Rethinking Risk

Adventures on the strategic risk frontier

By Adrian Slywotzky

Beyond earthquakes and currency fluctuations, there's a broad array of strategic risks poised to disrupt or even destroy any business. But embracing risk is also part of the growth equation. Is your business prepared? And what are the risks you should be taking but aren't?

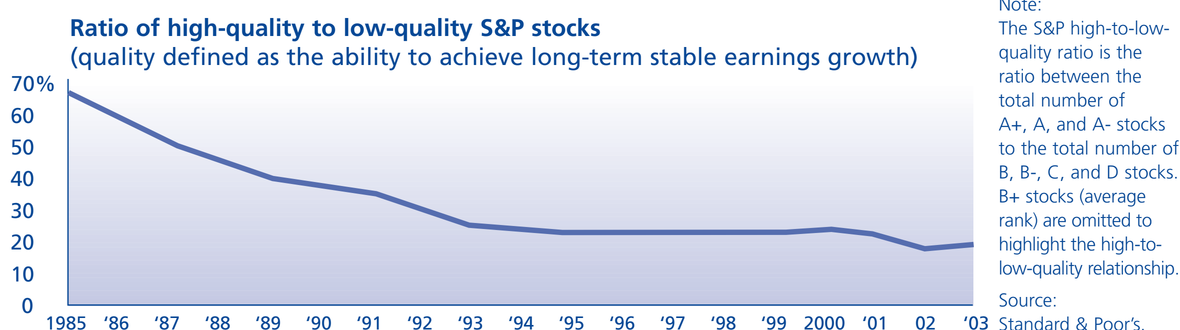
Most senior managers think of risk in relatively narrow terms—a chemical spill, an earthquake, debtor default. Against these financial and operating risks, they defend themselves through tried-and-true practices like insurance, hedging, and safety protocols.

But managers at numerous firms have benefited by expanding their view of risk. They've even come to embrace risk for the opportunities it affords. Their goal is not just to defend against bad risk events, but also to define and anticipate the upside risks that, when well managed, can deliver the maximum rewards. The discipline of *strategic risk management* allows firms to raise their growth potential in addition to reducing their economic volatility. That's especially important at a time when aggregate market growth is sluggish, for the biggest risk of all is in not taking the right growth risks for the business.

The risk equation has changed

Every large enterprise consists of a collection of businesses, each with a specific economic profile that includes both its upside potential and its downside risk. Many businesses entered the 1990s with strong upside potential and moderate downside risk. But a decade later, the reward/risk quotient for most firms has deteriorated for several reasons. On the upside (the numerator of the equation), most companies have weaker growth potential than in the past. As products and markets have matured and international competition has intensified, many companies have seen average revenue growth rates decline from the 10-15% range to the 1-3% range. Since 1985, the number of U.S. companies that are able to achieve long-term stable earnings growth has fallen sharply (Exhibit 1).

Exhibit 1 **Elusive earnings growth**



Note:
The S&P high-to-low-quality ratio is the ratio between the total number of A+, A, and A- stocks to the total number of B, B-, C, and D stocks. B+ stocks (average rank) are omitted to highlight the high-to-low-quality relationship.

Source:
Standard & Poor's.

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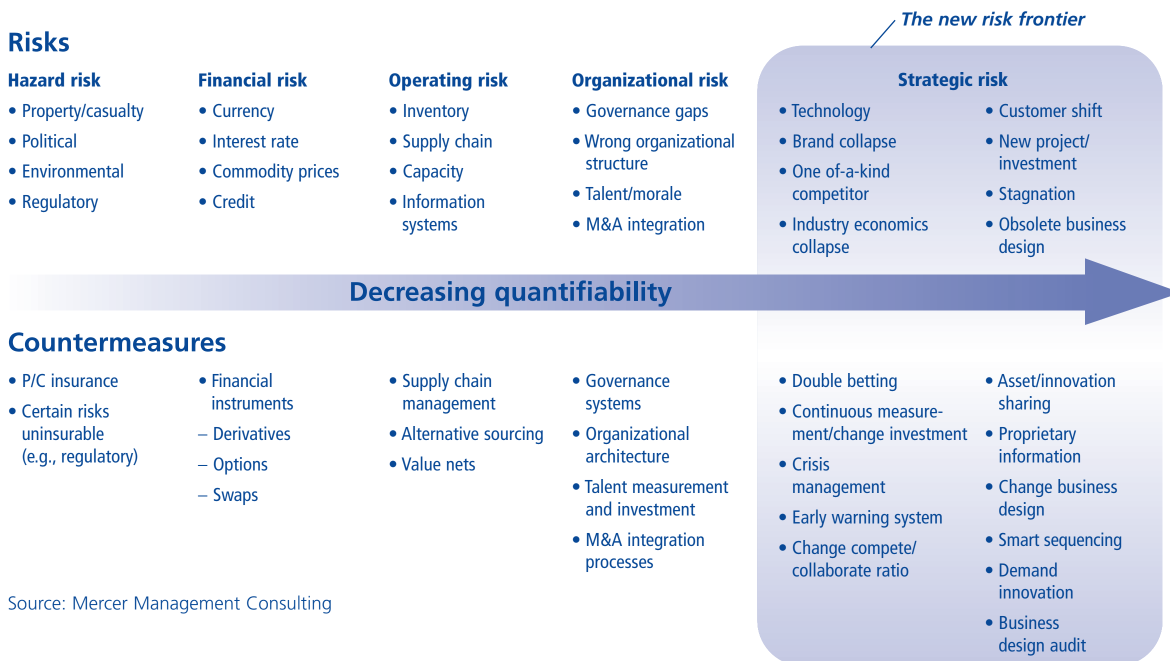
Exhibit 2 **An expanded risk spectrum**

Companies have traditionally focused on two types of risk: property/casualty risks and financial risks. Over time, these risks have been thoroughly analyzed and quantified, with effective countermeasures put in place by risk managers and corporate treasurers. In recent years, many companies have begun to link these two forms of risk plus some others under the rubric of enterprise risk management (ERM). But even ERM has not yet addressed the broad array of strategic risks. Thinking in terms of a portfolio of threats and countermeasures will help companies take an enterprise-wide perspective to anticipate threats and maximize rewards.



Source: Mercer Management Consulting

As a result of the decline in growth potential, companies have become less able to absorb risk than in the past. A business growing at 10% can take a hit and keep going; when growth is at 2%, the same blow is much more damaging and harder to recover from.

At the same time, the downside (the denominator of the equation) for most companies is much larger than in the past. Greater risk can be seen in events such as the terrorist attacks of September 11, 2001, and the collapse of numerous firms from Global Crossing to Parmalat amid charges of fraud and poor governance.

But these spectacular cases are only the most obvious examples. Businesses today are exposed to greater risks across the board, ranging from political risks to product liability and environmental hazard risks. Several economic trends (which have many positive implications, of course) play a role in the expansion of risk. For example, the acceleration of technological change and the growth of venture capital investment increase the risk that established companies will find that their current offerings have suddenly been rendered less competitive or even obsolete. Businesses are also more interconnected than ever through the rise of outsourcing and international trade, making supply chains more vulnerable to events in distant markets and making home companies subject to greater international competition.

Besides financial, property/casualty, and operating risks, there also are a set of *strategic risks* that have become increasingly disruptive. These include not just the obvious high-probability risks that a new ad campaign or new product launch will fail, but other less-obvious risks as well in areas such as technology and customer needs (Exhibit 2).

While most managers have become comfortable dealing with traditional risks, they have not yet recognized that strategic risks can often be a much larger source of value destruction. Failure to anticipate and manage this spectrum of strategic risks can expose a company to dramatic decreases in shareholder value and severe swings in stock prices. The high level of volatility in shareholder value that has long been a chronic feature of high-technology industries is spreading to most, if not all, industries. Witness, for example, the 10% *of Fortune 1000* companies that lost over one-quarter of their value in a single month during the late 1990s, even before the market meltdown. The list includes companies in every industry group, from health care and communications to retailing and services.

In today's risk-intense environment, firms must manage their economic and risk profiles more actively. The goal is not to eradicate risk, but to deliver the maximum reward for an acceptable level of risk.

Strategic risks and countermeasures

For most companies, traditional financial, property/casualty, and operating risks are unwanted by-products of the business. Strategic risks are different in that companies need to assume and manage them in order to generate high returns. Strategic risk and return, thus, are two sides of the same coin. Let's look at some of the most important forms of strategic risk and the countermeasures that can be used to address them (Exhibit 3).

Technology risk. When a new technology takes hold in the marketplace, specific product and service offerings may become obsolete in short order. For example, in recent years mobile telephony has stolen market share from fixed-line voice communications, and digital imaging has taken share from film-based photography.

In most cases, it's impossible to predict exactly how and when a technology will win acceptance in the marketplace. Even when technological change can be foreseen in broad brush, it's difficult to predict which version of a new technology will ultimately prevail, as Sony discovered when its Beta format lost out to the VHS version of videotape technology.

Smart managers "insure" against technology risk by *double betting*, i.e., investing in two or more versions of a technology simultaneously. That puts them in a position to survive and thrive no matter which version emerges as the winner. Betting on both OS/2 (co-developed for IBM) and Windows positioned Microsoft to be the winner, regardless of which operating system prevailed. Similarly, Intel's double betting on both RISC and CISC chip architectures ensured that it would succeed in semiconductor chips.

By contrast, Barnes & Noble was not an aggressive double bettor. It did not make an early enough and big enough bet on the Internet as a channel for book sales alongside its physical stores. That slow start gave Amazon the opening it needed to dominate online media sales, despite Barnes & Noble's initial advantage in brand awareness and bookselling experience (Exhibit 4).

Customer risk. Another strategic risk is that customers' priorities will shift quickly, reducing demand for a firm's current product or service offerings. That's what happened in the late 1980s when baby-boomer parents started switching from station wagons to the first minivans, catching most automakers off guard. One powerful countermeasure for managing customer risk is the use of *proprietary information* to anticipate the next evolution of customers' priorities.

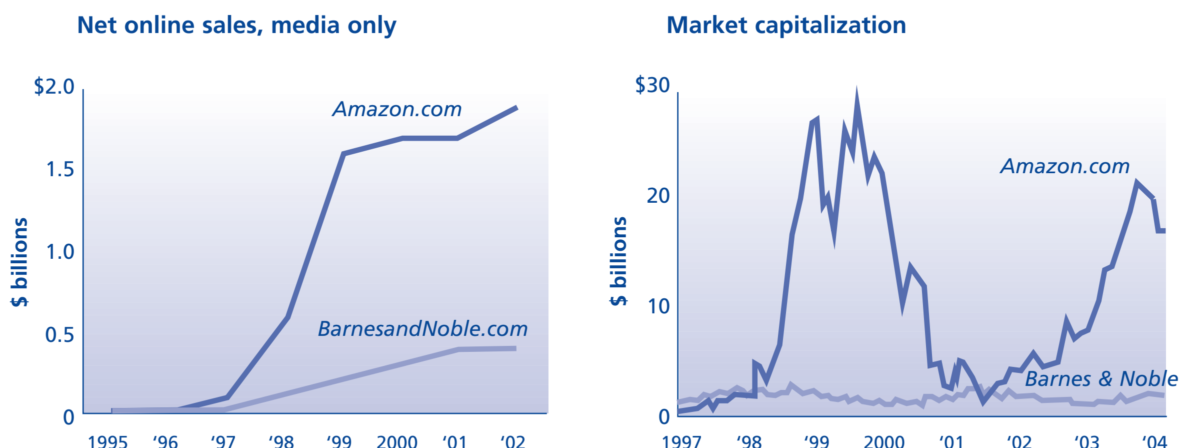
Exhibit 3 **Strategic risks and how to respond**

Strategic risk dimensions	Sample countermeasures	Company examples
Technology	Double-bet "insurance"	• **Microsoft** double bet on Windows and OS/2 • **Intel** double bet on CISC and RISC architecture for semiconductor chips. • **Charles Schwab** double bet on branch-based operations and eSchwab online.
Brand collapse	Change investment mix[1] Continuous brand measurement Crisis management strategy	• **IBM** offered broader solutions and repositioned its brand to articulate the benefits of its enhanced offering. • **Johnson & Johnson** handled the Tylenol product tampering case by investing heavily in a public awareness campaign, a massive product recall, and a packaging redesign.
One-of-a-kind competitor	Early warning system Change business design	• **Target** and **Kohl's** saw the Wal-Mart tidal wave coming and changed their business designs in order to stay competitive.
Industry economics collapse	Change compete/ collaborate ratio	• **Airbus** formed a consortium among European aircraft manufacturers. • **SMH** transformed the Swiss watch industry through its pyramid of brands. • **Airlines** formed code-sharing alliances (selling tickets on partners' flights).
Customer shift	Proprietary information	• **Capital One's** 65,000 annual market experiments create much smaller, more robust customer sub-segments. • **Tsutaya** continually monitors its rich database of customer demographics and preferences, and even sells its proprietary customer research.
New project/investment	Smart sequencing	• **Cardinal Health** carefully sequenced its growth initiatives with hospitals and drug companies to gain the experience, knowledge, and the reputation necessary for the next step. • **Johnson Controls** has expanded via sequencing into value-added services for automakers.
Stagnation	Demand innovation[2]	• **Air Liquide** seized new opportunities in services, allowing it to increase average revenue per contract and write longer contracts. • **GM** leveraged its installed customer base to introduce the **OnStar** subscription service.
Obsolete business design	Business design audit/ reinvention	• **GE** has reinvented itself again and again by divesting non-core businesses, incorporating services and financing, and offering truly valuable digital support.

Source: Mercer Management Consulting

1. See "Ready for the Next Move? Understanding a brand's potential requires a new set of metrics," by Andy Pierce and Suzanne Hogan, *Mercer Management Journal* 12, pp. 21-34, 2000.
2. See *How to Grow When Markets Don't* by Adrian Slywotzky and Richard Wise, Warner Business Books, 2003.

Exhibit 4 **Failure to double bet early allows start-ups to seize market position**



Source: Compustat, annual reports, Mercer analysis

A notable example in the consumer world is Capital One, which runs 65,000 in-market experiments per year to create smaller, more accurate customer segments in sub-prime lending. The robust detail within each subsegment allows Capital One to determine which combination of features, price, and marketing messages will yield the highest profit. As importantly, it signals when and how these segments are changing in their preferences and their priorities.

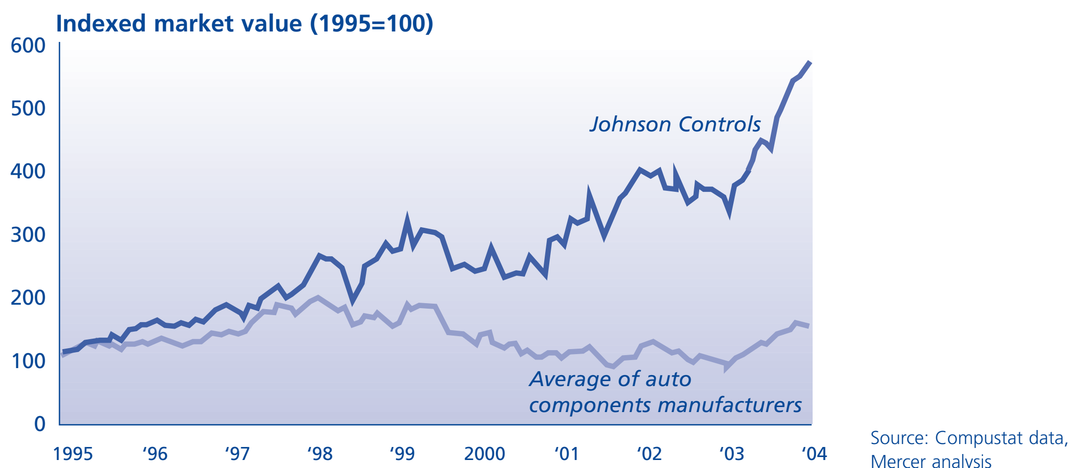
In a field where customer preferences shift quickly and unexpectedly, Japanese video and music distributor Tsutaya conducts a continuous analysis of customer spending patterns combining point-of-sale data, surveys, and databases. Tsutaya can pinpoint preferences down to the individual family or customer, allowing it to anticipate how their tastes are changing. The company has significantly outgrown all of its competitors as a result of generating the best proprietary information in the industry, and it even sells its proprietary data to other companies seeking to better track shifts in customer priorities.

In the business-to-business world, Johnson Controls, Inc. (JCI) has mastered the creation and application of proprietary information in the bruising auto supplier market. JCI was once a maker of frames for car seats that was vulnerable to any competitor that could cut metal for less. Over the past 15 years, the company has developed a broad range of assembly, integration, and R&D skills that set it apart from the competition. The company now designs and assembles not just seats but entire vehicle cockpits; its Comfort Lab conducts more consumer research on interiors and generates more proprietary information on consumers than any automaker.

Because of its unique capabilities, JCI now has continual contact with an automaker's entire design and engineering team. It gets involved early and throughout the vehicle planning process, gathering and generating an additional layer of proprietary information that produces a depth of insight into the automaker's needs and activities that traditional parts suppliers cannot match. This makes JCI a supplier of choice, reducing bidding volatility and allowing it to plan with greater certainty. As a result, JCI's revenues, profits, and market capitalization have all shown double-digit growth for the past decade (Exhibit 5).

New project risk. Any new product or service venture involves various risks—e.g., it will fail to attract profitable customers, competitors will quickly copy it and poach market share, the venture's growth will be too slow or costly, and so on.

Exhibit 5 **Johnson Controls becomes the supplier of choice**



Source: Compustat data, Mercer analysis

Companies that have mastered new-growth initiatives reduce this risk through a countermeasure that I call *smart sequencing*. It involves carefully planning and staging growth initiatives so as to maximize the rewards while minimizing the risk of failure at every stage of the development process.

In the mid-1990s, for example, Cardinal Health was just one of several large competitors in the low- and declining-margin pharmaceutical distribution business. Looking for new avenues of growth, the company started to provide new offerings in immediately adjacent market spaces. First it launched a series of adjacent businesses such as pharmacy management and automated drug dispensing in hospitals. When it succeeded in these operations, it added higher-value services in pharmacist staffing and consulting. For drug makers, Cardinal started with drug packaging and then moved into contract manufacturing and formulation.

Cardinal moved deliberately, leveraging its existing assets and customer relationships to gain the experience, knowledge, and the reputation necessary to take the next step with confidence and the customer's trust. Over the past decade, smart sequencing into new and larger markets has made the company the undisputed industry leader in financial performance. By establishing itself carefully along specific points of the value chain, Cardinal Health spread its risks and was able to sustain its growth.

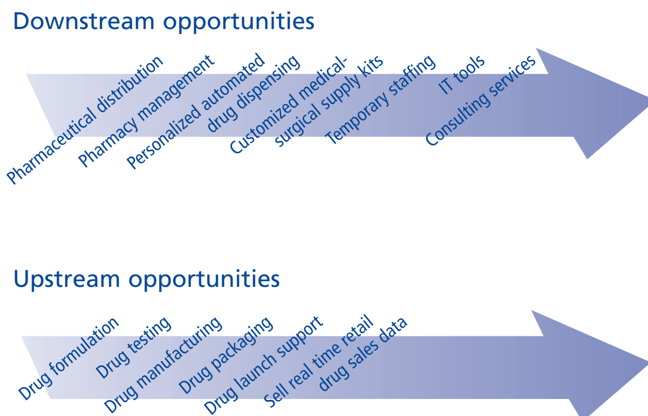
By contrast, Cardinal's primary competitor, McKesson, took a giant leap into enterprise software by acquiring HBOC for $14 billion in 1998. The move might have been a reasonable one if several intermediate steps had been taken, but under the circumstances it led McKesson into a market that was too far from its core pharmaceutical distribution. Since taking this overly risky move, McKesson's profits and market value have lagged Cardinal's (Exhibit 6).

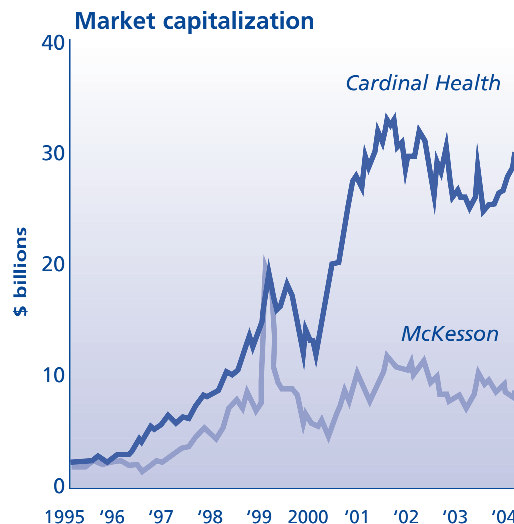
Brand risk. A powerful brand can yield a measurable premium over competing products or services that are otherwise similar. But brands are subject to risks, some predictable and some not, that can decimate their value.

In some cases, brand risk can strike overnight, as when a widely publicized problem with product tampering, quality breakdown, or a corporate scandal wreaks havoc with the image of a brand. Consider, for example, the decline of the Martha Stewart Living Omnimedia brand in the wake of the trial of the company founder or the decline of Bridgestone/Firestone after the recall of the defective Firestone tires installed on Ford Explorers.

Exhibit 6 **Smart sequencing at Cardinal Health**

Cardinal sequenced its initiatives to focus first on those with the lowest risk and most rapid payback.





Source: Compustat data, Mercer analysis

In other cases, the relevance and attractiveness of a brand may gradually erode because of demographic changes or a slow decline in perceived product quality. The power of the Disney brand declined during the 1970s and early 1980s as maturing baby boomers found the movie studio's traditional animated and family fare increasingly corny. Senior management was able to revitalize the brand with a series of fresh new films and cartoon features. Now Disney is suffering a second period of brand erosion, and it's an open question whether the company can reenergize its brand again.

There are two important countermeasures that companies can use to protect themselves from brand risk. The first is *continuous measurement*, which involves constantly monitoring customer perceptions of your brand and the specific dimensions of brand equity that underlie those perceptions. This includes the study of market shifts that are likely to lead to the emergence of new customer sets as well as the decline of customer sets you may have relied on in the past.

The second countermeasure is *reallocating brand investment* based on the changes your measurement system reveals. In extreme cases, this may involve abandoning a particular brand whose value is vanishing and shifting your support to a new brand with greater growth potential. More commonly, it means allocating resources to sales, advertising, marketing, customer service, or product quality efforts as dictated by the needs of your brand and the nature of the most potent risks it faces. For example, when the Tylenol product tampering case threatened to destroy the leading pain remedy brand, Johnson & Johnson saved the brand by investing heavily in a public awareness campaign, a massive product recall, and a packaging redesign.

To build its brand, an Eastern U.S. regional bank had spent prodigiously on advertising. Its service was terrible, however. The bank changed its investment mix dramatically, shifting millions of dollars from advertising to service improvements. This halted the brand erosion and eventually rebuilt the strength of the bank's brand. In a credit card setting, American Express in the late 1990s shifted its investment dollars to reward programs and to broader acceptance of its cards at retail and other service establishments, thereby strengthening its relative brand position.

Competitor risk. Competition is the normal equilibrium of business. Competitor risk refers to the possibility that a one-of-a-kind competitive threat will emerge to take aim at a market and perhaps drive established companies out of business.

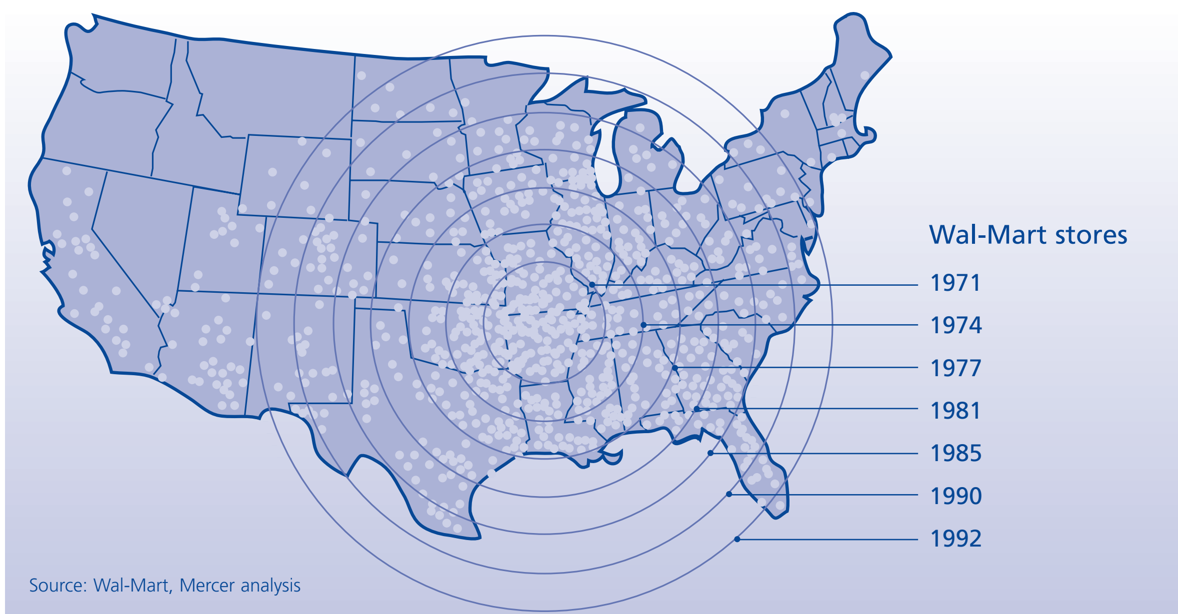
At any given time, only a few extraordinary competitive threats exist. Currently, these competitors fall into three categories. The first includes firms such as Microsoft and Wal-Mart, whose business design has allowed them to achieve dominance in one marketplace after another. The second includes emerging nations such as China and India, which parlay low-cost labor, an improving infrastructure, and an increasingly high level of education into a strong competitive force. The third category consists of a new class of competitors such as the Japanese watchmakers that suddenly threatened the historic dominance of traditional Swiss watchmaking in the 1980s.

The two crucial countermeasures that companies should use to manage competitor risk include an *early warning system* and, when appropriate, a *shift in business design* to respond to the threat when it appears.

An early warning system means continually monitoring the competitive horizon, mapping the moves of major companies in and around your marketplace. Any retailer that had simply tracked the expanding waves of Wal-Mart stores during the 1980s and 1990s on a map of the United States should have been able to predict when this retailing tidal wave would wash through home territory (Exhibit 7). Most major retail chains including Sears, Kmart, Bradlees, Ames, and Toys 'R' Us failed to do so. A handful including national discounters Target and Kohl's recognized what was coming and responded in time.

Foreseeing the onslaught of an extraordinary competitor isn't enough by itself; you must be ready to shift your business design (changing customer selection or value proposition or both) as needed to establish a survivable niche. Target and Kohl's have maintained their value against the Wal-Mart attack by shifting their business designs. Target has maintained low costs while crafting an up-market, style-conscious image that differentiates it from Wal-Mart, while Kohl's operates in convenient locations and focuses on national brand names.

Exhibit 7 **Could you see the Wal-Mart tidal wave coming?**



Industry economics risk. When an industry becomes mature and highly competitive, a series of changes tend to occur that gradually destroy profit margins. Product and service offerings among various companies tend to grow similar and become commodities; customers get more and more access to competitive information; and customers grow more willing to switch suppliers based on a lower price. The risk that an entire industry will become a "no-profit zone" is one that every business person must always be cognizant of, but it's difficult to predict when and how it will materialize.

The most effective proven countermeasure to industry economics risk is to shift the *compete/collaborate ratio* among the relevant firms. Collaboration can take many forms including sharing of back-office functions, asset-sharing or co-production agreements, repair or maintenance collaboration, purchasing and supply chain coordination, joint research and development, and collaborative marketing.

Most companies begin collaborating five to ten years too late. When the industry is new and growing and margins are fat, the industry can afford to support a compete/collaborate ratio close to 100/0. The ratio begins to shift only when margins have eroded, as has happened with airlines, utilities, steel, computing, and memory chips. The challenge is to anticipate the threat and prepare by laying the groundwork for collaboration in advance.

A notable exception to the "start too late" phenomenon is Airbus. Deteriorating industry economics could not support many aircraft manufacturers going it alone in Europe. They created a consortium that shared resources, eliminated redundancies, and enabled them to be competitive.

Market stagnation risk. Consider how great companies such as Maytag and Whirlpool have seen their shareholder value reach a plateau or gradually decline as a result of their inability to find new sources of growth in the face of market maturity. Market stagnation limits the upside potential part of the reward/risk ratio and sets up companies for value loss or stagnation.

The best countermeasure is *demand innovation*, which involves redefining your customer offerings so as to broaden your market, expand the value you can offer your customers, and strengthen your relationship with them.

Air Liquide, based in Paris, is a great example of how a tradition-bound supplier of industrial gases was able to make the shift to demand innovation. In the early 1990s, the company launched technology that allowed a smaller gas production facility to reside on the customer's site instead of at large centralized plants. One important side effect was a higher level of ongoing interaction between customers and Air Liquide staff. The on-site teams soon discovered that their customers had pressing needs that Air Liquide might be able to address, needs such as minimizing risk, reducing emissions, and improving supply chains.

Air Liquide gradually expanded from its core commodity gases to offer a set of new services ranging from gas management contracts to performance guarantees, supply chain management, and environmental consulting. By seizing these new opportunities, the company has expanded its potential markets, gained a greater share of customers' wallets, and improved customer loyalty.

Always prepared

Companies exploring the frontier of strategic risk management don't hide from risk. Instead, by actively defining and preparing for risk, they make themselves less vulnerable to risk events than other companies. This allows them to be both aggressive and prudent in pursuing new growth.

Furthermore, they use their insights into the nature of risk to raise their value to customers. Applying proprietary information and unique know-how to the risk challenges their customers face (see "Helping customers control their own risks"), they ally themselves more closely with customers, establishing long-term planning connections, multiple points of contact, and more powerful, longer-term relationships. This reduces customer turnover, which in turn diminishes long-term strategic risks for both customer and supplier.

By definition, a higher-risk environment makes it harder for businesses to protect and grow shareholder value. The right mindset and an arsenal of countermeasures can help companies improve their risk/reward profile in these volatile times. ❖

Helping customers control their own risks

In both business and consumer markets, there are ample opportunities to take on the challenge of helping customers reduce their own risks. By doing so, suppliers can expand their revenue and profit streams, strengthen their customer relationships, and further improve their ability to plan.

Industrial gas supplier Air Liquide has done this by using its technical expertise to address hazards that its customers face. Industrial gases can combust when concentrated or become toxic when mixed. To manage these risks for its own business and comply with increasingly strict regulations over the years, Air Liquide had developed sophisticated measurement, quality-control, and pollutant treatment systems.

These risk-management tools became a new source of growth, as Air Liquide started to manage customers' gas and chemical processes. Texas Instruments, a major chip maker, initially used Air Liquide simply as a supplier of specialty gases. Looking for ways to divest non-core activities, Texas Instruments asked Air Liquide to manage its chemical and gas operations. The reliability guarantees that Air Liquide provided gave Texas Instruments' managers peace of mind and greater freedom to concentrate on their core business.

By seizing such new opportunities in services, Air Liquide has expanded its potential market from industrial gas to a number of markets that are each two to three times as large. Because services have grown faster and have much higher margins than the traditional gas supply business, this shift also helps shield Air Liquide from the economic swings that buffet its competitors, allowing it to increase its average revenue per contract and write longer contracts. As a result, the company has enjoyed an average annual growth of revenues and profits in the 10% range, as well as greater planning confidence and reduced share price volatility—all in a much tougher business environment than it faced in the 1980s and 1990s.

On the consumer side, risk is more commonly perceived in terms of time, hassle, and security. For instance, coping with a car accident is the most time-consuming and hassle-filled experience associated with car ownership. Progressive Insurance has grown to become the third largest auto insurance company in the U.S. not because its coverage is different, but rather because of the way it helps customers control their risk of lost time and increased anxiety associated with collecting on a policy.

Progressive built an incredibly fast and comprehensive claims management service, including a fleet of "immediate response vehicles" equipped with laptop computers, intelligent software, and wireless access to the company's claims department. Often within an hour of an accident, a Progressive assessor arrives on the scene, ascertains the damage, approves the necessary repairs, and can cut a check on the spot. Progressive has thrived by eliminating a huge risk for the consumer, with revenue growth averaging more than 18% over the past decade. ❖