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Manage Risk Like An Entrepreneur

Welcome!

Innovation brings risks, but the most successful innovators understand that risk can be managed. In this issue of "Strategy & Innovation," I interview Innosight board member Clark G. Gilbert and President Matthew J. Eyring about their recently published "Harvard Business Review" article, "Beating the Odds When You Launch A New Venture." Also in this issue is an excerpt from Mark W. Johnson's "Seizing the White Space: Business Model Innovation for Growth and Renewal" that delves into a very specific type of innovation – how companies can innovate at the business model level by merger and acquisition.

Comments and suggestions are always welcome – send them to editor@strategyandinnovation.com.

— Renee Hopkins, Editor

Events

World Innovation Forum 2010 – Renee Hopkins will be tweeting and blogging coverage from the event, June 8-9, New York.

For World Innovation Forum:
http://us.hsmglobal.com/contenidos/wifhome2010.html

Feature*:* How to Manage Risk in New Ventures

Corporate innovators can learn how to spot and reduce risks the way entrepreneurs do.

By Renee Hopkins

Innosight President Matthew J. Eyring and board member Clark G. Gilbert's article, "Beating the Odds When You Launch a New Venture," was published in the May 2010 issue of Harvard Business Review*. Eyring and Gilbert, a former Professor of Entrepreneurial Management at Harvard Business School and* *currently President and CEO of Deseret Digital Media, spoke with* Strategy & Innovation *Editor Renee Hopkins about the best ways to manage risk in new innovative ventures.*

Q: In your article you talk about the concept of removing risk vs managing risk, and the sense that not all risk is created equally. Can you say more about this? Is the entrepreneur removing risk or managing risk?

Gilbert: They're doing both, because you can't remove all risk. We're not saying "remove all risk and then move forward," we're saying, "remove some of the key risks, reduce others, and learn. This sequence of key risk reduction will cause your value to go up disproportionately."

Eyring: Another important idea is that usually in a venture there are a set number of risks that we call dealkillers that could really terminate an opportunity. And it's very, very important to get to those quickly.

Q: When you say "value will go up disproportionately," you're talking about value as venture capitalist would use that term, right?

Gilbert: Yes, but even in a corporate setting there's value. When I lead discussions on this, I'll first show direct risk reduction and how it affected each round of funding in a venture capital setting. Then I'll ask the question, "OK, say you're privately funded or you're in a large corporation. Would you still follow this pattern?" And it leads to a great debate. But most corporate innovators end up discovering that this practice of removing the most important risks is the right rigor and approach to a new venture, regardless of its financing. In fact, the venture capital structure is helpful in many ways because it forces this discipline. But our experience has been that when large organizations or even small entrepreneurs follow the same discipline, they have unusual success in the launch and creation of their ventures.

Q: In that answer you touched a bit on how innovators within corporations can adopt this approach. Can you say more about that?

Gilbert: One of the things we encourage corporate innovators to do is to follow this same sequence as if there was a formal interim milestone, like a valuation event, around the venture. A true venture-backed start-up basically has this interim scorecard, whereas the large corporate venture setting doesn't have it. And so one of the things we suggest to corporate innovators it that they impose the scorecard on themselves. Identify a process, or develop a process, where you specify the key risks. Then you rank-order them based on the highest-risk aspects of the venture, and start to remove those in sequence. Then you measure the venture's progress based on how much risk has been removed, as opposed to how much capital has been invested.

Q: As you pointed out in your first answer, you need to identify "dealkiller" risks first. They're presented in the article in the order you need to go – dealkillers, path-dependent, then the easy-win, high ROI risks? What are the ways you can identify those dealkiller risks? You do say that a lot of these are things you really only see that well in hindsight – how can you learn to see them earlier?

Gilbert: Sometimes the risks are much easier to identify in hindsight, unfortunately. But one of the things we've done is lead organizations through an exercise that says, "which one of these risks, if unresolved, would destroy the entire premise of the venture itself?" In the article we cite the satellite example where no one looked at the issue around whether or not the radio device was affordable in a Third World setting. They proceeded to make huge investments in other areas of risk reduction without ever asking that fundamental question. So, in some ways it takes practice to be able to ask that question – "which one of these risks, if we don't address it or it can't be resolved, will kill the venture?"

Sometimes you can resolve that risk very quickly with a low-cost experiment. That's why the very next step is the path-dependent risk. Because sometimes the result of the experiment might change your strategy to a different part or a different emphasis in the venture. But that is the most common mistake we see, is that people run down the path of funding a venture with high investment without really having focused on reducing the risk that would determine whether a venture's viable or not.

Eyring: Risks that have to do with technology, and its cost and viability, are often places you want to look, especially if it's a first-of-a-kind technology. Other than that, the best way to start is to map out the elements of your current business model, if you are a corporation. Those are the "knowns" – the customer value proposition, how customers behave, how they react to the current pricing scheme, how distribution works, the current cost structure, etc. The biggest dealkillers in corporate innovation stem from ignorance about the elements of the new business model that may have changed vis a vis the old one.

For example, you would ask, is this a customer who I know very well or is this a new customer who is outside my realm of experience? If we don't understand the job-to-be-done of the customer very well, that's a potential deal-killing risk. Other places that we would look early for dealkillers in the customer value proposition would be price points and willingness or ability to pay. An example of that would be a company reaching out to a brand new group of customers that it has never served who have tastes that the company knows nothing about.

Other aspects of the business model offer more clues where to look for dealkillers: using brand new distribution channels or using a different profit model. Any time any aspect of the business model changes in ways that are outside the experience of the core team, those become dealkillers in a corporate venture environment.

Q: What are the best tools to use to manage risks?

Gilbert: In practice, we've found it helpful for people to structure the new venture process in a very rigorous way. A lot of people think, "oh, new venture creation, it's all just creative energy, and brainstorming, and free-flowing thought." While we've found that those are important elements of creating new ventures, actually imposing some rigor in a process that ensures these questions are asked can be very helpful.

Innosight has worked to develop a process that begins with stating the idea in very simple terms first – we often call that an "idea resume." Once you do that, you go through a process where you identify the key risks. Once the key risks have been identified, you rank-order them. A lot of entrepreneurs or corporate innovators don't do the simple exercise of identifying the key risks, deciding which ones are the most important, and how they should be sequenced.

But just imposing that three-part process – 1) summarize the opportunity in a very simple way, 2) identify the key risks and list them in bulleted form, and then 3) ask the question I mentioned earlier: "which one of these risks, if we don't address it or it can't be resolved, will kill the venture?"— is not enough. A final activity requires you to 4) run targeted experiments against the key risk-reduction areas.

If every time you launch a new venture you go through that process, redirecting your strategy in response to the targeted experiments and continuing forward, you'll see better results. You won't ever be able to eliminate all risk. But quickly determining what's right and what's wrong with the key assumptions you've made about your venture often means the difference between failure and success.

Q: In what ways do corporations stumble when trying to reduce risk in corporate ventures?

Gilbert: One thing I've noticed is that large corporate ventures very often fail due to very common mistakes. The first one is that they treat all risk as if it was the same. And they see no need to sequence risk. Since there is no funding event, they attack all risk at the same time, or worse, in an order that's problematic.

The second thing I've observed is that, not only do they not sequence risk in the right order, they somehow equate status with level of investment. And this is a real mistake, a classic large-corporation mindset, which is that the greater the investment, the greater the status within the corporation. Even with a really high-potential new venture, you must figure out the business model before you make significant investment in expanding the venture.

However, a lot of big corporations assume, "well, if this is a big deal, then we need to put a ton of money into it." And they do that without ever figuring out first what the business model is or if there's a critical risk that needs to be managed. One of the advantages the entrepreneurial organization has is they don't have a lot of money to put into ventures. So in some ways, this risk-management discipline's forced upon them.

Eyring: One of the aspects we didn't talk about in the article that is very important is getting people with the right schools of experience or the right skill sets in place to reduce each type of risk. Traditionally within a corporation the kinds of risks that are managed are fairly well-known – they're managed on a longer, predictable cycle. But in many corporate ventures the risks are different than the corporation has seen before – risks such as finding the right foothold customer, and understanding the market dynamics and how they might play out with pricing, distribution, and other elements. This can require a whole new skill set that often isn't found within the corporation.

So we often counsel clients that if you don't have 50 percent of the people on the corporate venture that are from outside the outside the corporation and have different skill sets, you could be in trouble. For example, say you're going from a brick-and-mortar sales and distribution system to a web distribution system. You're going to have to have entirely different skill sets to sell into that environment, to keep a relationship with a customer. So you may start out in some of your early experiments with some of the core team from within your company, but eventually you'll need to transition to people with fairly unique skill sets.

Another critical mistake we find is that people often overbuild experiments for dealkillers. Oftentimes they think that if they want to find out if there's demand for a website, they think they need to build a fully integrated fully functioning website. Sometimes it's true, that you need the fully integrated experience in order to get any learning. But often that's not true. You can get a fair amount of learning by quick, simple mockups earlier in the process than people think.

Sidebar: Three Ways Corporate Innovators Can Manage Risk There are three very important ways corporate innovators can approach new ventures that in and of themselves can help lower risk:

Dedicated resources. One hundred percent dedication to the projects is critical. Corporate venturing is not a part-time job. If you are engaging in piloting, especially, latter phases of a corporate venture, there needs to be 100 percent allocation of the members on that team, even if the total team numbers are small.

Speed counts. The rhythm of the inquiry and experimentation for new ventures is much quicker, faster and more integrated than for the types of projects people typically work on in corporations. Often daily check-in by most of the team members is required, because the pieces are so integrated and the data you're getting from the experiments can change on a weekly and sometimes daily basis. What you're hearing about the early sales, the early experience the customer's having with the product, the early feedback, requires that there's an integrated team and that they're cycling very, very quickly.

If you read one of the few insider views of Apple, you'll find that it's very tightly integrated, with teams that are communicating all the time. It's obvious that you can't get an experience like you do with their software and hardware unless everybody's communicating.

Top-down leadership. Corporate ventures are not a completely grass-roots effort -- there has to be a significant top-down, experienced leadership, first to green-light the project, to find and preserve the funds, and to get at the kind of unique resources and sometimes resources from the outside that it's going to need in order to succeed.

– Matthew J. Eyring

Feature: Buying New Business Models

How to succeed at mergers and acquisitions

By Mark W. Johnson

Companies constantly seek new growth opportunities, but organic new growth is far from a sure bet. While business model innovation is a powerful path to sustained, robust growth, new businesses can take years to mature. The skills needed to conceive and incubate them present a unique set of challenges that many companies find difficult to overcome. "A large enterprise has trouble making an investment in innovation," says Brad Anderson, the recently retired CEO of electronics retailer Best Buy. "It's in part because Wall Street has trouble imagining a new way to operate but, more important, because people inside the company can't see the value of a new idea and so won't allocate the resources and support the new initiative needs to succeed."

But organic growth is not the only option available to companies seeking transformational growth. Though most of my book *Seizing the White Space: Business Model Innovation for Growth and Renewal* is dedicated to developing new business models within incumbent organizations, I don't mean to imply that incumbents shouldn't seek to achieve transformative growth and exploit opportunities in their white space through mergers and acquisition. Incumbent companies can and should seek out opportunities to grow by mergers and acquisitions.

Some companies are legendary for their acquisitive prowess. For a time, GE acquired dozens of companies a year. Cisco has made more than one hundred acquisitions in its 26-year history. Acquisitions can be a way to quickly spur sales and develop reputations. They can allow mature organizations to brand an emerging company as "most likely to succeed" or steadily pursue sound strategic growth. And they can spur robust growth through business model transformation. When Anderson took over Best Buy, in fact, he led the company through a series of strategic acquisitions that helped it grow beyond a pure retail sales model.

But it's no news to point out that acquisitions, at the best of times, are tricky. Study after study finds that acquisitions tend to disappoint, variously estimating that half to as many as 80 percent fail to create value. The high-profile struggle of AOL after its $180 billion acquisition of Time Warner is one obvious example of an acquisition gone bad. But there are others: Daimler/Chrysler, Sprint/Nextel, and Quaker Oats/Snapple, to name only a few. Quaker Oats paid $1.7 billion for the Snapple brand in 1994 but sold it to Triarc three years later for a mere $300 million.

I believe many M&A disappointments stem from a failure to understand the fundamentals of business model development. Companies often acquire other companies without fully understanding what they're buying. The new company's resources can be folded into the core of the acquiring company, but new business models resist such integration. Consequently, successful acquisitions tend to fall into one of two camps. An acquirer can buy a company solely for its resources, which it would then fold into its own model, while jettisoning the rest. The bulk of Cisco's acquisitions follow that pattern. Alternatively, a company can seek to acquire another company's business model, which it then needs to keep separate, but can strengthen by injecting into it its own resources. That's that Best Buy did with Geek Squad. Trying to integrate in ways other than these that don't allow a way for two very distinct business models to integrate is a recipe for a failed acquisition.

What they're buying, essentially, is the other company's business model, which as I explain in more detail in *Seizing the White Space*, consists of a value proposition customers want, delivered through a coherent profit formula by employing certain key resources effectively through certain key processes.

Johnson & Johnson has understood this, buying business models at an early stage and then keeping them separate. For example, its Medical Devices and Diagnostics division bought three business models that were fundamentally new to its respective markets: Vistakon (disposable contact lenses), LifeScan (at-home diabetes monitoring), and Cordis (artery stents used in angioplasty procedures). J&J bought these companies young and incubated them into the larger enterprise, where they became the growth engine of the MD&D division for many years.

All too often attempts to fold an acquired business into the core can kill what made it unique in the first place. Video game maker Electronic Arts (EA) learned this the hard way. Propelled by investor expectations, rising development costs, and an industry consolidation trend, EA aggressively bought up small companies led by creative teams that had found success in the market. To profit from anticipated economies of scale, it built up a standardized technical infrastructure and imposed streamlined production processes on its new acquisitions.

The results were abysmal. EA fell into a pattern of producing mediocre products based on movie licenses and sports franchises, which were updated each year. "EA is a strong brand, but a predictable one," says Dan Hsu, former longtime editor-in-chief of *Electronic Gaming Monthly*. "Gamers know what they're getting into: something with high production value and solid but not spectacular game play."

Forcing creative teams to follow core processes was killing their innovative spirit. Luckily, CEO John Riccitiello saw the writing on the wall. "Where our industry has made mistake after mistake," he says, "is forcing those technologies down the throats of development teams who know what works . . . It's leading to creative failure . . . We're getting less-creative, less-innovative products."

Then he announced a sea change in EA's operations: independent creative studios would operate as "city-states" within the EA corporate structure. "[Riccitiello] fell on his virtual sword and admitted that his company had squandered its leadership position in the market by trying to reduce the creative process to a cell on a spreadsheet," reported the *New York Times*. "He said his company had lost its way by trying to homogenize and manage its creative process much like the consumer products companies (Häagen-Dazs, PepsiCo, Clorox) he used to work for . . . 'Frankly, the core of our business, like in any creative business, are the guys and women who are actually making the product,' Mr. Riccitiello said. 'You can't just buy people and attempt to apply some business-school synergy to them. It just doesn't work. The companies that succeed are those that provide a stage for their best people and let them do what they do best, and it's taken us some time to understand that. In our business the accountant, the guy in the green eyeshade, is like the guy in the alien movie that eventually gets eaten. If you let him run your business, it is neither inspiring nor effective.' "

Most of the same principles that govern the incubation, acceleration, and transition of homegrown new business models apply to acquired ones as well. Equally important is leadership's ability to allow a newly acquired business model to pull what it needs from the core, rather than having elements of the core model pushed onto it. Best Buy's Brad Anderson expressed this idea succinctly when asked about the company's acquisition of Geek Squad, an in-home computer services and support company. "Geek Squad bought Best Buy," he said, "not the other way around." Anderson knew that the synergy would produce growth and transformation for the company, but he also knew that the low-margin, high-volume, retail mentality of Best Buy could easily suffocate the high-touch, high-margin service orientation of Geek Squad. He let Geek Squad pull from Best Buy what it needed to thrive. At the time of acquisition, Geek Squad had 60 employees and was booking $3 million in annual revenue. Today, working out of 700 Best Buy locations across North America, Geek Squad's 12,000 service agents clock nearly $1 billion in services and return some $280 million to the retailer's bottom line.

As Vijay Govindarajan and Chris Trimble noted in *Ten Rules for Strategic Innovators*, a newly acquired business based on a model distinct from the core should decide what it can borrow from the parent, what it should forget (or forget about), and what it will do or learn that is completely new. The key to understanding what to forget and what to learn lies in the business model. You must understand both your own business model and the new company's model completely, so you won't throw away the most valuable thing you bought – the very thing that will help your company grow.

Feature: Yes, Big Corporations Can Disrupt

How P&G quietly launched a disruptive innovation.

By Scott D. Anthony

The Edison Best New Products Awards (see related reference)recently bestowed a Gold medal in the Consumer Packaged Goods, Consumer Drug Segment to "Align Probiotic Food Supplement" from Procter & Gamble. This gives me the opportunity repeat a story that has important lessons for innovators everywhere.

I first met the Align team in 2004 (see related reference). The team was developing a probiotic pill whose daily use could alleviate the symptoms of irritable bowel syndrome. More than 30 million people in the United States alone are reported to have this condition. The best that most can do is to modify their lives to account for the condition.

The idea was brimming with disruptive potential. A pressing problem with no adequate solutions. A potentially category-creating way to get the job done (see related reference). The product had unique intellectual property, and consumers who tried it reported that their lives were changed.

And, of course, it was about to get shut down.

Why the disconnect? The original market forecast said that the opportunity would be relatively small. Launching a new brand is expensive, and the team hadn't yet worked out all the technological kinks. Big investment, high risk, small return is not a recipe for corporate approval.

Yet, the team, under the guidance of Nancy McCarthy, persevered. We helped the team conduct scenario analysis to identify the assumptions that would have to prove true to justify a full-scale launch. Management agreed to provide a small amount of money to learn more about these assumptions. The team quietly launched the product over the Internet. It didn't spend tens of millions in advertising; rather it used its existing pharmaceutical sales force to push the product in a few cities.

P&G then moved to sell the product online through websites like Walgreens.com. Finally, the product launched nationally early last year.

Important insights came from this process. Instead of simply having a vial with a bunch of pills in it, the Align team created a "blister pack" with days of the week on it to remind consumers to take the pill every day. Branding changed as well. Initial packaging said Align was "from the makers of Metamucil." Today Align stands alone.

As Chief Technology Officer Bruce Brown told me for a 2008 Forbes article describing Align (see related references), "The team stair-stepped to market, never investing ahead of learning." (You can also read more about Align in Chapter 6 of *The Silver Lining.*)

Anyone who has seen me speak knows that one of my favorite quotes is Intuit founder Scott Cook's wonderfully pithy, "For every one of our failures, we had spreadsheets that looked awesome." The lesson is not to confuse an awesome spreadsheet with an awesome business. Similarly, crummy market forecasts can obscure solid business opportunities.

Innovation success requires looking at the numbers critically before making investment decisions. Look for the assumptions behind the numbers and find simple, affordable ways to pressure test those numbers in as-close-to-market-conditions as possible.

This story was originally published on Scott's Harvard Management blog, Innovation Insights (see related references).

Related references

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