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Risk Management and Innovation

The biggest risk could lie in misconceiving risk management itself, says Innosight's Mark W. Johnson

By Mark W. Johnson

Remember those analogy questions on the old SATs? An ordered pair was followed by several other pairs from which you were to choose the closest comparison—dogma is to heresy as rule is to exception, or consensus to dissent, and so on. Here's a hypothetical one I'd like to test out on executives responsible for breakthrough innovation in their companies:

RISK MANAGEMENT:INNOVATION:

A. ballast:ship

B. dead man's pedal:locomotive

C. vaccine:influenza

D. reconnaissance:battle

E. engine:automobile

My guess is that the vast majority of marks from the No. 2 pencils would show up beside answers A through D—risk management balances innovation, keeps it from going off the rails, inoculates it against danger, or scouts the territory ahead for danger. Few respondents would likely choose E, yet I think it comes closest to capturing the practice of the most successful and efficient innovators.

Their approach can be summarized in three counterintuitive observations about the often poorly understood relationship between risk management and innovation:

1. Risk management isn't the antithesis of innovation; it's the essence.

How an organization conceives of risk management will in large part determine how effectively innovation is pursued. As with the first four answers to my hypothetical question above, many people see risk management as largely preventative or as the opposite of the bold risk-taking that breakthrough innovation is assumed to entail. In this view, risk management is the guy in the green eyeshade whose job is to stand behind the visionary with his head in the clouds and keep his feet on the ground—and sometimes hold those feet to the fire.

But risk management and innovation aren't opposed. As Clark G.Gilbert and my colleague Matthew J.Eyring recently argued in *Harvard Business Review*, the core competency of the most effective and successful innovators is risk management. To repeat: Risk management is their core competency. For these innovators, whether in new ventures or in a corporate setting, the ability to identify, prioritize, and systematically eliminate risks is what drives innovation forward.

They approach risk management not as a safety procedure but as a learning process. They know that no new-business model is perfect from its inception. So they test its various components and their combinations—its customer value proposition, profit formula, key resources, and key processes—in controlled experiments in tightly circumscribed markets, learning as they go and making adjustments.

2. Risk management isn't the brake on innovation; it's the accelerator.

Risk management, treated as a learning process, not only propels innovation forward but can also speed it up. For example, Hilti, a maker of handheld power tools that was seeing its premium products undercut by lower-priced tools, innovated a new business model in which the company would lease and manage "fleets" of tools for contractors who found tool management a bigger headache than tool costs. The model would require on Hilti's part an entirely new set of skills—contract management, customer relationship management, fleet management—and require an entirely new way of working with clients. All of these challenges represented significant risks for success.

To manage those risks, the company tested an early form of the business model on only eight customers in its home market of Switzerland. During this early period, they were able to experiment with various accounting metrics, contract parameters, and service models—testing and refining the assumptions in their new value proposition. They had believed, for example, that only large construction firms would be interested in the leasing option, but they quickly learned that small and midsize firms had reasons of their own for finding it attractive. By conducting many small experiments in this limited foothold market, from which it learned valuable lessons and made important early course corrections, the company was able to take the new model from its pilot stage to rollout in all of its markets worldwide in only three years. As Hilti understands, the right kind of risk management isn't just built for comfort; it's also built for speed.

3. Real discipline in innovation risk management means a more relaxed approach to the financials.

In genuinely new-business innovation projects, it is critical to release the leaders of the effort from the norms and metrics of the core business. While experimentation speeds the time to a viable business innovation, it does not necessarily lead immediately to the kind of large-scale growth or increased market share that are usually the barometers of performance in the core business. When new-business innovation fails within a few years to generate major growth or market-share gains, one of two things often happens. Either the effort is abandoned prematurely or more money is thrown at it to push it forward. In the first instance, a more patient company often comes along and succeeds with a similar value proposition. In the second, we often see "zombie" innovation projects that limp along, continuing to suck good money after bad.

It is more prudent and ultimately more productive to first get the value proposition right and to judge it in terms of how fast it converts assumptions to certain knowledge. The relevant financial measure during this stage is whether the new business can be made profitable in its foothold market. Profitability confirms the strength of your fundamentals, allowing you the patience to scale up in a measured way. That is the real financial discipline in innovation risk management: the unswerving ability to resist applying the wrong kind of financial metrics at the wrong time and so unwittingly choke off growth potential before it can reach full fruition.

Taken together, these three principles suggest that one of the biggest risks in innovation is to see risk management as a framework to be superimposed on new-business creation rather than as an inseparable part of the process itself.

Mark W. Johnson is Chairman and Co-Founder of innovation consulting and research firm, Innosight. He is the author of Seizing the White Space: Business Model Innovation for Transformative Growth and Renewal, (Harvard Business Press, February 2010) and a co-author of The Innovator's Guide to Growth (Harvard Business Press, July 2008).