Risk-based strategies

The story of how one company confronted the risks and opportunities of its growth strategy.

“A traditional risk management approach would not be the right vehicle to lead a strategic and tactical response to marketplace signals of change, yet risk was central to the company’s earnings challenges.”

Context — a company under pressure

The chairman of an agricultural services company was worried about the acquisition targets and investment choices being proposed by management. Under pressure to improve bottom-line performance, management showed a bias towards acquiring high-risk targets with unknown track records.

The company had recently been bought out by venture capital shareholders with aggressive ambitions to increase its earnings. The new shareholders had concerns about the company’s financial performance and placed high expectations on management. The core business was stable but its income had stagnated. Other areas of the business had varying financial results.

Given the company’s mature market, management was under pressure to look offshore and into new sectors with its expansion plans. Management had experienced several acquisition failures before, but were currently looking at a dozen new prospects with renewed optimism. In particular, the chief executive was enthusiastic about investing into disruptive innovations. He recognized that the industry was transforming and he had a desire to leverage signals of change into opportunity, to develop a culture of leadership in innovation. After all, companies that turn a blind eye to disruptive innovation do so at their own peril, he believed.

The concerned chairman didn’t want to hinder the growth strategy but he saw a clear tension between governance and entrepreneurialism. The company’s investment committee governed investment proposals on a case-by-case basis, but had no tools to evaluate them against parameters such as risk capacity, risk appetite, or the potential impact of failure on the group’s fragile earnings.

The chairman believed that the company needed a more strategic approach to risk appetite, so he called the company’s Risk Executive for help. A conventional enterprise risk management approach for risk appetite had been in place for some time but it didn’t contribute any strategic insights.

A traditional risk management approach would not be the right vehicle to lead a strategic and tactical response to marketplace signals of change, yet risk was central to the company’s earnings challenges. The company needed a new set of tools that would help it to strike the right balance between risk and reward. It needed a more analytical approach to identifying under-performing and outmoded products, services, models, processes. Management and the board needed to better understand the risk capacity of the existing business and its capacity for risk-taking. The company needed tools to help management gauge the risk/reward profile of potential new ventures in the context of existing

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earnings dynamics, and needed a set of dashboards to communicate risk/reward profiles to the board of directors. It needed a change management process to achieve acceptance and adoption of these tools, and ultimately, it needed deeper insights to balance the debate between strategy and risk.

The Risk Executive turned to KPMG for help.

A risk-based strategy

The KPMG team designed and implemented a 5-step risk-based strategy process for the company. This delivered deeper insights into the risk-reward profile of the company's existing portfolio of services, and enabled it to take investment decisions based on improved insights into risk/reward parameters. Development of the risk-based strategy was achieved as follows.

Step 1 — Corporate Portfolio Management

The first step was to develop insights into the existing business' risk/reward dynamics. It was essential to help eliminate the subjectivity that had been allowed to shape investment decisions of the past, characterized by varying risk-taking propensities and political persuasiveness.

Risk in the company's existing portfolio of income streams was measured statistically for Profit before Tax and for operating profit margin. This revealed which services and subsidiaries had patterns of growth and stability, and which were vulnerable or bleeding money.

A strategic lens was then developed for the portfolio of subsidiaries and services. Corporate Portfolio Management matrixes were used to achieve this, such as market attractiveness vs competitive position, market growth vs relative market share, a pioneer/migrator/settler matrix, innovation portfolio vs risk matrix, and a core competencies matrix. These were overlaid with a dashboard of shortlisted opportunities, a group risk appetite heat map and the group risk dashboard.

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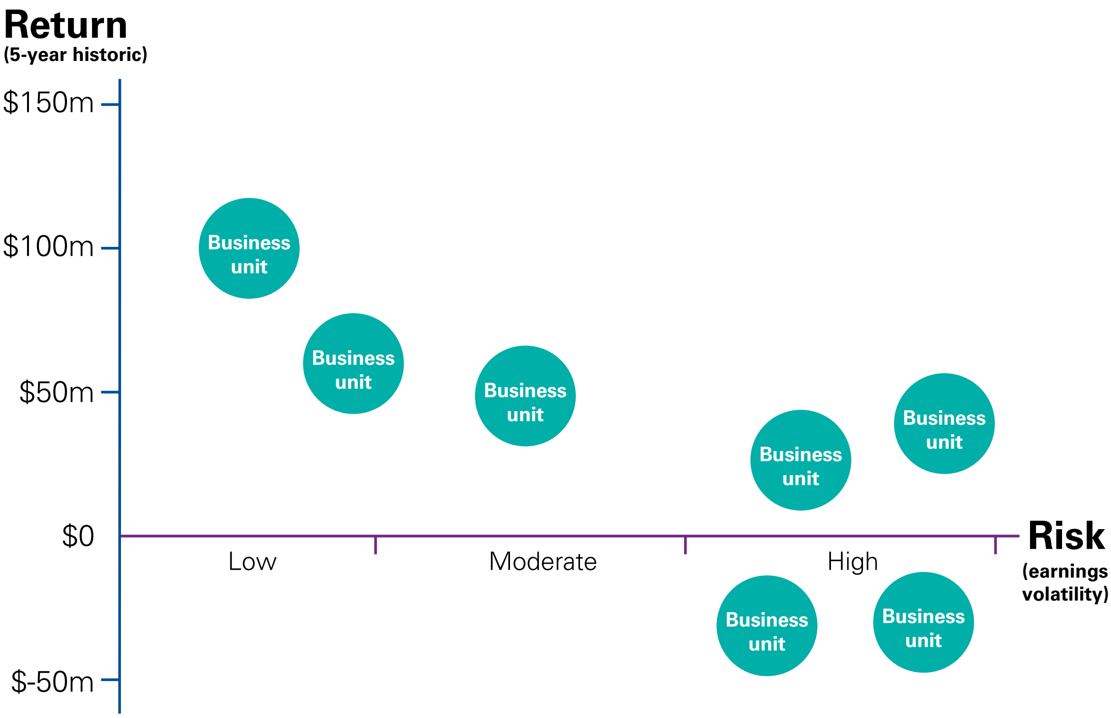
Figure 1: Risk/reward



All amounts are in US dollars
Source: GRC Today, October 2016, KPMG International

Step 2 — Signals of change

The second step was to provide management with insights into marketplace signals of change that could pose significant risks to vulnerable parts of the existing business — or that could present potential opportunities for investment.

This involved a research process that uncovered several dozen marketplace innovations and creative solutions that could be adopted and adapted by the company. Many of them were already being used by early adopters in the company's sector; others were trending in society at large. Management gained deeper

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insights into societal trends such as smart cities, design thinking and the sharing economy; and technology trends such as robotics, smart materials and the internet of things. Relevant trends to the company's customers were identified such as wearables, facial recognition, and the quantified self; and others relating to financial services such as peer-to-peer lending, crowd-funding, and mobile wallets.

The significance of relevant signals of change was measured and used as raw material for identifying potential new products, services, alliances, acquisitions and ventures. Those signals of change that posed potential risks were factored into the company's risk governance processes.

Trend analysis was performed to predict potential changes in the industry sector value chain. Strategic dialogue ensued with an examination of where the company has performance weaknesses that makes it vulnerable to disruptive innovation, which earnings are at risk; which processes are outmoded, inefficient, unpopular or time-consuming, and where are the signs of decline, earnings volatility, or competitive vulnerability?

Step 3 — Risk appetite

A critical point to address was to align appetites for risk across the executive team and also between the executive team and the board of directors. Determining the right appetite for risk

Figure 2: Signals of change

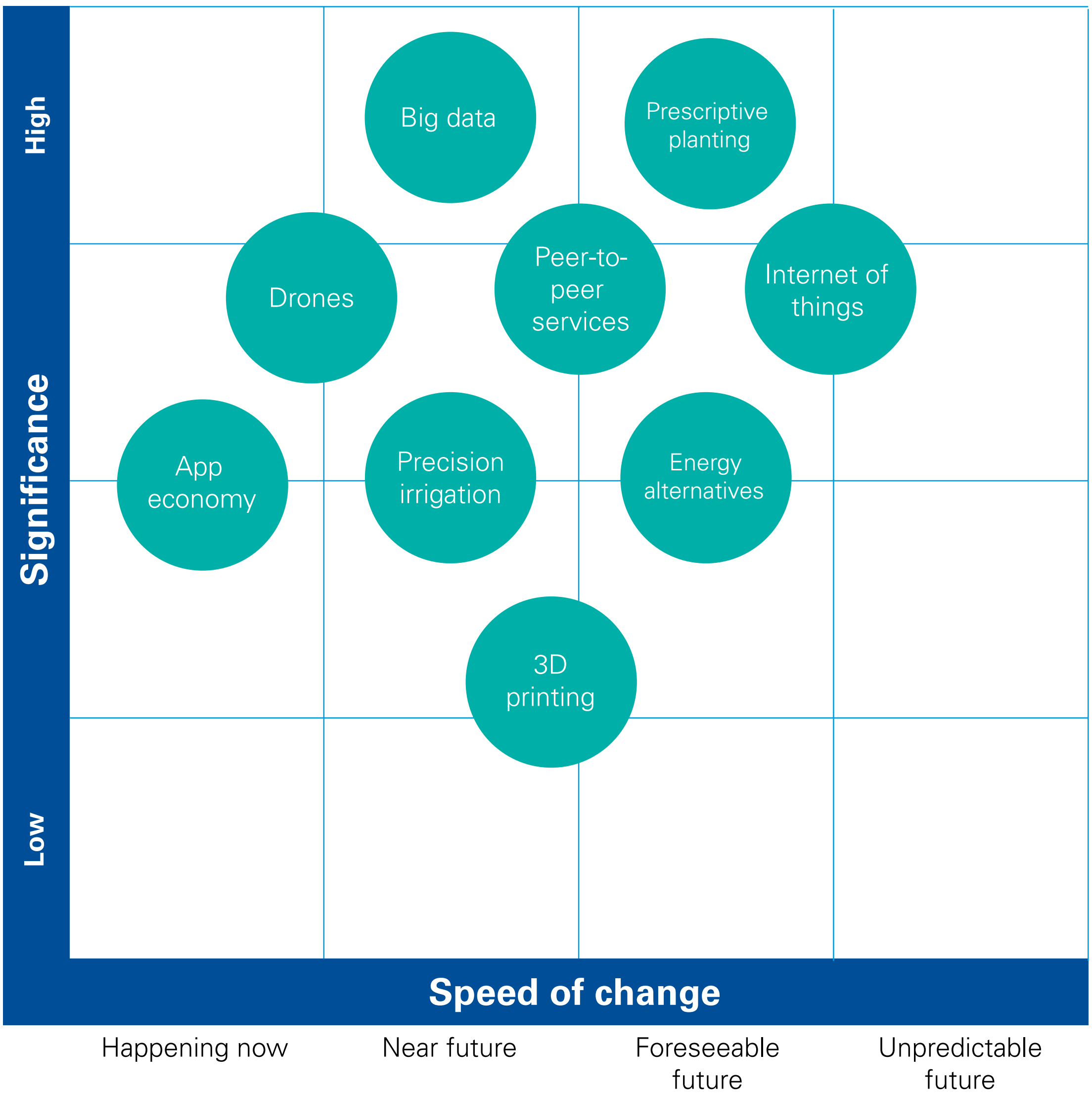

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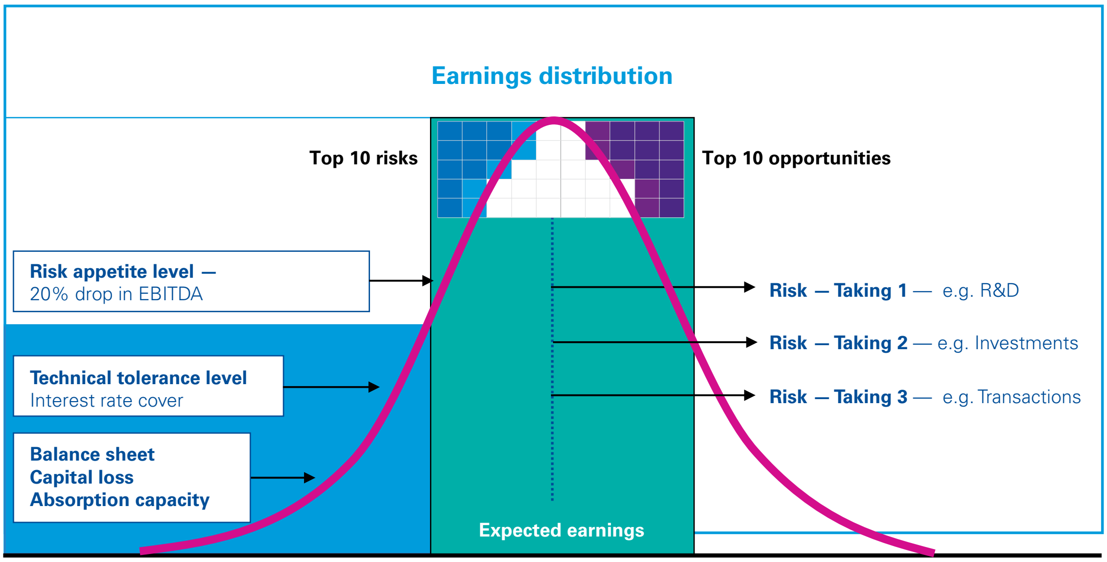
Figure 3: Risk appetite optimization



Source: GRC Today, October 2016, KPMG International

involved an analysis of available capital, resources and strategic imperatives. What is the total value at risk to capital posed by the company's current risk profile? What is the company's financial capacity for further risk-taking ventures?

Management and the board were challenged to determine how much risk the organization is willing to accept in pursuit of value and growth. The management team had historically based their forecasts on erroneous scenarios of success rather than on measured research. Management were alerted to the academic research which shows that poor performance often increases risk-taking propensity — which aggravates poor performance.

Step 4 — Create opportunities by leveraging signals of change

Management was then encouraged to complete a process of ideas-generation across the entire portfolio and business model per the results of the risk and opportunity assessments. The team was challenged to make calculated risk-taking decisions to craft its investment proposals to the board based on the insights gained from the first three steps. The resulting decisions resulted in a series of improvement projects, selective investments, a cost optimisation exercise, and the development of a digitisation strategy.

Step 5 — Ongoing monitoring

The risk-based strategies intervention highlighted that management had perception problems with regards to signals of change. Indicators of marketplace change were ignored. Management had become habituated to the dynamics of the marketplace, and often missed the relevance and significance of change and trends. Customer expectations were changing but management disregarded them in preference for misconceived quick fixes to the bottom line. Management addressed this by adopting a series of dashboards to bring visibility to the trends and disruptive changes facing the business.

The world has changed, and now the company has appropriate tools to respond.

No matter where you look, change is in the air. Some see it as innovation. Others see risk. But no matter what kind of change you're looking at, you can be sure of one thing: How you do business will never be the same again. Gaining new insights can make all the difference, by helping you make sense of all the chaos, and transform risk and change…into opportunity.

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