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FIRM FINANCIAL PERFORMANCE PRIOR TO DELISTING: A CASE STUDY OF INTEFRESH HOLDINGS LIMITED AND THE ZIMBABWE STOCK EXCHANGE

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ABSTRACT

This paper seeks to establish whether Interfresh Holding's financials were relevant in signalling there being a probability of delisting prior to management's decision at an Extra-Ordinary general meeting. The study makes use of the published financials from as far back as 2009 up to those published a year before the decision to delist. Key financial and performance indicators are analysed and the trend noted and contrasted to other findings in different economic set-ups. In the last two years of operation as a listed entity, Altman's z-score is applied to the company's financials to establish whether there were any signs of distress. This is done to establish the relevance of such findings in an environment such as Zimbabwe. Key findings suggest an increase in interest bearing debt to total shareholders funds from 21% in 2009 to 179% in 2012. Working capital indicators were signalling some stress as pronounced by the current and acid test ratios. The ability of the entity to raise equity capital through a rights issue was found to be difficult given that the auditors in 2012 cast a slight doubt on the going concern probability. The capital structure was found to be past the optimal levels in 2012 which hence had an implication on the ability to raise equity through a rights offer.

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INTRODUCTION

After having been listed for thirteen years on the Zimbabwe Stock Exchange, Interfresh Holdings Limited decided to apply for voluntary delisting in 2013. In as much as companies that delist voluntarily justify their decision by mainly handpicking reduced share activity and suppressed share value compared to net-asset value¹, it still needs enquiry whether the firm's financial health was on track prior to delisting for either types. Such firms which point to the aforementioned usually remain listed on other securities exchanges in other places and therefore guarantee liquidity and tradability of the shares held by the shareholders. On the international scene, a number of corporates seem to have taken the voluntary route of delisting, alerting their shareholders not to fear anything since they will be remaining listed on another exchange probably in another country². This however has not been the case with Interfresh since it was only listed on the Zimbabwe Stock Exchange. In

the US, once a company has delisted, it can still trade on the pink sheets³, the activity of such private equity still needs to be enquired on. As extracted from the firm's annual reports, the firm was in need of capital from mainly existing shareholders for working capital purposes (Interfresh annual report 2012, pp8). Such funds were however not raised to management's expectation. The decision to delist was categorically stated in the 2012 annual report that it is either the company secures long term leases or it delists (ibid, pp56). It is also prior to delisting that the corporate had a significant part of its cash generating asset seized and hence the gloomy picture painted by auditors in the 2012 annual report with regards to going concern ability of the entity (ibid, pp11). Whereas that can be viewed as being too harsh a comment, a note was also placed in the financials in that regards by management in support of that (ibid, pp56). Wang, Lin and Hsu (2013), note the issuance of the initial going concern opinion by auditors' results in the users of the financial statements getting concerned of whether the firm will delist or emerge from its financial doldrums and continue in operation. As such this study is an attempt to consider the financial health of Interfresh prior to delisting by the use of selected ratios and see whether the auditors' statement is validated by the financial performance.

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¹ & ² <http://www.primeromining.com>,

http://www.marubeni.com/dbps_data/news/2004/040820e.html

<http://www.toray.com/ir/pdf/131030.pdf>

³ <http://www.investopedia.com/terms/p/pinksheets.asp>

Research Objectives

- The primary objective of this study was to analyse the trends in selected key performance indicators of Interfresh prior to delisting.
- Establish whether Altman's Z-score indicated anything in terms of financial distress for Interfresh in the two years preceding delisting.

Literature Review

Djama, Martinez and Serve (2012), survey the literature on both voluntary and involuntary delisting. Despite their focus having an inclination towards Anglo-Saxon and continental Europe, they unravel a universal literature shortfall of lack of emphasis on such for Going Private Transactions (GPT's) compared to listing (going public). As such, they advocate for an equal weighting in terms of both research and literature on the area of delisting since it is an important phase in the life of an organisation. It is relatively ideal to study delisting in the developed world like the US given that the more than 7350-delistings have been recorded since 1995 to around 2004 (Macey 2004, pp3). This implies a relatively large pool from which research can be carried out and therefore inferences made even though company specific variables still need to be considered. If delisting happen in places like Zimbabwe however, it then may require fitting results of already carried out researches albeit in different economies and try and discover whether there is any relevance to their results. Zimbabwe's listed corporates are not anywhere close to US delistings since the number of listed entities is just above sixty-five (65)⁴.

Rezek (2010), in his seminal presentation delves on the advantages of remaining listed. Listed entities are more appealing to banks which may lend to such organisations provided they have acceptable gearing. Delisting on the other hand may unlock value for stakeholders including management (ibid). It also results in cost saving which are as a result of less onerous reporting requirements after delisting. It is the researcher's assumption that this will not imply engagement by management in creative accounting since the public's eye will not be in the vicinity of the financials. Whereas some companies agree that there are advantages that accrue to corporates that would have delisted⁵, an analysis of the financials for an already delisted corporate may assist in the determination of what needs to be put right after delisting. As such, such measures as Altman's Z-score, current ratio, P/E ratio, absolute liquid ratio and debt to equity ratio among other indicators were found to be of paramount in examining the financial state of affairs in the corporate under study.

Altman's Z-score

Sulphey and Nisa (2013), apply Altman's Z-score to Bombay Stock Exchange's listed small cap corporates to establish their

financial health since they considered it an important tool that categorises companies' in either 'safe', 'grey' or distress zones. They allude to the fact that the z-score helps overcome the shortcomings of individual financial ratio analysis and just like other ratios; it also provides a calculated measure based on past experiences rather than personal opinion. It is on this understanding that a decision has been made to include the z-score as a financial indicator for Interfresh Holdings Limited which delisted from the Zimbabwe Stock Exchange on the 31st of December 2013. Dheenadhyalan (2008) as quoted by Sulphrey and Nisa (2013), applied the z-score to SAIL and the results showed an increasing trend of the score, hence their conclusion that SAIL's financial health was good. The use of the score in India has proved the model's remarkable degree of accuracy in distress prediction (Sulphey and Nisa 2013, pp 147). The z-score can provide a simpler conclusion than the mass of other ratios combined (ibid).

Likewise Li and Rahgozar (2012) re-examined the accuracy of the original Z-score in its ability to predict financial failures in the US and bankruptcies for the periods 2000 to 2010. Their study however affirms the validity of the model for both manufacturing and non-manufacturing firms alike. Given that the original Z-score was originally designed for manufacturing firms, Li and Rahgozar (2012), confirm that the model fits very well in predicting financial distress for non-manufacturing firms as well. As such, its application to the financials of Interfresh which is a composite organisation biased towards agriculture is premised. Samarakoon and Hasan (2003), investigate all the three versions of the Z-score model in Sri-Lanka despite the model having origins in the US. All the three proved to have a remarkable degree of accuracy in predicting distress in an emerging market like Sri-Lanka. In this study, the z-score will be applied to Interfresh, a company not necessarily in distress but which has failed to attract equity on a bourse it is listed. The question is could the investors have considered the Z-score model to withhold their funds?

Current Ratio

Saleem and Rehman (2011), conclude that liquidity ratios do affect profitability ratios. In their study of the gas and oil industry in Pakistan which aimed at finding the impact of liquidity ratios on profitability, they find that the quick ratio does indeed affect significantly the return on assets, whereas the relationship is insignificant on the return on equity and return on investment (Saleem and Rehman 2011, pp97). Such results may not be contested since they apply to an oil and gas industry in Pakistan, and may need to be proved for such an industry in Zimbabwe. Comparisons with either ROA or ROE will not be part of the objective of this study but comparison to the universal standard which of the current ratio which stands at 1:1. The formula considered in the calculation of this ratio is the universally accepted one as adopted from Wood & Sangster 2012, pp 648. Ohlson (1980) empirically verifies that current ratio measures ability of the corporate to meet short-term financial obligations and confirms that it is a significant gauge for corporate bankruptcy. On the other hand, Altman (1968) notes that a deteriorating net-current assets position and liquidity for a corporate will threaten its short-term solvency and increase the likelihood of delisting. In this backdrop, the current ratio trend for Interfresh is also presented.

⁴ http://en.wikipedia.org/wiki/Zimbabwe_Stock_Exchange

⁵ <http://www.primeromining.com>,

http://www.marubeni.com/dbps_data/news/2004/040820e.html

<http://www.toray.com/ir/pdf/131030.pdf>

Absolute Liquid Ratio

This ratio is also known as the cash position ratio or the Over Due Liability Ratio, and establishes the relationship between absolute liquid assets and current liabilities. The ideal ratio is 1: 2, which means that 50% of liquid assets must be adequate to cover 100% of current liabilities⁶. Bose (2010), calculates the ALR as follows: Absolute Liquid Ratio = Absolute Liquid Assets / Current Liabilities. Thukaram (2007), considers it a giving a ideal short-term liquidity position and prescribes the widely accepted standard of 0.5: 1 or 1:2 as explained in footnote 6 above.

Debt to Equity Ratio

Pour and Lasfer (2013) agree to the cost-benefit dimension to the determination of whether or not to remain listed. They also note that prior to delisting, especially involuntary, leverage is usually high. This impliedly means the higher the gearing of a firm, the higher the probability of delisting. Should management require raising more equity capital from existing shareholders, the financial risk component attached will be input into their expected equity return. Such firms with high gearing delist because they will have constrained access to the market for purposes of raising equity capital. Leland and Pyle (1977) as quoted by Chowdhury and Chowdhury (2010, p2), propose that managers will take debt-equity ratio as a signal, by the fact that high leverage signals higher bankruptcy risk and costs for low quality firms. Whereas the original seminal paper by Modigliani and Miller (1963), dismisses the relevance of capital structure in value determination, Kinsman and Newman (1998) found out that firms with lower debt have higher value than firms with higher debt. They however concluded firms can maximise value by choosing low if not zero debt. Maximizing the wealth of shareholders requires a perfect combination of debt and equity, whereas cost of capital has a negative correlation in this decision and it has to be as minimum as possible (Chowdhury and Chowdhury 2010, pp119). As long as the capital structure is past the optimal level, value erosion starts to creep in the organisation and hence difficulties in accessing further funds from the securities exchange. Beaver (1966) and Ohlson (1980) make known that this debt ratio has a significant prediction power for business financial crisis.

MATERIALS AND METHODS

The research examined selected key financial ratios and interpreting them with the assistance of the literature. The financial distress estimator (Z-score) was also calculated for the three years prior to delisting. The research period (2009-2012), has been chosen due to the relatively stable economic environment that prevailed in the company's operating environment and it is also the immediate period preceding the decision to delist. The interpretation of the Z-score was premised on the following interpretation guidelines :

Z Score – Interpretation

Z-score Calculated	<1.81	1.81<Z<2.99	> 2.99
Interpretation	Failure Range	Grey Area	Financially Sound

The z-score calculation used for purposes of this research is as outlined below:

$$Z_{score} = 1.2 * X_1 + 1.4 * X_2 + 3.3 * X_3 + 0.6 * X_4 + 1 * X_5$$

Where: X_1 = Working Capital/ Total Assets

X_2 = Retained Earnings / Total Assets

X_3 = EBIT/ Total Assets

X_4 = Market Value of Equity/ Book Value of Debt

X_5 = Sales / Total Assets

Data Analysis and Findings

The Z-score for Interfresh as of 2012, even though giving credence to the IGCO is in actual fact an improved score to those that obtained in the years 2010 and 2011. The calculation of the same was however impossible for 2009 since the audited financial statements did not contain a closing price for the shares in question. Consistent with Pour and Lasfer's (2013) findings that delisted firms usually exhibit high debt to equity relationships, Interfresh's debt to shareholders funds ratio has grown over the years as extracted from their annual report. Starting off at 21% in 2009 and rising up to until it got to 179% in 2012. The bid to raise capital via a rights issue and through the ZSE was as it proved going to be an insurmountable task given this trend in the gearing. The market access hypothesis quoted by Pour and Lasfer (2013) has been contributory to the decision to delist. Fig.1 illustrates the trend in the debt to equity of the corporate under study.

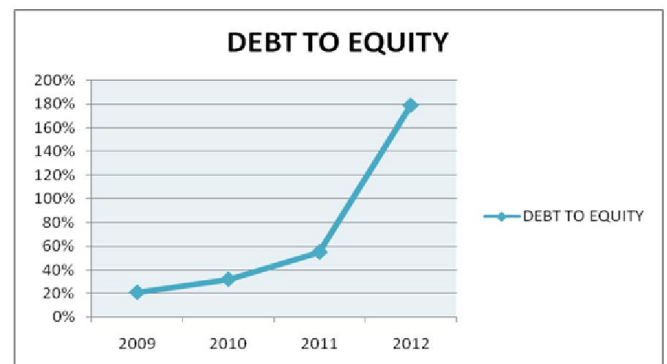


Fig. 1. Debt to equity ratio trend: source secondary data (annual reports)

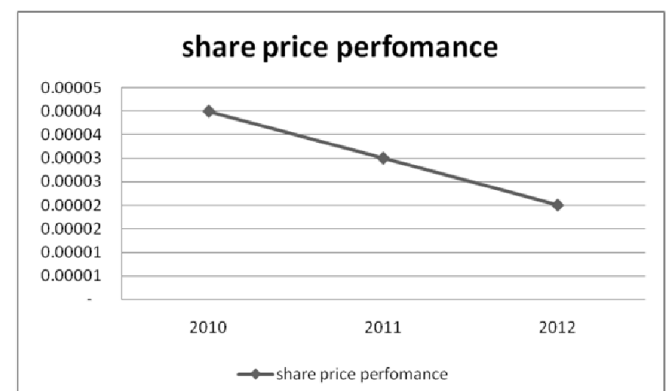


Fig. 2. Share price performance: source secondary data (annual reports)

The share price in efficient markets should reflect the net asset value of the company. With a sole aim of reaping a return on

⁶ http://www.accountingexplanation.com/absolute_liquid_ratio.htm

investment, shareholders seek to maximise their return on equity at any given point in time. Interfresh's share from 2010 through 2012 has however been diminishing and hence value has instead been lost. If for instance investor X bought shares in 2010 at the price as extracted from the annual reports, without any dividends having been declared, a loss of 50%

current ratio of 0.47 implies that for every \$1 which needs to be paid in short-term financial obligations, only \$0.47 is available if collected within that time frame. Adequate financial resources were however available to the firm in 2011 given that the current ratio stood at 1.07. Thus resources were

Table 1.

Indicator	2010	2011	2012
Calculated Altman's Z-Score	0.7505	0.5149	1.4743
Debt / Shareholder' Funds	32%	55%	179%
Price/ Share	0.00004	0.00003	0.00002
Market Value of Equity	24,000	18,000	12,000
PE Ratio	0.02	(0.04)	(0.00135)
Current Ratio	0.4712	1.0686	0.3494
Acid Test Ratio	0.2995	0.8350	0.1800
Gross Profit/Sales Ratio	25%	26%	35%
Working Capital	(4,654,843)	430,904	(4,836,836)
Absolute Liquid Ratio (2009 0.05)	0.01	0.11	0.02

would have been incurred. These are ironically the same shareholders from which the corporate sought injection of equity through a rights issue. This observation may however be discarded on the grounds of the form of efficiency on the ZSE, which may warrant further study. In like manner, the market capitalisation of the mentioned entity has also been diminishing as shown in table 1. Market capitalisation does assume importance when a firm needs to raise capital from the financial markets⁷. A proper value must be assigned to the shares of the corporate so as not to provide overvalued or undervalued securities to the market. A falling market capitalisation ceteris paribus shows a falling share price and hence diminishing value. Thus shareholders, consider this in line with the share price and net asset value of the corporate.

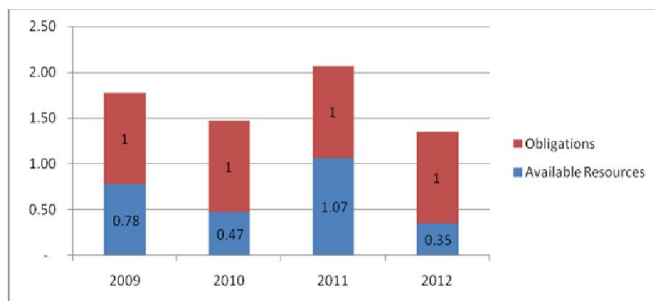


Fig.3. Current ratio analysis: source secondary data (annual reports)

A stock with a high P/E ratio suggests that investors are expecting higher earnings growth in the future compared to the overall market, as investors are paying more for today's earnings in anticipation of future earnings growth (Investopedia 2010, p48)⁸. Hence, a look at the P/E of the concerned entity shows that growth expectations of the firm by the investors have been diminishing from 2010 to 2012 (Table 1). This however confirms the findings by Pour and Lasfer (2013), on the fact that low growth firms are usually candidates for going private. The current ratio measures the firm's ability to meet all its short-term financial obligations using short term resources. Interfresh's current ratio has however been oscillating from 2010 to 2012. In 2010, a

slightly adequate to cover for the short-term obligation. The situation was no better off in 2012, when the current ratio was worse than that in 2010 as it stood at 0.35. This however justified the need by management to seek alternative funding which was to be channelled towards working capital so as to ease the pressure. The company's quick ratio still tells the same story as the current ratio, but has however been adjusted to leave the near liquid current assets only compared to the current liabilities. The trend is similar to that of the current ratio and the company is not better off since in 2010, a quick ratio of 0.3 implies there being \$0.30 available to meet \$1 of short-term obligations. To the investors, such a scenario tends to erode their confidence in the stock and hence the depressed value of the quoted stock on the ZSE over the years 2010 through 2012. The absolute working capital position of the firm was only positive in 2011, as also pointed by both the quick and current ratios but further diminished in 2012. The absolute liquid ratio of for the company is as shown in the table 1, but shows a position which falls short of the acceptable standard of 0.5: 1. For instance in 2012, an absolute liquid ratio of 0.05: 1, implies there being \$0.05 to meet obligatory requirements of a \$1. The \$0.95 required to meet the liabilities now depends on how the other current assets can be converted into cash by the management.

Conclusion

Voluntary as it may seem, the decision for the delisting of Interfresh Holdings was part of a financial strategy aimed at raising capital away from the bourse. Without adequate information on why existing shareholders did not exercise their full rights, the financials of the concerned corporate had a signalling effect on the capital raising ability of the firm given such measures as the Altman's z-score, absolute liquid ratio, current ratio, debt to equity ratio, P/E and acid test ratio. Available literature indeed has been adequate in provision of pointers that signal delisting and this has been applicable to ZSE's Interfresh.

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⁷ <http://www.capitalmarket.com/compendium/mc1621.htm>

⁸ <http://www.investopedia.com/university/ratios/landing.asp>

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