

# Part 2: Qualitative risks in a company's operations

Part 1 of this series of presentations provided 6 themes which formed a framework for corporate credit analysis at a time of disruptive and ongoing changes in business conditions.

The starting point for any corporate analysis should be to understand and evaluate the risks facing a business, and management's awareness of, and ability to, manage those risks. In part 2 of this series of presentations, I will take you through 6 themes in analysing qualitative risks when considering a company's operational risk profile.



# Key themes in qualitative risk analysis

Theme 1:  
Macroeconomic

Theme 2:  
Political and  
Regulatory

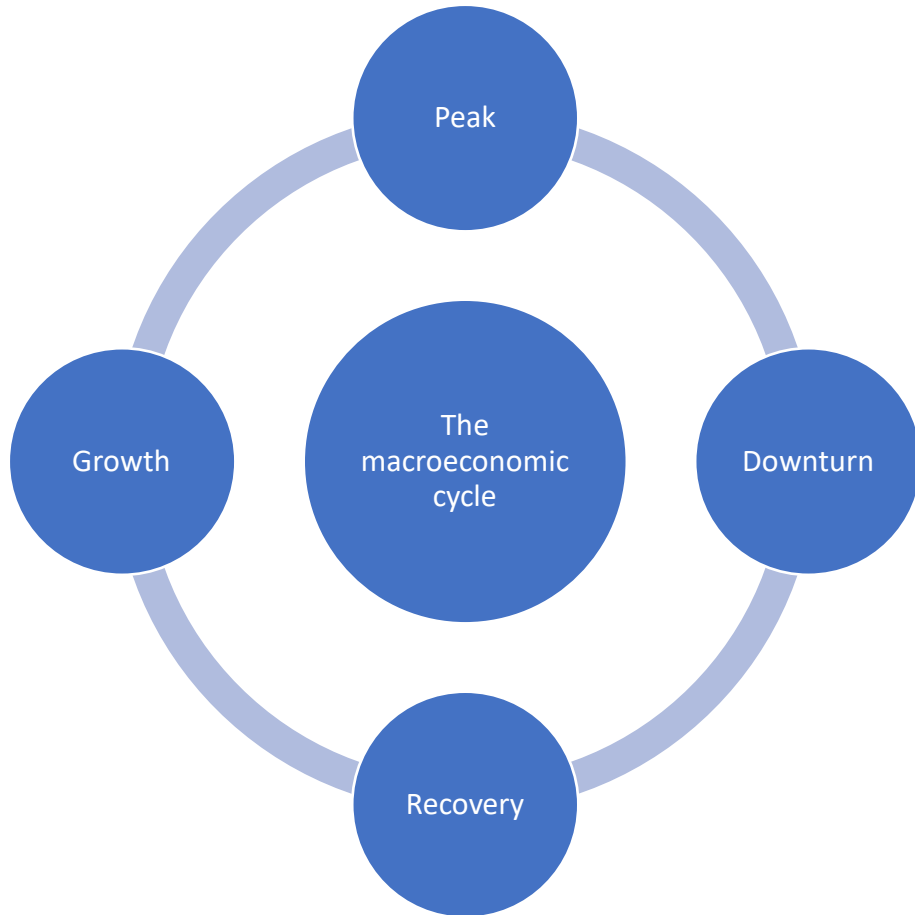
Theme 3:  
Technology

Theme 4:  
Industry  
dynamics,  
including and  
environmental  
and social  
factors

Theme 5:  
Operating risks

Theme 6:  
Business  
Strategy and  
Management

# Theme 1: Macroeconomic



In addition to usual business cycles, the impact of the Global Financial Crisis continues to have an impact on economic growth rates, particularly in some of the Developed Economies.

Recent moves towards protectionism are likely to result in a slowdown in global economic growth.

Disruptive change is likely to magnify the impact of macroeconomic cycles.

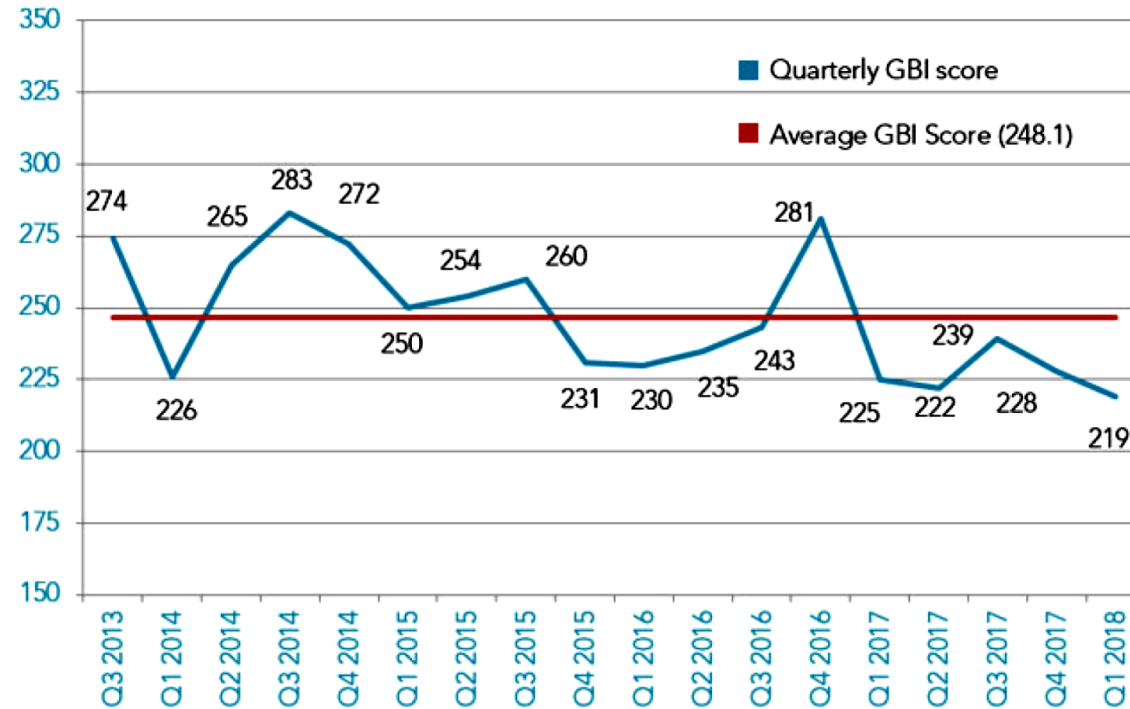
# The Macroeconomic environment is considered to be benign at the beginning of 2018

“...As the year 2018 begins, the world economy is gathering speed. The new [World Economic Outlook Update](#) revises our forecast for the world economy’s growth in both 2018 and 2019 to 3.9 percent. For both years, that is 0.2 percentage points higher than last October’s forecast, and 0.2 percentage points higher than our current estimate of last year’s global growth.

Source: <https://blogs.imf.org/2018/01/22/the-current-economic-sweet-spot-is-not-the-new-normal/>

According to Dun & Bradstreet the Global Business Index is reflecting the lowest level of business risks since the index was established

## Global Business Impact Score



## But how long will the positive global macroeconomic environment last?

“...This is good news. But political leaders and policymakers must stay mindful that the present economic momentum reflects a confluence of factors that is unlikely to last for long.....”

Source: <https://blogs.imf.org/2018/01/22/the-current-economic-sweet-spot-is-not-the-new-normal/>

# Macroeconomic risks

Every business will be impacted by the macroeconomic environment, but although the overall position may be positive or negative there will be , as always, differences between countries.

On the next slide are a variety of country flags. Which countries are they?

More generally, which countries have defaulted ,been upgraded or downgraded in the last 5 years and /or seen major changes in credit pricing. What were the principal reasons for the rating upgrades / downgrades?





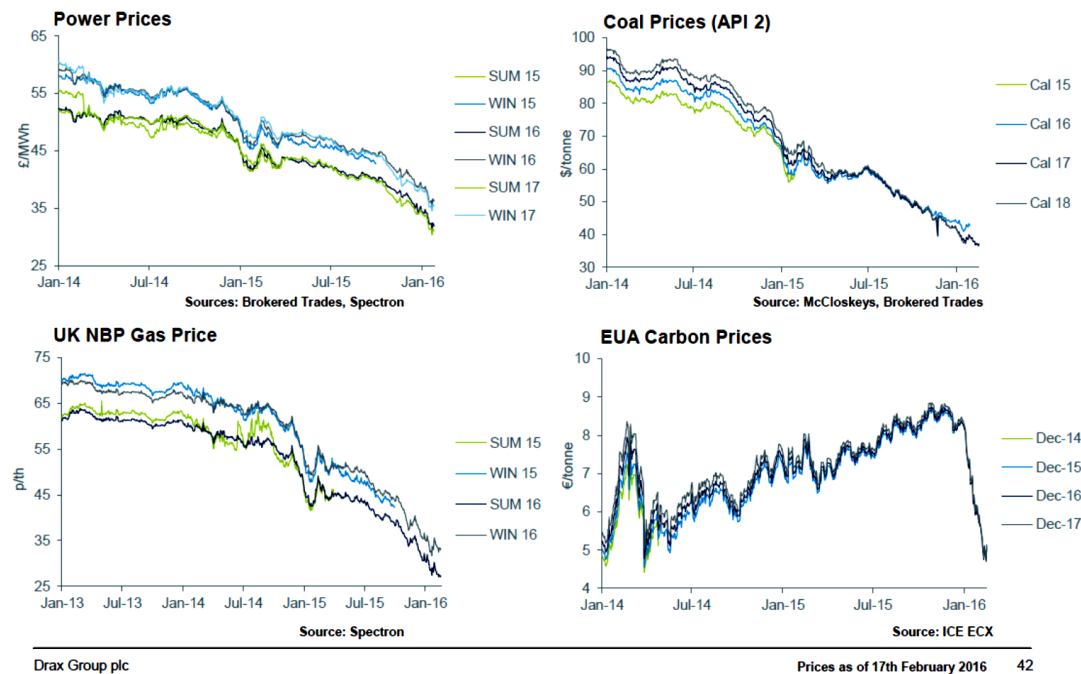
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# Macroeconomic growth will also impact commodity prices

## Appendix 15: Commodity Price Movements



Commodity prices will particularly affect countries with high dependence on commodity revenues.

Commodity prices will also have an impact on companies' financial performance. Moves towards increased use of clean energy have already had a major negative affect on power generating companies using fossil fuels as an energy source.

# Theme 2: Political and regulatory risks



- Events like Brexit are indicative of a change in the political environment
- Growing disparities in societies as a result of disruptive change and relatively slow growth in many mature economies is increasing the risk of protectionist policies ( both people and trade related), with an impact on trade and therefore sales growth potential and inflation

# Companies also face regulatory risks

Consumer protection legislation

Anti money laundering

Employment legislation with impact on employee costs (minimum wage etc)

Cyber security and data protection laws

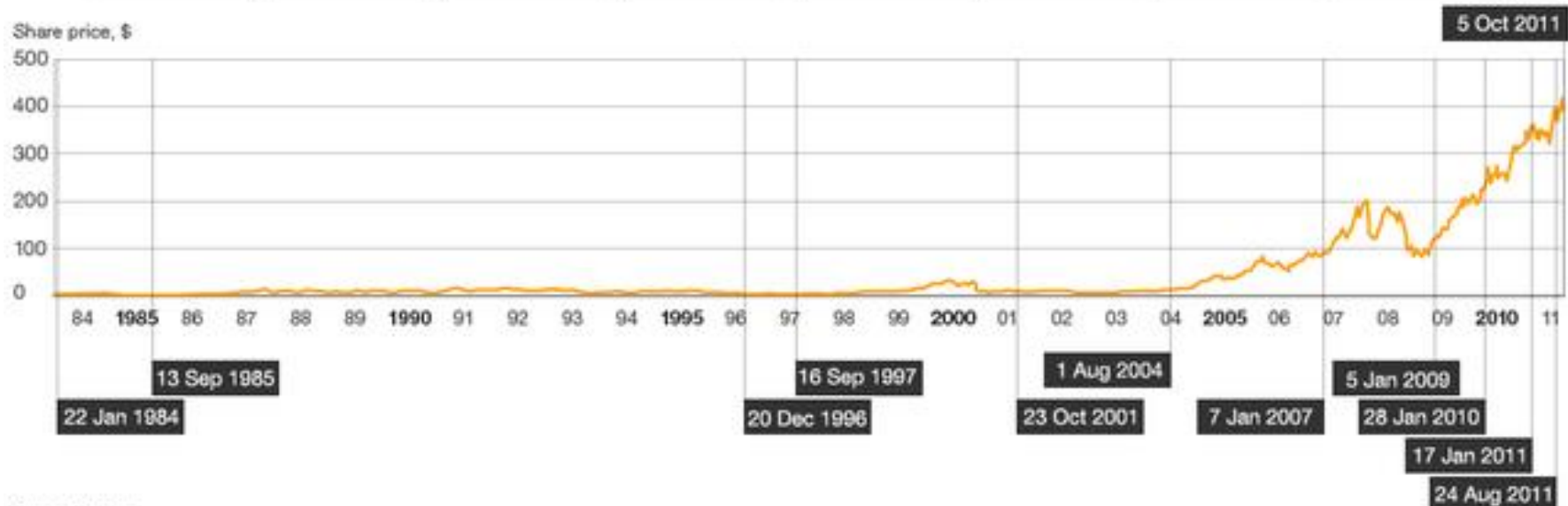
Product licensing and health and safety legislation

De – regulation of industry sectors , leading to increased competition

# Theme 3: Technology is moving quickly

As we know technology has been changing quickly....in computing and phones product cycles have become shorter.

Steve Jobs and Apple



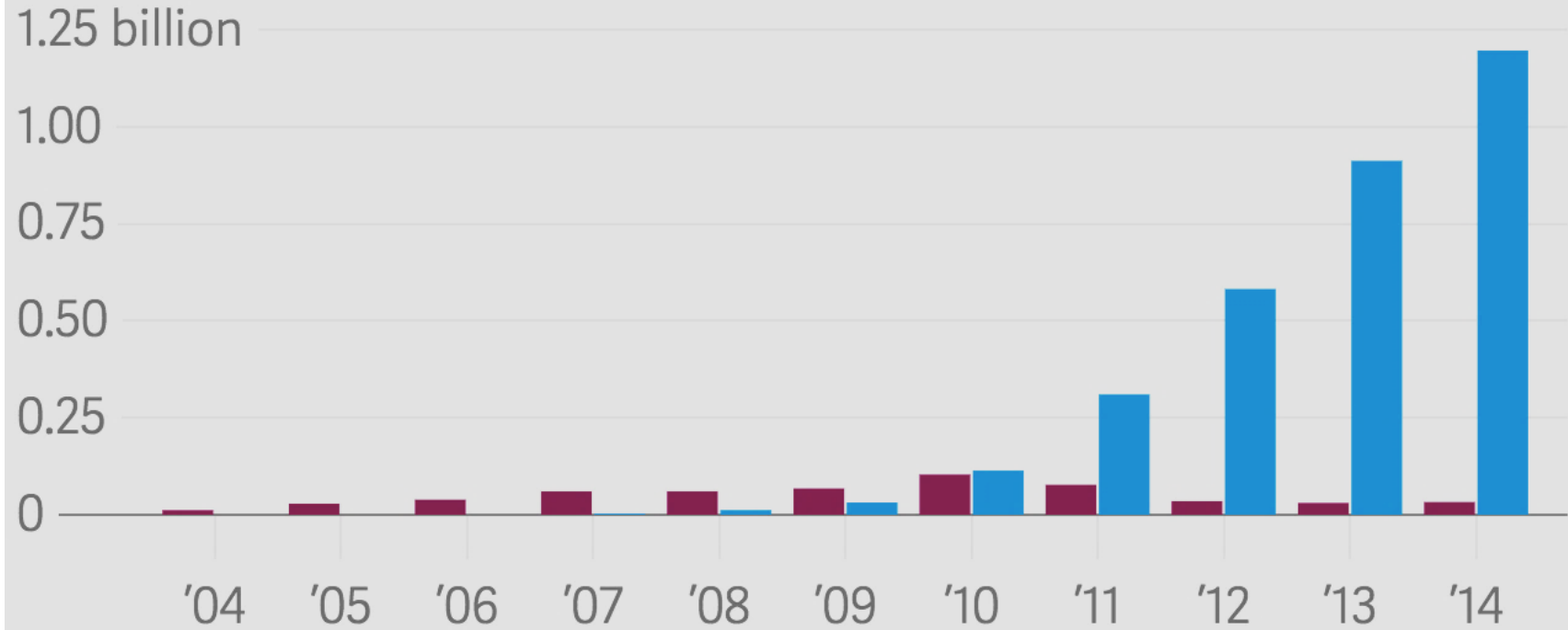
Source: Nasdaq

# And the pace of change has dramatically impacted even past market leaders , like Nokia



Annual smartphone shipments

■ Nokia ■ Apple iPhone and Google Android



Quartz | qz.com

Data: Nokia, Microsoft, Gartner, Quartz analysis



# Theme 4: Social trends

Traditional industries like power have been transformed through increased use of renewable energy sources, which reflect a combination of social trends and technological advances

“...Wind power in the UK set a new record today by generating 14 gigawatts for the first time - nearly 37 per cent of the UK's electricity....”  
Source: The Independent, 17 March 2018



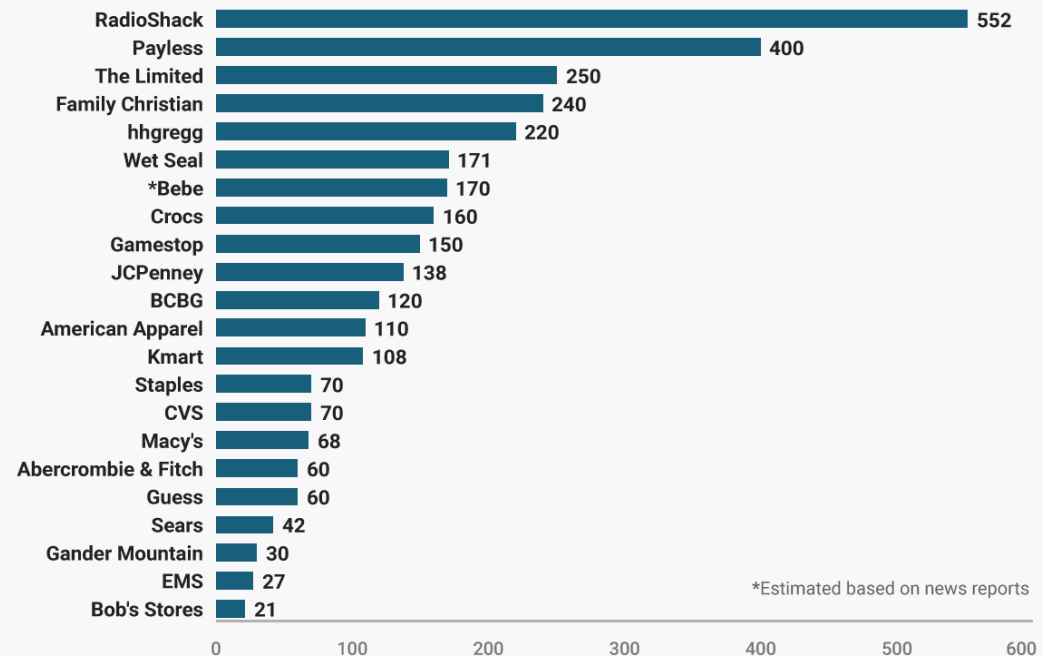
# How we shop and eat is also changing, as technology and changing business models are impacting consumer behaviour

“....In other words, shoppers' habits are fundamentally changing, and some retailers just aren't cut out to survive in the new retail environment.

Traditional retailers with large fleets of physical stores have been hit the hardest.

Visits to shopping malls have been declining for years with the rise of e-commerce and titanic shifts in how shoppers spend their money. Visits declined by 50% between 2010 and 2013, according to the real-estate research firm Cushman & Wakefield.....”

**NUMBER OF RETAIL STORES CLOSING IN EARLY 2017**



SOURCE: Company data

BUSINESS INSIDER

Source: <http://uk.businessinsider.com/retailers-are-going-bankrupt-at-a-staggering-rate-2017-4>





# Even consumer trends in food spending are changing

....And people are now devoting bigger shares of their wallets to restaurants, travel, and technology than ever before, while spending less on apparel and accessories.....”

But even restaurants are faced with difficulties

“News of Prezzo’s struggles arrive as other mid-market restaurants battle against diner disinterest.

Celebrity chef Jamie Oliver’s chain of Italian eateries [underwent a similar restructuring](#) in January as part of a CVA, while upmarket burger business Byron agreed a CVA with its own auditors the same month.

Unlike the above chains, Prezzo’s hopes its [£5m profit in 2017](#) and £11m cash in the bank will enable it to continue trading....



<http://uk.businessinsider.com/retailers-are-going-bankrupt-at-a-staggering-rate-2017-4>

<http://businessadvice.co.uk/high-streets-initiative/high-street-woes-continue-as-prezzo-closes-a-third-of-its-restaurants/>



# What's cooking?

“...Soaring business rates and rising staff costs have squeezed the profitability of Britain's top 100 restaurant groups, with a [third now loss-making businesses](#), according to new research.

Total pre-tax profits at the top 100 firms have plummeted by 64pc in the past year, from £345m to £125m....



<https://www.telegraph.co.uk/business/2018/03/26/profits-top-100-restaurant-groups-fall-64pc-year/>

# Theme 5: Corporate credit risk analysis needs to focus on the potential impact of operating and reputational risks



“BP said Thursday that it expects the pre-tax cost of its [2010 Deepwater Horizon explosion and oil spill](#) on the Gulf Coast to total \$61.6 billion....”

Source:

<https://www.usatoday.com/story/money/2016/07/14/bp-deepwater-horizon-costs/87087056/>



“..HAMBURG/BERLIN (Reuters) - Volkswagen ([VOWG p.DE](#)) is taking another \$3 billion charge to fix diesel engines in the United States, lifting the total bill for its emissions-test cheating scandal to around \$30 billion (22.43 billion pounds)...”.

Source: <https://uk.reuters.com/article/uk-volkswagen-emissions/vws-dieselgate-bill-hits-30-billion-after-another-charge-idUKKCN1C40RN>

# Environmental risks are increasingly important to consider



# Theme 6: What is management's strategy for dealing with change?





# In a disruptive business environment increased attention needs to be given to evaluating management and business strategy

Businesses are legal “persons”, not “real people” When people say “the business failed” it’s not true! Management is responsible for the failure, and they must develop and implement a strategy to maintain a business that could stay solvent and meet the objectives of key stakeholders.

Of course there will be businesses that operate in industry sectors undergoing radical changes or slowly declining or facing existential threats. Strong management should adapt to changed circumstances even if it involves exiting business areas.

# Corporate credit analysis will increasingly have to consider various aspects of management

- Corporate culture....the company's style and maintenance of a reputation as a good corporate citizen
- Attitude to and management of risk
- Willingness and ability to respond to rapid change
- Corporate Governance and compliance with regulations

# Gary Hamel: Strategic management styles

<b>Ability to change strategy</b>	Yes	Slow Moving Bureaucrats	Grey Haired Revolutionaries
	No	Cost & Efficiency Addicts	One Time Visionaries
		No	Yes
		<b>Ability to change industry structure</b>	

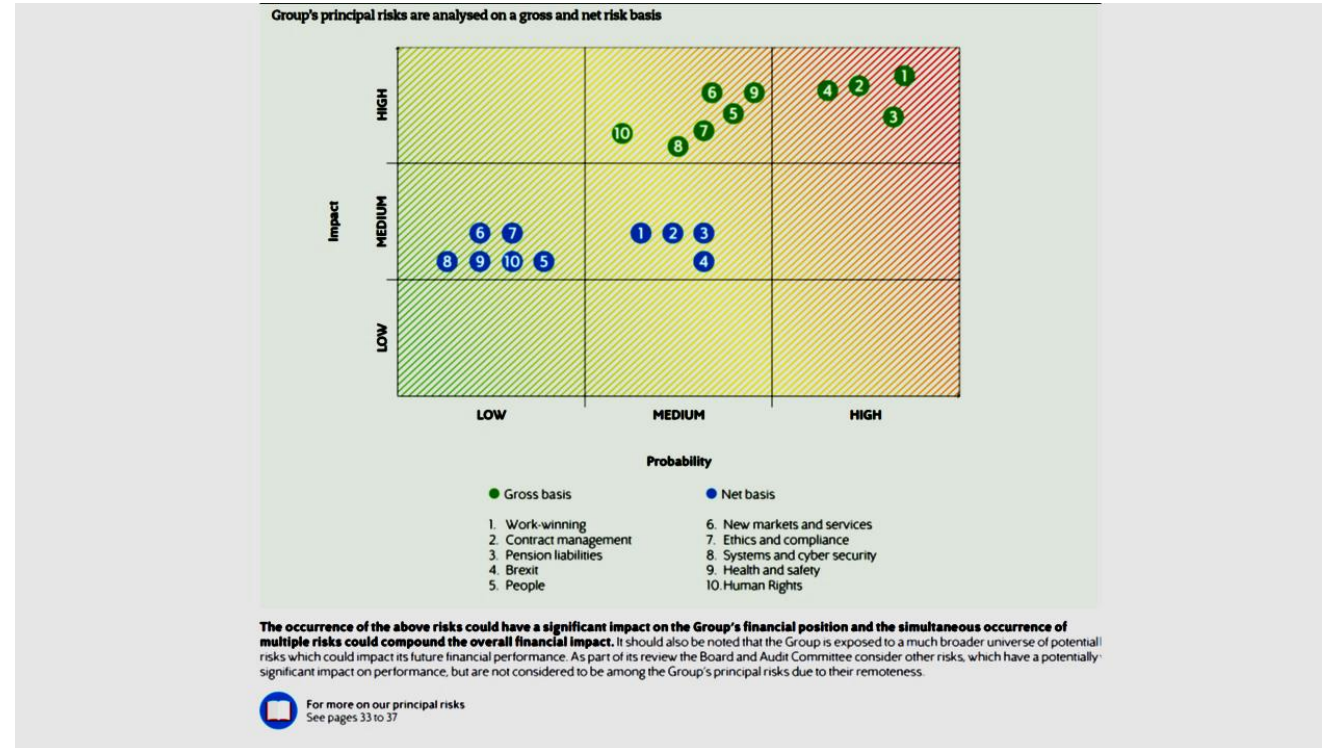
“...Organizations today face a set of challenges that are truly unprecedented, and that require, therefore, unprecedented solutions. For starters, we live in a world of accelerating change where the winds of creative destruction are blowing at gale force. Problem is, our organizations weren't built to change....

Interview with Gary Hamel

Source:

<https://resources.globoforce.com/globoforce-blog/the-end-of-management-as-we-know-it-q-a-with-dr-gary-hamel-part-1>

# The recent financial challenges of Carillion show that having a risk matrix is not the same as effectively managing those risks



Beyond the previously announced provision of £845m being booked for loss-making jobs, there was a further £200m provision to cover losses on support services contracts and a goodwill impairment charge of £134m in respect of UK and Canadian construction businesses. Cochrane said it was going to take three to five years to turn the business around.



# Non compliance, with huge reputational and financial consequences, are a result of management actions or lack of action

Mis – selling of financial products

Anti money laundering

Non compliance with employment legislation

Cyber security and data protection

Mis – selling of pharmaceutical products

# What's next?

In Part 3 of this presentation series, I will cover some of the key aspects of analysing corporate financial performance, and highlighting some of the reasons why published financial statements should be treated with caution.

In the meantime , should you have any questions or suggestions please do not hesitate to contact me at [malcolm@m-training.co.uk](mailto:malcolm@m-training.co.uk)