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Risk and Capital Budgeting

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WHAT'S COVERED

In this lesson, you will learn about operational, financial, and market risks. Specifically, this lesson will cover:

1. Risks

When thinking about the **capital budgeting** process, a firm has to take into account the number of potential risks related to the investments not panning out. Whether this is for new machinery, replacement machinery, new buildings, new products, or R&D, it needs to consider how it plans to address these risks.

Risk is the potential probability that an action or activity, or even the choice of not taking an action, will lead to a loss. This implies that there exists a choice that will have an influence on the outcome at some point. Potential losses themselves are often called risks.

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2. Types of Risks

There are several classifications of risks.

2a. Operational Risks

Operational risks are risks that exist in the execution of the core business and include issues that affect production and distribution of products and services.

IN CONTEXT

Consider an example of an organic food supplier. Operational risks could include weather conditions, farmers selling their goods elsewhere, quality deterioration during storage, damage during transportation, and others. The company needs to plan to take measures against each of these.

Operational Risk	Mitigation Measure
	Plan to provide technical assistance to farmers and calculate scenarios for

Weather	planting, droughts, or flooding.
Farmers selling elsewhere	Offer farmers an attractive price and pay them on time. Understand how other buyers are competing with them.
Quality deterioration	Choose suitable facilities for storage, keeping it clean and dry, with windows closed, and protected against pests.
Transportation damage	Use a reliable transportation service, making sure the truck is clean and that nothing else is loaded up. If it is being exported, the company needs to make sure that the container is well loaded and it's officially insured by the importer.

2b. Financial Risks

The second type of risk are financial risks, which involve how well a company manages its short-term credit, its account receivables, and collections from customers.

IN CONTEXT

Consider the organic food supplier scenario from before. Financial risks could include payments to farmers disappearing along the way, the profit margin not being large enough to cover operational costs, not having enough credit to maintain cash flows, and having buyers that do not pay after they receive the product. Below are steps to be taken to handle these risks.

Financial Risk	Mitigation Measure
Missing payments	Handle payments by bank accounts, most likely electronically.
Low profit margin	Protect by increasing efficiencies and reducing the production cost per unit.
Insufficient credit	Ensure that trade loans are secured and available on time.
Slow payment receipt	Know the creditworthiness of your customers, perhaps using letters of credit.

2c. Market Risks

The third type of risk that needs to be considered are market risks, which are changes in the external environment that impact the demand for products and services.

N CONTEXT

Again, consider the organic food supplier scenario from before. Market risks include things like the demand for the product slowing and not being able to find a buyer, clients not honoring their contracts or not buying at the volume they had committed to, competitors offering products at lower prices or better quality, and a sudden increase in local prices. Sales prices for the product may decrease or fluctuations in the exchange rate of other currencies may impact the business. Mitigation measures can be taken to address these market risks.

Operational Risk	Mitigation Measure
Lessening demand	Diversify the business. Look into storing.
Clients not honoring agreements	Build stronger partnerships. Negotiate solid contracts.
Competition shift	Work on reducing costs and improving quality.
Increase in local prices	Communicate with your buyers.

SUMMARY

In this lesson, you learned about **risks**. There are three **types of risks** that a company must try to mitigate. There are **operational risks**, which include those coming out of the core business, including issues that affect production and distribution of products and services. There are **financial risks** that involve how well a company manages its short-term credit, account receivables, and collections from customers. Finally, there are **market risks**, which are changes in the external environment that impact the demand for products and services.

Best of luck in your learning!