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What Is Your Opportunity Cost Costing You?

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The cost of an opportunity is, of course, the sum of the resources required to pursue a selected opportunity. Usually it is straightforward to add up this cost, although for innovation opportunities, uncertainties may make some part of the cost unforeseeable.

However, when we consider the cost of an opportunity, we often overlook an important component: its opportunity cost. Opportunity cost is the foregone value of an opportunity we chose not to pursue so that we could select and pursue that other one.

When we choose to pursue and fund an innovation project, its uncertainty often frightens us off from pursuing it fully. We may use a conservative financial analysis to cut the project to a "safe" size, or we may "hedge our bets" by shifting some of the project's funding and attention to projects we think are less risky. In this way, we degrade the actual project pursued. These unintended consequences can be massive.

Executives unintentionally degrade and wound our innovation projects because executives rarely appreciate the full potential of innovation. If we can estimate the opportunity cost from wounded projects and identify the hidden value in our portfolio, we can inform better investment choices.

The Opportunity Factor model in Figure 1 helps us estimate how much value we can realize by improving our focus on our innovation opportunities and by uncovering hidden sources of upside in them. The Opportunity Factor is a function of the Focus Factor and the Upside Factor.

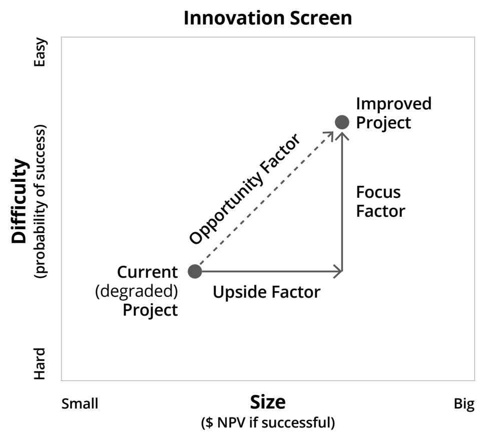

Figure 1. More emphasis on the upside increases potential project NPV; improved focus increases probability of success.

Focus Factor: Innovation is difficult, with many obstacles to success. It requires resources and serious critical thinking to learn, pivot and bend the rules on the way to success. Yet too many projects in the innovation portfolio creates clutter that harms all the projects. Clutter results in:

1. Wounded projects. Innovative projects can get short shift, with resources well below the level they need to drive effectively forwards.
2. Distraction. Innovation requires attention from executives and key people who are so busy with other things that they cannot bring their creativity and power to the project.

The Focus Factor is a measure of how much a project could improve if it got the proper focus. Some pressure on budgets and resources can be good, motivating efficiency, so a focus level a little below 100% might be OK. However, if the pressure gets too high, then project teams change their aspirations and plans, and the pressure creates neglect.

> *Never surrender to the momentum of mediocrity.*
>
> — Marlon Brando

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How wounded is the project?

Think of the full resources required ($, FTE) to reasonably overcome the innovation obstacles. Compared to the actual level of resources deployed, what percentage of the full resources does the project actually have?

How distracted are executives and key resources?

Think of the level of critical, strategic and creative thinking required by the project. How much of the required attention is available?

The Focus Factor is the product of these two estimates.

Upside Factor: Financial analysis and operational processes are inherently conservative, usually based on delivering a reliable promise. Consequently, the business cases used to represent the size of a project are conservative because conservative estimates seem more credible. The business case rarely considers upside systematically or in any detail. This becomes a self-fulfilling prophecy of mediocrity and low aspiration, as focus on delivering the conservative business case severely reduces the ability to drive the upside.

The Upside Factor is a measure of how much value is in the upside compared to the base business case. If the upside is relatively small compared to the base case, then the error in using the base case to understand value is a mere "estimation error." However, if the upside level is large, then using the base hides the upside and prevents teams from seeking it. This becomes a more damaging "innovation error".

Estimate Upside

Assume the project overcomes its obstacles and starts delivering returns. Think of several reasons that would cause this project to drive towards its upside. Thinking of these factors, how much bigger could the upside be than the current business case?

Opportunity Factor: Improving focus increases your ability to creatively overcome the obstacles in innovation and thus improves the probability of success. Visibility to the upside increases the potential for driving the business result above its conservative business case, improving the NPV. The product of the Focus Factor and the Upside Factor measures the total increase in risk-adjusted value available, which is the Opportunity Factor. This factor is the multiplicative improvement in risk-adjusted NPV of your example project from making different portfolio choices. Achieving this improvement requires a perspective of portfolio decision making, decluttering to increase focus and systematically creating visibility to upside.

The Opportunity Factor table in Figure 2 represents both danger and opportunity. When the efficiency pressure and the innovation error gets too high, the compound effect can be catastrophic, creating an unintended danger zone and dramatically undermining innovation in the organization. Addressing these problems can yield improvements in the NPV of the affected projects by several-fold.

Upside Level

Focus Level	1	1.25	1.5	2	4	8
100%	1.0	1.1	1.1	1.3	1.8	2.8
80%	1.3	1.3	1.4	1.6	2.2	3.4
60%	1.7	1.8	1.9	2.1	2.9	4.6
40%	2.5	2.7	2.8	3.1	4.4	6.9
20%	5.0	5.3	5.6	6.3	8.8	13.8

Upside Factor

Focus Factor

Efficiency Pressure

Neglect Pressure

Estimation Error

Innovation Error

Danger Zone

Figure 2. The larger the Opportunity Factor, the more your project is underperforming today, and the more it could improve with different portfolio choices.

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