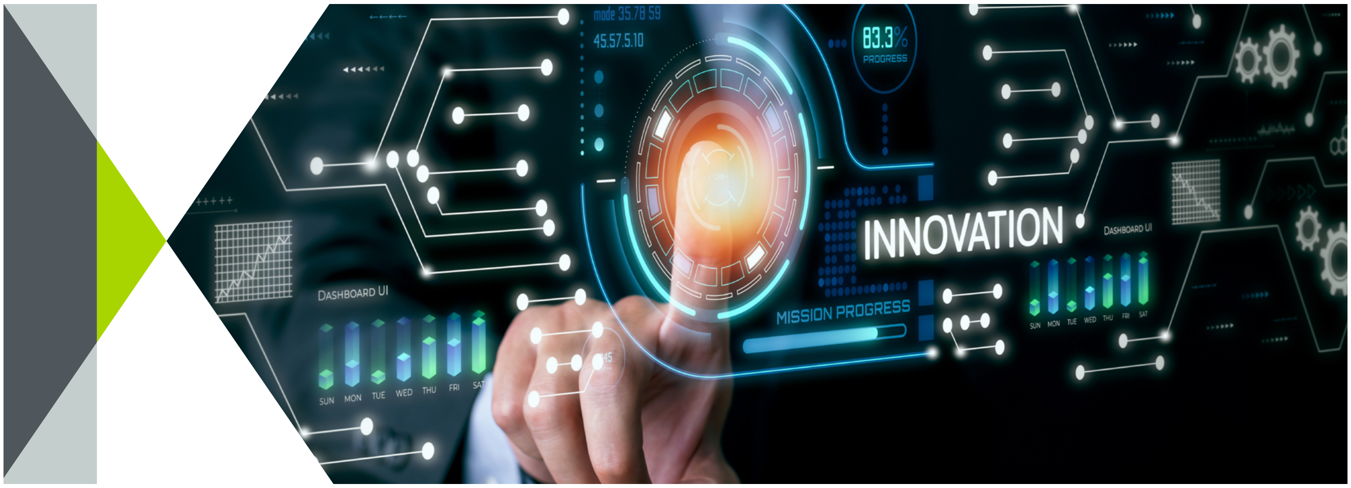

EXECUTIVE INSIGHTS

To Innovate and Create Value, Stop Being Consistent

To grow, you must innovate. In particular, you need breakthrough innovations, the kind that create entirely new products and services and even lines of business. That's the surest path to value creation.

But most large corporations are missing out simply because they don't do innovation well. The problem is that they set up barriers to innovation. The source of those barriers is something that's near and dear to most leaders' hearts — consistency. The way to innovate and grow is to avoid being beholden to consistency.

The need for consistency is the root of all barriers to innovation

Here's a basic and unremarkable fact: Most established businesses prioritize consistent performance from one year to the next.

Why? Obviously because consistency produces real benefits. It allows accurate forecasting and budgeting. Financial metrics such as profits and cash flow are generally good indicators of the health and value of the business. So, for most business leaders, consistent financial performance equals health. The devotion to consistency makes these businesses unlikely to succeed as breakthrough innovators.

By "breakthrough innovators," we mean companies like the S&P 500's "Magnificent Seven": Alphabet, Amazon, Apple, Meta, Microsoft, Nvidia and Tesla, a handful of companies whose capitalization now exceeds that of the stock markets of Japan, the U.K. and Canada combined. There is a wide performance gap between the Magnificent Seven and the rest of the field. From 2013 to 2019, while the Magnificent Seven delivered 19% compound returns, the other 493 companies in the S&P 500 delivered only 2%. It's true that most of the

Magnificent Seven are technology companies, and some might argue that they have "startup DNA." That ignores the fact that they are no longer startups — they are as large as or larger than the established companies that are underperforming them. Also, what does "startup DNA" really mean?

It's more useful to look at the specifics of how the Magnificent Seven behave and where they differ from the rest of the pack. One critical difference to note is that, unlike established companies, breakthrough innovators create value by driving rapid growth while they're building the infrastructure to support product efficiencies and scale up. In practice, that means their traditional financial metrics will be moderated — without maximizing short-term profits and with more cash flow reinvested in the business.

How consistency stifles innovation

The imperative for consistency creates three barriers to innovation: cultural, organizational and financial.

- **Cultural:** The drive for consistency generates a culture of "say-do" accountability, where managers are promoted based on their track record of consistently meeting budgets and serving as a "safe pair of hands." When the culture limits creativity and risk-taking, those inside the organization will avoid anything new and different.
- **Organizational:** Prioritizing consistency generates strong resistance to entrepreneurial innovation. Innovation creates career risk, particularly beyond the new product team — in parts of the organization that might quietly slow down any decisions that threaten the consistency of their operations.
- **Financial:** Consistency sparks resistance to unplanned costs. In the earliest stages of innovation, resistance may be manageable because costs are low and easily written off as part of the development budget. But resistance escalates as the product line is being ramped up, with higher costs while profitability remains a challenge.

Overcoming the barriers and creating breakthrough innovation

What's the fix? There are three critical steps:

- **Remove cultural barriers by embracing the idea that the organization must be good at more than one thing.** Yes, consistency and reliability are important, but organizations also need to reward and celebrate creativity and innovation. In addition to consistently delivering returns for established businesses, why shouldn't involvement in a breakthrough program — whether successful or not — be seen as a career requirement for high-potential managers who want to rise rapidly through the ranks?

Amazon is renowned for its obsession with doing the best for customers, including a relentless focus on competitive prices and low-cost fulfillment. But at the same time, Amazon embraces a passion for innovation[1] and has been named one of the Best Workplaces for Innovators[2] by Fast Company. Amazon describes "the importance of recognizing the difference between … a reversible and an irreversible decision. Understanding this distinction fosters a culture of experimentation. … If something doesn't quite work, you don't have to live with the consequences for that long. You can reopen the door and go back through."

- **Remove organizational barriers by recognizing that innovation cannot just be the responsibility of those in R&D or new product development.** Breakthrough innovators find ways to harness ideas that may come from any of their people. Microsoft introduced The Garage[3] as a hub to catalyze grassroots innovation. Other leading companies such as Amazon and Google enable certain employees to spend up to 20% of their time at work on personal innovation projects. More important, Google uses its peer-to-peer recognition program as a way to remove organizational barriers. The program allows Google employees to recognize their peers for doing something helpful that is not part of the peer employees' direct responsibilities. Often these are actions that would have gone completely unnoticed by managers. The rewards are generally modest, but the employees on the receiving end appreciate the kudos.
- **Manage financial barriers by understanding the value creation (or destruction) that resulted from past innovation spending.** One of the biggest barriers to innovation is having to pay the up-front costs when the financial benefits are uncertain and likely to arrive several years into the future.

Among the first things we encourage executives to do is map their past innovation spending to value creation or destruction. If they have not earned a healthy return on past investments, then the first priority is to understand why. Is it because of poor ideas at the top of the innovation funnel, where projects are identified? Poor choices in evaluating and prioritizing projects? Poor execution in bringing concepts to market? If the root causes of problems are not understood and addressed, then throwing more money at innovation is unlikely to yield attractive returns. But assuming companies do have confidence in the effectiveness of their innovation spending, there is still the issue of how to manage that spending in light of investor pressures for near-term results.

One solution is simply to do a better job of managing investor expectations. This is easy to say and hard to accomplish — but it can be done. Among U.K. supermarkets in the early 1990s, Tesco always lagged the market leader, Sainsbury's,[4] with lower share, lower margins and a more down-market positioning. Ten years later, Tesco was twice the size of Sainsbury's. Tesco grew to eclipse its competitor through a combination of innovative loyalty programs and more aggressive store openings, both made possible because Tesco told shareholders they were targeting an 18% return on equity, whereas Sainsbury's was targeting 21%. But the ultimate result was a much lower overall return for Sainsbury's shareholders. More recently, Amazon has followed the same path — willing to accept lower margins than other online retailers in the interest of faster growth and innovation.

Of course, reducing near-term margin targets cannot become a free pass to lower shareholder returns. Most CEOs and chief financial officers understand how value is created within their industry and what constitutes good trade-offs between growth and profitability. The challenge comes when the startup business or product line is very different from the corporation's core business. In that case, rather than having a fixed budget, it is important to replicate the discipline of the fundraising cycle that startups have to navigate. This requires showing clear progress against established milestones such as product performance and customer acquisition. If progress exceeds expectations, then more financial flexibility is granted; but if progress stalls, then management should avoid overinvesting in a losing proposition.

Barrier-breaking begins at home

All these steps are helpful, and most are essential, but the main point is this: There are plenty of companies, perhaps scores of them, that can create value at the pace of the Magnificent Seven. But to do that, they need to break barriers, and to do that, they need to step outside their comfort zone. Consistency is the stuff of business success — but it cannot be the only priority. Embrace multiple performance goals, break the innovation barriers and start to accelerate your growth.

For more information, please **contact us**.

Endnotes

[1]Fastcompany.com, "The 50 best workplaces for innovators." https://www.fastcompany.com/90378273/best-workplaces-for-innovators-2019

[2]Amazon.com, "6 things that make Amazon a "Best Workplace for Innovators."" https://www.aboutamazon.com/news/workplace/6-things-that-make-amazon-a-best-workplace-for-innovators

[3]Forbes.com, "The Future Of Innovation – How Microsoft Created 70,000 Innovators." https://www.forbes.com/sites/kmehta/2021/03/09/the-future-of-innovation--how-microsoft-created-70000-innovators/

[4]Infonet-economy.ch, "Tesco versus Sainsbury's Growth Strategies and Corporate Competitiveness 1990-2007." https://www.infonet-economy.ch/fr/publications/content/tesco-versus-sainsburys-growth-strategies-and-corporate-competitiveness-1990

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