Total Risk Management: Mitigating Insurable & Uninsurable Risk in Your Portfolio Investments

Risk Management Overview

Effective and prudent portfolio management requires addressing, managing, and/or minimizing all risks. Historically, these three options were used in concert to maximize returns:

1. **Financial Leverage** – Trouble is …. how long will robust credit markets last?

2. **Improve Operating Performance -** Execution and operational risks impede success 90 percent of the time; indeed studies find more and more evidence that the differentiating factor between solid and superior returns is M&A success plus day-to-day operational performance.

3. **Multiple Arbitrage –** Investments are no longer guaranteed to sell at the same equity/debt valuations i.e. valuation arbitrage is less certain today.

As the definition of success has changed for today's business owners (see table below), investors must also adapt and respond to changing market conditions if they want to realize investment grade returns. While investors are confident in dealing with traditional areas of risk such as financing, market volatility, and bad debts; our research shows a lack of confidence in effectively assessing and managing emerging risks especially in areas such as transferable, human capital

Key Point

Because growth in EBITDA is today's primary method for delivering IRR performance.

With

a. more 'B' deals, and
b. more leverage, and
c. less certainty of exit valuation arbitrage, and
d. greater competition for acquisitions driving up purchase multiples…

…how does a prudent investor reconcile market conditions that are forcing acceptance of greater risk and still deliver outsized returns?

► The solution many are turning to is Total Risk Management.

and market development risks. Because financial leverage and multiple arbitrage has become less certain, there is increasing pressure on investors and portfolio mangers to improve EBITDA through non-classical approaches.

CHANGING INVESTMENT ENVIRONMENT

Business Today	Investment Landscape
• Businesses today sell in less than five years - example: Salesforce.com's recent purchase of Sendia • Companies are scrambling to control the mid-market – example: ADP bought Intuit's SMB services business • Firms with $1M EBITDA are investable - as opposed to $5M EBITDA in the early 2000s • Venture type returns (40 percent) are possible in service industries	• Robust credit markets have lowered barriers to entry and increased overall investment risk • Competition for investmetns has increased significantly bidding up purchase values and impacting overall returns negatively • Multiple arbitrage is no longer a reliable method for improving EBITDA; companies must minimize and manage operational risk • Board expectations have risen and responsibilities have morphed from financial, governance, and compliance into strategic and even day-to-day operational demands in some cases

This report was written for institutional investors to increase company and portfolio IRR performance by mitigating insurable and uninsurable risk with Total Risk Management.

WHY RISK MANAGEMENT MATTERS TO PORTFOLIO MANAGERS

Institutionalization of private equity has led to greater leverage and increased competition for good deals which has caused more 'B' investment deals, i.e. companies with more operational risk than before. Coupled with less certainty of exit valuation arbitrage and greater competition investors are forced to reduce risk to improve EBITDA returns.

Because growth in EBITDA is today's primary way to deliver improved IRR performance; how does a prudent investor reconcile market conditions that are forcing acceptance of greater risk and still deliver outsized returns?

There is great opportunity for investors, risk management advisors, and insurers to work together to develop effective risk transfer solutions for both insurable and uninsurable risk.

INSURABLE RISK

Why insurable risk matters?

- Insurance is part of capital risk therefore portfolio's must match risk tolerance with portfolio risk preferences
- A recent University of Texas study revealed that 43 percent of businesses that experience a major disaster do NOT recover (see sidebar for example)
- Insurance and benefits is the second largest expense on the Income Statement
- 30 to 40 percent of the risk in companies' portfolio is insurable
- Protect the balance sheet
- Stability – quench fear of the unknown
- Compliance and legal requirements such as motor vehicle, contract obligations, loans

Buyers are looking to transfer risks away from their balance sheet – exchanging a known cost (premium) for an unknown cost (loss) in a defined period of time. Reducing this risk can mean a quarter turn more of EBITDA.

Insurable Risk Case Study

OVERVIEW: A manufacturer's lack of business interruption protection bankrupted the manufacturer.

RISK: As product supply from China sunk in a storm the firm had a lack of inventory to supply customers for three months.

RESULT: Loss of substantial customer base forced Chapter 11 filing.

Why Manage Uninsurable Risk

Operational risk for investors is either execution or macroeconomic. 10 percent of operational risk is a not pertinent to that particular sector such as a market or macroeconomic threat. However, 90 percent of business risk is tied to execution and therefore can be mitigated. Execution risk for investors has been historically defined as:

1. Due diligence evaluation
2. Monthly or quarterly reviews:
    a. Is the business going to make its investment thesis?
    b. Can I trust management's skill and expertise sufficiently to achieve the investment thesis

What is missing from these criteria is whether the company has the right skills, resources, and people focused on the right activities at the right time to capitalize on the market opportunity?

Mitigating uninsurable risk typically includes maximizing strategic and operation effectiveness via:

- ☑ Process mapping and optimization from beginning-to-end of the customer lifecycle (i.e. Customer Lifecycle Management)
- ☑ Installing scalable and repeatable business processes
- ☑ Management science around performance measures such as DSO's, retention, density and proximity inside geographic regions
- ☑ Monthly measurement and metrics at the day-to-day operational level to ensure performance
- ☑ Strategic positioning (mitigate competitive/substitutes and position for maximum valuation)

Protecting Your Investment: Total Risk Management

Total Risk Management provides the ability to identify and manage risk without relying on good fortune or the absence of problems to achieve success. With proper risk management measures in place indicators highlight potential problem areas and risk advisors supply appropriate action resolution.

Total Risk Management is not a bolt on activity; it needs to be embedded in both the investment thesis and portfolio management process. It targets cultural and behavioral actions by focusing on processes and manages all aspects of uncertainty.

At the heart of Total Risk Management is an assessment of the underlying risks of the business ranked against their impact to affect the business returns. This ranking is then factored into all major decisions. Equally important is ongoing KPI and dashboard to ensure a strong culture of risk awareness, prudence and integrity.

Risk Management Advisor

The most important value-add from Total Risk Management is the advice on best methods for treating exposures to risk and potential financial loss. Risk transfer tactics include insurance, proactive operational focus, and/or contractually mitigating risk via suppliers and customers.

A risk management advisor will determine the soundness of the investment house that has been built: straw, wood or brick in a two step process that:

1. Defines the risk landscape and conducts a cost analysis
    - Assess, ranks and prioritizes issues
    - Describes, explains, and provides evidence
    - Provides recommendations (action required, implementation advice, timeframe)
    - Anticipated benefit / What-if scenario planning
2. Aligns the risk profile with the portfolio requirements and implementing insurance program that syncs with portfolio and portfolio company objectives. Optimal program design only occurs when insurance program matches insurable risk profile.

Working from diligence to divesture risk advisors maximize returns through effective risk transfer tactics. Throughout the process, risk advisors add value by providing services: training, advice, audit and assessments, and business consultancy.

CONCLUSION

In today's world, there is an overabundance of capital, but a lack of investable businesses. With Total Risk Management investors can more confidently invest in more deals by transforming previously "marginal B deals" into attractive investments.

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