

Procuring innovation, wherever it may be

To catch the best ideas, companies need to cast their nets wider. Successful supplier innovation requires a structured approach, with procurement playing a crucial role.

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That innovation fuels business success is a truism. Across sectors, we estimate that 25 to 45 percent of revenues come from innovative products. Innovation also helps strip out unnecessary cost from products, while trimming waste from supply chains and manufacturing processes. Novel business models and ways of working help build brands, open markets, and unlock new revenue streams.

As valuable as successful innovation may be, it's also rare, with a yield that's frustratingly. Companies typically devote between half and two thirds of their R&D expenditure to innovation, but over three quarters of new product ideas never reach the end consumer.

But among the ideas that see light of day, there's a hidden success story that companies could exploit even further: the power of external ideas. We find that more than half of the innovations adopted today originate outside the organization: from suppliers, independent research centers, or customers. Sourcing an idea from elsewhere reduces risk, especially if the supplier has already evaluated its feasibility. It's quicker, too. Our research suggests that externally sourced innovations are typically commercialized 40 percent faster than home-grown ideas, often because they've already been partly validated (Exhibit 1).

Exhibit 1

Sourcing innovations from third parties can generate benefits in three major areas.

Areas of benefits	Dimensions	How innovation sourcing can help
Financial	Revenue growth	• Generating new revenues through new products and services or differentiating technologies
	Cost optimization	• Supporting cost reduction and sustaining continuous improvement across the value chain
	Faster innovation pipeline creation	• 40% faster route to commercialization for externally-sourced innovations
Brand awareness	Driving sustainability	• Strengthening your responsible image by influencing suppliers and customers to buy differently
	Brand building	• Strengthening your brand image both across the market and outside world
Organizational	Foster cross-functional collaboration	• Enabling procurement to get in the heart of the innovation agenda • Providing a strong platform for strategic supplier partnerships

Procurement's innovation role

The question is, how can organizations source even more innovation from beyond their four walls? Internal R&D functions already have a lot on their plate. They may lack the capacity to systematically scan a broad range of potential external sources for promising ideas, or to match those ideas with opportunities across product lines and business units. And when they do spot promising ideas at suppliers or partners, they may not have the relationships or background required to engage effectively.

The procurement function, by contrast, already has many of those essential capabilities. As part of the function's traditional cost-reduction mission, procurement teams are continually interacting with the organization's existing suppliers, and constantly monitoring the market for new ones. The procurement function knows how to negotiate contracts, build relationships, and manage ongoing supplier performance. A high-performing procurement function can therefore act as an external-innovation adviser, spotting innovative products and processes from the outside world that could boost profitability and deliver competitive advantage.

Accordingly, the procurement organization has a role at the heart of the innovation process: identifying and assessing potential suppliers, negotiating complex deals, and managing long-term partnerships with outside organizations. The procurement organization of a leading electronics manufacturer, for example, negotiated exclusive access to a range of innovative technologies from its entire value chain—not just from its tier-one suppliers. That approach let the company incorporate breakthrough innovations, from advanced batteries to the latest microchip designs, as unique and differentiating features in a blockbuster product.

A toolbox for successful innovation sourcing

When we look at companies with a successful track record in innovation sourcing, one thing becomes very clear: while there is no one-size-fits-all solution, the best companies build a comprehensive toolbox of intervention strategies that allow them to access innovation from different external sources, address different business challenges, and gain value at different stages in the product development lifecycle. Then they build the use of those various interventions systematically into their product development and procurement processes, supporting their use with appropriate resources, capabilities, and incentives. These tools apply at each of the three crucial stages of the product development process: ideation, partner selection, and execution (Exhibit 2).

Exhibit 2**Successful innovation sourcing depends on a few essential interventions.**

Interventions				
Ideation	Open innovation	Crowdsourcing	Competitive dynamics mapping	Enablers Right innovation mind-set, from governance to capabilities Independent, dedicated innovation team Early involvement with the business side and suppliers Partner management processes
	Innovation hackathon	Customer needs amplification		
	Consumer communities	Cross-industry sourcing		
Partner selection	Value chain mapping	External network		
	Conferences and fairs	Innovation award		
Execution	Partner-enabled development	Strategic alliance	Supplier brief	
	Collaborative design thinking	Codevelopment	Value optimization	

We have developed libraries and playbooks for all interventions, applicable for all industries

McKinsey&Company | Source: McKinsey Procurement Practice Supplier Innovation service line

Ideation

How best to capture innovative ideas from external sources will depend on the problem the organization wants to address. In **open innovation**, for example, companies ask a community of potential suppliers to offer solutions to a specific challenge. One consumer-packaged-goods company wanted to use innovative packaging to differentiate its products in a new market category. It asked local suppliers to propose possible solutions. The result was a new type of flexible container and easy-to-use cap, which helped the product achieve a leadership position in the segment.

To access a wider pool of potential contributors, companies can use **crowd sourcing**—running competitions or offering other incentives for professional or amateur enthusiasts to propose ideas or solutions to problems. One recent innovation competition, which focused on Internet of Things technologies, attracted several hundred entries by promising substantial investment for the winning teams. And under a related model, **hackathons** bring people with different skills together for a defined period to rapidly develop and prototype new concepts or solutions.

The widespread adoption of social-media technologies has made it much easier involve **consumer communities** directly in the development of new products. A manufacturer of sophisticated power tools uses its community online platform to get to know customers and their needs while gathering product, packaging and marketing feedback that helps to guide future R&D activities. And a global entertainment conglomerate has developed an online community where members can

discover cool creations by other customers and submit their own designs using the company's products. Fans can vote on submissions and give feedback. Selected ideas are put into production and sold worldwide, with recognition to the creator.

Customers don't always know what they want, however, and other interventions help companies identify previously unarticulated product or service opportunities. **Customer needs amplification** uses interviews and ethnographic studies to reveal unmet needs.

Competitive dynamics mapping compares the needs of stakeholders with the offerings already on the market to identify blank spots that might be filled with new products or services.

Many innovative ideas arise from the intersection of different industries and approaches. **Cross-industry sourcing** approaches can help companies identify ideas used in other industries, or opportunities for their existing products or technologies in those industries

Partner selection

Identifying the right pool of possible suppliers can be a key challenge in innovation sourcing, especially if a company is seeking to enter an unfamiliar product category or market. **Value-chain mapping** is a powerful way to identify new sources of expertise or potential partnerships. One high-tech defense player relied on supplier innovations to create an advanced weapon system. The company identified a network of suppliers with the technical capabilities it needed to create the highly complex system. Each supplier helped the company to produce a part of the final design. The result of that collaboration was a cutting-edge product that is now being incorporated into one of the world's largest-value defense programs.

Innovation awards can encourage existing suppliers to come forward with new ideas. Visiting **conferences and trade fairs**, especially those serving adjacent industry segments, can be a useful way to identify possible suppliers for future projects. Other companies build more formal **external networks** of partnerships with competitors, research organizations, or different industry segments. When managers at one food company wanted to add printed images and text to a new product, they developed a basic technology brief and circulated it to company's global external development network. Research by the network identified a small company in a college town where a professor was manufacturing equipment to print images using edible dyes. The company negotiated a collaboration agreement and scaled up the technology to launch the new idea quickly and cost-effectively.

Execution

The best way to execute innovation projects involving external organizations varies with the nature of the innovation. Some ideas can be developed at arm's length, at least in their early stages. Companies may choose to **brief suppliers** about a problem and leave them to propose possible solutions. Or they may **enable development at partner organizations** with venture capital funding—the approach one global retailer used to expand into a new product category. The company hired a design consultancy, imposed a set of constraints, and collaborated intensively, an effort that culminated in the product's successful launch throughout the retailer's store network.

Many innovations require closer cooperation and coordination.

Collaborative design thinking approaches bring customers and suppliers together to explore radical new concepts. **Value optimization** projects use a similar collaborative approach to identify ideas for cost savings and the improvement of existing products.

Other organizations set up specific **co-development** projects to solve problems or commercialize new ideas. A European heavy manufacturer worked with a specialty-chemicals supplier to develop new materials for the molds used in its casting process. The new material was designed to eliminate dangerous emissions, reducing environmental impact and improving working conditions for employees. Through intensive collaboration, the two companies were able to arrive at a solution that achieved its environmental goals at a cost suitable for large volume production, while also improving the quality and productivity of the manufacturing process.

For the most complex or valuable innovation projects, companies can create **strategic alliances** with selected partner organizations. In just a few years, one major healthcare company's dedicated supplier relationship center has generated several thousand innovative ideas. For the most promising, it establishes strategic alliance agreements, in which its own employees work full time with counterparts from the chosen supplier to develop the innovation.

Enabling external innovation

Beyond these specific interventions, procurement departments also need to build new structures and capabilities to enable their innovations. The first essential enabler for successful external innovation is the right mind-set, which puts innovation at the center of the procurement agenda. That needs to be driven from the top. A few companies have even appointed a chief procurement officer (CPO) responsible solely for sourcing innovation. Leading companies also establish a dedicated team to manage the external innovation process and encourage early supplier involvement in new projects. And as innovation sourcing isn't just about finding new partners, top companies also incorporate the continual search for new ideas into their existing supplier and partner management activities.

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Is your company harnessing the full power of its procurement organization to support its innovation efforts? Your competitors probably are. Building an effective innovation sourcing capability requires companies to learn an array of new tools and interventions and to build those processes into the DNA of their operations. That takes time, effort, and determination, but bringing the full capabilities of R&D and procurement together to explore the challenges and opportunities is a great first step■

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