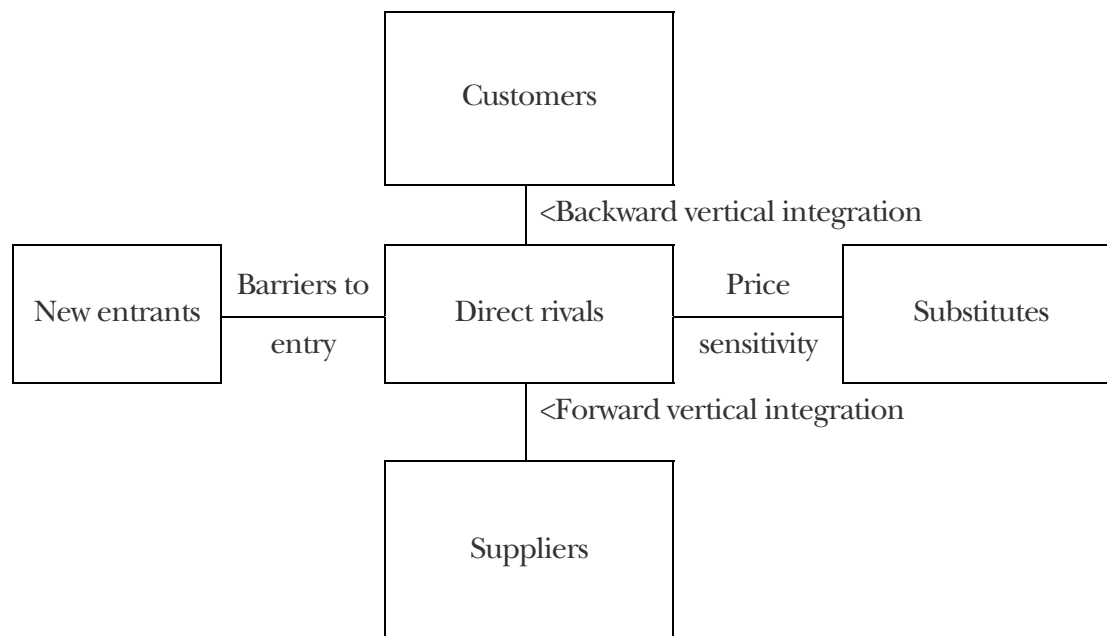


READING

MARKET RISK

- **Threat of new competition**—In some industries, barriers to entry is fairly low, brand names are not dominant, and customer loyalty to brands is fairly weak. In these industries a higher risk exists that new entrants can emerge and drive down profits for the entire industry
- **Threat of substitute products and services**—For some products and services, substitutes are plentiful, and with low buyer switching costs, a price-sensitive customer will make the switch when the price of a substitute at close to or below the existing product being used

Michael E. Porter's "Five Forces" Model



- **Bargaining power of customers** deals with the sheer number of direct rivals selling a similar product (not a substitute) and competing for the same sales. Another aspect is the existence of large customers that can command price concessions due to the size of their orders. In some cases, buyers can simply become their own suppliers. This is called *backward vertical integration*. For example, many supermarkets and food retailers have sourced or developed their own soft drinks to compete with established brands such as Coke and Pepsi. These same supermarkets and food retailers are also purchasers of Coke and Pepsi products
- **Bargaining power of suppliers** deals with various inputs such as raw materials, components, labor and services. Unionized or specialized/scarce talent can increase costs, as well as concentrations of providers. In some cases, suppliers can become their own customers or primary contacts with ultimate users of a product. This is called *forward vertical integration*. For example, Apple sells its products directly to consumers through proprietary stores, plus some products through service providers such as wireless phone companies AT&T and Verizon
- **Intensity of competition from direct rivals**—Sometimes called the “center ring of competition,” this is where direct rivals slug it out. Intensity often is signified by high level of advertising and brand maintenance, such as with Coke and Pepsi. Innovation is one of the few ways to build competitive advantage within an intense group of direct rivals

READING

These forces are assessed based on their effect on industry profitability. As with industry risks, each commercial borrower will experience different levels of competition from each of these forces. A business banker will need to use business development calls and credit investigation to determine which forces pose the greatest risk.

In addition to the five forces, a business banker should also consider the following factors:

- *Is the business considered a global, national, regional or local player?* Global players tend to be in more diverse markets (positive), but are more exposed to currency exchange risk (negative). Local players may enjoy less competition (positive), but more closely tied to strength of local economy (negative)
- *What is the firm’s market share and trend?* Market share should be considered relative to the “level” (global, national, regional or local) of the business, with heavy emphasis on current increases or decreases in share. For many small borrowers, detailed market share may not be available, but can be estimated based on contacts with suppliers, customers and other credit investigation research
- *Is the business a pricing leader or pricing follower?* This closely related to market share, since more dominant players tend to be able to dictate pricing
- *Does the business have a competitive advantage in cost of production or sourcing?* Some firms are able to purchase materials or hire labor at better rates, often a function of location, government regulation and other issues
- *Is demand for product/service stable or growing?* Stability of demand can be influenced by general industry trends, as well as the particular product or service being offered by the business, and its relative share of market
- *Does the business have established relationships with loyal customers?* This is another area where stability tends to reduce risk to revenues and profitability. Long-term customer relationships can be uncovered as part of the business development call effort
- *What is the firm’s overall performance (ratios) compared to peers?* Using industry association data or the RMA Annual Statement Studies, how does the business compare within its industry? Any favorable or unfavorable comparisons should be consistent with other research from the credit investigation. For instance, if the business has a competitive advantage in cost of production, its cost of goods sold as a percentage of sales should compare favorably to its peers

Using the example risk rating grid, the market risk section is shown below.

Risk Rating	1	2	3	4
Label ⇒ ↓ area	Minimal risk, (superior)	Modest risk (exceptional)	Average risk	Acceptable risk
Market risk (Position within industry and level of competition)	<ul style="list-style-type: none"> • Leader with large share in stable industry • Pricing leader and low-cost producer • Performance ratios rank high 	<ul style="list-style-type: none"> • Reasonable market share nationally or strong regional presence • May dominate local market • Competitive pricing with good margins • Above average performance ratios 	<ul style="list-style-type: none"> • Price follower with average market share • Stable demand • Established and loyal customers • Smaller firm with strong local position • Performance ratios generally better than peers 	<ul style="list-style-type: none"> • Position within industry is weak or deteriorating • Maintenance of market share is difficult and expensive • Customer/supplier relations price-driven • Smaller firm with average local presence

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As a final market risk issue, a business banker should find out the industries in which the customers of the business operate, plus key trends affecting those industries. As an example, a firm can produce steel pipe, but if sales are primarily to oil and natural gas servicing businesses, the pipe producer's sales levels will tend to be more cyclical, and have added pressure from changes in the underlying commodity prices. In contrast, another steel pipe manufacturer may sell primarily to municipal, county-level or regional utilities as they lay pipe for various applications and maintenance. Since utility firms tend to have a stable customer base and exclusive rights to service certain territories, their steel pipe suppliers would likely have more stable revenue opportunities and less exposure to commodity price swings.