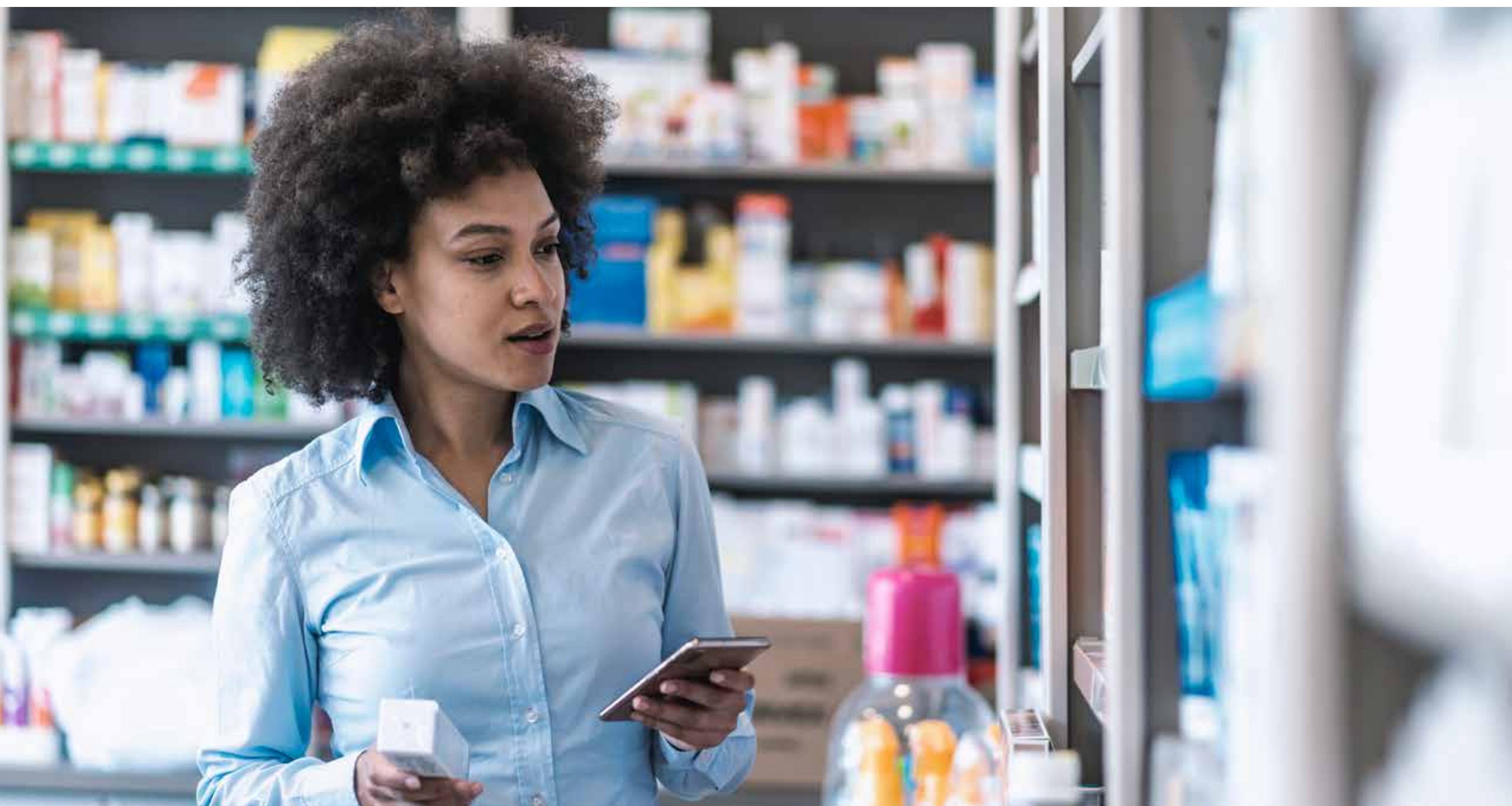
McKinsey & Company

Consumer Packaged Goods Practice

Will innovation finally add up for consumer-goods companies?

In a changing landscape, companies can better meet consumers' needs by understanding the true value of innovation.

by Vinit Doshi, Stacey Haas, and Jon McClain



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In response to massive consumer-behavior changes due to COVID-19, multiple consumer companies have recently announced cutbacks in their innovation pipelines. These announcements may signal a new era for the consumer-packaged-goods (CPG) sector, one in which the innovation agenda can escape the endless line extensions of the past several years. The lower-value launches that pervaded pre-pandemic innovation portfolios have failed to drive meaningful growth or return on investment for many CPGs (Exhibit 1). The average first-year sales for new-product pacesetters declined by an astonishing 50 percent between 2012 and 2018.[1]

Innovation will be more important than ever as we move toward the next normal amid changing consumer needs and occasions. Companies can rethink their innovation agendas to more effectively address those needs and drive growth. However, many executives see barriers to boosting innovation performance, including the complexity of multi-functional organizational dynamics and the difficulty of predicting consumer preferences and behaviors. In addition, these innovations seem to be occuring faster than ever. Disruption due to the pandemic lends even greater urgency to ensuring that innovation strategies adapt well to changes in consumer needs and retail environments.

The industry has been weighed down by innovation that fails to deliver meaningful, incremental growth. While challenges exist, they can be overcome. CPG companies can significantly boost the performance of innovation by measuring it more effectively, managing it more strategically, identifying ideas worth pursuing, and supporting them with necessary resources. Understanding the true, incremental impact of innovation is fundamental to developing a pipeline that delivers on the strategic objectives of the company.

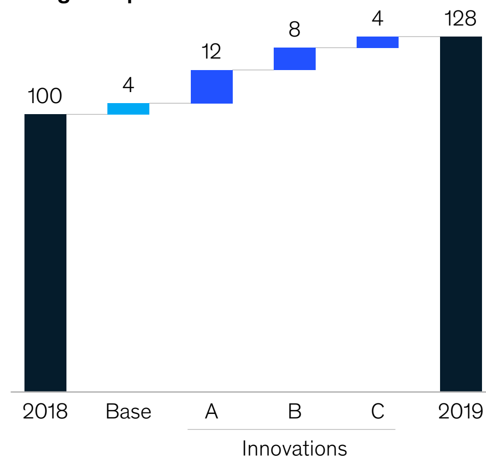
[1] Joan Driggs and Larry Levin, ***New product pacesetters: Product innovation and the pace of change***, IRI, May 2019, iriworldwide.com.

Exhibit 1

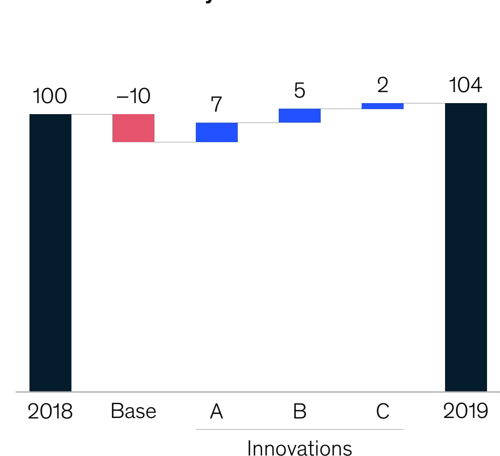
Consumer-goods companies face a different landscape than the one they imagined.

Portfolio sales, $ (2018 = 100)

The grand plan . . .



. . . the hard reality



Leading CPG innovators aim to be first to scale, rather than first to market.

Implement a better measure of innovation

In a previous article, we described successful innovators' strategies, agile processes, investment approaches, and organizations.[2] The first element of a winning model is to focus on targeted consumer needs. For example, instead of casting a broad net, they aim precisely at well-defined pockets of winnable opportunity that are linked to a broader platform. They launch more "speedboats"[3] by applying agile approaches to iterate their way to growth instead of risking everything on a few big bets. They also manage innovation as venture investment managers would, tracking progress against key performance indicators, adapting quickly to in-market performance, and appointing leaders to make decisions with autonomy. Leading CPG innovators also aim to be first to scale, rather than first to market. They identify high-potential ideas and trends and then leverage size to get to scale quickly.

Many companies also aim to have better insight into innovation impact that can inform the next set of innovations to launch. We previously described how companies can benchmark their overall innovation performance using measures of R&D-to-product conversion and new-products-to-margin conversion.[4] These metrics provide valuable insights on efficacy of R&D dollars and impact of new products on overall margin. We now have the rigorous data, systems, processes, and analytic knowhow to expand this to include additional metrics.

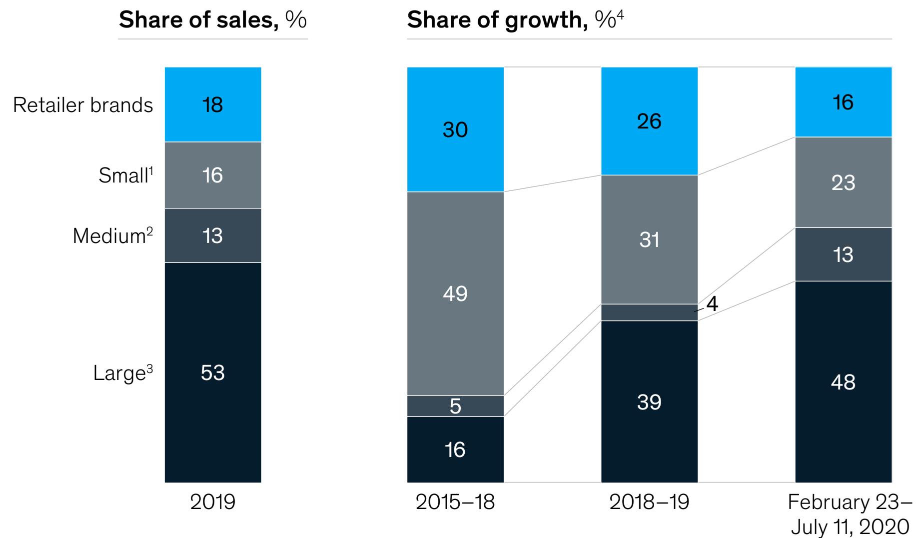
Currently, many companies track the share of sales coming from innovation, known as the vitality index. But with its simplistic focus on total revenue, this metric not only fails to differentiate profitable and unprofitable investments but also evaluates all innovation through the same lens, regardless of strategic intent. The vitality index is a kind of thermometer: it measures temperature but does not improve health. It can distract companies into shifting volume, effectively cannibalizing existing sales, rather than driving more valuable and disruptive innovation. Indeed, many companies with a strong vitality index—as much as 20 percent of sales from products launched in the past three years—are not growing their top lines. In a world of endless line extensions, the feel-good vitality index is becoming less and less meaningful. The decline in first-year sales of new products is evidence of the challenge facing large brands.

In a postpandemic world, this challenge of anticipating consumers' needs—and managing innovation to address those needs—is likely to get tougher as a result of massive, lasting behavioral disruption across consumers, categories, and channels. Consumers are placing greater priority on necessities. They're seeking larger sizes, shelf-stable and easy-to-prepare products, and products that deliver a higher value. They're shifting their shopping behavior to online and direct-to-consumer channels. Changes in disposable income and consumer attitudes increasingly favor brands that stand for trust, safety, health, and value. Established

[2] Mark Dziersk, Stacey Haas, Jon McClain, and Brian Quinn, "From lab to leader: How consumer companies can drive growth at scale with disruptive innovation," September 2018, McKinsey.com.
[3] Smaller launches to test and refine products in-market.
[4] Guttorm Aase, Erik Roth, and Sri Swaminathan, "Taking the measure of innovation," *McKinsey Quarterly*, April 2018, McKinsey.com.

Exhibit 2

Since March 2020, large companies have made significant gains in growth share.



[1]Companies with annual sales less than $500 million.
[2]Companies with annual sales $500 million to $2.5 billion.
[3]Companies with annual sales more than $2.5 billion.
[4]Figures may not sum to 100%, because of rounding.

brands, which had been suffering slow growth compared with smaller, more nimble brands, have now rebounded and account for nearly half of growth (Exhibit 2).

Leading companies are evaluating and adjusting their portfolio strategies in anticipation of the eventual recovery. Many are acting decisively to adjust assortment, fill product gaps, evolve price-pack architecture, adjust promotional activity, and increase omnichannel presence. Some companies are further exploring ways to align brand priorities with growth opportunities and accelerate the right innovation initiatives to compete effectively in an altered landscape. One leading food marketer sought to establish a more consistent and objective process for assigning limited resources to the right places earlier in the process. To achieve this, the company's innovation team is testing a data-driven approach to simulating innovation potential ahead of extensive product-development and -launch efforts.

The pandemic is also lowering barriers to brand switching. According to a recent survey, 75 percent of consumers have started a new shopping behavior—including 36 percent of consumers who have purchased new or alternative brands and products—often out of necessity due to product unavailability but also out of changing attitudes.[5]

This potential for easier trial may be good news for future innovation. But before that happens, marketers will need to know which past innovations have been successful and why (or why not); this knowledge is key for ensuring that innovation strategies can meet evolving consumer needs in a demanding retail environment.

It is critical to measure, simplify, and manage innovation performance differently and more effectively. To identify the true impact of innovation, marketers need a strategic and fact-based view. Better measures of innovation performance

[5]McKinsey & Company, COVID-19 US Consumer Pulse Survey, conducted between June 15 and June 21, 2020.

allow senior leaders to make superior decisions on the R&D, marketing, branding, and commercial levers used to support those innovations. A disciplined approach allows companies to institutionalize the process of learning and incorporate lessons back into strategic planning. Most important, it can shift organizational mindsets toward a relentless focus on ensuring that innovation works.

To accomplish this, we recommend three improvements to innovation: determining strategic roles, measuring net incrementality, and shifting evaluation from sales to profit and returns.

Determine strategic roles for each innovation
Not all innovations are equal. The most successful innovators understand the roles different kinds of innovation play in the overall growth algorithm—and the portfolio composition required to reach growth targets. Portfolio innovation can be grouped in four categories, each with a distinct role and a different path to achieve scale (Exhibit 3):

— *Line extension,* a low-risk, close variant of an existing brand that delivers the same essential benefit proposition—such as vanilla-flavored soy milk

— *Innovation expansion,* in which a new product in the same category delivers new or more benefits in ways that fundamentally expand total category potential—such as almond milk in the space of plant-based beverages

— *Disruptive innovation,* where marketers innovate to enter white space (new categories or business models) to serve new or unmet needs, reach new opportunities, and engage with consumers in pioneering ways—such as plant-based beverages as alternatives to dairy milks

— *Renovation* of an existing brand's positioning, product, or packaging to deliver improved benefits—such as cookies without trans fats;

Exhibit 3

Companies focused too heavily on line extensions can apply incrementality learnings to shift the balance toward expansion and disruption.

	Line extension	Expansion	Disruption	Renovation
Description	Extend existing product or positioning with similar benefits	Innovate with new product in current categories, consumers, or occasions	Disrupt to enter white space, such as a new category or business model	Improve existing brand's overall benefit delivery
Strategic objective	Renew the core value proposition through additional product choices	Create competitive advantage with meaningful product differentiation	Create new spaces for highly incremental and sustainable sources of growth	Improve the core value proposition of an existing brand; eg, "fix what we have"
Actions	Extend existing brand in category with new packs, format, flavor, or sizes	Launch new product under existing or new brand to serve consumers differently and more effectively	Launch into new categories, new consumers, occasions, unmet needs, or new business models	Improve existing brand's product, positioning, packaging, or benefit delivery
Investment[1]	Low	Moderate	Large, sustained	Low to moderate
Impact	Smallest	Moderate	Largest	Moderate
Typical timing	<12 months	1–2 years	2+ years	Immediate

[1]Represents typical scenarios; actual investment profiles vary widely across companies and categories.

this underused approach can benefit growth by delivering meaningful differentiation to the entire brand in a cost-efficient way

It is critical to measure each type of innovation against different standards of performance and over varying investment horizons. One critically insightful and necessary measure of performance is incrementality, or the portion of innovation volume that comes from new buyers and additional usage occasions. Incrementality can also be thought of as a new product's volume after netting out cannibalization from a brand's existing buyers.

A typical line extension's incrementality might not exceed 10 percent, but it should require less support and pay out more quickly. An expansion, which requires greater product differentiation and spending, can deliver incrementality of 20 to 50 percent. Disruptive innovation can deliver more than 50 percent in incrementality but typically requires more time and money to develop and scale. It is important to note that true breakthrough innovation (a step further than disruptive) requires different measurement approaches (both before and after launch).

Measuring innovation in the context of a portfolio helps senior leaders set the right performance bars for each initiative. It also provides strategic flexibility in innovation sequencing and mixes that can deliver both near-term results and sustained portfolio growth.

For example, a leading food manufacturer found that its rate of innovation was similar to those of its peers, but two-thirds of its launches were line extensions that yielded little incremental revenue. Many investments in innovation produced negative returns, diverting valuable resources from the more disruptive ideas required to build sustainable competitive advantages. With a clearer view of end-to-end profit and return on investment (ROI), including capital- and operational-expenditure costs, the senior team reprioritized innovation initiatives, favoring expansion and disruptions over line extensions. The shift significantly improved net sales, gross margins, and ROI.

Measure net incrementality to the portfolio

A critical step is measuring each innovation's true incremental impact to the brand and portfolio, net of cannibalization. Measuring the baseline can often prove a tricky affair. But recent advances in analytics using data-driven models of consumer behavior have made it possible to measure true incrementality while controlling for other factors. This shifts the conversation from what to sell toward which consumer behaviors innovation should strive to replace. The focus on incrementality is useful

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both in postlaunch evaluation and in identifying where to play when developing innovation strategy. Incrementality metrics can identify impact from new buyers to a brand and portfolio as well as incremental purchasing from existing buyers, net of cannibalization.

For example, a leading brand of household cleaners launched a close-in line extension touting superior cleaning benefits, but it resulted in less than 20 percent incrementality because it had entered a crowded space where headroom was limited. The challenge was even more difficult given the dynamics of a category with limited expandability, a high bar for consumer credibility, and consumer momentum moving from liquid cleaners to tools. Moreover, the overall brand declined by 4 percent as the new product cannibalized marketing support from the rest of the brand's products, resulting in negative ROI (Exhibit 4). These shortfalls persuaded senior leaders that they needed to innovate in growing spaces, create more differentiated benefits, and avoid cannibalizing the parent brand of its own marketing support.

A similar analysis in the milk and milk-alternatives market shows that plant-based beverages such as almond or soy milk were about 44 percent incremental to the overall category, meaning that 44 percent of growth in alternative-milk consumption came from other beverages, not dairy milk. The remaining 56 percent represented cannibalization from dairy milk, a number that may sound alarming but ultimately represented only a tenth of the

Exhibit 4

One brand entered a declining liquid segment with limited headroom and with consumer momentum going to tools.

Retail sales, year-over-year change

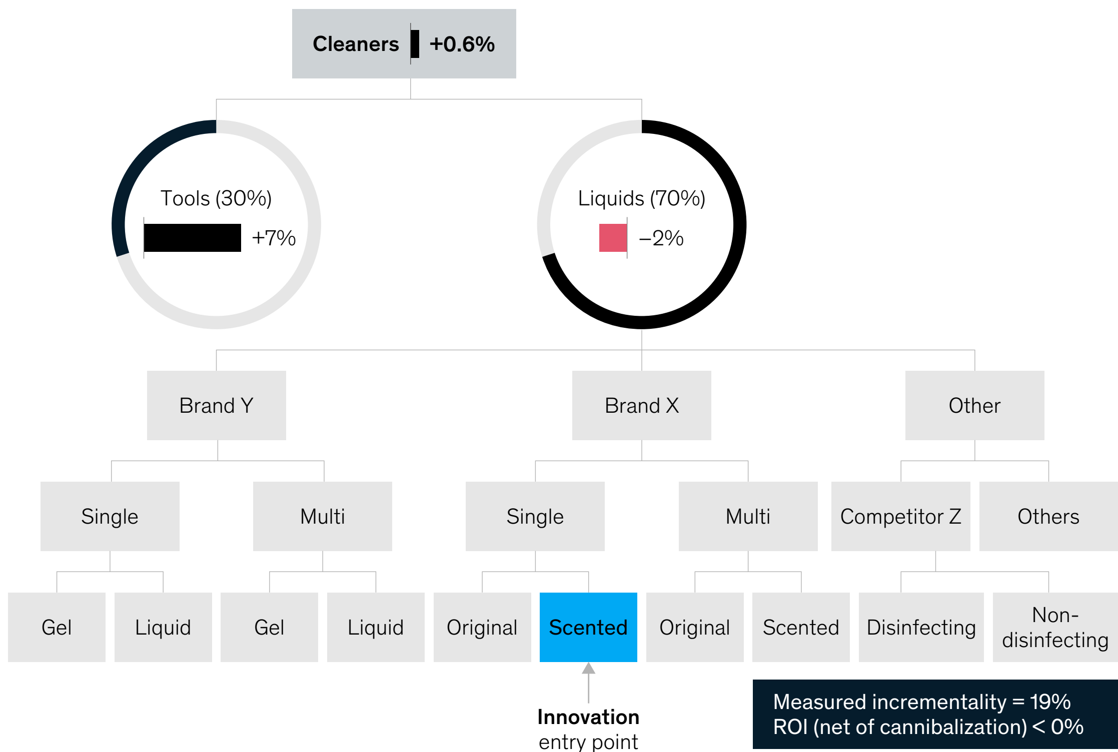
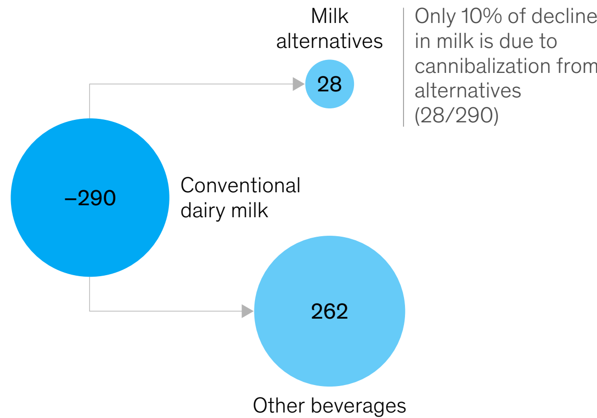


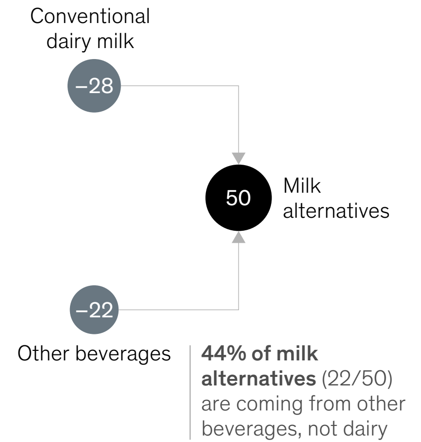
Exhibit 5

An analysis of incrementality shows that milk alternatives are not the main cause of declines in conventional dairy sales.

Milk: Beneficiaries of volume losses, gallons, millions



Milk alternatives[1]: Sources of gains, gallons, millions



Most of the decline (–262 million) in conventional dairy milk is due to other factors not directly caused by plant-based alternatives: erosion of product appeal related to changing consumer tastes, loss of distribution, less effective marketing, price changes, etc

[1]Milk alternatives include almond, soy, coconut, oat, and rice. Conventional dairy milk includes cow's, lactose-free or -reduced, and other milks.
Source: Nielsen, 2015–19 sales; McKinsey Growth Mapping

total decline in conventional dairy milk. The quantification of true incrementality showed how the emergence of milk alternatives was more a symptom than the cause of decline in dairy (Exhibit 5).

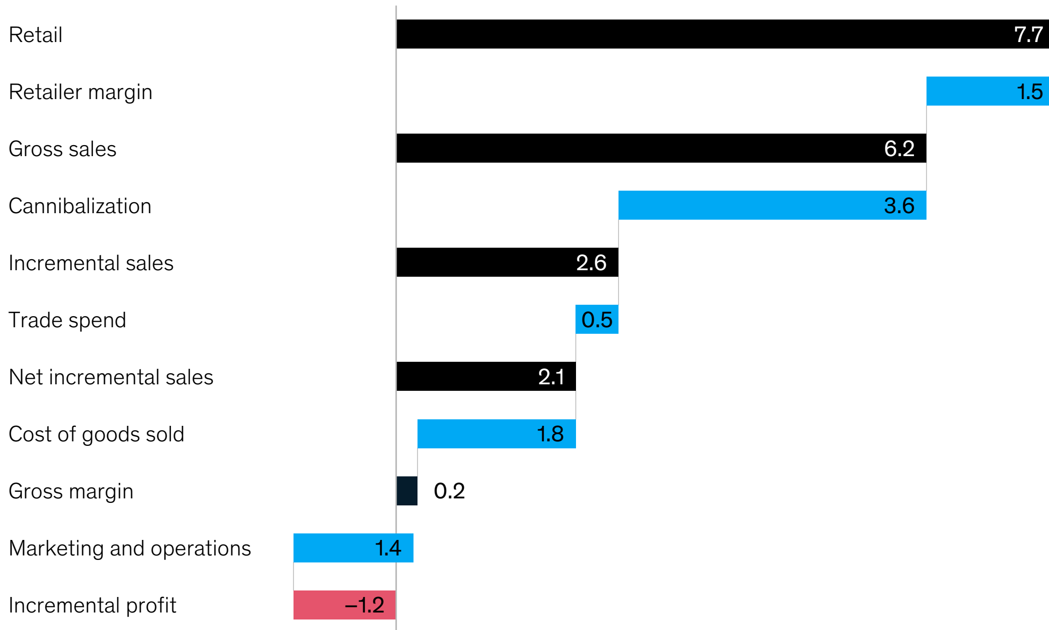
Shift innovation evaluation from sales to portfolio profit and return on investment

Marketers who manage innovation based on incremental profitability to the portfolio, instead of sales or share, stand to make better decisions to drive portfolio growth. They need to measure whether the innovation is profit accretive to the portfolio mix and quantify the ROI. With this fresh perspective, marketers can plan for accretive margins from the early stages—and give more disruptive innovation enough time and investment to become profitable.

For example, a leading snack-food manufacturer launched a fruit-flavored line extension of its brand in a fragmented category. The extension delivered the expected gross sales, based on the size of the parent brand. And by the standards of a line extension, its 42 percent incrementality appeared healthy. But after fully accounting for cannibalization and the costs of product development, marketing, and operations, the company discovered that the innovation yielded a negative ROI (Exhibit 6). Although a low ROI is not unusual for new products in the first year, the comprehensive measurement of incremental sales and profit led the company to revisit resource allocation behind line extensions.

Exhibit 6

For one company, an innovation netted negative returns after considering true incrementality.



Note: Figures may not sum, because of rounding.

Next steps

It may feel daunting to manage and measure innovation in the context of complex portfolio-growth strategies. But it doesn't need to be. We recommend starting with an unbiased assessment of the organization's capabilities and practices by asking nine questions:

1. Does innovation empower sustainable, profitable portfolio growth?

2. Do we use an analytical, data-driven framework to choose where to innovate?

3. Do we develop innovation systematically, based on consumer-led and analytical insights?

4. Are we able to accurately predict the size of innovation and sources of volume?

5. Do we pursue a balanced mix of innovations with distinct roles to meet specific strategic goals?

6. Do we set metrics and targets by type of innovation based on objectives and portfolio roles?

7. Are we able to accurately measure innovation incrementality?

8. Do we measure the impact of innovation to understand if it is margin accretive to the portfolio?

9. Does our organizational structure use a disciplined process to measure and manage innovation?

In our experience, nearly every CPG company could stand to make meaningful improvements in one or more of these areas. Leaders who commit to managing innovation performance in more purposeful and rigorous ways can expect to drive more profitable portfolio growth through innovation.

Advances in data and advanced analytics make it easier than ever to rapidly measure root causes and improve innovation performance. The real challenges lie in finding the discipline to establish a consistent and agile measurement process, glean the right insights from consumer and shopper data, and apply powerful advanced analytics based on machine learning to evaluate performance.

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