

**g.a.kraut company inc.**

# **Managing the Perception of Risk & Reward**

*Investor Relations is used to dealing  
with risk solely from an investor's point of  
view. The focus must now be widened to include  
all audiences that impact enterprise value. The  
approach must become holistic and top-down,  
not fragmented and bottom-up.*

G.A. Kraut believes that Investor Relations has evolved into the art of managing the perception of risk and reward.

With the high-profile failure of companies like Enron, investors have become more aware of the potential for hidden risk to suddenly and unexpectedly hobble or destroy businesses. As a result, investors now weight risk more heavily in the reward-vs-risk equation. Anything companies can do to reassure investors will boost their attractiveness and competitiveness in the capital markets. In effect, low perceived risk has become a kind of reward in and of itself.

Reassuring investors takes two forms: managing risk, and managing the perception of risk. Not only must companies introduce proper measures to identify and control risk, they must also communicate the effectiveness of those measures to investors.

Ineffective communication is itself a risk that can damage a company, by limiting its access to capital and reducing the confidence of other stakeholders – such as customers and suppliers – who assume that investors have the best information on the strength and viability of the company.

G.A. Kraut Co. works with clients to effectively communicate to investors what the company is doing to manage and control risk. We can also help companies begin the process of identifying and prioritizing the risks most important to investors. In the past, these used to be specialized financial risks. Today they are often the same risks that are most important to management and the board.

Here we offer a simple overview of the four steps of risk management, and how our skills might be useful:

- Identify risks
  - o Define
  - o Categorize
- Prioritize risks
  - o Estimate likelihood and potential impact
  - o Categorize as “high”, “medium” or “low” priority
  - o Determine aggregate level of risk for each risk category
- Manage risks
  - o Set policies that address areas of weakness
  - o Allocate risk management resources
  - o Implement tactical risk management plans
- Communicate risk management
  - o Top risk categories
  - o Top individual risks

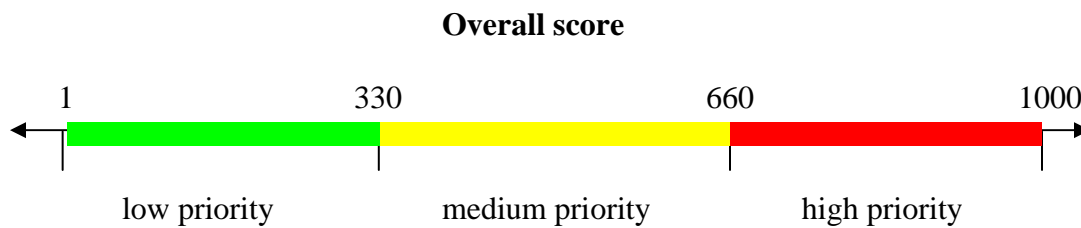
### Step 1: Identify risks

The first step in effectively managing and communicating risk is to identify where a company's greatest areas of vulnerability lie. There are ten major categories of risk faced by most companies (particular industries may also have additional special categories).

<b><u>Ten Major Categories of Risk</u></b>	
<b>Strategic</b>	The risk that your competitive strategy is wrong
<b>Market</b>	The risk from competitors, industry trends, or general economic conditions
<b>Operations</b>	The risk of making a mistake in the day-to-day running of your business
<b>Organizational</b>	The risk that corporate structure, corporate culture, or human resource policies will undermine competitiveness
<b>Financial</b>	The risk of insufficient capitalization, due to poor cash flow, lack of access to affordable credit, or inability to tap capital markets
<b>Governance</b>	The risk of committing a damaging ethical or regulatory violation
<b>Communications</b>	The risk that internal and/or external perceptions of your company do not match reality
<b>Political</b>	The risk from external political events, including legislation
<b>Litigation</b>	The risk of damaging lawsuits or judgments against the company
<b>Environmental</b>	The risk from weather, natural catastrophes and other environmental conditions such as toxic waste



Use the overall scores to prioritize risks as “high priority”, “medium priority” or “low priority”. The cutoffs for each group will depend on each individual company’s appetite for risk as well as the resources available to manage risk. Example:



Risk management and communication will focus on those risks which are “high priority”.

In addition, an analysis should be done for each category of risk (strategic risk, market risk, financial risk, etc). Sum the overall scores for each individual risk in the category to achieve a risk score for the category as a whole. Compare the scores of all the categories to identify where the company’s greatest areas of vulnerability are. This information should be used to manage risk at the strategic level as well as at the tactical, case-by-case level. Example:

<b>Strategic Risk</b>	<b>Market Risk</b>	<b>Governance Risk</b>
Risk (overall score)	Risk (overall score)	Risk (overall score)
Overemphasis on cash cows at expense of new products (800)	Competitor innovation (400)	Accounting fraud (200)
Dilution of brand through cheaper product lines (500)	Continued recession (850)	EPA violations (100)
	Shrinking demand in segments where Company is market leader (650)	Conflicts of interest on Board of Directors (350)
<b>Total:</b> <b>800 + 500 = 1,300</b>	<b>Total:</b> <b>400 + 850 + 650 = 1,900</b>	<b>Total:</b> <b>200 + 100 + 350 = 650</b>

This company is clearly least vulnerable to governance risk. The magnitude of individual strategic and market risks is about the same, but there is a greater number of important market risks than strategic risks. Therefore, the company’s area of greatest vulnerability is market risk, followed by strategic risk.

### Step 3: Manage risks

At a strategic level, risk management focuses on cultivating company-wide policies that reduce the overall level of risk, particularly in a company's areas of greatest vulnerability. This is a job for senior management and the board.

At a tactical level, risk management programs focus on three tasks:

- **Predicting undesirable events**
- **Preventing undesirable events**
- **Mitigating the effect of undesirable events after the fact**

Clearly, risk management resources will be allocated mainly to high priority risks.

But not every risk is created equal. Some can be predicted, but not prevented (example: weather). Some can be prevented but not predicted (example: accounting fraud). And some can be predicted and/or prevented, but once they occur there is no way to mitigate the damage (example: loss of life due to equipment failure).

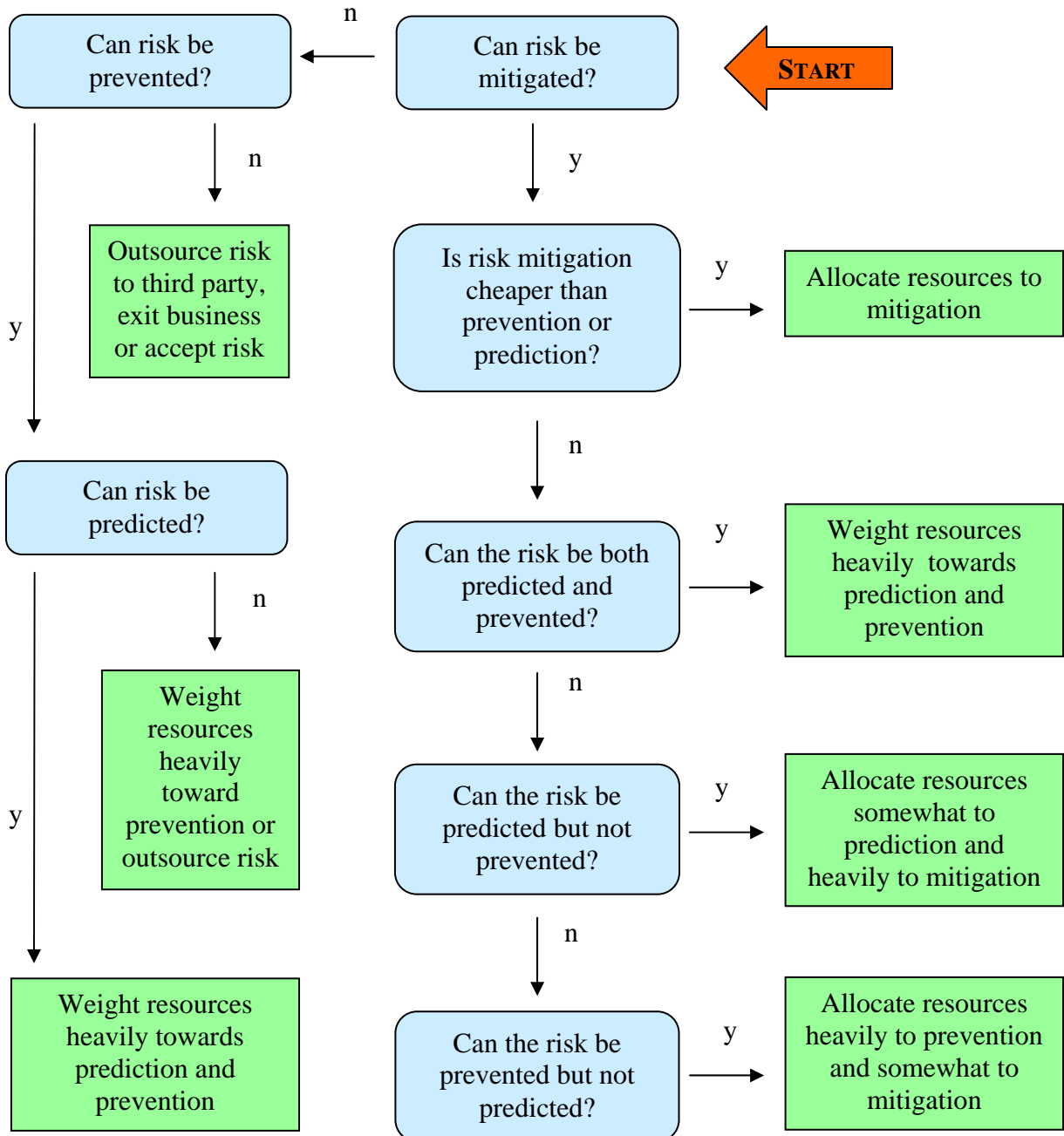
Risk management resources should be allocated according to the profile of the risk in question (see figure on next page).

For example, if this is a risk that cannot be prevented, money is better spent on predicting it, so the company has maximum advance warning, and on cleaning up the damage afterwards (mitigation). On the other hand, if a risk cannot be mitigated at all, perhaps the company should consider outsourcing the risk, for example via a hedging policy, or if this is a severe risk which cannot be outsourced, simply exiting the business which gives rise to the risk (e.g., switching oil exploration operations from the Middle East to the North Sea).

Once the appropriate risk management approach has been determined for a particular risk, specific control measures can be put in place. This is a job for the owner of the risk (often middle management) working together with the company's risk management professionals.

### Decision-making Tree for Allocating Risk Management Resources

(n = no, y = yes)



#### **Step 4: Communicate risk management**

It is not enough for a company to take effective measures to control risk, just as it is not enough to produce a good product. The markets must be aware of the product, or the risk control measures, and of the benefits these things provide.

G.A. Kraut helps clients to craft messages that communicate to investors what the company's top strategic and tactical risks are, and how the company is managing them. We help clients to craft these messages in a way that is simple and easy for investors to understand, that builds confidence in the company's ability to manage risk over time, and that illustrates how the company is building shareholder value. If desired, we can also help companies assess the impact of a particular risk on capital market competitiveness.

Examples:

- Strategic risk:
  - o Helped a media company to assess the valuation impact of a strong Internet orientation after the dot.com bubble burst. Guided communications to track the company's progress back to a bricks-and-mortar company.
- Market risk:
  - o Helped an aerospace manufacturer to credibly explain the benefit to shareholders of its diversification strategy.
- Operations risk:
  - o Helped a defense contractor to reassure investors that senior management was well qualified to transition the company from growth via acquisition to organic growth.
- Organizational risk:
  - o Helped an oilfield services company to reposition its unpopular acquisition of a large electronic technology company.
- Financial risk:
  - o Helped a wood products company to assess the valuation impact of cutting its dividend, and to communicate the long-term advantage to shareholders of doing so.
- Governance risk:
  - o Helped a gasfield services company to communicate new internal controls and the competence of the new management team following a series of accounting misstatements.

- **Communications risk:**
  - o Helped a semiconductor manufacturer to dispel misperceptions that its revenues were tied to the capital equipment cycle; clarified the company's value proposition for semiconductor investors.
  
- **Litigation risk:**
  - o Helped a European diversified manufacturer to weigh the pros and cons of a U.S. listing, given that this would raise awareness of its asbestos exposure. Helped communicate the controls in place to mitigate exposure, once the investment community became more aware of the issue.