

# *The Risk Evaluation Process*

*by Josh Patrick, CFP®*

*The first and most important aspect of looking at any risk is coming up with a budget.*

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*John Aardvark was evaluating several opportunities he had for new business opportunities. He was looking for some systematic methods of evaluating these opportunities that would give him a way of going through the opportunities that were presented to him and choose the one that would have the highest probability of success.*

We all have looked at new business opportunities and many times taken a chance, thinking the new opportunity was something that might be profitable and interesting. We also may have learned over the years that those opportunities that look good actually have lots of pot holes along the way.

The first and most important aspect of looking at any risk is coming up with a budget for how much you are willing and able to lose on any new project. In the food service business, I believe it's prudent to find line extensions or business opportunities that might fit in with what you are doing now. But, before doing so, it's extremely important that you first decide how much money you want to risk before starting on a new project.

The evaluation process must take into account not only expected income and profits, but also factor the cost of taxes into available cash. I've seen people look at a new project and have a very thin margin for error. Almost all of the time when this happens, in addition to the thin margins, there is no tax cost added to the cost of operations.

If you have profits, you will have taxes. So, if you think your before tax additional profits will add up to \$1,000, you must take off \$350 to \$400 for your tax cost. This will leave you with only \$650 to \$600 instead of the \$1,000 that you were expecting.

*As John was evaluating his various opportunities, he thought that some of the opportunities should be easier to evaluate and others were much more difficult. He was looking for an easy formula to figure out which risk to take. He also wanted to know about how to add overhead to the costs of each of the opportunities that he was presented.*

I would suggest that when it's time to look at your various opportunities, there has to be three areas you examine before going forward.

The first would be how familiar are you with the new business. If it's a new account, then you are very familiar with the costs associated with taking on that account. However, if it's a new line of business, you must then factor in a much larger variance for both sales and costs that are associated with those sales.

The second is how much of your time is going to be taken by the new venture. Again, if it's part of your day-to-day business and you are just making a capital investment decision, you could assume that there will not be a huge drain on your personal time. However, again, if it's a new venture, you can and should assume that a great deal of your time will be used for this new venture. So, you should also factor your time as part of the cost.

If your salary is \$150,000 and a new venture would force you into hiring a persona to pick up some of your slack at \$50,000, then you need to account for this cost as part of the overhead associated with the new venture. So, if you plan to spend ten hours per week on the new venture, you would have to charge \$30,000 for your time and \$50,000 for the new manager who's been hired to free you up on the new venture.

Under this scenario, your cost before you even bring in your first dollar is an additional \$80,000 per year. However, if the venture has enough profit potential, you will still want to go forward. The important thing is making sure you go forward with your eyes wide open and understand all of the costs you will incur.

The third area you always want to look at is having the ability to afford the risk and making sure the payoff for success is large enough. If your potential loss is between \$50,000 and \$100,000, you will want to make sure that there are enough potential profits that will make this risk reasonable.

In the example above, I would suggest that you have at least a \$200,000 per year potential payoff for taking the risk on a new venture that is related within your company. For example, if you wanted to start a catering operation, you would want to make sure that you could have a profit of over \$200,000 for this risk, if you were willing to bet \$100,000 on the venture.

You also need to evaluate whether you can afford to lose \$100,000 on your new catering risk. We often will fully believe that we are going to be very successful in our new ventures. However, I see many businesses trying something new and then after a year or two and \$100,000 spent, they decide to close the new venture.

*John was facing three different opportunities. One was a large new account in his vending operation, one was opening a catering operation and the third was opening a franchise fast food operation. He decided to first concentrate on the new vending account and then move his attention to the other two opportunities.*

When looking at an extension of your present business, you have the tools to evaluate this business in your data base today. It's crucial that when you evaluate your new business that is in your present line, you add all overhead costs to this business. Although you may not add any overhead costs today, if you continue adding new business, you will certainly add the new costs tomorrow.

When comparing two competing new opportunities, it's important to not only factor the cost of the opportunity, but also the risk factor associated with it. I would suggest that you use the following grid to evaluate a new business opportunity:

Your time needed for new venture	15%
Predictability of sales	15%
Profit potential of the new venture in dollars	20%
Profit potential of new venture in return on investment	20%
Business potential in potential profits	30%

So, in our example with John, he can open a new catering operation or a fast food operation. He believes that the fast food operation will take 100 hours of his time to start and then five hours per week for the first year. With the catering operation he would spend 50 hours in start up time, but spend 10 hours per week for the first year.

Fast Food Time	350 Hours
Catering Time	550 Hours

The profit potential that John found in the first year for each business is as follows:

Fast Food Sales	\$750,000
Direct Costs	\$500,000
Overhead	\$150,000
John's Time	\$22,000

Profit in \$	\$78,000
Profit as %	10.4%

Fast Food Fixed Investment	\$400,000
Fast Food Return after tax	\$60,000
Fast Food Return on Investment	9.5%
Fast Food Sales Potential	\$1,250,000
Fast Food Potential Contribution to Profits	\$437,000

Catering Sales	\$400,000
Direct Costs	\$160,000
Overhead	\$120,000
John's Time	\$34,000

Profit in \$	\$86,000
Profit in %	21.5%

Catering Fixed Investment	\$100,000
Catering Return after Tax	\$72,000
Catering Return on Investment	38%
Catering Sales Potential	\$800,000
Catering Potential Cont. to Profits	\$480,000

At first glance, the fast food opportunity provided John with higher sales potential and probably more stability in his sales projections. However, he would be risking four times the amount of capital with a potential on investment that was considerably less than with the catering operation.

You will notice that John adjusted the return on investment not only to an after tax amount, but also subtracted his actual cost for time he would have to spend on the project. So, as John was evaluating his two opportunities he gave a point value of one to ten on each of the evaluation areas.

Fast Food Operation:

Time needed for venture 7 pts.	10.5
Predictability of sales 9 pts.	13.5
Potential of new venture in dollars 5 pts	10.0
Potential of new venture in return on investment 3 pts.	6.0
Potential of new venture in potential profits 7 pts.	21.0

Total for fast food operation 61.0

## Catering operation

Time needed for venture 4 pts.	6.0
Predictability of sales 3 pts.	4.5
Potential of new venture in dollars 7 pts.	14.0
Potential of new venture as return on investment 8 pts.	16.0
Business potential profits 8 pts.	24.0
Total for Catering Operation	64.5

John now has a comparison of his two opportunities. He clearly sees that from a profit potential from both a dollar amount as well as a return on investment number, the catering opportunity is the clear winner. However, he has to balance this with having much less predictability of sales as well as time investment that will be required on his part.

So, as John makes his decision about which if any of the two business opportunities to pursue he now has a systematic way of looking at each of the risks he can take. He also now has a great way of evaluating each risk on five different and distinct points.

John wanted to make sure that he did not bet the store on any new profit center for his company. He realized that he's worked hard and long to get to where he is today. The last thing he needs is a new venture that could put his business at risk.

Using a systematic way of looking at his business allows him to make sure he keeps his options open and not make a decision that could put his business and personal financial situation at risk.



For More information contact Josh Patrick  
at 802-846-1264 or email to: [Jpatrick@patrickgroup.com](mailto:Jpatrick@patrickgroup.com)

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20 Kimball Avenue - Suite 201 - South Burlington, VT 05403