

## Healthy or Unhealthy: Defining the Risk Assessment Environment

BY KENNETH R. YAGER II

**The environments in which risk analysis takes place** can be healthy or unhealthy. The latter is generally the case when corporate culture becomes the controlling factor in all decision making, rejecting objective analysis from outside the bubble and requiring the same questionable risk framework even in the face of new unknown factors. No one wants to make mistakes, but those may well be inevitable unless analysis is undertaken with a healthy respect for the unknown of new markets.



**KENNETH R. YAGER II**  
*Principal,*  
MorrisAnderson

**R**isk management, like so many essentials in the aggressive world of lending, has many healthy and unhealthy elements. Unfortunately, too many companies have fallen prey to the latter without realizing it. Among the problems is the lack of thorough analysis of the way the business goes about its need assessment, the lack of understanding of the corporate culture of the company under acquisition consideration and failure to properly assess soft data — the non-financial information not contained in the spreadsheets.

To understand the impact of risk in business, just look at the growing list of failed companies and the reasons behind their demise. Few may consider that the root of their downfall may have been their approach to risk assessment. Perhaps it was hubris in the risk assessment process that set up a company up for failure even before it began. It was just a matter of time — between inception and failure — as the company struggled to attract capital, unaware of a fatal flaw in its risk analysis.

The process follows a certain and sometimes unwritten set of rules, especially when debates both pro and con are conducted strictly in-house. Experience of the team conducting the analysis may lead to different interpretations of how the data placed before it will play out. Additionally, there is another intangible: the company's previous methods of handling risk most likely dictate future approaches. That's because companies knowingly or unknowingly take the position: "This is how we always handle every risk analysis," even when unknown factors are in play.

The latter is overwhelmingly the case when decision making occurs in an environment shaped long ago by the corporate culture. It's like living in a bubble. Long-standing and usually unchallenged corporate procedures and philosophies about risk tend to govern each step of the analysis, meaning that the structure dictating the approach is simply taken as a given and is never questioned even when variables change. Another factor is the company's current status. While a successful company might act conservatively and avoid risk to protect its precious assets when the situation appears dire, blind boldness may take over management as it rationalizes doubling down on a previous weak decision increasing the risk. As losses mount, the next failing at best may cost owners and managers little, but their stakeholders plenty. It is this type of unhealthy and sometimes closeted environment that can negatively impact risk taking.

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## Approaches to Risk Analysis

Money and machines are to blame for encouraging this form of risk taking. The turning point in the approach to risk analysis can be pinpointed to development of the simple spreadsheet. Before this software existed, risk analysis was assigned to “the elders,” those with years of business and risk experience assumed to be more capable of making reasoned judgments. Once spreadsheets became ubiquitous, evaluations of risk were reduced to numbers crunching and experience lost some importance. Now, it's a different type of person and perspective that comes to the analysis table — the young analyst with minimal perspective in the game.

The new look of risk analysts has its advocates and detractors. On the positive side, younger and more numbers-oriented professionals can access data that their older peers would have never thought possible. These newer analysts have no qualms about challenging any real world assumption that is thought to run counter to their data — and that's the problem for the detractors. They argue that total reliance on data without considering unquantifiable intangibles such as psychology or external market forces means that conclusions based solely on numbers go unquestioned. These newer numerical assumptions are taken as facts incorrectly crowding out soft data.

The ever-growing availability of money has also had an impact on risk assessment. Despite recent bad news, liquidity has actually improved thanks to hedge fund managers, venture capital funds and private equity. The influence of these sources on risk has been rather profound. Thanks to these fresh sources for liquidity, companies appear to be more aggressive and less apprehensive when analyzing the risk associated with a strategic move.

## The Tough Questions

Whether aggressive or conservative, there should be little argument that every risk assessment includes common and not-so-common questions that may go beyond the capabilities of an in-house team to resolve, e.g., organic growth, acquisition or both in corporate primary strategy. Consider, for example, discussing the risk of entering new markets and finding that current data is less than comprehensive. Here are some questions that go well beyond numbers crunching when considering acquisitions:

- Does the company truly understand how this new market works?
- Can it adapt or is there the possibility the company has underestimated this new market?
- Does the company have enough knowledge to manage the new market or simply apply existing rules?

These questions expose flaws in a company's strategic acquisition risk assessment because they show gaps in the knowledge of integration with existing departments, sales processes and other factors not so easily quantified by financial data at hand.

There is one other unknown that many firms are reticent to even evaluate: What happens to us if our strategy is unsuccessful? All too often, the potential cost of failure is not as scrutinized as it should be. In a go-go or aggressive environment formed in the in-house bubble, no one wants to hear talk that the “grand strategy” could possibly go wrong. Such hubris actually increases risk because no Plan B is in place and little or no thought has been given to negative benchmarks or milestones that spell trouble if or when they appear. Risk may change as the strategy plays out, but without the negative milestones the company is unprepared to adjust. There are plenty of case studies that bear this out, and some involve major American corporations.

## Unsuccessful Risk Takers

One of those corporations is General Motors, which took a major risk when it launched Saturn in 1985 — the car designed to compete with Japanese imports and their huge gains in American market share. “We're a different kind of car company,” the Saturn team boasted. With vehicles produced at a new and costly facility in Spring Hill, TN, Saturn appeared to gain some ground against its foreign competition, but a crashing economy, prohibitive production costs and apparent buyer disinterest doomed the brand. GM ended Saturn's life in October 2010.

So what did America's largest automaker overlook in its risk analysis? One flaw was underestimating buyer perception. Saturn was supposed to be different from anything else produced by the parent company, but it was still GM — a company with its own brand and public identity. It essentially could not change to be that other company it so desperately wanted to be. Another was an ongoing liquidity shortage and the parent company's burdensome debt, which ultimately led to a federal bailout. Capital became scarce, exposing Saturn as a failed idea. It was a flaw in risk assessment that has been repeated elsewhere on an equally large scale.

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Remember TED? This airline spawned by United Airlines in 2003 was supposed to be an affordable economy alternative to compete with cost cutting upstarts like Southwest. TED lasted only six years. Much like its automotive brethren, United had failed to substantially include “what if” as part of its risk assessment. The airline did not fully understand what made Southwest Airlines profitable. TED was a brand more than an airline. It suffered in comparison with the cost-cutters and the public ignored it.

Perhaps the ultimate example of a risk analysis failure is the now infamous Silicon Valley dot-com bubble of 2001. Risk analysis was non-existent as was analytical vigor when investors rushed into technology stocks with companies that had yet to make a profit let alone produce a real business model.

Fixated as they were on the vision of breathtaking top line growth in the technology sector, few investors bothered to question what might go wrong, which was an irrational and unhealthy risk assessment approach that led to catastrophic losses. The lesson: consensus thinking is not always correct when it feeds on itself without objective analysis — not unlike a management team assessing a new market or acquisition outside its market.

## Changing Risk Assessment Behavior

Such classic case studies are incentives for companies changing their risk assessment approach and behavior. The profile is likely to change as companies weigh the desire for growth versus the risk of failure. Perhaps an aggressive growth company may suddenly decide to pull back due to fears of jeopardizing its liquidity and assets. At the other end of the spectrum may be a company with liquidity and debt issues taking an unexpected approach by moving aggressively in acquisition mode in the hopes of turning things around and surviving. Whatever the reason, behavior in

both instances is inconsistent with previous corporate strategy leaving investors with mixed messages.

Both actions are indicators that management is taking a second look at asset management and fiduciary stability because the current status is viewed as precarious. Signs are readily available that something is going on; business as usual isn't. Companies not known for flexibility begin extending aggressive credit terms with customers while others start stretching accounts payable hoping to pay vendors much later.

A company may be more open to a business relationship with a risky customer that has a history of either late payments or deliverables. Such actions are referred to as "signaling" and can be easily uncovered by a careful reading of financial statements. All are signs that the philosophy behind a company's risk management has obviously changed.

Yet recognition of flaws in risk analysis can lead to positive rewards as a Midwest automotive aftermarket company discovered several years ago. The firm aggressively grew, but executives later admitted they had not broadly considered whether their acquisitions effectively meshed with the parent company. "We never really asked why we should enter that business," one executive painfully admitted. "We got into it because we all thought it was rather cool."

It didn't take long for the senior leadership to realize that coolness and consensus were no substitutes for considering such elements of risk as demographics, innovation and market understanding. The firm changed its approach by going beyond in-house thinking and later divested itself of unnecessary acquisitions.

### **Know When to Change**

So how do companies determine that their process of risk analysis is as thorough as possible? It's not necessary to wait for results to find out. It is critical for the process to begin with the clearest

presentation of the facts. In this case, it's all about making sure that the numbers crunched through technology or other means add up and connect to one another rather than a collage of data that supports specific viewpoints but do not connect with other data points.

Another rule: examine whether the corporate culture is impeding an effective risk assessment environment. Perhaps the biggest argument against strategizing risk inside the management team bubble is that it limits the knowledge integral to comprehensive assessment and analysis. Placing such limitations on the decision-making process can lead to underestimating the role of such essential data as supply chain management, variables as customer profitability and the other company's corporate culture. An objective external opinion may also find that data is being improperly interpreted — a finding that could protect the company from what may be a half-truth due to a flawed understanding of markets, customers and/or business environment.

The environments in which risk analysis takes place can be healthy or unhealthy. The latter is generally the case when corporate culture becomes the controlling factor in all decision making, rejecting objective analysis from outside the bubble and requiring the same questionable risk framework even in the face of new unknown factors. No one wants to make mistakes, but those may well be inevitable unless analysis is undertaken with a healthy respect for the unknown of new markets. **abf**

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**KENNETH R. YAGER II** is a principal of MorrisAnderson, a national consultancy whose service offerings include performance improvement, financial advisory, interim management, turnarounds, workouts, litigation support and insolvency services and wind-downs. He can be reached at 312-254-0880. For more information, visit [www.morrisanderson.com](http://www.morrisanderson.com).



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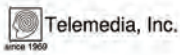

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