Deciphering third-party business risk in a period of COVID-19 and weak commodity prices

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Introduction

At this point, no one can predict the continuing impact of COVID-19 and how deeply global business will be affected or for how long. Some businesses have suspended operations across industries and geographies.

The impact is compounding to certain industries, such as the extractives—oil, gas, and mining—which were already challenged by low-price commodity environments. Now, these industries are exploring whether demand patterns have been permanently altered and what the "new normal" may be.

Even for companies that are able to avoid the cash crunch, other financial hardships washing over the oil, gas and mining industries pose a significant risk. Liquidity issues for customers or suppliers can have significant—and potentially unforeseen—strategic, financial, and operational consequences.

These may include the disruption to capital projects because of supply chain volatility, lost cash flow from important customers, or lost hedges from counterparties.

The costs of these disruptions to the typical business scenarios can be significant, and fall into three main categories:

- *Opportunity cost* or the loss of potential revenue from inadequate negotiations with high-risk business partners.
- *Cost of nonpayment* associated with default from a customer or counterparty.
- *Cost of nonperformance* associated with a supplier default.

With little improvement expected in commodity pricing, oil and gas companies need new tools for assessing their risk exposure—whether the demand trigger is COVID-19 or price wars. In the world of digital, these tools can provide not only deeper insights into a client's, supplier's, or business partner's risk profile, but also continuous monitoring, which identifies the risk with the potential lead times required to adjust to changes.

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Mitigating risk

Companies that were already struggling with liquidity issues are now faced with government and public orders that are affecting their ability to produce for timelines underdetermined. In one instance, a refiner undertaking a significant expansion project was forced to delay construction as the government stay-at-home order negated the ability of the contractors to get to the site. The refiner is now evaluating not only uncertainty associated with how long the government mandate will be in effect, but also the difficulties in coming back online, assuming some reductions in the available workforce and what will be an inevitable delay in project completion. There is a domino effect extending beyond the refiner and the contractor, but also to the local community and collective suppliers and customers.

Other examples include companies facing force majeure, slowing production due to wanes in demand, and corresponding implications on storage.

Companies that manage to weather the current price environment and maintain their financial stability may still face unexpected changes in the operating environment stemming from their key suppliers or customers who were unable to weather the storm.

These examples underscore the importance of assessing risk among customers and counterparties, including third-party suppliers. Understanding which suppliers, business partners, and customers are at greater risk—or conversely are positioned to recover more efficiently— will enable companies to return to normal operations in a more informed way with a streamlined view of where they require contingency plans. On an ongoing basis, better due diligence and risk assessments through continuous monitoring can alert companies to their business partners and customers who may be stumbling and therefore present financial risk, which provides more time to develop options, pull levers, or implement contingency plans.

Companies that are struggling with liquidity issues will take whatever steps they deem necessary. In some cases, those decisions can pose even greater financial or reputational risk to their business partners.

Types of business disruption risk

The first step in mitigating risk is understanding where the risk lies. Given the size of companies today, this can be a massive undertaking that includes analyzing loans and investments, contract counterparties, working capital accounts, and, increasingly, public perception through social media channels.

Credit risk, for example, is typically identified through financial hindsight, such as quarterly financial data, analyst reports, and other publicly available economic data. In assessing credit risk, companies should ask how their customers, counterparties, and third-party suppliers are performing; how economic changes have affected them; and whether they will need to take action.

Distress risk is identified by capturing public insight, such as real-time public sentiment, executive speeches or presentations, and analyst rating changes. Have analysts' attitudes changed? Are executives hinting at trouble ahead?

Assessing operations risk relies on reoccurring nonpublic financial and operations data that can lead to strategic foresight. These business interactions can indicate risky patterns of behavior unknown to the public that may not be reflected in analyst reports or on financial statements. The questions they raise may include: Which business partners are responding to financial stress by requesting changes to payment patterns? How might one business partner's stress affect the stability of other partners?

By answering these questions, companies can assess the state of such risks and develop a plan for mitigating them. Then they can develop an early warning system that gives them time to address risk factors before they become critical. Finally, companies should develop a feedback mechanism to prevent similar problems from reoccurring.

The first step in mitigating risk is understanding where the risk lies.

Match 1
Match 2
Match 5
Match 4

Business Disruption Risk Analytics tools

Deloitte Risk & Financial Advisory's approach to analyzing potential supplier and customer disruption collects a wide range of internal and external data in monitoring and assessing financial stability across a portfolio of vendors, customers, and counterparties. It creates the capacity to do additional in-depth analyses as needed. Our approach includes:

- *Proprietary tools for assessing private companies* – Including modeling that uses a company's financial and operational transactions with private entities to estimate the potential risks and the timeline for possible disruptions related to suppliers and counterparties whose financial information is not publicly available.
- *Publicly-available data assessment* – Including modeling and text analytics to review public financial statements, stockholder meeting transcripts, credit analyst reports, blogs, and other reported data.
- *Risk rating methodologies* – Advanced analytics, data enrichment, and rich visualization techniques rank suppliers, customers, and counterparties based on patterns of distress or potential bankruptcy that are tailored to a company's individual business model, data, and processes.
- *Stress test trigger event scenarios* – Stress analytics that use public information to estimate the likelihood of an entity's financial distress in the near future.
- *Continuous results* – An automatic refresh process that incorporates public and nonpublic data and periodically recalibrates the model by updating outcomes and patterns events to enhance the risk metrics.
- *Ranking of strategic suppliers and customers* – Once the entities have been ranked by risk, this function enhances decision-making by developing mitigation strategies across all suppliers, identifying potential future disruptions, and identifying the more immediate concerns.

An intuitive interface prioritizes the entities by potential risk and identifies early warning indictors. The data are periodically updated and monitored using filters, text analytics, and trend changes to obtain a current and more precise understanding of patterns and identifiable trends. The risk engine is adjusted throughout this process to reduce false positives.

Analyzing third party risk

After the inputs are collected and the suppliers and customers are ranked by risk profile, the Business Disruption Analytics Risk solution can assist in identifying anomalous patterns and use them to provide a broad and more detailed ranking of third-party risk. The most at-risk third-party suppliers can then be analyzed further by using a variety of more in-depth criteria, which may include:

- Fundamental market analysis
- Peer comparisons based on ratios, contracts and agreements, pipeline capacity, and other factors
- High and low case simulation
- Estimation of free cash flow required for funding operations, capital expenditures, dividends, interest expense, and fixed cash requirements
- Probability of default and the corresponding amounts of that default
- Financial models based on publicly available sources
- Estimated production levels and the revenue they generate
- Forecasting models and other forward-looking market indicators
- Price simulation modeled against specific company portfolios
- Application of workout and rehabilitation methodologies

At Deloitte, we can assist companies during this time of market uncertainty by applying our analytics and financial modeling capabilities and identifying the significant risks posed by their suppliers, customers, and business partners. We can also assist in developing risk mitigation strategies. Using our proprietary scenario analysis tool, we provide a pragmatic approach to managing uncertainty and anticipating future risks.

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Because of the increased volatility in commodities prices, the costs of unmitigated financial risk—such as nonpayment or nonperformance—from customers, suppliers, and business partners are likely to increase significantly during the next three years. Companies should consider the right tools not just to identify that risk, but to develop the appropriate approach for responding to it.

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