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Opportunity Cost vs. the Cost of Opportunities

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One of the biggest factors in valuation of an innovation portfolio is opportunity cost. Unless you have sufficient management bandwidth, technical capability, time, and money to execute every idea in your innovation portfolio, you will only be able to fully pursue some of the projects. The remaining projects will either be set aside completely or, worse, be underfunded and understaffed, never getting the resources necessary to reach either success or failure. It's usually straightforward to understand the cost of opportunities you pursue, but sometimes you can lose sight of the opportunity cost of the portfolio choices you make.

One view of the projects in an innovation portfolio is a Significance Ranking. Each bar in the chart represents the range of value of a single project, where the range is determined by the uncertainty in the success factors of that project. The thin white line in each bar is the most likely value. In this example, the most likely value of Project A is the largest of the portfolio projects, but more significantly, the potential upside of Project A stretches far to the right. With a well-crafted and executed Upside Exploitation Plan, the actual value of Project A could be more than the combined value of Projects E, F, G and H.

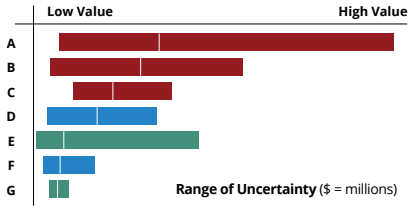

Figure 1. Significance Ranking

Note that each project, regardless of its significance, requires a certain amount of management attention to pursue. Managing Projects E, F, G and H takes away from the attention available to manage Project A for maximum upside. The champions for small projects may not see the opportunity cost from not redeploying their efforts to higher-growth projects. However, you can see that Project F also has a big upside; finding a way to pivot this project toward that upside can make it more valuable than Projects C or D. Set aside less significant projects—or pivot them to more growth—to reduce your portfolio's opportunity cost and increase its overall value.

Scarcity of technical resources, such as engineering and marketing hours, affects each project's chances of technical success, its potential value, or both. At the top of the Innovation Screen by Difficulty are easy projects that require less effort: Bread and Butters offer small returns and Pearls offer large returns. At the bottom are difficult projects requiring a great deal of effort that may not pay off: White Elephants offer small returns for the extra risk and Oysters offer potentially high returns. Pursuing White Elephant projects creates opportunity cost in the form of resources that could be used to drive growth through creating and cultivating Oysters. Examine each White Elephant project to determine if it can pivot to be a high-potential Oyster; if it can't, cancel it and redirect those resources to other projects to increase the overall upside potential of the portfolio.

> *The difference between successful people and really successful people is that really successful people say no to almost everything.*
>
> — Warren Buffett

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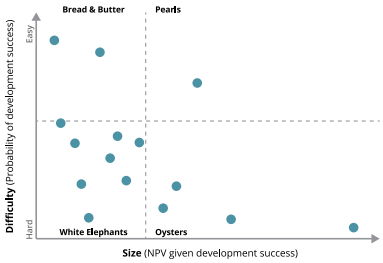

Figure 2. Innovation Screen by Difficulty

Time also drives opportunity cost. CFOs are familiar with cash velocity, the rate at which cash invested in business operations generates revenues and billings that replenish that cash. The same principle applies in innovation. Some projects require a few months to turn R&D investment back into cash-generating innovations; others may take years. A small-return project that completes quickly frees up development resources for the next project: the quick turnaround boosts cumulative returns. Conversely, a small-return project that ties up resources for years creates the opportunity cost of preventing you from conducting several small projects in the same span of time. Slow projects are Snails (small returns) or Tortoises (large); fast projects are Rabbits (small returns) or Racehorses (large).

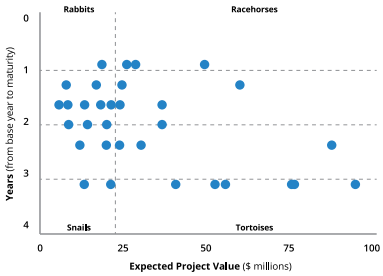

Figure 3. Innovation Screen by Time

Opportunity cost also stems from scarce financial resources. Fully funding one project over another means incurring the opportunity cost of forgoing the second project. However, fear of incurring the opportunity cost of cancelling some projects outright often leads to too many underfunded projects. Because underfunding can lead to failure of projects that would otherwise succeed, this strategy often has a greater opportunity cost than committing to some projects and cancelling the rest. The CFO Chart helps in allocating the budget efficiently by ranking projects by their ROI, or return-to-cost ratio. In the example, the budget is sufficient to fund Projects E, O, D and C, and no other combination would yield greater total value. The vertical lines indicate that management can choose to cut the budget to just fund those four projects without losing potential value, or choose to increase the budget to capture the value from funding Project G.

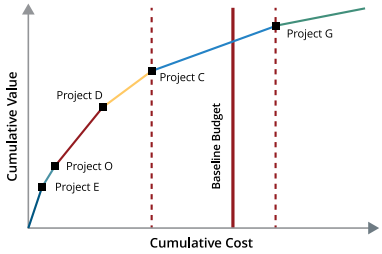

Figure 4. Efficient Budget Allocation with the CFO Chart

Understanding the costs of your available opportunities—in difficulty, time and money—is the key to assessing the opportunity costs of your portfolio choices. SmartOrg gives you the tools and training to understand the drivers of value in each of your projects, to find and unlock upside potential, and to make the most of your opportunities while minimizing opportunity costs.

Upcoming Webinar

Portfolio Management in Florida and the Caribbean

Temperince Morgan, Executive Director of the Florida Chapter of The Nature Conservancy, will share how The Nature Conservancy implemented a new discipline for managing its portfolios of conservation projects with SmartOrg's help. As a result, The Conservancy's Florida and Caribbean chapters improved their focus on beneficial outcomes for both nature and people.

13 February 2018 | 11 AM EST / 8 AM PST | More information

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