Avoiding Unacceptable Risks

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1 The Relevance

We assume that each real family business owner has the vision to transfer their business to the next generation. Transferring it as a viable business and as an independent company capable of finding its own way to the future. What could prevent this vision from becoming reality is not earning less than the market leader. The risk is not posed by investing so much in good assets or in the infrastructure of a business that the Return on Capital Employed is reduced. The risk which could lead to the downfall of the company is posed by mistakes; a series of minor mistakes or one big mistake made by an already weak organization. Thus, the first priority to secure sustainability is to avoid big mistakes. We have statistics on the causes for the downfall of businesses: The top reasons are categorized as “management failure” or “lack of liquidity.” These explanations are not instructive. They are too general. Which are the root causes preceding these consequential events?

There are three categories of negative events endangering a company: deteriorations and big failures are two of them, but there are accidents too, which are—almost—beyond our control. Let us illustrate the specific features of each of these threats by examples.

2 The Continuous Deterioration

The case of continuous deterioration is seldom an obvious and almost never an urgent problem: Seemingly there was nothing wrong with this company, a regional brewery. Certainly, it had to struggle for the profits each and every year, some years...
were better, some were worse. This could be easily explained: the weather was sometimes advantageous, sometimes disadvantageous. Some years the output grew by a few percent, some years there was stagnation or even reduction. They did not have a liquidity problem. There was not that much investment needed. Further, one could sell some idle real estate that the company owned. But, all of a sudden loss showed up in the profit and loss statement. They called in a consultant. The team identified huge investment requirements to bring the brewery equipment to a reasonable productivity level, but this would have increased the capacity for which the market demand was not there anymore as the market share has been shrinking for some time. They were lucky that they could sell the company to a large competitor. It closed down the facilities and served the market from its central, modern plant.

Another company in the B2B business once had with its engineered products an almost monopolistic situation. Then they faced increased competition. They counteracted this by offering special high discounts to customers. Initially, these were just a few deals, but they grew more and more. Finally, the general price level did not cover the costs anymore. Tight cost-cutting programs were the consequences. This could not avoid losses, however, and the company had to cease business.

What could possibly be done in order to realize the trend of deterioration early enough to start countermeasures in time? The problem in these cases is to identify early the seriousness of the trend. These examples of loss trends are similar to a fire. Detected early enough one can extinguish the fire. As time elapses, the destructive power of the fire increases until it grows beyond control. Some practical ways to gain insight early enough could be the following analyses:

- Compare all your business data with the data from 5 years ago. Do not take the data of the 5 consecutive years, but just that of the 5th year back. Compare the sales per capita and profit ratio to sales and all relevant data in your kind of activity and check if there is stagnation or real progress.
- Choose one company which you consider to be an example of good management. It need not belong to the same product–market category. It is sufficient if it belongs to a similar industry (B2B). Compare the trends in your business with the trends in their data over the years.
- Break down the total sales of your business into four groups of profitability: Sales with the highest profitability to those with lower profitability. Calculate in full cost to get profit and loss, not contribution margins only. Check whether the portion of loss-generating sales is increasing or decreasing over time. Work on the reduction of the portion of loss-making sales. To some extent, the difference between companies of good overall profitability and low profitability is not the difference in the cost level, but just the difference in the portion of loss-generating sales.

The deterioration problem can be cured if detected early enough and the treatment is decisive. Of course, more is needed than just the will to manage. One needs creativity to improve a product, one needs highly motivated employees to build good
relationships with the customers, one needs discipline and extra efforts to get a reputation for reliable performance. If one sees the need for improvement clearly, then this can push the motivation to change significantly.

3 The Big Mistake

The category of “big mistakes” is even more dangerous. There is no room for trial and error. The first big mistake could be a fatal one. There are contracts which could imply unlimited obligations. There are sales projects which are too large compared to the capacity of the organization. Think of a situation that someone offers you the opportunity to make one deal for the delivery of your products in the order of magnitude of 1-year sales or more—at marginal prices—and you are really not sure whether your organization can solve all the technical requirements involved. Or think of the option to acquire a company that is almost as large as your acquiring company is. In very general terms one tends to assume unlimited obligations when one acts in an area in which one does not have any experience for the first time. Entering a new market first time is such an area without prior experience. Entering a new market with a new product is risk multiplied. Then one lacks the competence to assess the risks realistically.

Paradoxically the risk of falling into the trap of incompetence or underestimating a risk is highest for those entrepreneurs which have been very successful. Success creates overconfidence. It can lead to the conviction that one can accomplish everything and anything. Underestimating the danger results from the false logic of assessing the danger by the standard-formula: Risk is the product of damage amount multiplied by the probability of occurrence. In strategic, one-off actions, one cannot work with probability-percentages.

One does not make a mistake purposely. Nevertheless, wherever possible, one needs to take precautions in order to reduce the likelihood of falling into the trap of a big mistake. The first exercise is to assess the danger realistically. To achieve that, one has to evaluate the “worst case,” the maximum possible damage. An action that could eventually lead to an existence-threatening risk is a taboo. Second, one can train oneself to increase the diligence of one’s work whenever one acts in unknown territory. One can approach step by step. One must not hurry under time constraints if one does not have experienced routines. Working in a team is one of the means to increase the know-how and the diligence.

4 The Accidents

Then there is a third category of danger. These are accidents: sudden, externally caused, damaging events. The COVID-19 crisis is such a very destructive accident. But there are more frequent, mundane examples. If fire destroys the major production unit, if your major customer goes bankrupt, if a new regulation eliminates your market, if a new technology makes your product obsolete. These are events beyond
your influence. However, insurances are there to compensate at least portions of the
damage. Analyzing the risk is the way to find some protection and to learn where one
has to be specifically cautious.

One strategy to prepare for any kind of danger is proposed by the writer on
strategic thinking, Kahnemann: He labels the exercise “pre-mortem-analysis.” List
all those events you can think of, which could endanger the existence of your
company. And then figure out which protective measures are conceivable. This is
not an exercise to make you anxious. Quite to the contrary. Being aware of the—
few—really essential dangers sets your mind free to assume the normal risks of
entrepreneurial activities. This exercise should even encourage you to take afford-
able losses, because this is the entrepreneur’s art and mission.

**Bibliography**

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