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

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Introduction

Across the oil and gas industry, companies are buckling under the steep decline in commodity prices since mid-2014. Forty-two companies filed for bankruptcy in 2015. With oil prices hovering near 10-year lows, that number could quadruple this year. A recent Deloitte study found that 175 more companies, or about one-third of the world's publicly traded oil companies, are at risk of bankruptcy. They carry a combined $150 billion in debt, and prospects for raising cash are diminishing amid weaker prices for asset sales and decreased value of secondary stock offerings.

Credit ratings have been cut as companies' cash flows have shrunk and they have struggled to sustain debt payments. The four biggest US banks have set aside some $2.5 billion to cover underperforming energy industry loans. When oil was still at $70 a barrel—almost double the current price—Goldman Sachs estimated that about $1 trillion in spending for future projects was at risk.

Even for companies that have avoided the cash crunch, the bankruptcies and financial hardships washing over the industry pose a significant risk. Liquidity issues for key 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 they 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. Ideally, these tools can provide deeper insights into a clients', suppliers', or business partners' risk profile—and provide it quickly enough to adjust to any changes.

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Mitigating risk

Companies that are struggling with liquidity issues will take whatever steps they deem necessary to avoid bankruptcy or default. In some cases, those decisions can pose even greater financial or reputational risk to their business partners. In one instance, a service provider hired for a drilling project by a large independent was struggling financially and didn't pay its insurance premiums. Only when a drilling incident occurred and the independent attempted to collect the insurance from the service provider did the problem come to light, leaving the independent to shoulder the cost.

Companies that have managed to weather the current price environment and maintain their financial stability still may face unexpected changes in the operating environment. For example, an oil producer drilling in North Africa secured a commitment from a local company to build infrastructure in the area. However, the contractor lacked the financial wherewithal to complete the work. When the project was disrupted, the producer had to pay costly fees for the delays.

Both these incidents underscore the importance of assessing risk among customers and counterparties, including third-party suppliers. Better due diligence and risk assessment can alert companies to financial risk and give them more time to develop options.

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Types of business disruption risk

The first step in mitigating risk is determining 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 must ask how their customers, counterparties, and third-party suppliers are performing; how economic changes may affect them; and whether they need to take action.

Distress risk is determined 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 possible trouble ahead?

Assessing operations risk relies on reoccurring non-public 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: Are business partners 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 determine how to mitigate them. Then they can develop an early warning system that gives them time to address risk factors before they become critical. Finally, companies need a feedback mechanism to prevent similar problems from reoccurring.

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Business Disruption Risk Analytics solution

Deloitte Advisory's unique approach to analyzing potential supplier and customer disruption collects a wide range of internal and external data in monitoring and evaluating 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 predictive modeling that uses a company's financial and operational transactions with private entities to project the risks and the timeline for possible disruptions related to suppliers and counterparties whose financial information is not publicly available.
- *Publicly available data assessment* – Including predictive modeling and text analytics to examine 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 project the likelihood of an entity's financial distress in the near future.
- *Continuous results* – An automatic refresh process that incorporates public and non-public 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 determining the most 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 all the inputs are collected and the suppliers and customers are ranked by their risk profile, the Business Disruption Analytics Risk solution can identify anomalous patterns and use them to provide a comprehensive 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.
- Determination 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 Advisory, we can assist companies during this time of market uncertainty by applying our analytics and financial modeling capabilities and identifying the greatest risks posed by their suppliers, customers, and business partners. We also can assist in developing risk mitigation strategies. Using Deloitte Advisory's proprietary scenario analysis tool, we provide a pragmatic approach to managing uncertainty and anticipating future risks.

Because of the increased volatility in commodities prices, the costs of unmitigated financial risk—such as non-payment or non-performance—from customers, suppliers, and business partners is likely to increase significantly during the next three years. Companies need the right tools not just to identify that risk, but to determine the best approach for responding to it.

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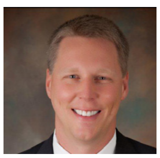

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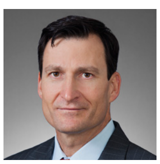

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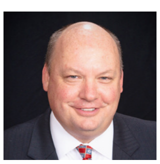

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