Camms.Risk

Whitepaper

The value of effective risk management for IPOs and PE-backed businesses

Camms.

Introduction

What are the prerequisites for protecting and then enhancing a business's value when working to attract external investment: Strong outlook for revenue growth? Market-share expansion? A management team that can deliver profitability? The answer is all the above. However, these common goals often overshadow another vital factor that can make a significant contribution: demonstrably effective risk management.

Private equity (PE) backed businesses and those preparing for an Initial Public Offering (IPO) have several things in common: they are seeking investment that will support their continued growth; they exist within buoyant spaces; and, more concerningly, they often overlook the role a comprehensive risk management program can play in protecting and increasing their value. All too often, these businesses suffer from tunnel vision when preparing their offerings, causing them to lose sight of this vital activity – a dereliction of duty that could directly impact Earnings Per Share.

This typically leads to a 'tick-box' approach to risk: instead of establishing a proactive risk management program, they attempt to address the issue by demonstrating that they are managing risk through the periodic review of a list of their top risks – a reactive mindset that lacks the foresight to prevent issues from occurring in the first place and doesn't contribute to making informed and intelligent business decisions based on an appreciation of what might happen.

The current investment landscape

The ongoing impact of Covid-19 has forced these businesses to rethink how they can protect and, where possible, enhance value – perpetual goals that have been magnified by the pandemic after business conditions were reshaped and risk exposure increased. So, how are both spaces shaping up in the face of pandemic-fueled uncertainty?

Private equity-backed businesses

The number of announced PE exits dropped almost 70 per cent globally in May 2020 compared to May 2019, as the economic impact of lockdown restrictions dealt a blow to businesses. However, the tide appears to be turning. Growing hopes of a faster-than-expected economic recovery – inspired by rapid vaccine rollouts – has raised expectations that PE exit activity will surge again in 2021.

Pete Witte, Global Private Equity lead analyst at EY, echoed this optimism: "If economic conditions continue to improve in the wake of successful vaccine deployment, we'd expect that the pipeline of assets coming to markets would increase substantially" adding "I think what we're seeing now that many of the most immediate concerns around the portfolio – such as supply chains and liquidity – have been addressed, is that firms are taking a renewed look at their exit-ready companies and making fresh plans."

Initial Public Offerings

Despite choppy IPO market conditions in 2020, activity gathered pace after the first lockdown. In total there were 1,415 IPOs globally in 2020, raising a total of $331.3 billion. This represents a significant increase from 2019, both in terms of the number of transactions and proceeds, when 1,040 IPOs raised $199.2 billion..

For example, London's IPO market demonstrated strong resilience in 2020 against a backdrop of lockdown restrictions and Brexit-related uncertainties: £5.5 billion (€6.1 billion) was raised in the eleven months through 9th December 2020. Despite pandemic and political headwinds, European IPO proceeds reached almost €20 billion in 2020.

Buoyant sectors

Investors are attracted to businesses that will perform well in a post-Covid-19 world, with those specializing in technology and life sciences attracting particular interest at the moment. If we scratch the surface of both these sectors, we can see that define and biotech companies stand out as attractive investment opportunities. For example, global fintech investment reached $44 billion in 2020 – a 14% surge compared to 2019 – with the US ($22 billion) first in the global fintech investment ranking, followed by the UK ($4.1 billion). Meanwhile, a staggering 71 biotech companies collectively raised more than $16 billion through IPOs in 2020 – a new record for the sector..

Both sectors might be booming, but with success comes risk that investors may not be familiar with – and potential investors need to know how that risk is being addressed. For example, fintech businesses have a unique combination of exposures that are not contemplated by traditional financial institutions, increasing the threat of serious cyberattacks and creating regulatory challenges. While all financial services companies can be hacked, fintech businesses are perhaps more likely to be attractive targets for criminal hackers because they tend to move high volumes and values of funds and are major users of cryptocurrency. Meanwhile, intellectual property is a biotech company's most valuable resource, and its protection is key to that company's future success.

Think big, think risk

Companies working towards an IPO, or PE- backed businesses planning a successful exit must first get their house in order. Including laying the groundwork to be SOX complaint. Since 2002, public companies have been bound by regulations of the Sarbabes-Oxley Act which establishes compliance regulations around corporate public records. Organizations must report annually on their internal controls for financing reporting. This provides assurance on the adequacy of controls, protects stakeholders and prevent fraud and financial misstatements. SOX carries some of the heaviest fines for any instance of non-compliance and can cost organizations up to $5,000,000 per violation.

Reputational damage resulting from non-compliance inevitably detracts from representing an attractive opportunity. Organizations should prepare not only for the event itself but strive to meet shareholder/investor expectations around transparency, accountability, and performance. This comprehensive approach – which should be underpinned by a readiness assessment – will enable them to provide an evidence-backed view of why they represent a sound investment.

For many CFOs, directing an IPO or a PE exit will be one of the most challenging tasks they undertake. To set the stage for success, they should oversee a comprehensive readiness assessment that identifies big picture issues early – including people, processes, and technology – and establishes realistic timetables. Focusing narrowly on revenue, market share, and management issues will deprive the business of the holistic view required to achieve its goal: become a public company or achieve its next phase of expansion by attracting a new buyer. Businesses that are fully prepared will be best placed to protect and create value – and fully leverage windows of opportunity when they open.

A vital cog in the readiness assessment is one that is often overlooked: risk management that enables effective decision-making. Organizations must recognize that fortifying their systems and processes will amplify their chances of success in the context of an IPO or PE exit. Potential shareholders/investors want reassurance that the business is being run properly, so they will examine it with a fine-tooth comb – you wouldn't buy a house without having a survey conducted.

Norman Marks, recognized globally for his risk management thought leadership, tells us that:

"Effective risk management is about the ability to understand all the things that might happen so you can make informed and intelligent business decisions. It is about seeing the big picture, weighing the potential downside against the potential upside and making a considered judgment. Effective risk management helps leaders know when to take a risk because of the potential for reward, and when to delay a product launch because the risk outweighs the potential for increased revenue."

Norman Marks CPA, CRMA,

Author, Speaker, Thought Leader

OCEG Fellow, Honorary Fellow of the Institute of Risk Management

To achieve this, company leaders should evaluate their ability to identify, understand, and address all forms of risk: strategic, cyber, credit, safety, quality, reputation, compliance, intellectual property, and other operational risks. As Marks says, "if you want to see the big picture and make informed and intelligent decisions, you need to understand and assess the upside, not only the downside." This must involve the assessment of existing systems, including money laundering controls, whistleblowing, code of conduct, internal audit, compliance, monitoring of the external environment, and information technology; failure to do so could be costly.

Impact of poor risk management

The consequences of poor risk management can restrict an IPO or PE exit due to their potential to devalue a business in the eyes of investors – who want to limit their own investment risk. (However being able to demonstrate effective risk management that enables informed and intelligent business decisions will make a company stand out to investors.)

A failure to anticipate events and situations with harmful consequences might lead to:

Project delays: unforeseen risks can significantly delay a project because it takes time to understand them, analyse them and prepare management plans to monitor, act on and track them. Delays can also occur when risk management activities take longer than anticipated.

Project failure: by failing to adequately manage risk, some projects may never be completed or deliver anything of value – meaning time, effort and cost are wasted and the objectives are not met.

Budget overspend: while effective risk management is not cheap; the cost of addressing poor risk management is typically far greater. Budget overspend occurs when risks and the associated actions related to managing them effectively are not budgeted for or when a risk is not identified at all.

Reputational damage: according to a study by Deloitte and Forbes Insights, the C-suite and board directors consider brand reputation as the highest strategic risk area for a company. Reputational damage can be caused by a variety of issues – from compromised customer data to taxation practices – that cause a negative shift in perception of the company's behavior, performance, or communications.

Legal action: failing to mitigate risk effectively increases the odds of a business becoming subject to legal action. For example, data breaches enabled by weak cybersecurity, cover-ups or avoidable mistakes have resulted in sizable fines for some businesses.

Insurance costs: businesses with a poor safety record due to weak risk governance and controls will experience a surge in insurance premiums. This might be caused by a data breach, property/asset damage or accidents involving employees.

At the same time, the failure to anticipate and be prepared to respond to opportunities can also lead to a failure to optimize enterprise value. For example:

Lost opportunities: if an organization does not recognize when it is able to take advantage of a competitor misstep, a gap in the market, or the possibility to deploy new technology for advantage, can not only lead to a failure to grow revenue and profits, but also allow another to step in.

Overly risk averse: if an organization is not able to see when a risk is worth taking because of the potential for reward, an opportunity can be lost. For example, if an organization delays a product launch because of a cyber risk, it may allow a competitor to leap ahead and gain lasting advantage.

Add value by mitigating risk

The most common method of valuing a business is the 'income approach', which bases the value on its ability to generate desired economic benefits for potential investors. A well-defined risk management framework can protect and create value for a business in this context by helping them excel. Risk management guru Norman Marks identifies how it can achieve this:

- Risk management enables better decisions – from setting corporate strategy, to driving major projects, to operational decision-making. With reliable, timely, and current information on risk – both the negative and positive potential – people can make better quality decisions.
- Informed decision-making enables more risk-intelligent management, which can lead to optimized and sustained performance.
- By anticipating potential events, the organization becomes more agile. It can respond quickly, whether to minimize the impact of adverse events or to seize opportunities for gain.

When investors can see this demonstrated, they will see that the business is not only well-managed but is more likely than others to be a low-risk and high return investment.

The three dimensions of effective risk management

It is one thing knowing that a comprehensive risk management program will help your business excel, but how do you plan and establish one if your readiness assessment shows you are falling short in this area? Understanding this will reaffirm its potential to enhance the value of your business.

Effective risk management involves identifying risks and opportunities that can have a significant effect on a business's objectives, assessing them for likelihood and impact, developing a response strategy and monitoring progress. The C-suite has a critical role to play in developing robust risk-management capabilities that can facilitate this process. This project is typically three-dimensional, during which you should rigorously examine your risk management controls and compliance infrastructure through the lens of today's markets, regulators and investors.

1

Developing an effective risk operating model

The risk operating model should consist of two layers: an ERM framework and individual frameworks for each type of risk. The ERM framework identifies risks and opportunities across the business, defines risk appetite and other guidance, and implements the appropriate controls to ensure decision-makers are taking the desired level of risk. This overarching framework puts in place a system of timely reporting and corresponding actions on risk and opportunity to the board and senior management. The risk-specific frameworks address all risks that are being addressed, which can be broadly categorized as strategic (risks and opportunities that affect or are created by the business strategy and strategic objectives) and operational (risks and opportunities that affect a business's ability to execute its strategic plan).

Robust risk governance, organization, and culture

2

The most effective way to manage the risk operating model is through an effective governance structure and organization with clear accountabilities. The governance model will foster a risk culture that reinforces better risk and compliance management across three vital layers: business and operations, compliance and risk functions, and audit. An enhanced risk culture covers mindsets and behavior across the business. It promotes a considered approach to risk, neither overly risk-averse nor risk-taking.

3

Crisis preparedness and response

A high-performing risk operating model, an effective governance structure and a well-developed risk culture add up to proactive, resilient and agile risk management. What they cannot do, however, is eliminate the possibility of harm or missed opportunities. When crises strike unexpectedly and rapidly, companies can lose value almost overnight, before struggling to keep their market position. A comprehensive risk management environment provides the ideal conditions for preparation and response (resilience). To cultivate this, the C-suite should ensure strong leadership, develop action plans and communications, train managers at all levels, and implement a detailed crisis-response playbook.

Throughout this process, businesses that are looking to access capital via an IPO or PE exit need to be aware that environmental, social and governance (ESG) issues will form an integral part of their equity story. Forward-thinking businesses that are building for the future recognize that employee engagement, worker productivity and strong brand equity can be strengthened through proactive sustainability practices. By January 2020, 33 per cent of the $51.4 trillion in total US assets under professional management used a sustainable investment strategy.

These businesses must demonstrate that ESG genuinely forms part of their overall strategy and they understand the impact these factors can have on their business. Some investors will only consider businesses that meet certain ESG criteria, which impacts their access to the investment pool. Increasingly, they are treating ESG issues such as public health, climate change and racial equality as key risks or opportunities having scrutinized a business’s adherence to them.

Integrated risk management

The process of identifying, assessing, monitoring, and responding to risk will only be effective if the systems used to manage these vital stages are coordinated, if not integrated. Any attempt to convince potential investors that risk management is a top priority will fall on deaf ears if you do not adopt an integrated approach.

Therefore, your business should implement robust controls and make informed decisions using software solutions that provide an integrated approach to governance, strategy, risk, and compliance. This central point of oversight should have the power to facilitate key risk requirements, such as.

Risk management: embeds operational risk management into your business's safety culture, so you can identify, track and manage the more significant risks and opportunities effectively.

Incident reporting and monitoring: facilitates incident and near miss reporting in real-time, and a timely investigation process post-event.

Compliance management: identifies potential and actual areas of non-compliance to drive business action and address legislative changes.

Register management: allows you to access, update and maintain WHS registers efficiently.

Audit management: allows you to schedule and manage internal audits based on enterprise risks and utilize the results.

Demonstrating effective risk management

We live and operate in a world of risks – now more than ever. This ever-growing exposure to internal and external corporate threats has brought the need for proactive risk management into sharp focus for the C-suite. At the same time, significant opportunities may appear without warning, requiring agile responses that weigh risks and rewards to make informed and intelligent decisions.

For businesses seeking investment – whether through an IPO or PE exit – effective risk management will not just safeguard employees, data, assets, and reputation; it will protect, and even increase, share price/company value. Paying lip service to this vital element of business operations simply is not enough during the IPO or PE exit process. Potential shareholders/investors want reassurance that your business is operating safely and securely, seizing opportunities with agility, and have good processes around decision-making. They will demand evidence to prove this.

Choosing the right software partner

To manage and integrate your risk management approach, organizations today need next-generation enterprise software that can consolidate disparate processes, systems and data sources into a single, holistic solution, delivering deep insight into the risk profile, status and respective performance of every part of the organization, while enabling integration and cross-functional interaction.

But selecting the right software solution is a complex undertaking that demands multi-level, multi-regional, cross-functional, and inter-departmental collaboration.

Contact Camms today to discuss how we can help you to redefine the way your organization pursues opportunity, manages risk and makes the right business decisions with the help of an easy to use solution that provides a comprehensive integrated approach to governance, risk and compliance.

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