Payback

Reaping the Rewards of Innovation

James P. Andrew
Harold L. Sirkin
with John Butman

Harvard Business School Press
Boston, Massachusetts

Printed in the United States of America
10 09 08 07 06 5 4 3 2 1

Library of Congress Cataloging-in-Publication Data

Andrew, James P., 1962-
Payback : reaping the rewards of innovation / James P. Andrew, Harold L. Sirkin, with John Butman.
p. cm.
Includes bibliographical references and index.
ISBN-13: 978-1-4221-0313-5 (hardcover : alk. paper)
1. Technological innovations—Management. 2. Industrial management. I. Sirkin, Harold L. II. Butman, John. III. Boston Consulting Group. IV. Title.
HD45.A628 2006
658.5'14—dc22
2006024530

The paper used in this publication meets the minimum requirements of the American National Standard for Information Sciences—Permanence of Paper for Printed Library Materials, ANSI Z39.48-1992.

CONTENTS

ONE

Overview

FOR ALMOST EVERY COMPANY, the greatest challenge of innovation is not a lack of ideas but rather, successfully managing innovation so that it delivers the required return on the company's investment of money, time, and people. Most attempts at innovation fail to deliver this return—they do not generate enough payback.

Payback means one thing—cash. Cash that is realized within the planned time frame. When a company makes an investment in innovation and creates something new that produces a cash return swiftly and directly, it has created a winning situation, particularly when the return is larger than expected. The company has a "hit" on its hands. And this is true regardless of whether the new thing is a product, service, process change, business model, customer experience, or anything else that is new.

But it is the nature of innovation, of all types, that cash is not always produced from it, and rarely is it produced immediately. There can be a lag between the time of investment in innovation and the cash return. This lag can make companies and leaders nervous. Perhaps the cash payback will never come at all? With other types of investments (particularly in tangible assets like factories, machines, or new trucks), companies can often calculate their cash return with much more certainty. But, as with advertising and certain other expenditures, the return on an investment in innovation cannot be so easily predicted or measured.

To complicate matters, the innovation process sometimes generates a cash payback, but indirectly—not through the specific product or service being developed but through a benefit that only later impacts the company's ability to generate cash. These indirect benefits are real, although difficult to capture. There are four of them:

- Knowledge. The innovation process always produces knowledge, some of which can usually be put to work in more than one way to produce cash.

- Brand. Innovation can enhance a brand, thereby attracting more customers and enabling companies to charge a premium, which can mean greater cash returns.

- Ecosystem. Innovators can create exceptionally strong ecosystems of partners and associated organizations, enabling them to leverage their position in multiple ways, for the benefit of their payback.

- Organization. People want to work for and contribute to innovative companies, and being innovative allows companies to attract and retain more of the best people, or at least more of the most innovative ones. Having better people, with less cost to keep them, results in more cash.

For managers, the fundamental challenge of innovation is to achieve the required cash payback, by managing the overall innovation process with the understanding that payback can come quite directly and quickly, but also that it may take longer, be much less certain, or come back to the company only indirectly, via other products and services.

To achieve payback, companies must manage the innovation process holistically and with discipline. They must make careful choices about how much and where to invest. They need to be smart about which innovation business model they choose to execute with. And they must deliberately align and lead their organizations toward payback.

They must also accept that innovation—more than other business strategies—entails a significant amount of risk. There are three types of risk: technical, operational, and market. If the new product or service has some technical failings, if the organization cannot actually commercialize or realize it, or if the market does not embrace the product as planned, the company is put at risk of not achieving the needed or desired payback.

Many companies try to remove as much of the risk as possible—installing strict procedures and ironclad approval mechanisms. There is value in control, of course, but for the most part, trying to make innovation risk-free either stifles the process or causes people to lower their sights, so nothing big ever happens. A few companies, surprisingly, are "risk optimistic." They embrace risk too freely and end up paying for it. Companies must learn to understand risk, how to analyze and evaluate it, and how to manage it. And they must realize that often the greatest risk for a company seeking to grow is to take no risk at all.

When companies manage innovation with this understanding and in these ways, they can create new products and services (as well as process improvements, customer insights, new business models, and other types of innovations) that deliver payback and increase the company's ability to continue to grow and thrive. Failure to do so puts the company on the path to commoditization, nondifferentiated positions, lack of advantage—and lack of cash.

Many companies are not achieving the payback they would like. This is clear both from our experience in the field and from the results of our annual survey—The Boston Consulting Group (BCG)/*Business Week* "Senior Management Survey on Innovation," which was first conducted by The Boston Consulting Group (BCG) in 2003.

In this survey, completed in April 2006, 1,070 executives representing 63 countries and all major industries responded, and they answered 19 questions.[1] The bottom-line finding was that 48 percent of the respondents said they are not satisfied with the return they get on their investments in innovation, and they gave a fascinating array of reasons for their dissatisfaction. Here are just a few of the most typical:

- "We make exaggerated estimates of the benefits of a new product."
- "We have not established satisfactory performance metrics that consider leading, as well as lagging, financial factors."
- "We pursue too many things simultaneously and cannot execute them all."
- "We don't have the right people or capacity in place."
- "Our time to market is too slow."
- "Our sales force focuses on our traditional business."
- "Seniors managers won't fund new products because they are too risky."
- "Innovation is not a priority for the board of directors."
- "We have a block in mind-set."

All of these issues—and almost all of the others that we gathered in the survey—pertain to issues of management, capabilities, metrics, mind-set, decision making, and leadership. Very few respondents to the survey said that their problem with innovation was a lack of ideas. This is significant, because there has been a great deal of attention paid in recent years to issues that have to do with ideas—including practical methods of idea generation, the importance of creativity, and the role of invention.

But as important as ideas are, they are only a small part of the issue. Creativity is not synonymous with innovation. Good, even great, ideas are not enough to guarantee payback. Innovation is the entire process of developing ideas *with the goal of achieving payback*, and it comprises three phases of activity, each with a distinct output.

- **Idea generation.** This is the phase when ideas are generated, developed, tested, evaluated, and refined, but during which the company makes no commitment to actually creating a product or service (or taking some other action) based on the ideas. The output of this phase is . . . an idea.

- **Commercialization.** This phase begins with the green light from management to develop a proposed idea into an offering that can be produced and marketed, either externally or internally, and ends when the product is launched to the buying audience. At this point, the process has produced an *invention*—the technology, product, service, or process improvement that has achieved a tangible form but that has not yet been tested by the external (or internal) market. The invention is the thing itself. Innovation is the process.

- **Realization.** This phase begins with market launch and ends when the product or service comes to the end of its life cycle. Although this is the phase when the cash payback is achieved, many important aspects of the size and timing of the payback have been determined by the activities of the earlier phases.

As our survey suggests—and as we've found in the vast majority of companies we've worked with—a lack of ideas is not the main stumbling block to achieving payback from innovation.

The central challenge for innovators, and the main focus of this book, is the commercialization phase. This is true whether the idea is for a new product, service, business model, customer experience, or any other new thing. It is during this phase that the company must evaluate the payback potential of the available ideas. It must determine the proper level of investment for each idea. It must choose which innovation business model to use to develop and produce the product. It must figure out how to organize the company to innovate and achieve payback. And its leaders must find the best way to lead the effort.

Payback is organized into three parts, the main ideas of which are summarized in the remainder of this chapter:

1. **What Is Payback?** Chapters 2 and 3 explain the four *S* factors that directly affect cash payback, as well as the indirect benefits of innovation that can lead back to cash.

2. **Choosing the Optimal Model.** Chapters 4 through 6 explore the characteristics, advantages, and management challenges of the three innovation business models—integration, orchestration, and licensing—and how they affect risk and payback.

3. **Aligning and Leading for Payback.** Chapters 7 and 8 discuss how to align all key elements of the company around innovation, and the essential elements of leadership that are needed to achieve maximum payback from innovation.

The Characteristics of Cash

In innovation, as we've said, cash truly is king. Four factors have a direct impact on cash payback:

- *Start-up costs*, or prelaunch investment

- *Speed*, or time to market

INDEX