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# How PE Firms Can Mitigate Risk

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In a recent Axial study on **Evaluating Risk and Return in Private Equity (http://www.axial.net/forum/evaluating-risk-and-return-in-private-equity/)**, the majority of private equity respondents (76%) said they do not regularly measure risk. In order to deal with risk there needs to be a clear definition of a few factors:

- what risk is,
- how is it identified,
- how it is measured, and
- how it can be mitigated.

For a company, financial risk refers to those factors that could affect its ability to make a profit. Risk comes in many forms; it can be internal or external as well as strategic, financial, operational, compliance, etc. Most categories of risk have a financial impact in terms of extra costs or lost revenue. Examples include losing a major customer, a sudden increase in short-term interest rates, or a large customer's delay in payment or the inability to pay.

For a private equity firm, overall risk — the possibility that investors will lose their money or not get the expected return — is directly linked to the level of risk in its portfolio companies. As an investor, your ability to define the financial risk of a new deal is just as important as evaluating the company's operations, sales, marketing, customers, etc.

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## Identifying Financial Risk

Financial risk is often referred to as a company's creditworthiness

or ability to absorb and pay on debt. Too much or too little inventory, falling profit margins, inadequate cash flow, or an ill-informed business model are all examples of indicators of financial risk.

Whether evaluating a new deal or providing oversight on a portfolio company, risk should be defined in a manner that can be measured.

Key financial ratios and KPIs play a part in defining areas of risk that can be broadly measured across a portfolio in areas of liquidity, profitability, asset efficiency, and growth sustainability. Financial ratios such as current ratio, quick ratio, collection period, and deferred payment period are used for measuring a company's liquidity. Likewise, key performance indicators (KPIs) like sales growth, cost of goods sold (COGS), gross and net profit margins can also help define areas of risk.

Tracking KPIs and data from your own organization is helpful, but an even more accurate way to identify risk is to benchmark these metrics against similar high-performing companies in your industries. For privately held companies, benchmarking tools can help ensure that you're using true apples-to-apples risk analysis.

## Measuring and Mitigating Risk

Comparative analysis between a company's financials against industry standards can help identify the company's areas and degree of risk. The table below is a sample comparison of a manufacturing company's financial ratios and KPIs with industry standards.

| **Financial Ratios / KPIs** | **Company** | **Standard** | **Difference** |
|---|---|---|---|
| Current ratio | 2.75 | 3.5 | – 0.75 |
| Quick ratio | 1.05 | 1.5 | – 0.45 |
| Inventory age – days | 132 | 10 | +122 |
| Collection period – days | 51 | 11 | +40 |
| Payment deferral period – days | 26 | 72 | -46 |

In the example above, benchmarking shows this company is at considerable risk in liquidity and is operating in the bottom 25% of the industry. The amount of inventory along with the extended collection period days and payment deferral is correlated to the current and quick ratios and overall liquidity position of the company.

In looking at a new deal, a PE firm can ask itself: Is this level of risk acceptable? Can it be easily fixed within a given period? Or does this point to other underlying issues within a company?

## The Impact of Risk Mitigation

In providing oversight to a portfolio company, this information helps the PE firm identify risk areas for management to address, and determine if additional PE oversight is needed.

Once risk is identified and measured, the PE firm can create a strategy and action plan to mitigate it. Hands-on PE firms might work closely with management to evaluate the best approaches for mitigating risk, while firms with more hands-off models might relay the information with management to address. Ongoing benchmarking can be used to report on changes to the financial ratios and KPIs.

In the example above, reaching an ideal operating level of 15 days' inventory may take a considerable amount of time. Using what-if analysis, management might decide the best approach is to initially aim to reduce the inventory age from 132 to 68 days, reducing its risk exposure by 49%. A strategy and action plan can be put in place with monthly reporting to monitor progress. Once met, the

company can take additional steps in closing the inventory gap to reach optimal peak performance to match the risk standard of 15 days they established. Managing financial risk is by nature a continuous process.

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