

Strange Bedfellows: Innovation and Risk Aversion

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The age of innovation is clearly upon us. The cry for more innovation in all sectors of business around the world has grown to a deafening roar. The financial markets are clearly rewarding stockholders in companies that possess a healthy and demonstrable new product pipeline. The question is no longer what to do but how to do it. While there are many obstacles to building a sustainable innovation capability, one of the more insurmountable obstacles is the organization's aversion to risk.

All organizations have some degree of aversion to risk. At a certain level, it's a healthy instinct that protects us from betting the farm on brussels sprouts. However, in many organizations there is an unhealthy level of risk aversion. It can be a major barrier to developing a sustainable innovation capability and the silent killer of many potentially great innovations.

For illustration, let's consider Google and Ford Motor. Why is the former an innovation dynamo and the latter mired in a life-threatening rut? The answer to this has much to do with their relative sizes (employees, not equity) and positions in their respective lifecycles. Google is young with much to gain and little to lose. It is growing rapidly, creating opportunities and wealth for multitudes of energetic young employees. Fear of losing one's job or a promotional opportunity or a bonus is nowhere to be found at Google. At Ford Motor, I suspect, the culture is tinged with all of these fears. Ford Motor managers have much to protect. It has become more important to protect *what is* than to create *what could be*. And the result of this mindset is risk aversion. In simple economic terms, the costs of failure are greater than the rewards of success. It happens to every, yes every, company that has ever succeeded long enough to become one of the surviving players in a saturated and slow growth industry. But is Ford Motor doomed. Absolutely not. Just ask BMW.

Do you have a risk averse organization? Nobody likes to admit this publicly but, in many companies, this self-criticism is often heard. Maybe you are not sure if your organization is risk averse or not. Ask yourself these questions:

- Does management spend more time in monthly/quarterly business reviews talking about (A) making the monthly or quarterly forecast or (B) innovation and growth opportunities?

- Which is the more closely watched performance metric: (A) days of receivables outstanding or (B) % of revenue from innovative new products?
- Does your company spend more resources on (A) cost reduction efforts or (B) new product development?
- Do most of your senior leaders have reputations for (A) strong execution and delivering results in existing business lines or (B) creating new products and building new businesses?
- Is project management a role that is (A) viewed as subordinate to line management and not worth the career risk or (B) celebrated and rewarded as critical to the organization's success and a necessary leadership development step?

If you answered (A) to one or more of these questions, you are probably working in a fairly risk averse organization. But not to worry! So are most of the rest of your peers in the corporate world. Whatever your risk aversion profile, it is likely that you have become more so in this new age of Sarbanes-Oxley regulations.

At first, "risk averse innovation" appears to be an oxymoron...like "short-term vision" or "strategic operating plan". Surely, if you hope to have a more innovative organization and culture, you are simply going to have to figure out how to reduce your aversion to risk. Right? Wrong. There simply is not enough time for Ford to transform its culture from timid giant to nimble Google. I prefer the approach that recognizes and accepts your aversion to risk and works to make innovation a less risky proposition. Over time, as innovation success occurs, the culture will also begin to change in the direction of less aversion to risk. So, the question I pose is this: how can you mitigate the risk inherent in innovation, thereby transforming your ability to innovate within your risk averse culture? As you will find in the following paragraphs, the answer to this question is that there are many ways to mitigate these innovation risks.

The panaceas usually offered in the business media rarely take risk into account. These pathways to greatness can usually be paraphrased as "do all things perfectly well all the time" and are likely to make the reader or listener feel positively energized...for about a half a day. There is little recognition for the realities of running a business...as if resources were abundant, capital was free, competitors were scarce and time was infinite (no short-term pressures). The pressures of budget, time and competition make tradeoffs and risks critical considerations for business leaders.

There are many ways to mitigate the risk inherent in a broad innovation effort. The most important six things to do to mitigate innovation risk are as follows:

1. Focus the effort
2. Recruit partners
3. Create the resources
4. Streamline the investment decision process
5. Experiment
6. Measure, measure, measure

1. Focus the Effort Avoid opening up the innovation funnel too broadly. Initially, it is important to keep a focus on areas of opportunity that play off existing capabilities, known customer insights and established brand positions. The business journals are full of recommendations to open up the innovation funnel all the way to “unleash the creative power of your people”. Most organizations don’t have the bandwidth to unleash all their people on an unbounded range of opportunities nor the resources to sort through and develop them. For example, Toyota is getting significant innovation kudos for their work on fuel-efficient hybrid engines. This *breakthrough* technology is well within the range of Toyota’s existing research and engineering capabilities and supports existing products and brands. In addition, a strong focus on leveraging your current capabilities is more likely to lead to early momentum-building successes. Finally, as Geoffrey Moore states convincingly in *Dealing with Darwin*, specific types of innovation can only be successful at certain stages of industry and category life cycle maturity.

2. Recruit Partners Avoid the natural tendency to go it alone. It is important to spread risk by bringing partners into the process. This not only can spread investment risk but also greatly increases the odds of finding truly innovative, value-creating new products and services. This means forming partnerships with suppliers, trade partners, technologists, other adjacent businesses and even competitors. The greatest obstacle to this approach may well be your legal department due to the risk that they perceive in partnership agreements. Also, if procurement is involved, entering these partnership discussions as purely competitive negotiations aimed at getting more than your fair share spells disaster. The cost to the enterprise of not creating these agreements greatly outweighs the potential gain from favorably negotiated agreements. Remember that your legal and procurement functions may be more concerned with the *what is* than the *what could be*. If your legal and procurement functions are impediments to your innovation effort, it may be increasing the risk to your business rather than reducing it. The operative word here is *trust*. It also helps to avoid the temptation to predetermine the financial outcomes for all partners early in the process. It’s a huge time waster and resource drain at a point when the odds of success are still low.

3. Create the Resources Do not confuse commitment to innovation with funding for innovation. It is possible to be very committed to innovation without throwing bags of money at it. In fact, a 2006 study of the 1,000 largest R&D spenders in the world found no correlation between R&D spending and shareholder return. In addition, it is healthy to challenge the organization to “create” the human and capital resources necessary to deliver more innovation. Most product development organizations want desperately to work on innovative opportunities rather than incremental product improvements or cost reduction. If the means to do this work lies in freeing internal resources or spending capital more wisely, these product development organizations will find a way to do it. Finally, having a strong human and capital efficiency program in conjunction with your innovation effort provides a nice *yin and yang* strategic balance. The opportunities to create resources in today’s world are plentiful, including global service center (centralization), outsourcing, offshoring and six-sigma or lean enterprise. A balanced approach that pursues any or all of these productivity programs in conjunction with an innovation program will help to accommodate the company’s aversion to investment risk.

4. Streamline the Investment Decision Process Companies have limited resources, both human and capital. Consequently, decisions must be made about how to allocate these limited funds. This is often referred to as portfolio management. Making sound investment decisions poses a great challenge for most companies. Making these decisions quickly and decisively poses a secondary challenge that can increase investment risk if done poorly. Some of the challenges are:

- consistency and integrity of business case assumptions across all projects in the portfolio
- political power trumps rational decision-making
- lack of a disciplined decision-making technique
- incremental budgeting in which innovation resources are spread like peanut butter across all businesses, brands, regions or product categories

Investment decision-making is like sales forecasting – it is very difficult to be right even half of the time. World class performance in your industry might be improving your success rate from 5% to 25%. Ultimately, knowing what customers will be willing to pay for a new product or service is very difficult and uncontrollable. However, managing all of the other variables within your control can create a major competitive advantage. This requires an integrated combination of organization design (decision accountabilities), management process, information tools and decision-making frameworks. This sounds difficult but it need not be so. This is an area in which perfect may well be the enemy of good enough. The low hanging fruit is in the elimination of the really bad decisions...decisions to invest in opportunities that have no chance from the outset of leading to marketplace success. A clearly defined and disciplined portfolio management process can be implemented in three months time even for very large companies. This will not achieve perfection in investment decision-making right out of the gate but immediate benefits will accrue, your natural aversion to investment risk will be accommodated and you will be on your way toward competitive advantage.

5. Experiment The inclination in most companies is toward the *big bang* product launch of innovative new products. The sense of urgency, the limitation of investment dollars, the pressure for short-term performance and the mobility of professionals within companies creates a go-for-broke tendency when it comes to new product launches. There is not much tolerance in these cultures for a more pragmatic approach that tests product innovations at various stages of development with limited customer trials. This experimentation approach dramatically reduces overall investment risk and speeds “time to profit” but often at the expense of “time to full scale launch” and upfront product development and testing budgets. Companies must establish a culture of experimentation by instituting rules within their stage gate product development processes that contradict the natural go-for-broke tendency of product development managers. These rules should mandate a progression of experimentation types from the earliest concept development stages to the final pre-launch preparation stages.

6. Measure, Measure, Measure All business leaders know that the old cliché “what gets measured, gets done” is a rule of law, not a quaint aphorism. Yet, so often we find reasons not to do it. In the innovation space, we know that measurement is fraught with challenges. How do you define which projects are innovative and which are not? How long after launch does a new product get to be counted as innovation for the purpose of measuring innovation-driven revenue or profit? How do you hold any one function accountable for innovation metrics when the responsibility is shared by many functions? These are all legitimate questions but should not get in the way of getting measurements in place and working. You can improve them over time as your experience and sophistication grows. Yes, measures can be misused and create unintended consequences. But getting measures in place quickly sends a clear message to the organization that you are serious about innovation and that you are going to reward those who support it. This will get the innovation crankshaft turning.

In summary, there are real risks inherent in pursuing a broad innovation platform in your organization. To the extent that your organization is risk averse, you are swimming upstream and likely to run into hidden shoals or submerged trees lying just below the surface. It is better to expose these risks and openly address them than to pretend that they are non-existent. It can be difficult to admit publicly that your culture is risk averse. Get over it! You are not alone. Admitting the problem is the first step toward recovery.