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Corporate Strategy: Is Your Business Model Sound ? Looking in the Rear View Mirror.

Written by Peter Deans, Director of Notwithoutrisk Consulting, and first published in October 2011.

Business leaders often neglect to critically question the sustainability of their business model. When a line of business, department, segment or product is going well the temptation is to rely on it more heavily for future revenue and earnings growth.

What follows is that in both the strategic planning and budgeting processes these areas are given higher targets and more resources to grow their businesses.

However, one of the many lessons from the Global Financial Crisis (GFC) – and in fact many case studies prior to the GFC – is that if it is ‘too good to be true’ it probably is. A fundamental structural flaw or weakness in the business model is often the key reason for previously successful areas either failing to be an engine of continued growth or suffering a collapse in earnings.

In the banking and financial services arena, there is a long list of ‘boom time’ products and sectors – energy trading, emerging markets bonds, subprime loan products, collateralized debt obligations, private equity, leveraged finance, and so on – that subsequently turned out to be unsustainable or unprofitable business lines. Failures were often attributed to ‘excessive risk taking’.

A more thorough analysis should be undertaken however. It is necessary to discriminate between excessive risk taking, cyclical business risk and other more serious structural flaws in the business model.

In the famous example of Enron, businesses grew rapidly and (at the time) prospered but were found to be wanting due to flawed business models and excessive risk taking.

Businesses that grew during the subprime era in the US - both retail banking and investment banking businesses - are also examples of flawed business models. It is now apparent that there was no assessment of **Business Model Risk** by many of the firms participating in the subprime ‘boom’.

Whilst both are extreme examples of business model failures, there are learnings for other businesses.

What questions should be asked in the quest to identify Business Model Risk ?

There are at least five questions that can provide some insights into the robustness of the business model.

- How sound and sustainable is the underlying growth and profitability ?
- Does the business truly own a piece of the value chain or is it essentially just a trader ?
- Does the business need to continually engage in high or excessive risk taking to sustain itself and continue to grow ?
- Is your business at risk of becoming obsolete ?
- Is the business reliant on key agreements or a government concession to exist ?

The analysis is all about challenging how an organization or individual business generated its revenue and earnings. Then being assured that the business(es) can continue to do so in the future.

How sound and sustainable is the underlying growth and profitability ?

As I remarked earlier in this article, if it is 'too good to be true' it may actually be too good to be true.

Are the underlying reasons, principles or basis for the business sound and sustainable? Has historic revenue and earnings growth been the result of sound end-user demand? Some businesses opportunistically operate in what is subsequently seen to be (in hindsight) a window of opportunity.

The challenge for business leaders and corporate strategists is to also understand the

true reasons for success and plan accordingly. Many businesses do not fully understand the underlying earnings of their enterprise.

It is therefore important to accurately account for product, segment and divisional earnings in order to identify any cross subsidization and highlight the real earnings generators of a business. This analysis can then highlight any over-reliance on a particular product, customer (or customer group) or line of business. Lack of diversification is a key cause of business failure.

The strategic planning and decision making that follows may consider continuing to ride the crest of the wave, reinvesting profits into a more diversified product range or portfolio of businesses, or taking more aggressive steps to adapt/change the business if unsustainable features have been identified.

For financiers, other debt providers and equity investors it is more difficult to assess Business Model Risk, particularly without an intimate knowledge of true product and/or segment earnings.

Does the business truly own a piece of the value chain or is it essentially just a trader ?

Critically assess if the business really does own a piece of the value chain. Does it have a specific competitive advantage that has given rise to ownership of a particular segment or customer franchise?

The business will be in a fortunate (and perhaps hard fought) position if this is the case and the challenge is to maintain and defend this territory.

Business leaders need to carefully consider if the status quo can be maintained. Is the business at risk of being squeezed out of the value chain due to competitor actions

(changes in strategy, pricing initiatives), industry structural changes, external shocks or government/regulatory changes?

Does the business need to continually engage in high or excessive risk taking to sustain itself and continue to grow ?

The root cause of many businesses that encounter financial distress is excessive financial risk taking, usually high financial leverage. Digging deeper however it is often not just financial leverage where there is excessive risk taking. Many businesses – particularly banks and financial institutions – have to put significant capital at risk in order to continue to generate current returns. An incorrect assessment of these risks can cause a business to generate losses on a regular basis.

Consider whether or not over a longer time horizon cycle the short-term returns being generated are sustainable. Financial institutions (including insurance companies) strive to accurately model losses over a longer time horizon in order to assess if the returns are acceptable.

Businesses in other industries can adopt similar approaches by looking at the underlying returns and risk profile of a business line or segment. Assessing if the returns are sustainable over a longer time horizon and adequate for the capital at risk.

It is an important analysis to undertake if there is regular volatility in the revenue and earnings streams. This may be due to such factors as pricing fluctuations, periodic and significant changes in market share or business volumes, and/or regular debtor default.

Similarly, businesses that choose to move up or down the value chain need to critically review any additional risk taking that this may

entail. Whilst this can be a sound strategy, it will often give rise to a significant change in the risk profile of the organization.

Is your business at risk of becoming obsolete ?

Business leaders are constantly on watch for product obsolescence. For single product line businesses, advances in technology and other forms of product development by competing firms can lead to the entire business becoming obsolete.

In a broader sense, businesses that rely on a series of products, processes or other form of unique customer proposition can also be at risk of business obsolescence. Rapid changes in business systems, industry structure, technologies and other economic or social factors can drive this.

A simple SWOT analysis can assist identify potential changes and future challenges. The value of this analysis however can only be gained by being completely honest about the true Strengths of the business and the Threats.

Consumer electronics, media and related entertainment industries provide many examples of business models that have been made redundant over a short period of time due to rapid changes in technology. The suburban DVD rental outlet has become redundant in many countries due to the emergence of web- based downloading and viewing businesses, for example.

Is the business reliant on key agreements or a government concession to exist ?

Businesses that are reliant on one (or a small number) of key agreements or a government concession face unique challenges. On one hand, there is usually a high degree of revenue and earnings certainty offered by the

existence of an agreement or concession. However, the future viability of the business beyond the tenure of the agreements or concession (if dated) represents a significant uncertainty and business risk.

In addition, the mere existence of an agreement or concession can also expose the business to a higher level of government or regulatory risk.

In Australia, many businesses operating in the wagering and gaming sectors have recently experienced this risk. The existence of concessions to legally operate horse racing totalizer (tote) businesses and electronic gaming machines – both of which generate significant profits - focused governments, competitors and the public on the terms and conditions of these concessions, and license extensions.

For several industry participants, subsequent government action led to the non-renewal of these concessions. There was a significant negative impact of the enterprise value as a result.

It is important to firstly identify this reliance and then develop a longer term strategic plan to mitigate the risks that arise. Plans can include diversification into other products, businesses and industries to reduce this dependency. It may also involve developing new products and technologies to enhance (and reinforce) the value of the agreement or concession to the end user/customer. In a worse case it may simply be planning for the end of the agreement or concession term, and ensuring the organization is in a sound financial position to operate whatever residual businesses there are.

The above is not an exhaustive list of issues to consider when assessing Business Model Risk. The key activities are to critically assess

the status quo and challenge the assumption that the business can continue to generate value the way it has in the past. As the title of the article suggests, business leaders, strategic planners and risk managers should regularly glance up and look in the rear-view mirror.

About

Notwithoutrisk Consulting, founded by former Chief Risk Officer Peter Deans, is an Australian based firm. It offers a range of strategy, business and risk advisory services to banks & financial institutions, corporate and government clients.

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