Managing Innovation Risk

BY JOANNA BARSH & MARLA M. CAPOZZI

It's a profound and often costly paradox: When companies most need to innovate, they are least inclined to do so. Leaders reflexively associate innovation with risk, and many run away from it when the economic climate generates risk on its own.

Why do so many steer clear of innovation? Our research reveals a wide gap between the aspirations of executives to innovate and their ability to execute. While more than 70% believe innovation is and will be a top driver of growth and value creation in the next three to five years, they often don't have the mechanisms in place to make it happen. Additionally, more than half of executives say that, while they have pockets of innovation throughout their organizations, they have limited innovation at scale and, thus, aren't capturing maximum value.

Leading Innovation from the Top

While there are many practical methods to cultivate innovation, not all of them are effective when transferred from one organization to another. Our research, however, shows that three "people fundamentals" do apply universally: leading from the top and integrating innovation into the senior leadership agenda, making better use of talent through innovation networks, and taking explicit steps to foster a culture of trust where it's safe to express ideas (see Joanna Barsh, Marla M. Capozzi, Jonathan Davidson, "Leadership and Innovation," *McKinsey Quarterly*, January 2008, www.mckinsey.com). What differentiates high-performing organizations from others is the role leaders play in managing, driving, and scaling innovation from the top.

Executives who formally make innovation a priority as important as growth, risk management, and regulatory compliance reap significant benefits from doing so. This is confirmed by our research: High-performing organizations employ a top-down focus on innovation. Specifically, leaders make innovation a top-three agenda item and manage it as a strategic priority, are held accountable for making innovation happen, and integrate innovation as a lever to achieve corporate strategy aspirations.

Innovation driven from the top isn't the portfolio of incremental ideas important to enhancing core businesses and essential for ongoing continuous improvement. It is much more than incremental. Leading organizations are moving beyond defining innovation as product and service to pioneer innovations in business processes, distribution, value chains, and business models.

A Critical Role for the CFO

Given the importance of leadership in driving and managing innovation, we see an untapped and critical role for CFOs: *managing innovation risk*. Our data indicates that few executives have much confidence in their innovation-related decisions. They rely on consensus and the leveraging of a fact base—a set of data that's extremely difficult to compile for products, services, and business models that don't yet exist. Leadership teams at high-performing innovators, on the other hand, are more likely to be confident in their innovation decisions because of the top-team process in place to support effective decision making and risk mitigation. CFOs are uniquely positioned to provide their peers in the C-suite with tools to make more informed and confident innovation decisions and therefore to place bigger "bets" while reducing risk.

Establishing a decision-making foundation for innovation requires balancing the tension and emphasis between process discipline and financial rigor on the one hand with learning, experimentation, and flexibility on the other. Specifically, we suggest that innovation-supportive CFOs take three actions:

- Integrate innovation into planning and budgeting processes;
- Establish a formal portfolio management process for innovation initiatives; and
- Track and measure innovation with explicit risk profiles.

These actions will go a long way to support risk-return strategies. A word of caution is necessary, however: Many organizations place too much emphasis on processes and financials. The result, unfortunately, is that innovation is marginalized—big ideas are made small—because of the application of too much financial rigor too early in the innovation process. Moreover, time is wasted applying unnecessary processes to incremental ideas rather than spending valuable leadership time on big bets. Even more so than many business topics, innovation balance and judgment are two of the most important elements to keep front and center.

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Integrating Innovation into Planning

Only 27% of executives we surveyed said that innovation was fully integrated into strategic planning and budgeting. For 19%, planning is focused solely on budgeting and forecasting. Just under half reported that innovation is addressed only informally, and then on an ad hoc basis.

Integration doesn't mean a redesign of strategic planning, although many executives agree that this would be beneficial in their organizations. Practically, it means:

1. Upon completion of strategy development and target setting, explicit discussions are held on the role of innovation in meeting these objectives and in driving growth. Where will resources allocated to innovation result in the highest returns?
2. Then, business-unit and functional leaders integrate not only the strategic objectives, but specifically how innovation will play a role. Where will innovation drive growth of their businesses, and how does this integrate with operating plans?
3. Last, business units define resource-allocation needs for core business operations as well as innovation. How will they allocate resources for moving into adjacencies (products, customers, markets, etc.) and more substantial or breakthrough innovation?

Creating a Portfolio Management Process

Collaboration between strategy and finance teams to establish a portfolio management process will go a long way toward more effective decision making. A portfolio management approach maps innovation initiatives against timing and risk to evaluate the pipeline more effectively, weighing whether it's balanced or unbalanced and considering how resources should be allocated to meet strategic objectives. This window into innovation efforts can be dynamically adjusted if it's a regular part of the top-team agenda. Doing so will save valuable executive time.

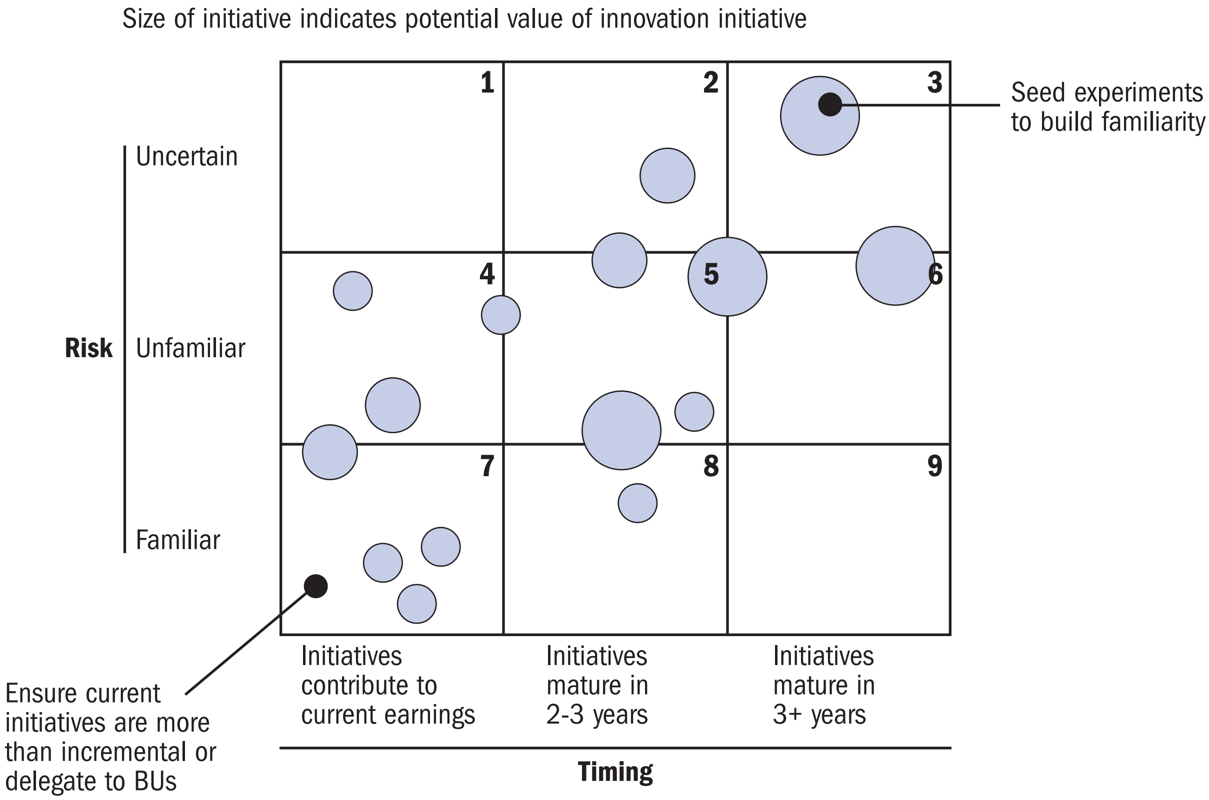
Figure 1 shows an example of a portfolio of innovation initiatives.

Measuring and Tracking Innovation

There is one capability that most businesses claim they don't do well: "killing failing innovation projects early enough." Quantified measurement of innovation initiatives is a complex task, and it comes in two parts: deciding what to measure and deciding how to track it. Metrics and measures are best selected by dividing innovation into categories based on type of innovation and uncertainty or risk. Metrics such as net present value (NPV) have the benefit of familiarity, but they tend to be useful only in analyzing more incremental innovation. For long-term projects, NPV is a blunt instrument because it lacks the flexibility needed to address uncertainty. Consider this set of categories:

- **Category 1: Incrementals.** Innovation that is largely a variation

Figure 1: A Portfolio of Innovation Initiatives



on or expansion of products or services fits neatly into traditional metrics such as NPV.

◆ **Category 2: Adjacencies.** Innovation that leverages assets and core competencies often features characteristics similar to those of current services and product lines. The business case for such efforts is usually a well-defined function that appears out of traditional methods.

◆ **Category 3: Breakthrough Bets.** Innovation initiatives that address new or unfamiliar areas require different approaches. Leaders should set goals and dates for teams, but goals should reflect the creation (or at times the exploration) of the components of larger goals and ideas.

Additionally, innovation risks associated with Category 2 and, most important, Category 3 ideas should be explicitly considered. A risk framework should outline such areas as:

◆ **Market/competitive risk.** What consumer or sector dynamics such as competition might impact success?

◆ **Talent risk.** Do we have the talent required in key positions to ensure success?

◆ **Cultural/political risks.** Are innovations being launched in countries with specific regulatory environments? (See Figure 2.)

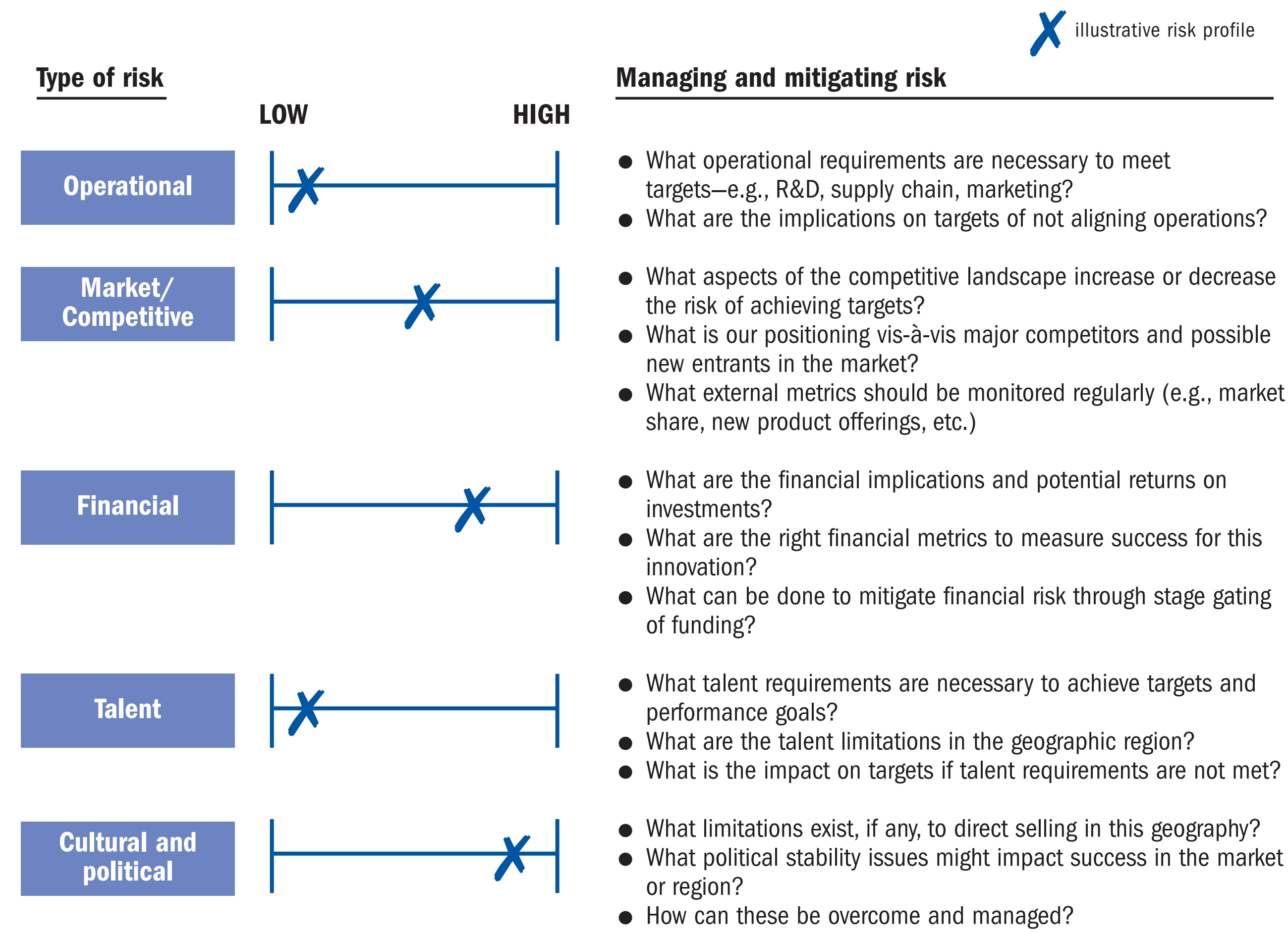
◆ **Financial risk.** Are the development costs high enough so that the the risk of capturing returns within a time frame of three to four years is low?

◆ **Operational risk.** Can the organization mobilize and have the capabilities to take this innovation to market?

Another core attribute of high-performing innovators is that they are more likely to have a formal approach to dealing with innovation failures and to learn from them. Many measurement and tracking tactics don't allow for innovation failures. Leadership teams must become comfortable with seed investments for exploration, especially in Category 3 ideas.

The mysterious nature of innovation comes just a little bit clearer to the leaders who are willing to approach the challenge with the same rigor as they do other important management topics. But there's an additional necessary factor: rigor

Figure 2: A Risk Management Framework



on risk management with flexibility for experimental learning. ■

For more information, see "How Companies Approach Innovation: A McKinsey Global Survey," *McKinsey Quarterly*, October 2007, www.mckinseyquarterly.com.

Joanna Barsh, a director in the New York office of McKinsey & Company, is the leader of the firm's North American Innovation Practice, and she can be reached at Joanna_Barsh@ mckinsey.com.

Marla M. Capozzi, an associate principal in McKinsey's Boston office, is an expert in the firm's Innovation Practice, and she can be reached at marla_Capozzi@mckinsey.com.

EDITOR'S NOTE

The research by McKinsey & Company presented in this article provides great insight into how companies can better manage innovation risk, some guidelines for doing it, and discussion of a valuable role for the CFO. Managing risk is of paramount importance to executive teams and boards, and innovation risk is an area where many companies may have a blind spot. Previously in this section we have discussed how high-performing companies in the Return Driven Strategy study (www.returndriven.com) have pursued a pattern of innovation that balances focus and options in innovation pipelines, use performance measures to monitor innovation, and learn from innovation failures. These high-performing companies have managed innovation in ways that drive sustainable superior growth, returns, and shareholder value.

Mark L. Frigo, Ph.D., CMA, CPA, director, The Center for Strategy, Execution, and Valuation, Kellstadt Graduate School of Business, DePaul University, can be reached at mfrigo@depaul.edu.