

The second in a six-part series on Corporate Risk Mitigation looks at how to protect corporate value in a bad environment



Guarding against a fall

Events contributing to the recent recession have once again shown that, when times are good and the money is rolling in, regulatory practices at both industry and corporate level can become slack. Authorities and individuals who should know better take their eye off the ball, with the inevitable result that rules are bent, accounts are not scrutinised, and dubious logic is allowed to cloud sound judgment.

Companies presumed to be well run and financially strong can fold with little or no notice, and the repercussions can be immense. Partners, suppliers, clients and contractors, which may have been in good condition and followed every regulation, then find themselves drawn inexorably into the maelstrom, facing sudden closure because of the risks taken by a counterparty somewhere along the supply chain.

My experience as a consultant indicates that these "unseen" risks can occur, particularly when private equity and hedge funds take significant, but perhaps non-controlling, positions in companies in Asia. The funds – and their bankers – may indeed have regular access to the financial reports and forecasts of the enterprises in which they invest. However, this data is historical in nature, or necessarily speculative, so these numbers are of limited value in anticipating sudden or unexpected difficulties that can strike at lightning speed.

What compounds the situation is the bald fact that prior to the financial crisis many hedge funds and private equity investors failed to do adequate due diligence. Swept along by talk of exponential growth and the positive mood of the boom years, they forgot that some mainland-based companies had never previously faced an economic downturn, senior management often lacked experience, and reporting standards were not the most rigorous.

In the rush to invest, some banks and financial institutions also paid insufficient attention to a couple of basic principles: know your customer, or KYC, and relationship management. They did not always have a complete grasp of the actual situation and were unable to give timely, strategic advice to protect investments or recover monies before problems multiplied.

If that did happen, they can still recover some ground by doing a thorough retrospective due diligence exercise. That

EXECUTIVE INSIGHTS

Edited by John Cremer

Investors must ensure that companies in which they have an interest are conducting business to the highest standards

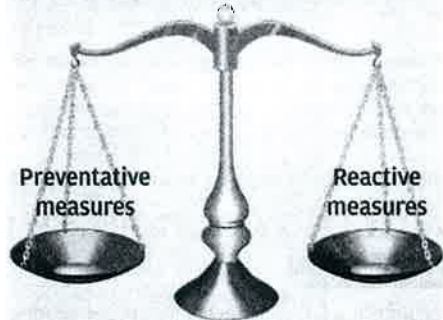
should lead to enhanced, regular and discreet monitoring of any companies which received investment. This is the only prudent and effective method of mitigating risk and must not be skipped or deferred, especially in the current market conditions. The costs involved are comparatively minor and, in any case, insignificant when compared to the potential loss of the total investment.

As a minimum, investors must ensure that companies in which they have an interest, as well as subsidiaries and key principals, are conducting business according to the highest standards of corporate governance. This has nothing to do with the relative state of the economy. It should be mandatory at all times and across the board.

The wise investor also needs to be fully aware of important plans and developments

Risk mitigation

A considered balance



Preventative measures

Reactive measures

SCMP GRAPHIC

SOURCE: FTI-INTERNATIONAL RISK

which are intended to have an impact on the business. Whatever the circumstances, there is no reason to accept incomplete explanations or vague outlines. Management should be required to supply answers, especially in young entrepreneurial companies led by executives inclined to risk-taking.

Equally, it is vital to be alert to "off-balance-sheet" risk. This can be in the financial sense, but also in terms of overdependence on a key supplier, a cosy relationship with an audit firm, loss of a major client, or frequent customer complaints. The sudden departure of staff to competitors is also a classic warning sign of impending problems.

Once the retrospective due diligence exercise is completed, the process should continue with regular monitoring, specific reporting and, if necessary, targeted investigations. In this respect, an outside consultant may be able to bring different approaches and insights for mitigating risk. Our experience shows that for an "investment assurance exercise" of this type to be effective, it pays to focus on the following points:

- Recent or unreported changes to the corporate structure or to licensing
- Comments by auditors and, in particular, their sudden resignation or replacement
- Negative or ambiguous comments from associated stakeholders, such as banks, suppliers, competitors and clients
- Key staff with other business interests, whether or not these appear to be under financial stress, or are in unrelated fields
- Litigation involving the company, its staff or their immediate family members
- Pertinent labour issues, the sudden loss of management or the departure of staff who have generated significant business in the past
- Suspicions of fraud or other concerns hinting at the possibility of corruption
- Legal and regulatory issues that could have an impact on the business
- Failure to observe environmental, social responsibility or other compliance issues

If serious concerns are discovered at any point, the investor must make swift decisions to minimise risk and either protect or expeditiously recover any funds. Generally, there are three avenues to consider: looking for a negotiated settlement, taking legal action, or seeking liquidation or insolvency.

The first of these options is preferable, provided an acceptable level of financial recovery is achieved. Legal action is more likely to be expensive, slow and uncertain.

Before taking that step, we usually

recommend a thorough asset search of the company in question and its key principals, especially if personal guarantees are involved. Experience shows that individuals redistribute and conceal their assets in anticipation of action against them. It is therefore important to have up-to-date and accurate information about the disposition of known assets and any recent changes.

A properly conducted search should identify all types of assets. Individuals or corporate entities may own or control these directly and indirectly. The information initially turned up will help to build a comprehensive profile of the reported business activities of the subjects and make it easier to decide whether legal action will be cost effective or appropriate. As an investigation broadens, the best intelligence about the type and location of assets comes from those who know the subjects or have had dealings with them. For instance, business partners can provide factual and – often as important – anecdotal information giving crucial clues about actual assets, possible transfers and beneficial ownership.

Where legal access is allowed to search computers and PDAs, forensics experts can then use advanced analytical tools to recover relevant information. This can include e-mails, spreadsheets and other documents, and can add considerably to the understanding of assets held and methods possibly used to conceal their actual ownership.

In complex investigations, analysts can use sophisticated link analysis software to map relationships between subjects, assets, cash flows and timelines. Through such exercises, it is common to discover the existence of unsuspected bank accounts, securities accounts and offshore trust structures.

In many cases, once the parties concerned are made fully aware that a private equity investor, bank or hedge fund knows the extent of their assets, attitudes quickly change. It becomes easier to reach a reasonable settlement without needing to resort to expensive legal action or pressing for insolvency.

Article contributed by Steve Vickers, president and chief executive of FTI-International Risk, a leading risk mitigation consulting and investigative organisation in Asia



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