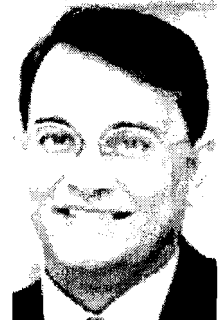


# Is Risk Management Really Profitable?

Navin Pasricha

**Risk management is often seen only as a defensive strategy by organisations. It is indeed, a very useful defensive strategy aimed at profit retention. However, it is not only defensive and there are sufficient real world examples to demonstrate that effective risk management, proactively applied improves profitability, sometimes in remarkable proportions, even when competitors are suffering serious reversals.**



Navin Pasricha, Chairman of Columbus Circle Group in Malaysia explains how to profit from risk, in this extract from his forthcoming book, "How to Profit from Risk Management in the Real World".

Many things in life and business are a given. Risk is one of those. However, even though risk will always be there in business, you do have a choice as to how you react to it.

You can be constantly fearful of business risks and take very few initiatives; or you can learn to use and manage risks to your advantage to make your business more profitable.

There is a common impression that risk management is a defensive strategy. With this view, risk is seen as a negative event,

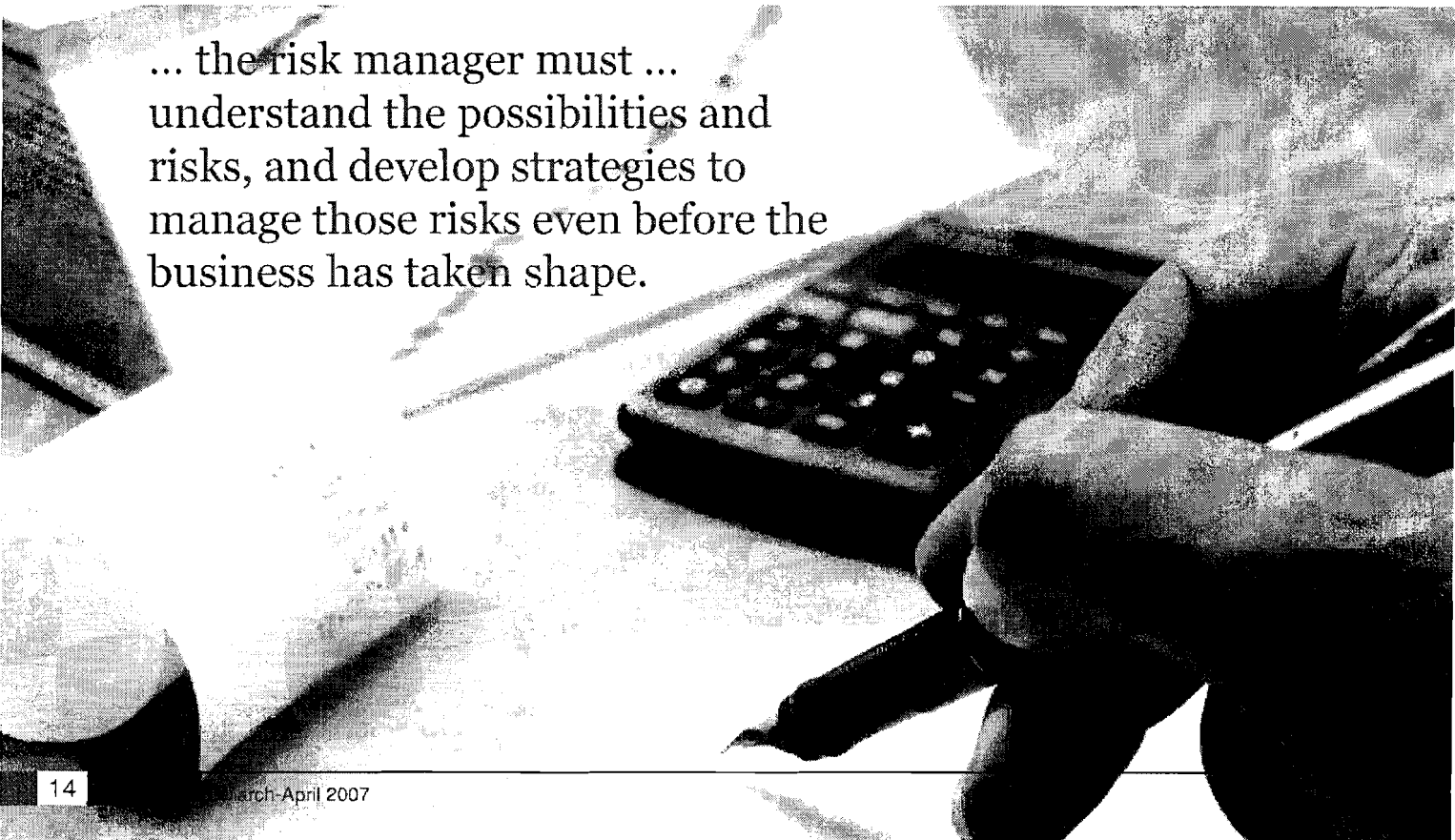
such as a fire or fraud that might happen and which has to be guarded against.

Whilst this is often true, there is plenty of evidence to support the opposite view that risk is a positive resource in business. Risks can be turned into opportunity and opportunities made more achievable by managing some of the risks that surround them.

The majority of techniques for converting risk into opportunity are proactive, that is to say they require action. This may be a little alien to many business managers

whose most common reaction to risk situations such as fluctuating commodity prices or rising inflation, is simply to do nothing.

Proactive risk management is not new. Indeed the techniques are ancient and well tested. Although it is not commonly known, the first truly ingenious risk manager was probably Leonardo Da Vinci. His engineering designs are of course well known and he is accredited with designing the first flying machine, to which the modern day helicopter has an incredible resemblance.



... the risk manager must ... understand the possibilities and risks, and develop strategies to manage those risks even before the business has taken shape.

What is a lesser known fact is that amongst the seven thousand or so pages of notes that Leonardo Da Vinci left behind for posterity, there is included the description of a parachute. He wrote, "If a man has a tent made of linen, of which the apertures have all been stopped up, and it be twelve cubits across and twelve in depth, he will be able to throw himself down from any great height without sustaining injury."

This was classical risk management methodology. He saw the business opportunity, which was the flying machine. He saw the risks, which was death or serious injury if you fell out of the flying machine and then finally he developed a method of mitigating the risk which was the parachute.

As amazing as it may sound, Da Vinci developed the parachute even before the first successful flying machine existed.

That is what the risk manager must do - understand the possibilities and risks, and develop strategies to manage those risks even before the business has taken shape.

We will return to the risk management genius of Leonardo Da Vinci many times. However, for now be assured that proactive risk management has a long and successful history. The talented risk manager can use his or her skills in a commercial way and create profit for the organisation.

An effective risk management unit in a business can contribute to profit in the same way as say, a talented marketing unit or a product development unit. There is no better proof of this than some real examples.

In 2003, the food industry was going through a particularly rough patch all around the world. Mad cow disease, avian flu and rocketing freight costs because of tensions in the Middle East, had hit the profits of many food giants. An exception to this was the South America based food company, Bunge. That company was showing growing profits, directly against the trend of its competitors. In fact, Bunge reported a fourth quarter growth of some 4% in profits for 2003 when most others were reporting steeply declining profits.

In explanation, Bunge's chief executive officer, Alberto Weisser had this to say,

## An effective risk management unit in a business can contribute to profit in the same way as say a talented marketing unit or a product development unit.

"... competitive freight pricing, locked in as part of our risk management programmes, helped offset current record freight rates."

Obviously, Bunge had foreseen the risk of increasing freight costs and therefore fixed rates in advance as a stabilising strategy. Other companies who left their freight costs to the vagaries of demand and supply alone lost out. They had decided to gamble rather than proactively manage their risks and they lost the gamble.

The practice that many companies have of investing in their suppliers is another example of a strategic risk management move to reduce supply risk.

Companies with a high degree of vertical integration are the ultimate examples of this. For instance, the Australian retail giant Coles Myer was often at the mercy of dairy producers for milk supply into their food supermarkets. Any milk shortages have an immediate impact not only on milk sales but on sales of almost all other food items, because many customers in Australia actually go into a supermarket for the purpose of buying milk and their other purchases are complementary.

Partly as a hedge against the supply risk of milk, Coles Myer purchased a dairy operation called Sandhurst Dairies and thereby greatly reduced the risk of unreliable milk supply.

Using the capital markets to hedge your business supply risk can also be effective and this is a strategy that was suggested to an Asian company which was one of my firm's clients. The company which was in the automotive industry was naturally a big user of steel. In fact, it's steel cost made up something like 80% of its product costs. Any increase of steel price would show up immediately in declining gross profit margins.

Following a review, we suggested that the company should buy shares in steel suppliers, because we could demonstrate a clear and opposite relationship between steel company share prices and our client's own gross profit margins. Although the inverse relationship was not equal, the impact on the company of future steel price increases would be significantly reduced by the increase in the market value of the shares it owned in the steel supplier.

There does not appear to be any reason why the same principle of investing in the supply chain should not be applied by all businesses that are dependent upon supplies of commodities as their raw material. Hence, it would make sense for airlines to invest in oil companies as a hedge against rising jet fuel prices.

Such investments would mean that they no longer have to pass on the cost of fuel price increases to passengers. Can you imagine the competitive advantage that such an airline would have?

On a smaller scale, the retail industry offers many examples of improved profits brought about by good risk management. For instance, a sizeable retail chain in Australia managed to dramatically reduce the number of consumer litigations that it suffered by making sure that all its advertising material was first vetted by a legal firm, as a risk management step. Once this process was introduced, the company's legal defense costs were slashed in the first year alone. The legal firm was paid on a retainer and eventually two of its staff members joined the retail company on a permanent basis. The original idea to have advertisements vetted had been put forward after a risk management audit.

So, the contention that risk management can improve your profit is easily demonstrated through examples such as these. ■