Mark L. Frigo, Editor

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.

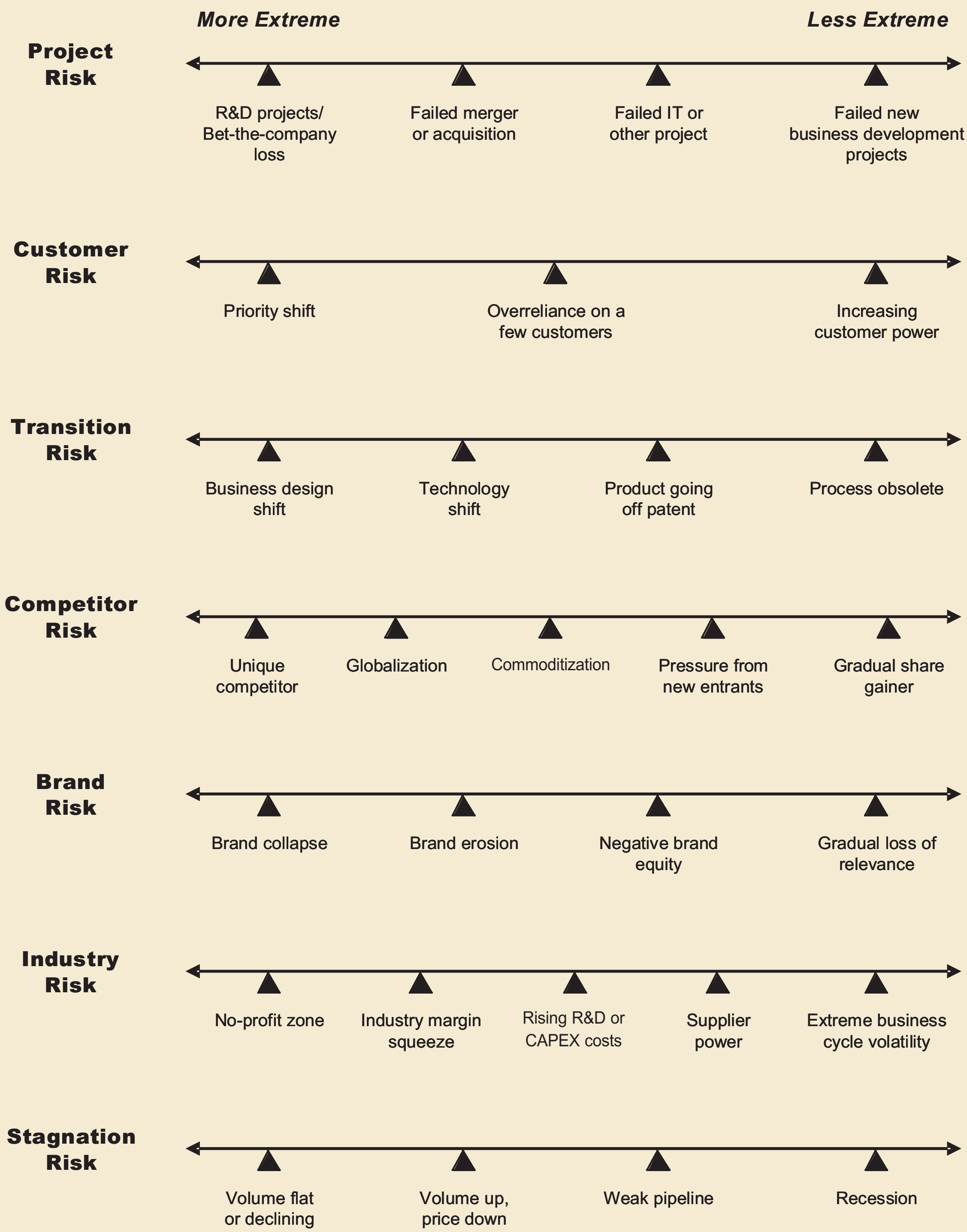
Examine Your Business

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

Figure 1: The Expanding Universe of Strategic Risks



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 the just the first step in creating a strategic risk management program 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 category 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 noticeably 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 theoretically 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 underestimate the likelihood of risk events. It therefore pays to err on the *high* side when estimating the likelihood of a risk event. If you subjectively 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 starting point for your development of these plans.

For example, to deal with transition risk, a highly effective countermeasure is double betting, whereby a company invests simultaneously in two or more technologies so as to outlast any shift in consumer preferences. Companies can beat stagnation 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 functions or processes.

But it will take considerable time, research, analysis, and discussion to turn these ideas into concrete programs 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 strengthen 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 positive? If your company is in danger of losing all or some of its customer base, is there a way of refocusing your product development, marketing 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 significant 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 restructuring your current investment decisions. Investment decisions are some of your most fundamental tools for managing the major risks your company 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, including the size and likelihood of the specific risk, the estimated cost to the company that this represents, the value 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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