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Linette, Estonia

- Type of restructuring:
  Internal restructuring
- Employees before restructuring:
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- Employees after restructuring:
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Abstract

This Estonian lingerie company had to compete with producers from Asia, changing economic circumstances and disagreements between shareholders. This led to dividing up the company into three separate entities, losing some of the workforce and changing the management structure.

Organisational profile

Linette OÜ designs and makes high-quality women's lingerie. Its products are sold both directly and through retailers all over the world. In 2008–2009, Linette carried out an internal restructuring process that resulted in staff cutbacks, redistribution of tasks and outsourcing of many of the company's activities. This case study focuses on the internal restructuring.

Linette was founded in December 1940 when some entrepreneurs pooled their finance and know-how and decided to establish a clothes production *'artel'* (cooperative association) called Võit (' victory'). Since 1956 the company has specialised in making women's lingerie.

In 1991 Võit had a pioneering role as one of the first seven companies privatised in the Soviet Union. The company, now owned by its employees, was renamed Linette OÜ. Shortly afterwards Estonia regained its independence and the business environment changed considerably. Linette's management was quick to take advantage of these new opportunities.

In the same year, construction work started on a new building. Up to this time, Linette's production had been scattered in 14 different locations across Tallinn, but most of the facilities were old basements, unfit for purpose. In spring 1992 the first retail store was opened in Tallinn. Today Linette has seven stores across Estonia.

In 1993, Linette started producing for the Swedish lingerie brand Miss Mary of Sweden. Soon most of the products carrying Miss Mary's trademark were made by Linette. The owner of this company also became a majority shareholder in Linette – Torpet Förvaltnings AB bought 75% of the shares. The rest was owned by 64 small shareholders (mostly current and former employees, including the managing director at that time). In 2009 Torpet Förvaltnings AB was bought out by the minority shareholders. Six of these seven shareholders are working at the firm.

Finally, in 1994, Linette moved to a new 6,800 m² production facility where brand new equipment had also been installed.

In 2001, Linette started producing for the United Kingdom's second largest retail store Asda (which belongs to the WalMart group) under the brand name George. This widening of activities resulted in a considerable increase in turnover and exports. The annual turnover was approximately €4 million and during the best years the company made a profit of over €200,000. About 70% of production went to export.

Most of Linette's staff of 200 employees in 2008 had very long tenure. The majority had worked there between 10 and 40 years and many were close friends. For example, the now former Managing Director, Mai Parras, had been running the company successfully since the 1970s. There is a trade union in the company. It was formed a long time ago during Soviet times and has in many ways become a nominal body which has not been actively involved in company activities. The trade union was informed of the restructuring, but it did not take active role in the restructuring process.

Background to restructuring event

The economic environment started to negatively affect Linette in 2005. International textile and clothes quotas, established 31 years before, were removed and Chinese products flooded the European Union markets (with a five-fold increase in many categories). This was followed by the negative impact of a sharp rise in average salary level accompanying the economic boom in Estonia. Linette did not go along with the salary rally. As a result, many sewing operators (a relatively low paid profession) left the firm in search of better pay and an easier job.

Initially, the warning signs were largely ignored. One reason was that income from real estate sales kept the cash flow positive and the company profitable in 2007. Otherwise, the loss that year would have been almost €500,000.

At the same time, problems began with the Asda orders. Asda company policy did not allow its orders to exceed one-third of the supplier's total production. It wished to place larger orders with Linette, but this would have meant also increasing overall production. This was not an option for the company for a number of reasons, such as the fact that sewing operators were leaving. Soon afterwards Asda stopped ordering from Linette.

Linette was also experiencing other problems. Some western European companies, knowing of Linette's rapid and high-quality production, ordered small test batches which Linette priced low on the basis of promises of larger follow-up orders. However, the latter were instead ordered from cheaper Chinese producers.

So at a time when Estonia's economy was booming, orders were decreasing year by year and sewing operators were leaving. The number of employees decreased from 360 in 2005 to about 200 in 2007 (this includes closing down a branch in Viljandi where 13 sewing operators were employed). In a way, this voluntary downsizing made it easier to adapt to lower production levels. However, the size of administration and other support staff remained unchanged. In addition, the new building was now too large for this lower volume of orders.

Restructuring processes

In 2008, the company experienced negative cash flow each month. By the end of the summer the company started running out of money. Relations with the banks became tense as Linette had outstanding short-term loans due next year and also an overdraft. The looming global financial and economic crisis only compounded matters as the banks became even more conservative in their lending policy.

In July 2008, the long-time manager, Ms Parras, stepped down as Managing Director and instead became Chair of the Board. Hendrik Tibar took over her role. He had joined the company in 2000 as a production manager. Ms Parras had been preparing him as her replacement for some years, keeping him informed of the company's business, as she had been thinking about stepping aside. He did not have prior experience of running a company and no familiarity with the restructuring process that was awaiting him. However, he had an MBA from Tallinn University of Technology.

The first major task for Mr Tibar was to prepare a restructuring plan for the company and to present it to the board. Two issues were clear: the administrative staff was too large for the size of the company and the building was too large for its purpose. The first restructuring proposals were presented in the beginning of August 2008. However, at the board meeting it became clear that there was a clash of interests between the majority shareholder and minority shareholders. No agreement on the restructuring plan was reached. Mr Tibar was asked to prepare a new plan for the next board meeting. These took place monthly and for each one Mr Tibar prepared new restructuring scenarios. The negotiations continued for six months. During this time Mr Tibar prepared about 20 different restructuring plans (including many with detailed financial calculations).

The cornerstone of these plans was that Linette had three primary business lines – production, sales and design under the Linette trademark – plus real estate. There were three to four possible answers to questions such as:

- whether Linette should shut down production in Estonia and start outsourcing from Latvia or China;
- whether Linette should be in the real estate business at all.

One scenario was bankruptcy if no changes were made. The others were variations of the answers to the questions above with minor differences in financial figures.

Finally, at the end of 2008 the majority shareholder pushed his wishes through and an agreement was reached. It had three parts.

The first was that Linette would be split into three different companies according to activity:

- production of lingerie (Linette Production OÜ);
- design and sales of Linette lingerie (OÜ Linette Retail);
- real estate (Linette AS, which owned the former two companies);

Second, transactions between these three companies would be made using cost-based prices (the market price for real estate) plus a small profit margin.

Third, the company would be reorganised. Some people would be laid off, the functions of all departments and employees would change and some functions would be outsourced

Although the agreement had been reached in December, the management did not want to start laying off people before Christmas. Mr Tibar waited until 3 January and then started announcing to employees that they were being laid off. To be considered a collective redundancy this had to be done at the same time. However, some employees claimed they were ill in order not to receive the redundancy notice. This increased the restructuring cost for Linette since public support could not be used for their severance payments.

The employees had known for a long time that some changes had to be made in the company and were expecting them. However, the extent of the restructuring came as a surprise to them. Even so, they appreciated that the management worked by the rules, followed the law and paid the appropriate benefits. With cutbacks happening in many Estonian companies due to the economic crisis this was often not the case.

Altogether 60 people out of 200 were laid off, but none of the sewing operators. Two people remained in Linette AS (Mr Tibar as manager and one handyman instead of nine previously). In Linette Retail 32 remained, including six sewing operators. The rest of staff (mainly sewing operators) were employed by Linette Production. The split up into three companies took place in March 2009.

The employees were informed of the restructuring at the same time as the staff cutbacks. They had of course known that something was about to happen as Mr Tibar had had to consult them in developing the restructuring plans. The employees who did not lose their jobs were consulted after the restructuring announcement on how to divide the tasks between themselves. They had to do additional tasks and take on new responsibilities.

There are some rules for picking people to be laid off in case of collective redundancy. According to the Employment Contract Act the representative of employees and full-time employees have the priority to remain employed. From the latter the workers with best performance should be given priority. In addition to following these rules in picking people to be laid off Mr Tibar tried to choose the pensioners or those soon to become pensioners.

Most employees took the news reasonably well, although in a tight-knit community it was still a shock to many. Some were struck by the realisation that being one of the best in a field is no guarantee against redundancy. The first half of 2009 was a hard time for the staff as they had to see their friends and colleagues leave. For the ones who remained, no pay cuts were implemented as salaries were already not very high. However, everybody had to take on new responsibilities while working hours and salaries were left unchanged.

The employees who were about to leave trained the ones who remained during the four months before their contract could be ended. If someone had successfully trained a replacement and had no more work responsibilities they were not obliged to come to work anymore. Some of the employees laid off in 2009 now work for the company part time or on project based contracts. In this way, management's effort to part in friendly terms has proven to be valuable later on.

Finally in November 2009 the minority shareholders made the majority shareholder an offer to buy them (the minority) out. To their surprise, the majority shareholder responded with a proposal to sell out to the minority shareholders instead. The latter decided to take up the offer. Consequently, an unforeseen second phase of restructuring, followed.

It was agreed that the majority shareholder would get full ownership of Linette Production OÜ and the minority shareholders would get the two other companies. For that purpose a new holding company with seven owners with equal shares was formed. The seven owners were employees (including Mr Tibar and Ms Parras) and one new person. This way Mr Tibar also became an owner of the company. He financed his acquisition of shares by taking a bank loan. In addition, this new company made a compulsory takeover of the shares of roughly 60 small shareholders (most owning 1–2 shares, but some also with 50 shares, in total 6% of 5,600 shares).

No new bank loans were used by Linette AS to finance these two phases of restructuring. Part of it was financed by Linette's savings. In the autumn they had tough negotiations with the Tax Board concerning the payment schedule for the outstanding tax arrears. The outstanding bank loans were refinanced when the minority shareholders reached a deal with the banks and signed a contract on 11 December 2009. According to this deal, the minority shareholders bought out the majority shareholder and paid the money directly to the bank to cover his other loan obligations.

Challenges and constraints of restructuring

It was hard to reach an agreement between the shareholders. The interests of the majority shareholder did not converge with others. He preferred Linette Production OÜ to use lower transfer prices for production in transactions with OÜ Linette Retail and Linette AS, to make outsourcing cheaper for the Miss Mary brand. With the payback date for the loan coming closer and closer, both the majority owner (joined by Mr Tibar) and minority shareholders (represented by Ms Parras) went to the banks for discussions about the restructuring plans. The banks were inclined towards the latter. However, the banks also saw that the company shareholders were not unified, which displeased them. Consequently, neither party made much progress with the banks.

At the same time, tax arrears (from severances) started to accumulate during the summer of 2009. By the end of the summer the firm had outstanding obligations of about €400,000 to suppliers, €250,000 in tax arrears and a €640,000 overdraft.

There was an unfortunate event as part of the staff cutbacks. One salesperson, a long-time employee at Linette, did not take the news of being laid off very well. During the first four months of restructuring he was still responsible for maintaining relationships with his clients. He was asked for an offer by an important buyer from Sweden, but he rudely refused to prepare one. Linette's management learned about it only after the man had already left and a new salesperson contacted this company. They were so offended by this behaviour that they never became a customer again.

Restructuring advice and support

Mr Tibar considered also using an external adviser to guide the company through the restructuring process. He asked for offers from some consultants for both major restructuring phases (split-up and ownership change). However, the management considered these offers to be too expensive and decided to do it on their own.

They did use lawyers to deal with the legal aspects of restructuring, but only the contracts for buying out the majority shareholder were fully prepared by the lawyers. All other restructuring matters were handled by the management itself as there is lots of relevant material available on the internet. They did, however, use about two hours of legal consultations to see if they were on the right tracks – doing things in the right order at the right time (especially for tax purposes and to minimise costs).

Given the number of people made redundant, the Estonian Unemployment Insurance Fund (Eesti Töötukassa) met half of the severance costs. At that time the labour laws were quite strict in Estonia. As most of the staff had long tenure they had to be given notice four months before their contract could be ended and then be paid severance equal to four months' salary. This meant a total of eight months' salary costs (including taxes) for the company – a considerable amount. Therefore, funding from the Unemployment Insurance Fund helped greatly in avoiding bankruptcy.

Outcomes of restructuring

In general, the new owners and management consider the restructuring to be successful. The process itself went according to plan. The cost of restructuring was almost €500,000. Thanks to the efforts of the new owners, the building is now fully rented out (Linette uses one-tenth itself, but together with the former Linette Production they use one-third), despite the fact that there are several half-empty office and production buildings in the neighbourhood.

The company earned a profit in 2010 and in the following years (the turnover is now over €1 million and profit over €100,000). In 2012, its cash flow turned positive. Today, all support services (lawyers, cleaning, accounting, IT and so on) are outsourced and according to Mr Tibar's estimates this provides a considerable cost saving for the company. No major risks have been identified due to this outsourcing. There is also no longer a personnel specialist – these tasks are performed by others.

The company can now focus more on producing profitable niche products and promoting Linette's trademark. However, the separation of production functions remains a risk for the company. The production of larger orders is outsourced from Miss Mary Productions OÜ (the new name of Linette Production OÜ). Essentially, these are the former colleagues of current staff still residing in the same building. However, the working relations with these people are now formal. This means, for example, that reacting quickly to Linette's orders (which is important to their customers) or allowing them to use some specific machines is currently often done out of goodwill from the former colleagues. Should the employees leave, these exceptions might no longer be possible.

Commentary

Mr Tibar pointed out that SMEs, especially the smaller ones, might be disadvantaged compared to the large companies in restructuring mainly due to financial issues. Linette was big enough so the banks did consider its case. For smaller firms it could be more difficult to convince banks of their profit potential. For example, it is harder for loan advisers to understand the specific business area if the company does not have close and frequent contact with the bank.

On the other hand, SMEs have the advantage of reacting quickly to changing environments. Otherwise, the large and small companies face similar issues in restructuring. The key is to understand:

- what a company is good at;

- what a company can do by itself and what can be profitably outsourced.

In general, Mr Tibar is satisfied with the restructuring process and outcomes. He is very pleased that they chose a do-it-yourself approach and did not use too many lawyers and other expensive consultants. In his view, this saved Linette a lot of money and the process was carried out faster. Looking back, he mentions three things he would have done differently.

First, once an agreement is reached on some aspects of restructuring that have to be made anyway (that is in this case staff cutbacks), the company should start implementing these right away. Linette waited until an agreement was reached in all aspects of the restructuring plan. Consequently, they lost six months and this cost them €30,000-40,000 per month, almost bringing the company to bankruptcy. In the end, the implemented restructuring scheme was essentially the same as laid out in the very first proposal.

Second, he should have listened less to shareholders' quarrels and pushed more vigorously on starting the changes. He should have taken more risk himself as a leader-manager. One reason for the hesitation was that when he became the manager at the beginning of the restructuring process the former manager, Ms Parras (now Chair of the Board), was still present at the company every day for a few months. She was still his boss, and employees often went to her to complain, not to him.

Third, they should have thought through better how to divide the assets between the new companies. This is important for two main reasons: it matters how the balance sheet looks to the banks, and in terms of tax issues it is better to have a clearer division.

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Interviews

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