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Managing innovation risk - for startups, new ventures, and their funders

by Stephanie Owen (stephanie@strategy2life.com)

Innovation is increasingly important to individuals, organisations and economies. However, startups and new ventures have a high failure rate. This article outlines three keys to managing innovation risk in order to improve the chances of success.

Rarely has disruptive innovation been such a hot topic since the term was popularised in Clayton Christensen's 1997 book, *The Innovator's Dilemma*. Now, not a week goes by without a new conference or book in which innovation gurus tell established organisations that they must innovate or be disrupted. And the growing startup community - along with the accelerator/hackathon events that feed that growth - is testament to the many who aspire to the rock-star status - and stratospheric wealth - of the founders of Facebook, uber, and other iconic disruptors.

There are numerous reasons why innovation and startups are more important to individuals, organisations, and economies than ever before. The sluggish growth experienced by most developed economies over the last few years means that growth in existing products and markets can be hard to come by. On the other hand, the exponential spread of communication technologies like internet-connected smartphones means that new global market opportunities are opened up as never before. High unemployment in some countries, especially among youth, means that self-employment or working in startups is the most viable alternative for many. The availability and falling cost of products and services needed to build new businesses (eg, technology components and freelance developers and marketers) have dramatically lowered the cost of entry. Meanwhile, social changes such as collaborative consumption means that new business models like Airbnb can quickly disrupt incumbents. Technologies such as 3D printing, driverless vehicles and the internet of things promise future disruption for even the disruptors of today. No wonder innovation is now considered key to survival.

Behind the glamour and hype, however, the sobering reality is that some **90% of startups and new ventures fail** (see some reasons here). If startups and new ventures are inherently risky, then surely, one of the keys to success is to understand and work with risk in innovation.

Innovation methodologies such as Lean Startup rely on rapid experimentation and iteration to manage risk. This has been a breakthrough in improving the odds of startup success. However, many promising startup and new venture ideas do not even get off the ground. Apart from exhortations to embrace failure, there is little specific guidance on how to overcome risk aversion, particularly in large established organisations. And while there are many prescriptions on how to develop an innovation strategy, and build an innovation factory, engine or ecosystem (for example, http://masstech.org/innovation-ecosystem), information is scant on how to think about, assess and manage risk in innovation.

I have worked with founders, leaders of new ventures and proposers of project ideas since the first dot-com boom in the late 1990s. In my work on strategic and project risk with several large organisations, I have seen the need for, and the power of, good risk management. Based on this experience, I think there are three keys to managing innovation risk.

1. Understand different stakeholders' risk-reward equations

A starting point for thinking about risk in innovation is to understand stakeholders' varying risk-reward equations. This includes their appetites for risk (the type and level of risk they will accept), because the consequence of a failed venture would vary significantly, depending on whether you are the founder/venture leader, a funder, worker, customer, or supplier.

Founders or venture leaders are mostly optimistic risk takers, to the point where it is easy to focus on the reward and ignore your own risk appetite, or that of others. When you are the founder or venture leader, a failed venture may bring reputational damage, or the loss of your particular "skin in the game": ranging from sweat equity, all the way to your family home or retirement savings. For workers, a failed venture may mean loss of employment, and perhaps the opportunity cost of better earnings or career growth if they had worked elsewhere. For funders, obviously there may be the loss of monetary investment, and depending on how the investment is made, the funder may also suffer from reputational damage. If the funder is providing hands-on guidance and attention, then there is also the opportunity cost of putting their attention and efforts elsewhere. If the funder is an established organisation and the new venture threatens the existing business, be prepared for a whole new level of complexity – even if the venture is explicitly designed to disrupt. If the venture already has customers, a failed venture may mean the loss of valued customer information that is stored in the cloud. Last but not least, suppliers would also suffer from monetary loss if there are unpaid invoices and the loss of future business.

Understanding the varying risk-reward equations of your stakeholders is akin to understanding your target customer segments, because their perceived risk-reward equation affects whether they want to do business with the startup/new venture, and on what terms. This understanding gives rise to opportunities to design your product/service or terms of business to align rewards to the perceived risk taken on by various stakeholders. It is also an essential pre-condition to overcoming risk aversion on the part of funders - whether they are external investors, or an organisation's capital allocation committee.

2. Evaluating risks, and the art of pitching

Risk is often the proverbial "elephant in the room" when assessing new ventures. It is rare to see risks explicitly addressed in a typical business case or pitch deck (for example, two great templates for pitch decks by PitchDeckCoach and Guy Kawasaki and . Funders' assessment criteria, too, often address risk only implicitly (for example, see this checklist).

When risks are not explicitly addressed, promising new opportunities may not get funded because funders' perception of the likelihood or consequence of risks may be worse than they really are. Keep in mind that a typical funder assumes that a venture will fail unless convinced otherwise, and the corollary is that explicitly addressing risks provides confidence that things have been carefully thought through. One of the most dramatic examples in my experience is the use of risk management to reverse a rejection of a business case. Back in the early days of the consumer internet, when cloud-based computing was rare and risky, a major Australian financial institution was considering offering an externally-run cloud-based service to its customers. The service would allow customers to store login credentials from the financial institution and other sites, thereby allowing customers access multiple web-based services with a single login.

The cost of the outsourced service to the financial institution was relatively small, less than 10% of what would be considered a major project at that organisation. However, the proposal was considered extremely risky by the senior management team and was summarily rejected. I worked with the proponent of the service and other stakeholders to identify and assess the strategic, operational and execution risks associated with the proposal. Topping the list was the security management at the outsourced provider, and the potential reputational damage to the financial institution in the event of a security breach. Armed with this knowledge, an IT security specialist was sent to review the security arrangements of the outsourced provider, and I facilitated the development of a contingency action plan in the event of a security breach. On the basis of the review and detailed contingency plan, the executive obtained approval for the project to go ahead, and the financial institution gained new customers, and PR kudos, for its innovative offering.

Explicitly addressing risks in evaluating new ventures means that these questions must be answered:

i. What is the worst-case scenario consequence for the funder if the venture failed, or sustained an operational risk incident (eg, security breach compromising users)? Are these risks within the risk appetite of the funder? How might these risks be managed?

ii. What might threaten the success of the venture? How are these risks managed? (These are the risks that are often addressed in other elements of the business case/ pitch deck, such as a competitive analysis.)

iii. What are the assumptions underlying the venture and what would happen if the assumptions were wrong? How might we test these?

iv. What are the risks (to the funder) of "doing nothing"? Are there any risks that might arise from a "do later" decision?

3. Managing risks in execution

Having secured funding or approval to proceed, a new venture or startup can fail due to poor execution. Or rather, and more common than outright failure, the venture may fail to meet launch timelines, burn cash ahead of growth, or miss other targets. Even if the venture eventually succeeds, these factors can erode the venture's credibility with funders and other stakeholders.

Managing the execution risks for a new venture involves the following four steps:

i. Identifying threats to the venture's objectives;

ii. Assessing the likelihood and consequence of each risk;

iii. For the most significant risks - developing mitigating plans, contingency plans, or changing some aspect of the venture so as to transfer or avoid the risk. Alternatively, the risk - and its consequences - may be accepted;

iv. Regularly reviewing the venture's objectives, risks and action plans to ensure they remain relevant and effective. This includes the ever-present risk that the market is no longer viable, possibly despite early successes.

These steps are not difficult, but the discipline to apply them consistently can separate winners from losers. A founder I know viewed project management as bureaucratic and outdated. Not surprisingly, his startup lacked direction and missed several launch deadlines. The best managed startups and new ventures execute with discipline, and this usually involves good project management, including continually identifying and managing the risks that threaten execution success.

There are good reasons for the current focus on innovation, whether it is within established organisations, or as independent startups. However, the management of innovation risk is seldom discussed in-depth, especially unfortunate given the high failure rate of startups and new ventures. A good understanding of risk-reward tradeoffs of each stakeholder group, explicit identification and sound evaluation of risks that are inherent in new ventures, and consistent, rigorous management of execution risks can help improve the odds of successful innovation, thereby delivering benefits to customers, funders, venture leaders and the broader economy.

Stephanie Owen is the principal and managing director of Strategy2Life, a management consultancy that helps leaders drive change and bring strategies to life. She has worked in and advised several new ventures and startups in fintech, professional services, scientific/clinical devices, and scientific/medical research. She has consulted to several ASX top companies in strategic and project risk management. As Risk Manager for one of them, she had oversight of risk management practices and Board reporting for all international and technology new ventures in the organisation spanning Australia, New Zealand, US and UK.