Finding the Upside Advantage in Downside Risk

BY ADRIAN J. SLYWOTZKY

In today’s rapidly changing business world, potentially devastating risk events are becoming more frequent and obvious. Companies that once owned seemingly invulnerable strategic niches have been reeling under assaults from quarters no one predicted. You may sense that your company is likely to face its own moment of life-threatening risk somewhere, sometime soon.

This is why a growing number of business leaders are identifying strategic risk management as the crucial discipline for the first decade of the 21st Century—one that managers at every level of the organization, from the factory floor and the departmental office to the executive suite, need to master and apply on a daily basis. One manager I know has gone so far as to say, simply: “Strategy is risk management.”

Unfortunately, the familiar ways of thinking about risk management don’t offer much help.

Traditional risk management focuses on three categories of risk that are widely understood: hazard risks (fire, flood, earthquake), financial risks (bad loans, currency and interest rate swings), and operating risks (the computer system goes down, the supply chain gets interrupted, an employee steals).

These kinds of risks are extremely important. But even more dangerous are the strategic risks your business faces. Strategic risk targets one or more of the crucial elements in the design of your business model. In some cases, it shatters the bond between you and your customers. In other cases, it undermines the unique value proposition that is the basis of your revenue stream. In still other cases, it siphons away the profits you depend on. And sometimes it destroys the strategic control that helps your company fend off competition. In the worst case, a major strategic risk can threaten all these pillars of your business.

How can you prepare for strategic risks of this kind? There’s no insurance policy you can buy to minimize the risks—at least not in the usual sense. Instead, a new way of thinking about risk is required together with a new array of strategic tools.

Examine Your Business

Begin by taking a close look at your business in terms of its current risk story. It’s a challenging task—the equivalent of several screenings of your company’s worst horror show, containing scenes with all the most frightening scenarios you can imagine.

To help you get started, I’ve identified seven varieties of strategic risk that most companies today can expect to face. Each exists on a spectrum from the most extreme to the least extreme. You can think about the risks you face all along this spectrum, with the severity of the risks requiring different levels of response and preparation, as depicted in Figure 1.

The chart is just suggestive. Your own business may well face additional categories that aren’t captured here; add your own specific risks to the table. For example, companies have
faced regulatory and geopolitical risks that have the potential to disrupt their business. Microsoft’s battle with antitrust authorities in the European Union is just one prominent example. Another is Arla Foods, a Scandinavian company whose $480 million of Middle East sales collapsed due to its association with Denmark after a newspaper published controversial cartoons of the prophet Muhammad.

Identify the Risks
To start writing your business’s risk story, identify the major risks facing your business—just the ones you can think of in the next two minutes. Perhaps you’ll come up with a list of 10 or so. You may feel reluctant to do this exercise because it seems to be all downside, but the actual outcome may be just the opposite.

Identifying the major risks you face is just the first step in creat-
ing a strategic risk management pro-
gram for your company, division, or
department. The process follows five
main steps:

1. **Identify and assess your risks.**
   Work your way through each of the
seven main categories of strategic risk,
and list the specific risks in each cate-
gory that your company may face.
   Naturally, the risks you face will vary
from those that seem extremely likely
to those that seem far-fetched. An
example of the former might be a risk
that has been widely predicted and
may in fact already be happening—
for instance, a customer shift that has
begun affecting younger users of your
products, causing the average age of
your customer base to increase notice-
ably and threatening the long-term
survival of your brand. An example of
the latter might be a risk that has
occurred in other industries but for
which there is no real “cloud on the
horizon” yet, so it seems only theoreti-
cally possible.

2. **Quantify your risks.** This step
   has two parts. First, for each risk on
your list, estimate the potential cost
to your company if the risk were to
strike with full force. Come up with
a dollar amount, roughly calculated
on the basis of your organization’s
annual revenues and profits and the
percentage of those revenues and
profits that might be lost in case of a
risk event.
   For example, suppose you are
working on a risk management plan
for a company division with annual
sales of $800 million. Next year you
plan to launch a new product (now in
the final phases of testing) that’s
expected to generate 10% of that
division’s revenues in its first year.
   Thus, the potential cost of a new
product failure risk in this case (if the
market were to completely reject the
new product, for example, or if some
government agency were to step in to
forbid its sale on health or safety
grounds) would be $80 million.
   Next, calculate the likelihood of
the risk event. This is tricky. The
natural human tendency is to under-
estimate the likelihood of risk
events. It therefore pays to err on the
high side when estimating the likely-
hood of a risk event. If you subject-
ively feel that a particular risk event
has a 20% chance of happening,
label it at 30%—that’s probably
more accurate.

3. **Develop risk mitigation action
   plans.** This will be the most complex
   and valuable step. You and your
team will examine each of the risks
you’ve identified and come up with a
strategic move, an action plan, or a
management system to eliminate or
at least reduce the potential damage
from each one. Not sure where to
start? In my book, The Upside, I
explain countermeasures for each of
the seven risks that can be the start-
ning point for your development of
these plans.
   For example, to deal with transi-
tion risk, a highly effective counter-
measure is double betting, whereby a
company invests simultaneously in
two or more technologies so as to
outlast any shift in consumer prefer-
ences. Companies can beat stagna-
tion risk with demand innovation, a
technique for expanding the array of
goods and services a company can
sell to its customers. To counter
industry risk, smart companies are
changing the compete/collaborate
ratio in their industry, joining forces
with their rivals (it’s legal) to carry
out largely undifferentiated func-
tions or processes.
   But it will take considerable time,
research, analysis, and discussion to
turn these ideas into concrete pro-
grams for practical action. This
process will probably involve cross-
functional teams with knowledge of
the business areas affected and the
ability to connect with others who
can provide detailed information
with which to evaluate and strength-
en the specific plans proposed.

4. **Identify the potential upside.**
   Here’s where creative thinking can
play the lead role. For every risk, ask
yourself: How could this potential
negative force be turned into a posi-
tive? If your company is in danger of
losing all or some of its customer
base, is there a way of refocusing
your product development, market-
ing and promotion, or customer
information management programs
in a way that not only retains those
customers but also increases their
buying and draws new customers as
well? If your company faces signifi-
cant risks of new product failure, is
there a way to redesign your research
and development (R&D), testing,
marketing, and business design
efforts, not only to reduce those
risks, but to improve the potential
breakthrough sales value of your
new product pipeline?

5. **Adjust your capital decisions.**
The last step in formulating your risk
management plan involves restruc-
turing your current investment deci-
sions. Investment decisions are some
of your most fundamental tools for
managing the major risks your com-
pany faces. You aren’t serious about
strategic risk management unless
your assessment of the risks affects
your major financial allocations.
   And, of course, the decisions you
make must be shaped by all the
information you’ve gathered, includ-
ing the size and likelihood of the spe-
cific risk, the estimated cost to the
company that this represents, the val-
ue of any potential upside, and the
nature of the  

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proposed countermeasure plans.

Many of today’s smartest companies are already adopting the new way of thinking about strategic risk. They’re the companies most likely to survive the catastrophic business events of the future—not if they happen, but when.

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Editor’s Note—In this column, Adrian Slywotzky provides great insight into the challenges and rewards of Strategic Risk Management. This area is a necessary competency and capability for today’s managers and directors and will require a change in the way risk is assessed and managed, new tools, and integrated processes. The approach described in the May 2007 article “Strategic Risk Management: Creating and Protecting Value” using the Return Driven Strategy framework is consistent with and complementary to the process described here. As we witness the current events of risk management done badly and the devastating results, business leaders need to start a real process of Strategic Risk Management. At recent executive forums in the Strategic Risk Management Lab in The Center for Strategy, Execution, and Valuation at DePaul University, we have heard many comments and cases that support the need for the process described in this column.

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