rate of net turnover has decreased, but since 2010 it has been increasing (Figure 4).

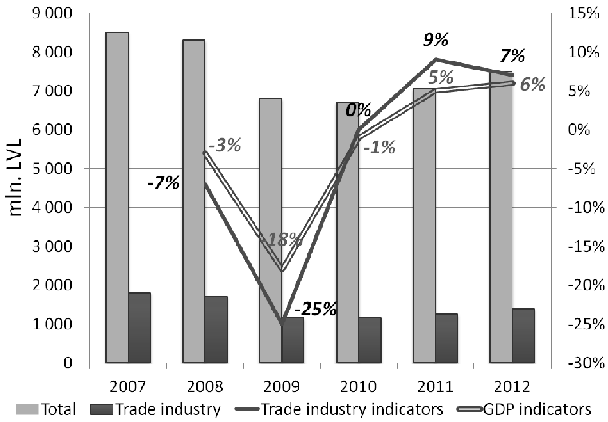

Fig. 4. Dynamic of GDP and trade industry indicators in Latvia (2007-2012) (source: The main macroeconomic indicators 2013)

In 2008 both the Gross domestic product (*GDP*) and domestic consumption suffered a decline, including the volume of retail trade. However the grocery shop retail turnover increased by 8.9% in 2007 and in comparison with 2006 the turnover of ten biggest Latvian grocery retail chains increased by 29%. Clearing it out of the average inflation rate in 2007 (10.1%) actual growth of ten biggest grocery retailers was approximately 19% which exceeds the average increase level in the market.

The market tendencies show the gradual changes of domestic trade structure, since the total trade space is increasing while the total number of shops is decreasing in 2012 (The main macroeconomic indicators 2013).

Analysis of the closest competitors' effectiveness indicates that since the gross income margin of the LLC RVP is average or even a little higher than average, the profitability falls far behind from sales process. However the owner's investment profitability (equity profitability) is the lowest. Owners of the LLC RVP have managed their business by using the conservative method (high equity and low liabilities). The profit has not been paid out in a form of dividends since 2005.

As one of the most critical restructuring stages the forecasting of future activity may be considered. Based on how qualitative and objective the future forecasts are formed, the decision will be made about the company's restructuring program.

During the research the authors have concluded that it is necessary to study, classify and bear in mind the main risk factors when analysing the activity of the LLC RVP. Key macroeconomic risks are related to the changing level of consumer financial prosperity. However the specific risks and their impact on LLC RVP are similar to other Latvian retail businesses. Risks related to the internal environment of LLC RVP are considered the main risks of a company's economic activity.

Table 1. Restructuring tasks of the company LLC RVP (source: compiled by authors)

<table>
<tr><td rowspan="14">Increasing company's value</td><td rowspan="8">Increasing sales</td><td rowspan="3">Marketing</td><td>Establishing product portfolio</td></tr>
<tr><td>Product advertising</td></tr>
<tr><td>Sales promotion</td></tr>
<tr><td rowspan="5">Finances</td><td>Additional funding</td></tr>
<tr><td>Purchasing obstacles change</td></tr>
<tr><td>Credit restructuring</td></tr>
<tr><td>Price reduction policy</td></tr>
<tr><td>Specifying costs</td></tr>
<tr><td rowspan="6">Increasing profitability</td><td rowspan="3">Logisgistics</td><td>Separation of warehouses</td></tr>
<tr><td>BAR Code Readers enactment</td></tr>
<tr><td>Establ.of unit. infor network formation network</td></tr>
<tr><td rowspan="3">Personnel</td><td>Establishment of motivational and stimulation systems</td></tr>
<tr><td>Selection of employees</td></tr>
<tr><td>Training and professional skills improvement</td></tr>
</table>

Problems related to these risks form a listing of tasks that need to be solved during restructuring of LLC RVP. The "tree" of listing is presented in Table 1.

The task listing in Table 1 indicates that each target has to be divided in easier achievable sub-targets that further turn into particular tasks. By accomplishing the tasks the sub-targets are achieved, and consequently the main target – increasing the company's value – is gained. The solvable tasks of LLC RVP are the "leafs" of the "tree".

Misleading and groundless future cash flow may lead to wrong investment decisions, but the potential increase of cash flow is the main manner of attracting new investors to the company.

Financial forecasts for LLC RVP are drawn up for five year long time period – from 2013 to 2017. The ground for the chosen time period is the expected changes in company's activity during the next five years. After that date a steady development of the company is expected.

It is planned to maintain the gross profit margin constant in a five year perspective (22%), which is close to the actual data – in 2012 the company has performed with a gross profitability of 22%. The most significant changes are planned in the cost structure. It concerns such expenditure items as selling and management costs.

During analysis of the expected free cash flow of LLC RVP the authors have concluded that starting with 2013 the cash flow will improve rapidly. It is improved by results of operational activities (EBIT growth) and suppliers' deferred payments, because there is no need for additional funds to finance working capital.

In order to determine the most profitable capital structure – to find the minimal weighted average cost of capital (WACC) which provides the largest income, prices of the company's borrowed and equity capital were calculated with different funding models or structures.

WACC indicator with different capital structures was calculated with the obtained results of capital price calculation with the use of CAPM model and borrowed capital price calculation with the use of the allocated synthetic rating method. Matrix of calculation is presented in Table 2.

The obtained results indicate that WACC reaches its lowest point with the capital structure with 40% borrowed capital and 60% equity funding, thus WACC is 13.89%. Thereby by defining the necessary capital in amount of 8 800 000 LVL for LLC RVP in order to achieve optimal capital structure where the company's market value is the highest, 5 280 000 LVL have to be invested as the owners resources and 3 520 00 LVL have to be borrowed.

Due to calculations made it is concluded that the company's LLC RVP market value can increase by 7 716 610 LVL or 2.05 times by increasing the capital up to 8 800 000 LVL in case of successful enactment of the restructuring program.

This result can be achieved if the management is able to overcome the obstructive risk factors of restructuring process discovered in the research.

Table 2. WACC calculation matrix (by CAPM method) for LLC RVP (source: compiled by authors)

Proportion of borrowed capit. %	**Proportion of equity, %**	**Borrowed capital price after taxes(by allocated synthetic rating method) %**	**Equity price (by *CAPM model*)%**	***WACC* %**
0	100	6.46	14.16	14.16
10	90	6.46	14.85	14.01
20	80	6.89	15.71	13.95
30	70	7.10	16.82	13.90
40	60	7.27	18.30	13.89
50	50	8.54	20.37	14.46
60	40	8.93	23.48	14.75
70	30	9.65	28.65	15.35
80	20	10.63	39.01	16.30
90	10	10.63	70.06	16.57

5. Conclusions

Based on analysis of restructuring in the process of company's financial strategy implementation the authors have concluded the following:

Restructuring is a process aimed at the maximization of a company's market value by implementing activities aimed at improving the company's activity. During the process of enacting a successful financial strategy the following targets are gained:

- increase of company's equity value as an obligatory condition to increase the competitiveness;
- company's financial position is improving due to strengthening of its solvency, liquidity, financial stability and profitability;
- attraction of long-term investments in form of direct investments or long-term debt commitment is accomplished.

In order to eliminate the insolvency, the financial position of the company has to be evaluated in a short time, and in case of an unstable situation a financial strategy has to be enacted to recover the company. One of the key elements of financial strategy is company's restructuring.

The actual restructuring target is the gain of an additional effect (effect of synergy). As the best quantitative indicator to evaluate the effect the company's market value indicator concept could be used. In order to evaluate the company objectively it is necessary to use at least two concepts. For more active companies the income capitalization and discounting the future cash flow methods could be the most appropriate.

When determining the company's market value in order to define the minimal profitability or the equity price demanded by the owners, it is recommended to use the *CAPM* model. The use of *CAPM* in countries without a highly developed stock market, including Latvia, is performed by using the stock index of the geographically and economically closest countries or regions, or the systematic risk coefficient of the industry (beta coefficient).

The great amount of unsuccessful restructuring cases does not decrease the amount of performed restructuring projects because of their potential advantages when compared to the traditional methods of business strategy implementation. Therefore the causative factors of failures should be identified during the restructuring and the risks of restructuring enactment have to be evaluated.

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