

# **Evaluating, Planning and Managing Risk Ventures**

C. M. GOOD

*Lockwood - Greene Engineers, Inc.  
New York, New York 10017*

## **INTRODUCTION**

For purposes of this paper risk ventures are defined as any company activities which are outside the area in which the company normally operates or is familiar. Further, the enterprise, if successful, must have sufficient benefits to compensate for the inherent risk of failure. The types of risk ventures we plan to discuss are those which might be undertaken by a single established company; or, at most, a joint venture of two such companies.

The pressure for risk ventures develops because of constant change which is characteristic of business. To survive, a company must constantly venture into new areas of business. In some cases these new areas can be explored and developed in small bits. These result in gradual change and can generally be readily adjusted to. Other potential ventures require a relatively large commitment of either capital or manpower, or both, on the part of a company. These usually imply a dramatic improvement in company performance if they succeed. Conversely, failure sometimes results in severely limiting a company's maneuverability until losses have been made up.

These major ventures with great potential rewards are the ones we are considering. These require careful consideration and decision making in order to increase the chances of success and at the same time minimize the costs of possible failure. Adequate evaluation and planning often make it possible to go after these big ones at a risk which is acceptable to the company. The purpose of this paper is to outline some of the specific steps which will help assure success in risk ventures.

## **CLASSIFICATION OF RISK VENTURES**

Risk ventures can be classified by degree of complexity or the number of new problems you expect to encounter. One level of complexity is expansion of a single proven activity into new geographic areas. Examples of this sort of venture would be expansion of a sales territory or establishing a processing plant in an existing fishing area where the company has not had a plant before. This involves successfully duplicating what is already being done.

A higher level of complexity and risk involves moving several segments of the business into new areas. Examples of this would be opening an entirely new fishing ground in a remote location. This involves proving out the fishing ground, establishing a fishing fleet, fleet support facilities, handling, processing and transporting the catch and many additional details of a similar nature. Another example is introduction of a new product line involving entirely new processing techniques.

In these examples there are a whole series of interdependent elements, each of which is unproven in practice. These complex new ventures require highly competent evaluation, planning and management to insure a maximum

possibility of success; and, at the same time, to minimize potential losses in the event of possible failure.

### ***Ideas for risk ventures***

Ideas for risk ventures are usually plentiful; and we will assume that to be true in this instance. Therefore, the problem becomes screening available ideas to select an idea, or ideas, which warrant detailed consideration.

## SELECTING A VENTURE

Characteristics of the sort of venture we are concerned with are: (1) Success will significantly improve company profits, yield a very high return on investment, or significantly increase the company's market share. (2) Adequate management is available or can be obtained. (3) A critical element or elements which will determine success is unproven. (4) Cost and manpower requirements of proving out the unknown elements are within the capability of the company. (5) Capital required is available, or can be obtained as each step is proven out.

Screening available ideas against the above criteria will produce those which deserve the attention of the company's top management. We should note in passing that putting capital in last place was intentional. Even in these days of tight money a highly regarded company which proves out a sound concept can generally obtain capital to take advantage of it.

### ***Evaluating proposed ventures***

The kind of investigation required to evaluate a venture, of course, depends on the specific nature of the proposed project. However, there are general guidelines which simplify this evaluation.

On larger projects a formal written evaluation will increase the likelihood that all significant factors have been considered. Elements which must be considered are:

1. *Specify the goal of the proposed venture* - (i.e., increase raw material available to the company, reduce the cost of raw material, reduce transportation costs, increase the area which can be served economically by a company, etc.) This step may seem somewhat academic; but merely stating the goal of a venture often stimulates development of alternate approaches to the problem.

2. *Detail program proposed to achieve goal.*

3. *Define information needed to evaluate the venture.*

4. *Collect data* - i.e., what information is available regarding the proposed venture? What non-company assets are available, (i.e., freezing and storage facilities, transportation, etc.?)

5. *Define critical factors* - (those which are critical to the success of proposed venture and the operating results of which are unknown.)

6. *Define appropriate format for presentation of evaluation* - (consider comparisons to existing company operations, to similar competitive operations, standard P&L.)

7. *Define secrecy requirements.*

8. *Make sure alternate means of achieving goals have been given adequate consideration.*

9. *Develop the most economical means of prognosticating accurate estimates of operating results in the critical unknown areas.*
10. *Define performance standards – (go-no-go criteria, projected operating results anticipated with various assumed results for critical unknown areas.)*
11. *Find a means for subjecting all assumptions and plans to the most rigorous critical review.*

Even in preliminary evaluations a clear distinction should be made between anticipated costs of proving out (or researching) a concept and the cost of implementing a concept which has been proven to your satisfaction. The research costs are not usually expected to be recoverable; and, are normally treated differently from an accounting standpoint. In addition, delineation of these costs helps clarify thinking with reference to the project.

### ***Planning***

After the project has passed muster, in the evaluation phase, you move into bedrock planning. This phase is greatly simplified if evaluation has been thorough; however, some new elements are introduced. These include: (1) Establishment of a firm program and schedule. (2) Definite program check points with pre-determined performance criteria to monitor progress. (3) Alternate action plans to be initiated dependent on results obtained up to the check points above. For example, what is to be done if results are greatly better than anticipated? (4) Precautions to insure that the company, rather than its competitors, benefit from positive operating results.

### ***Implementation***

This is the phase toward which all prior work was directed. The overall picture has been well defined. The detail which went into this definition allows for rapid evaluation of operating results. Stepwise testing and review of assumptions is followed by scaling up the various segments of the new operation.

Speed is often crucial both from the viewpoint of securing a position against possible competition and from the standpoint of cost. Again, the speed with which one is able to move is dependent on the thoroughness of earlier planning; and on the caliber of management assigned to the new venture.

The proving out of untested assumptions and gearing up new operations requires a great deal more management attention and skill than is required to manage an on-going operation. No matter how carefully planning has been done, unexpected situations do arise. When they arise there is no substitute for experienced management which has a "feel" for the total situation so that they can quickly evaluate the significance of deviations from plan. Many companies assign their most qualified managers to the testing and gearing-up phase of new ventures. Also, it is fairly common to find a greater than normal number of management personnel assigned to new ventures. After the venture is underway the excess management is then reassigned to other segments of the business.

Everyone who has been through the start-up of new ventures knows the challenge and excitement of proving out new areas of business. Also, developing a theory, proving it and building it into a continuing part of a business, yields lasting satisfactions. If our suggestions lead to greater speed in evaluating, and sureness in implementing risk ventures, they will have served their purpose.

Items which should be kept in mind are: (1) The better the preparatory work the fewer number of unanticipated events which will occur. (2) The better the preparation the easier it is to evaluate the effect of unanticipated events. (3) Don't let your enthusiasm suck you in over your head. If after giving the venture the trial you felt was reasonable before you started, results are not up to your predetermined standard, follow your plan and gear down or cut off according to your original plan. (4) Adhere firmly to a predetermined review schedule to maintain direction of your program. (5) Find a means of subjecting every element of your program to the most uncompromisingly thorough review.

### **Examples**

Now, let's look at how two different companies have approached two entirely different ventures.

First, a conservative United States meat canning company who successfully initiated a canning operation in Venezuela.

Over the years a profitable business had been built up based on importing U.S. production into Venezuela. In the late 1950's the Venezuelan government began serious efforts to accelerate industrialization in order to reduce imports and broaden the Venezuelan economy. The government program entailed gradually restricting imports of products which could reasonably be produced locally.

There were several concerns which the company had: (1) Whether increased prices resulting first from smaller scale operations and later from more expensive local raw materials would drastically affect sales volume. (2) Ability to maintain suitable management in a remote Venezuelan area. (3) Ability to produce products at a new location which were commercially identical to those produced over several decades in the United States. (4) Productivity of Venezuelan labor. (5) Whether the Venezuelan government would nationalize foreign manufacturers.

The company had two choices, either: (1) Establish a local company which would can, distribute and market their products, or (2) Gradually relinquish their market position to new competition which would accept the risk.

The company chose a cautious stepwise program aimed at establishing an independent Venezuelan operation. It consisted of the following elements: (1) Simultaneous [a] Site search and operating cost analysis to determine initial production costs (based on imported raw materials); and to establish the most favorable long-term production location. [b] Market research to determine the effects on sales volume and profits of various cost and price levels. (2) Based on satisfactory projections in the above, establish a local canning plant. (3) After the canning plant was established, actively participate in development of local raw materials sources. (4) Develop a local distribution, marketing and sales organization.

The distinguishing features of this program were: (1) An established demand. (2) Stepwise planning and execution where progress from one step to the next was based on satisfactory accomplishment of the preceding step.

Everything was not easy. There was a lot of hard work and some costly shortcomings. However, every initial objective was met by a comfortable margin and the program has been eminently successful. Furthermore, most of the initial concerns have proven groundless.

The second venture we will look at is a tomato growing project in Mexico. Since progress in this case was not as smooth as in the Venezuelan venture we will look at it in more detail.

The Bracero farm labor program in the United States was eliminated a few years ago. This was a program under which Mexican nationals entered the United States on temporary agricultural work permits. When the Bracero program was eliminated it was widely predicted that agricultural labor costs in the United States would sky rocket.

Shortly after the Bracero program was terminated, a produce growing area in Sinaloa State in Mexico came to the attention of a very large and sophisticated United States firm. Tomatoes were grown, almost exclusively for export as fresh vine-ripe tomatoes to the United States. A joint venture with Mexican interests to provide general management, technical guidance, financing, distribution and sales for a large tomato growing enterprise was suggested.

This concept was being vigorously promoted by vegetable brokerage firms with operations in Nogales, Arizona; which is the major United States entry point for fresh tomatoes from Mexico.

The major points brought out in favor of the venture were: (1) Low cost of labor. (2) Low cost of irrigated virgin land. (3) People who had pioneered tomato growing in the area had made fortunes. True, in regard to the last item, it was admitted that for the last few years things had not gone too well; but, termination of the Bracero program in the United States was expected to change all that.

The question was referred to the United States company's economist. Based on low labor and land costs he wrote a favorable opinion. Based on this opinion, and without thorough research, a tomato growing program was launched as a joint venture with the Mexican partners.

Neither acreage, growers nor a packing shed were available in the vicinity of Culiacan where most of the Mexican tomato production is concentrated. However, all three were available about 100 miles north near Los Mochis. Because of climatic conditions, the Los Mochis tomato harvest usually starts in late March and peaks in late April or early May. It is, therefore, directly competitive with major production areas in Florida.

As the project developed it began to assume proportions beyond the economic means of the Mexican partners; so, the U. S. firm assumed the major economic role with the Mexican partners providing primarily grower coordination, farm management, Mexican legal counsel and local government liaison.

A substantial first year loss was shrugged off as the necessary entry fee to a good thing. However, as it became clear the second year would also result in substantial losses, a hard second look was initiated. This second look brought out that a pro-forma profit and loss projection for the venture had been prepared. However, the overall initial evaluation had the following serious weaknesses: (1) The economist's favorable opinion was based on general considerations. He had developed no financial calculations on which to base his judgement. (2) The pro-forma P & L did not take into account the effect of Mexican production volume on the United States price structure during the Los Mochis harvesting season. (3) There was no comparison of production and distribution costs with those of the major competitive production area (southern Florida).

Projected cost estimates which allow for evaluation of these factors follow:

## COMPARATIVE TOMATO PRODUCTION AND MARKETING COSTS

	<u>Southern Florida</u>	<u>Los Mochis Mexico</u>
Growing cost per acre <sup>1</sup>	\$1,520	\$ 550
Yield per acre (20 lb. lugs) <sup>2</sup>	1,800	1,000
<i>Costs per 20 lb. lug</i>		
Growing cost	.84	.55
Harvesting and Packing	1.10	.84
Hauling to U.S. Shipping point (Nogales, Ariza.) plus Duty and Fees	-	.85
Selling and Administrative Overhead	<u>.19</u>	<u>.27</u>
<b>TOTAL FOB U.S. SHIPPING POINT</b>	<b>\$ 2.13</b>	<b>\$ 2.51</b>

### DELIVERY COST TO SELECTED MARKETS FROM NOGALES, ARIZONA AND SOUTHERN FLORIDA

FROM	<u>New York</u>	<u>Chicago</u>	<u>San Francisco</u>
Southern Florida	\$0.45	\$0.50	\$0.80
Nogales, Arizona	<u>0.93</u>	<u>0.61</u>	<u>0.39</u>
<b>DIFFERENCE (unfavorable to Mexico)</b>	<b>(0.48)</b>	<b>(0.09)</b>	<b>0.41</b>

The cost data from both production areas were evaluated for possible errors; and, the magnitude of such potential errors was estimated. The conclusion was that tomato production in the Los Mochis area exceeds the economically justified level in normal production years; and further investment in that production area was not justified.

### CONCLUSIONS

Risk ventures are an essential element in successful businesses. Careful evaluation, planning and management of risk ventures minimizes the degree of risk involved; and, at the same time maximizes profits flowing from successful ventures. In evaluating potential ventures it is important to state the specific goal of the venture and evaluate the position of the venture in current and projected competitive situations. Careful and detailed planning is essential to smooth project implementation and to confident decision making in the management phase of a risk venture.

<sup>1</sup>Based on 1967-68 growing season.

<sup>2</sup>Estimated, based on better than average grower competence in each area.