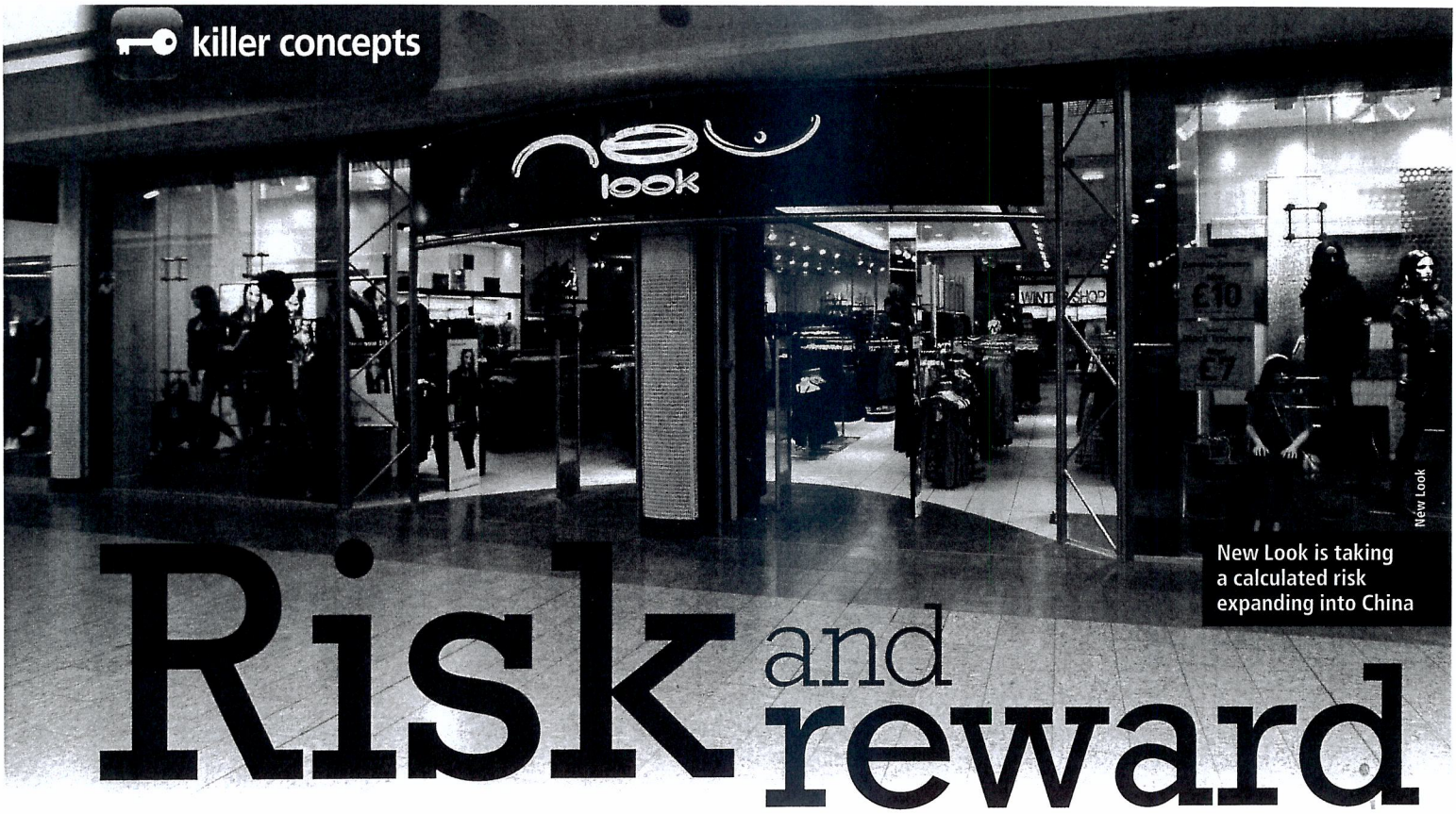


New Look is taking a calculated risk expanding into China

New Look

# Risk and reward

1.5.2

**Ian Marcousé** continues his look at the concepts that separate the As from the A*s

For most businesspeople, risk is like temperature. It is always there, but sometimes it's high and sometimes it's low. High in the case of new product launches, where the success rate for big firms has never been higher than one in five (i.e. a failure rate of 80%). Low in the case of established cost-cutting measures, such as buying a robot to replace staff on an assembly line.

So isn't a low-risk decision always preferable to a high-risk one? The answer depends on the level of estimated reward involved. Businesspeople often refer to this as the risk:reward ratio. A one in five chance of new product success might be an attractive level of risk if the rewards from success are huge.

For example, Cadbury's Creme Egg was launched in 1963 at an estimated cost of £6 million. It has generated approximately £600 million of net profit in its 50 years of life to date, so the rewards have been worth 100 times the money put at risk. Therefore the risk:reward ratio proved (in hindsight) to be 100:1 in favour of reward. Clearly it is worth taking risks with new product launches if the rewards can be this high.

## Assessing risk

Entrepreneurs love to talk about risk taking, which is undoubtedly important to business success. Some people and businesses are risk averse, meaning that they are unwilling to take decisions that involve more than a minimal level of risk.

This is understandable if there is little to gain but a lot to lose, such as with Microsoft, which over the past decade has held a monopoly position in personal computing. Risk aversion would also be a sensible strategy for an employee earning a salary high enough to cover fixed costs such as a big mortgage (especially if young children are involved) — it would verge on recklessness to give up the job and start a new business.

## Killer risks?

For most businesses, significant decisions are being taken on a regular basis. All involve a degree of **operational risk**. They may be unsuccessful, as in these examples:

- A £120,000 robot proves less flexible than staff and is therefore poor value for money.
- The £20 million budget for a new product launch yields no more than £10 million of contribution. The product is withdrawn from the market.
- £10 million spent on advertising has little effect on sales (as was the case with Yeo Valley).

Disappointing though each failure would be, there is no reason to suppose that any would represent a risk to the survival of the business itself. There is operational risk but no **corporate risk**, i.e. a flop would not put the future of the business in jeopardy.

Contrast the examples above with decisions that have killed companies:

- When Kingfisher plc floated Woolworths as a separate stock exchange company, it loaded it up with sale-and-leaseback deals that had regularly rising rents — eventually raising fixed costs to the point where the whole business became unsustainable.
- When the new management at GEC Marconi borrowed heavily to refocus the business towards telecoms, the financial black hole dragged the whole company down.

## The risk matrix

It is important to assess risk in two ways: operationally and financially. The matrix shown in Figure 1 is a useful way to analyse the risks a business is undertaking.

The risk matrix works as follows:

- Across the top is *operational risk*. In effect this is a flattened version of Ansoff's matrix, in which *low risk* would mean market penetration and *high risk* would be diversification. Market

development and product development would be in the middle of the scale.

- Down the left is *financial risk*. High financial risk occurs when a large-scale investment is made by a business with relatively limited financial resources, e.g. low liquidity and high gearing. Low financial risk would be when the investment is relatively small within a context of good liquidity and moderate gearing.

The risk matrix offers four takes on business strategy.

### Low financial/high operational

A business with low financial risks can afford to take bold operational risks. When Apple launched the iPad in 2010 few commentators expected much success. Even Apple underestimated demand and ran out of stock. The launch was a real operational risk, but because Apple's balance sheet had nearly $50 billion of cash, the corporate financial risks were minimal.

The conclusion from this is that firms that operate in risky markets should make every effort to keep clean balance sheets. This would include businesses that:

- operate in the fashion sector
- rely on something unpredictable such as the weather
- are heavily dependent on one major customer (e.g. a farm where Tesco takes 50% of the output)

### High financial/low operational

A business with a high level of financial risk (perhaps gearing is high and liquidity is low) has to be cautious about operational risk. It needs safety-first strategies such as cost cutting instead of risky strategies such as takeovers or new product launches.

At the time of writing British Airways (BA) has severe financial troubles, partly because of a badly timed merger with Spain's Iberian Airways. BA's 2011 current ratio was an unimpressive 0.90, but it worsened to 0.66 in 2012; gearing went from 44% in 2011 to 51% in 2012. It would be reckless for BA to take big operational risks until it can improve its balance sheet.

However, whether a company has a high level of financial risk or not is open to interpretation. Figure 1 shows a fascinating new initiative by the retail chain New Look. In this case the operational strategy is bold and therefore risky. The financials of New Look are not dreadful (2012 acid test = 0.76) but neither are they robust; in this case the business is taking a calculated risk.

### Low financial/low operational

If a business with a low financial risk profile takes low operational risks, this might be because of a short-term lack of viable high-risk options, or because of a lack of entrepreneurial flair among those at the top. The former would be forgivable but the latter would not.

### High financial/high operational

A business with a risky financial profile may take big operational risks. These risks could be described as **existential**, i.e. failure with one strategy may bring down the whole business.

This could be viewed as immoral, as business failure is likely to mean a host of job losses, including staff who have been loyal employees for years and are completely blameless for the company's demise. But why would any boss take a risk with a company's survival? Few would, but in the world of private equity there is a theory that companies are simply parts of an overall

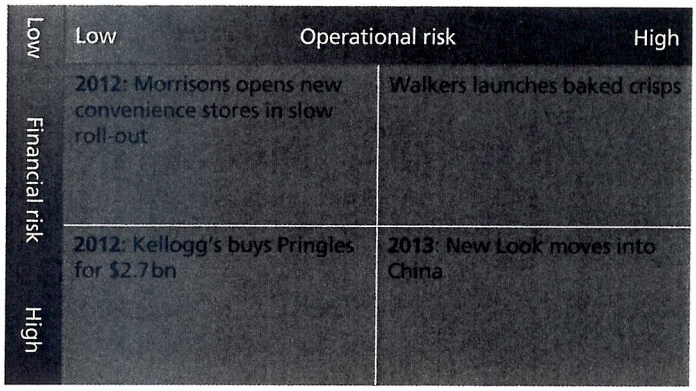


**Figure 1** The risk matrix

portfolio. All the parts should be encouraged to take risks and those that succeed can make up for those that fail. This may be true for the owner of the portfolio but it is of no help to the workers who are made redundant.

## Relating risk to reward

If a strategy has a significant chance of bankrupting a business, it is hard to see any reward being high enough to be worthwhile. But usually life isn't like that. Walkers is a big, profitable business and is owned by the massive PepsiCo, so if Walkers takes a chance on a new product launch there is effectively zero risk of corporate failure. It makes sense to proceed as long as the rewards for success outweigh the cost and frequency of failure.

Often, even though the costs of an action may be predictable, the benefits are not. Take the example of New Look's decision to invest heavily in China. It will be investing up to £20 million in opening 5–10 stores in major Chinese cities in 2014. There is a significant risk that £20 million will be wasted, but the upward potential (i.e. the maximum possible reward) could be huge. Perhaps there will be 200 highly profitable New Look shops in China by 2024. That could represent a reward level as high as £100 million a year, so the huge upside justifies the risk of wasting £20 million.

Other investments have no comparable upside. If Topshop opened a second outlet in Coventry, the risk of failure would be low but the reward level would also be quite low. If the finances of the business were a little shaky, such a low-risk investment would make perfect sense. However, if Topshop's finances were healthy there would be a strong case for it to invest in China.

## Conclusion

Most business students fail to analyse risk effectively, despite recognising that it is an important issue. Ansoff's matrix is a great starting point, but by ignoring the financial condition of the business it omits a key criterion. The risk matrix shown in Figure 1 is not only a good theoretical measure of risk, it is a form of analysis that is powerfully effective in the real world. In the UK, businesses such as Lloyds Bank, RBS, HMV and British Airways have risked everything in pursuit of risky strategies when their finances were weak. It is time that risk was better understood.

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