Risk management

Risk Reduction Methods

SLEZSKÁ UNIVERZITA
OBCHODNĚ PODNIKATELSKÁ FAKULTA V KARVINÉ

Ing. Šárka Zapletalová, Ph.D.
Katedra Podnikové ekonomiky a managementu
KRIZOVÝ MANAGEMENT

Risk Management Process

Risk Reduction Methods

- **Risk reduction** by building a backup operation - solves the risk by using 100% redundancy, ie almost in absolute value (we say almost, because the risk of failure of the backup line is not zero), but it is the most expensive option that a rational entrepreneur will not be able to afford; the exception may be such a lucrative delivery with extremely set delivery conditions that it will take this "business".
- **Transfer of risk** by securing alternative production operations of another entity - the entrepreneur will not invest in unused equipment, however, he will have to rely on the availability of equipment of the entity over which he has no control, only a contractual relationship. The question is to what extent the contract will be a sufficient motivation for the supplier to keep the available capacity in total readiness (the costs of 100% redundancy will be close to the entrepreneur 's own costs, etc.)

Risk Reduction Methods

- **Transferring the risk** by insurance against production failure can minimize the financial loss of the entrepreneur, but it will probably be costly and, above all, will not compensate for the loss of reputation (reputation).
- **The option of avoiding risk** (not concluding a trade under the given conditions) is a highly defensive method, however, an entrepreneur, however desirable for profit, should not reject it without further consideration and evaluation. There are contracts whose failure can jeopardize the existence of the whole company - the authors are aware of the case of a turnkey information system manufacturer who signed a contract with such sanctions and without the possibility of untying, that he had no choice but to let the company go bankrupt.
- **Risk retention** without further action is of course possible if the results of the risk analysis give us hope that the probability of the threat being met is very small and / or the impact is tolerable; unfortunately, in most cases, entrepreneurs choose this path without thinking about the actual level of risk, or rely on circumstances that cannot occur (miracles).

Risk Reduction Methods: Diverzification Strategies

SLEZSKÁ UNIVERZITA
OBCHODNĚ PODNIKATELSKÁ FAKULTA V KARVINÉ

- The most common way of diversifying manufacturing companies is to expand the production program - the goal is to expand production by the production of various other types of products so that the consequences of declining demand for one product (or group of products) are offset by increasing demand for another group of products.
- The purpose of this strategy is to expand (spread) business activities in such a way that the crisis as a whole cannot be affected by the company as a whole.
- However, diversification decisions must also consider the expected effect and other potential risks (eg when entering a new industry). Thus, there is a possible risk here that the failure of diversification may worsen the company's situation.

Risk Reduction Methods: Diverzification Strategies

- The aim of this diversification is to expand the current range of products or services with additional activities. As a rule, a company can approach this if the company's activities are already on the verge of market saturation and the new activity can (presupposes) generate a profit.
- It is therefore a matter of finding such activities where the failure of one will not cause a crisis of the company. The failure of one activity will be eliminated by the stability or growth of other activities.
- Diversification when entering a new industry is demanding on the input capital, on the managerial skills of the company's management. The opposite phenomenon can occur in a company. The company will abandon some existing activities and thus narrow its portfolio of activities. The company decides whether to be average in some activities and in which it can be at the forefront. To do this, it needs top resources, the best technology, top development and certainly also managers at the highest level.

Risk Reduction Methods: Diverzification Strategies

SLEZSKÁ UNIVERZITA
OBCHODNĚ PODNIKATELSKÁ FAKULTA V KARVINÉ

- Diversification occurs when an organization moves to areas that are distinctly different from its current businesses.
- Diversification strategies may be suitable for companies that cannot achieve their growth goals in today's industry, with their current products and markets.
- Diversification strategies are sometimes referred to as "wild animal strategies" for their potential management complications.
- The strategies of this group have recently become less and less popular due to their complexity, the need for a large number of experts, which makes them more expensive.

Risk Reduction Methods: Diverzification Strategies

SLEZSKÁ UNIVERZITA
OBCHODNĚ PODNIKATELSKÁ FAKULTA V KARVINÉ

Types of diversification strategies:

- Concentric strategy - there is an expansion of activities in the field of original business activities and thus fully secure its position in a slowly developing or stagnant market.
- Horizontal strategy - new products are being introduced that do not relate to the company's main activities, but are of interest to current customers.
- Related diversification strategies - related diversification is a strategic approach to value creation, as it is based on using the links between chains of activities and costs of different companies to reduce costs, transfer skills and technological knowledge and benefit from other types of strategic adaptation.
- Unrelated Diversification Strategies - Unrelated diversification is a financial approach to diversification, where shareholder value increases from the conspicuous allocation of corporate financial resources and from executive skills in identifying financially attractive business opportunities.

Risk Reduction Methods: Diverzification Strategies

SLEZSKÁ UNIVERZITA
OBCHODNĚ PODNIKATELSKÁ FAKULTA V KARVINÉ

- Diversification can be vertical or horizontal.
- With **vertical diversification** of production, where we produce a certain product, we can exchange the purchase of individual components for our own production of these components (on the input side), or on the output side we can sell finished products ourselves and not supply them to a foreign sales network.
- This method of diversification reduces the risk of the company's dependence on suppliers of production components, reduces the risk of contact with the company's insolvent customer and shortens the value chain.

Risk Reduction Methods: Diverzification Strategies

SLEZSKÁ UNIVERZITA
OBCHODNĚ PODNIKATELSKÁ FAKULTA V KARVINÉ

- With **horizontal diversification**, production is expanded to include other products of various natures, which either complement our original program or are based on the company's production knowledge.
- Specifically, we can mention, for example, manufacturers of crystal chandeliers, who will expand their production with the production of crystal glass figures.
- Horizontal diversification can be found in a number of Czech banks, which have significantly expanded their portfolio of products and services with products of subsidiary leasing companies, insurance companies, building societies, factoring companies, etc.

Risk Reduction Methods: Diverzification Strategies

SLEZSKÁ UNIVERZITA
OBCHODNĚ PODNIKATELSKÁ FAKULTA V KARVINÉ

- Related diversification introduces products that are related to the company's know-how, its technological experience and financial and marketing opportunities.
- This type of diversification has its advantages (knowledge of the field, environment, know-how, customer database, etc.) and disadvantages (diversification is too narrow, these are very related fields, where the sale of one of them also affects the related field - in other words: the eggs are in several baskets, but we still hold them in one hand ”).
- Another possibility is diversification into unrelated fields. With this diversification, the existing production and business strategy also changes
- For example, an engineering company operating in the vicinity of Brno has decided to do business in the field of tourism and car sales. Subsequently, she founded both a travel agency and a car showroom. These completely new business activities were very far from the original field of business in engineering.

Risk Reduction Methods: Diverzification Strategies

- Other diversifications also apply, such as **geographical (territorial)**, where branches of small and medium-sized companies are established in countries with lower taxes or other conditions for business support. Multinational automotive companies will opt for this diversification, among other things due to cheap labor and the low probability of the current deterioration of economic conditions in all countries where their production plants are located.
- Diversification into new markets and territories has a similar effect as product diversification. A company that operates in a smaller national market and wants to continue to prosper must expand and focus on foreign markets. Territorial diversification also means spreading risk. For example, high inflation or even a recession in one country (one market) can be offset by economic growth in another country. But this may no longer be the case in the global world. Due to the interconnectedness of markets, the economic problem of one large country carries economic problems to other countries

Risk Reduction Methods: Diverzification Strategies

SLEZSKÁ UNIVERZITA
OBCHODNĚ PODNIKATELSKÁ FAKULTA V KARVINÉ

- Often companies also use **diversification of suppliers** (supplies of strategic raw materials for the company are spread over several suppliers), we also encounter **diversification of customers** (the company has more customers, structured so that the failure of one of them, although significant, does not endanger its existence).
- A large and stable customer, who regularly buys a large number of products, is welcome for every company. For suppliers, this means cost savings and relative certainty. The customer is aware of his role and position and may push for lower prices, longer invoices, may require additional or additional services. If a company is tied to only one supplier or customer, it can be linked to its fate. A company that focuses on the strategy of one, even a large partner, should have in its crisis scenario and plan alternative solutions to the problems that may arise from such a partnership.

Risk Reduction Methods: Diverzification Strategies

- **Alliances and strategic partnerships** belong to the area of diversification strategies. They are usually mergers of companies and the aim is to provide their own significant activities to other partners in exchange for acquiring other activities that the company does not own. The aim is to achieve a synergistic effect as a result of the merger and also to spread the risk over several entities.
- Alliances and strategic partnerships then take the form of contractual arrangements for joint research, sales, production.
- Alliances and strategic partnerships can also pose some new risk.
- An important prerequisite for such a partnership is getting to know the other partner, finding a common goal and agreeing thinking and acting. Examination of partners, finding out their financial situation and resources, finding out managerial skills and much more information is a prerequisite for the decision to join the alliance and strategic partnership.

Diverzification – Synergistic Effect

SLEZSKÁ UNIVERZITA
OBCHODNĚ PODNIKATELSKÁ FAKULTA V KARVINÉ

- A synergistic effect is usually explained as an effect that is created by combining several elements and is greater than the sum of partial effects. The diversification strategy is an example for achieving a synergetic effect (eg by expanding the portfolio of activities).
- Synergies in the sales area - the company can use its established brands of goods and its sales network to produce another product and sell in this established sales network.
- Synergies in the field of human resources - the company can use the skills and knowledge and experience of its employees in another sector where it has its activities.
- Synergies of inputs - the company uses the same material for its own production and can thus achieve volume discounts, including logistics, when purchasing and thus reduce input costs.
- Management synergies

Venture and Development Capital

- Venture capital is one of the ways to raise funds to eliminate the financial crisis in the company. This form of capital is also available for companies for which obtaining bank loans and borrowings is unrealistic.
- Venture capital (private equity) is capital invested in a company by individual investors or specialized financial institutions that act as intermediaries between primary sources of funds and companies.
- Venture capital investments are investments in the share capital of start-ups or recently established companies.
- The invested funds are intended to enable the company to implement an innovative idea. Development capital investments are investments in existing companies with a lack of equity and debt for subsequent growth, fulfillment of new plans or conquest of new markets.

Venture and Development Capital

- Venture capital is the financing of private growth companies by increasing their share capital. Venture capital is a partnership between a business owner and an investor.
- The venture capital investor acquires the agreed share of the company's share capital (share capital or ordinary shares) in return for providing the necessary capital. The basic identifying feature of this source of financing is the synergistic effect that the connection with venture capital brings to the originator of the business plan.
- The essence of venture and development capital lies in medium- to long-term investment in promising projects, which brings the promise of high value. These projects can be offered by both start-ups and established companies, whose further development requires more funding. Such investments associated with high risk promise above-average annual appreciation of invested funds significantly higher than less risky alternatives such as investments in shares, bonds, derivatives, etc.

Venture and Development Capital

- Venture capital investment is not a one-time provision of finance, but a long-term process of coexistence of a business entity with a venture capital investor comprehensively helping the development of the company and regularly monitoring the current situation in the company. It is the expertise that the investor brings with them that is often more important for the company's development than the investment funds themselves.
- Venture capital can be a welcome help, especially for small and medium-sized enterprises. In our conditions, despite relatively acceptable interest rates, they still have a minimal chance of financing their development with bank loans.
- Venture capital does not have precisely defined areas of interest; most investments go to the manufacturing sector, such as the consumer industry, telecommunications, information technology, medical technology, but also to commercial services for the business sector. Venture capital can be used in a company during a financial crisis to save it, for example by the entry of a new investor who invests his capital in the company.

Venture and Development Capital

The benefits that invested risk capital can bring are, for example, the following:

- venture capital provides a capital base for the future - in order to meet the company's growth plans and development plans;
- the company does not pay any installments or interest costs for the invested capital;
- an investor who invests venture capital usually becomes a business partner who provides practical advice and expertise (as needed) and helps the company to succeed in business;
- the company's business assets will not be under any retention rights and the entrepreneur will not have to provide any personal guarantees;
- there are many different sources, types and kinds of venture capital organizations, so that diverse needs can be met.

Venture and Development Capital

The disadvantages are the following:

- Investors participate in the share capital and are rewarded depending on the success of the company, they contribute to the profit, but also to the loss and the final sale of the investment.
- Possible change of the current business culture after the entry of the investor into the company.
- Differentiation of opinions with the investor in the following areas: company management, strategy creation, human resources management, etc.

Venture and Development Capital

Types of venture and / or development capital investments:

- Seed capital - seed or pre-start financing focuses on newly established companies, groups of people or individuals with a dreamy innovative idea, for the research and implementation of which they do not have sufficient background or resources.
- Start-up capital - the product in this phase of financing is already in its final form, but companies do not have enough capital to produce and sell it
- Financing early development (early stage development capital) - especially small businesses that do not have sufficient resources to expand their production.
- Later stage development - expansion capital - when it comes to development financing, it is about helping companies to significantly grow in the order of tens of percent per year. It can be, for example, penetration into new markets or increase production by building a new factory, etc.

Venture and Development Capital

SLEZSKÁ UNIVERZITA
OBCHODNĚ PODNIKATELSKÁ FAKULTA V KARVINÉ

- Rescue capital - rescue financing is targeted at companies that are in danger of bankruptcy, but still have sufficient potential for the subsequent appreciation of investments made by venture capitalists.
- Debt replacement capital - companies enter into replacement financing if they have an extremely high share of foreign capital in the company's total liabilities. Such a situation causes a high burden of interest expenses.
- Acquisition financing - acquisition is the purchase of one company by another, for example due to increased profits, economies of scale, diversification and reduced risk, etc.
- Managerial buyouts (MBO / MBI / BIMBO, etc.). - financing of management buyouts provides a certain group of managers with sufficient resources to be able to buy all or at least a sufficient share of the company in order to take over its management.

Venture and Development Capital

Venture capital companies are divided according to the way investors raise funds for their business.

- Private venture capital companies (Business Angels) - their founders tend to be experienced former employees of banks who have such a large image that they are able to raise sufficient investment funds. Sometimes they also operate in such a way that they support the projects they have chosen with their own name and contacts, and only then do they seek funding for them.
- Subsidiaries of banks, insurance companies, etc. - Venture capital companies established by banks have significantly facilitated access to capital and parent banks will also provide them with enough interesting projects to finance. Often, however, these founders try to interfere with the operation of venture capital companies, narrow their business space and direct them according to their own criteria.