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Elements of Corporate Risk (Fourth of a Series)

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In astronomical terms, it was a close call. Last Wednesday an asteroid almost a mile long passed within 1.1 million miles from Earth. The object, known as JO25 and nicknamed “The Rock,” was visible in small telescopes. “We’re safe,” remarked NASA plantetary defense officer Lindley Johson. ”From this one.”

Keeping a sharp eye out for close encounters of the credit kind are always on the mind of portfolio defense officers, otherwise known as credit risk officers. Leverage loans provide greater yields to investors than lending to investment grade corporate borrowers, but also entail higher risk. More leverage means less cushion in event of operational or systemic problems impacting revenues and cash flows.

Technology risk – While advances in technology have always created winners and losers, the pace of disruptive innovation has accelerated dramatically in the past decade. In particular, the advent of on-line marketing has altered the retailing landscape forever. This year alone HH Gregg, Gander Mountain, Bebe Stores, The Limited, and Wet Seal either filed for bankruptcy or closed all their stores. The Amazon effect has caused even premier chains like Walmart and Neiman Marcus to struggle.

Tectonic shifts in software and search engines – let’s call it the Google effect – are also impacting the way businesses track consumer buying patterns and preferences. Instant accessibility to products and services at minimal cost (“Free Shipping!”) puts enormous pressures on smaller companies that lack scale or reach to compete effectively in the global arena. And just as there seems to be nothing you can’t get on Amazon, Google’s unmatched ability to process and manage consumer data makes it an existential threat to any marketing or sales generation business.

Regulatory risk – Certain sectors are notoriously prone to changes in regulations. Healthcare, as a recent example, will certainly be affected regardless whether ACA is repealed. Lower reimbursement rates, while rarely the sole cause for borrower bankruptcy, can hurt coverage and leverage ratios.

Financial services are also subject to increasing scrutiny from regulators, no matter what policy changes emerge from the new administration. Payday lenders and subprime auto insurance are much-needed services, but their relatively high costs to borrowers will always attract attention.

Some companies benefit from systemic inefficiencies. Take private for-profit prisons and related services to the corrections industry. Soaring incarceration rates challenged federal and state prison capacity, creating opportunities for Geo Group, CoreCivic, Securus and GTL. But this came with a higher political profile and the resulting volatility. The Obama administration had planned to phase out for-profit federal prisons back in August, but five months later Trump reversed course.

Next week we discuss legal risk, geographic concentration, and second ways out.