Strategy & Corporate Finance Practice

Innovation—the launchpad out of the crisis

How organizations can innovate their way into the postpandemic era.

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As companies prepare for the recovery from the pandemic, many leaders hope innovation will set them up for the next phase of growth. In this episode of the *Inside the Strategy Room* podcast, Laura Furstenthal, whose client work focuses on healthcare organizations and innovation transformations, and Erik Roth, leader of McKinsey's global innovation practice, explain how to establish a sustainable innovation process. This is an edited transcript of the discussion. For more conversations on the strategy issues that matter, subscribe to the series on Apple Podcasts or Google Podcasts.

Sean Brown: Laura, perhaps you can set the stage. How do you define innovation in the corporate setting?

Laura Furstenthal: If you look up "innovation" in a dictionary, you see definitions like creating novel ideas or even just the word "creativity." We believe you have to think about the impact, so our definition of innovation incorporates delivering net new growth that is sustainable, repeatable, and substantial. You can focus on new products, markets, customers, or business models, but however you measure it, innovation has to increase value and drive growth.

Erik Roth: The word "substantial" is really important. Organizations often experiment with incremental initiatives that take up a lot of resources, but if innovation is to be the growth engine, it has to be large enough to matter.

Laura Furstenthal: For successful organizations, innovation is a choice. It has to be backed by a commitment. Putting your organization on a new growth trajectory requires both deliberate action and resource allocation. However, while innovation is at the top of most organizations' agenda, far more fail than succeed at driving successful innovation. In fact, 86 percent of executives we surveyed told us that innovation is a top three priority, yet fewer than 10 percent say they are satisfied with their organizations' innovation performance.

Sean Brown: How should business leaders decide what innovations to prioritize, especially when there is still so much uncertainty?

Laura Furstenthal: We have found that every successful innovation throughout history has come at the intersection of three lenses: an unmet customer need, or the who; a technology that generates a solution, or the what; and a business

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—Laura Furstenthal

model that enables you to monetize that solution, which is the how. Another way to think about it is to ask yourself the three questions. First, does what you are doing matter? Will customers benefit from it? Second, can you build it, and what technologies do you need to do that? And third, will it win? Is there an opportunity for the innovation to take on a market? Because all of these lenses are required for successful innovation, the best way to generate new concepts is to collide them in a very structured and purposeful way.

Think about the famous inventor Thomas Edison. In every case, he did not just invent the what, he also invented a how. He was often not the first person to create the innovation, whether it's the light bulb or the motion-picture player, but his unique contribution was to make it salable and scalable. In the case of the light bulb, he created the filament and the vacuum tube that allowed it to turn on and off, and he developed the production process that enabled mass production. That's a great example of all three lenses, and the lens we find organizations often spend the least amount of time on is building that scalable operating model.

Sean Brown: You both mentioned that the innovation has to be substantial to merit the resources you allocate to it. How do you determine if the innovation concept will deliver that substantial outcome?

Laura Furstenthal: We often find that people come up with ideas and build business plans, laying out all of their assumptions, but those assumptions become assertions over time and their teams end up trying to prove that their assumptions were right rather than testing them. Instead of building a business plan, we recommend building what we call a reverse P&L: What would need to be true for this idea to meet your hurdle rate and get to the level that you would consider a success? Then take those assumptions and rank them by the level of uncertainty and the degree of impact they have on the business case, and test the highest ranked first. If those assumptions fail, you know you need to pivot early. We often find people test the customer interface first, but it's the business model or the supply chain or the technology that require early testing.

Erik Roth: We recommend getting rid of business cases altogether. They are a waste of energy and time. I will go so far as to say they actually increase risk, for the reasons that Laura mentioned: everybody writes down their assertions, showing hockey-stick growth at the end, and I am willing to bet the models are dominated by market growth as the dominant variable, not growth driven by your innovation. If that's the case, there is no point in creating something. The point is, if you are going to innovate, start with the end goal. Start with the size of the business you want and work backward. If nobody can conceive of a way to get it to that size, maybe it's not the right business for your company. Many teams then apply what looks like a new product development (NPD) process, which is a sequential risk-management tool. The problem is that innovation processes are iterative and learning based, not linear and risk management based.

Sean Brown: The past year has forced companies to get innovative to overcome constraints the pandemic imposed on us. What are your favorite examples of organizations coming up with clever and valuable solutions to these challenges?

Erik Roth: It's always interesting how the old becomes new again. The pandemic obviously hit retail in an unprecedented way, and retailers' ingenuity in leveraging their store assets, retaining some level of customer experience, and reconnecting the brands with people was incredible. One of the more fun examples is Walmart using their giant parking lots as drive-ins to create entertainment and connectivity to the brand in a time when we were all hungering to be outside of our homes but still safe.

Sean Brown: Did innovation take a back seat during the pandemic at most companies?

Laura Furstenthal: We did some research looking at pre-COVID-19, during COVID-19, and the expectations for the post-COVID-19 environment, and we found that most organizations battened down the hatches during the crisis and focused on the core business, with the expectation that they would focus on innovation projects once they recovered from the crisis. So we asked, is this the right thing to do? We looked across multiple crises, including the SARS epidemic that ravaged Asia and became the impetus for widespread adoption of online transactions, and back to World War II when we saw rapid growth in manufacturing of convenience technologies to capitalize on the fact that women were working. During the financial crisis, stranded assets and an unemployed workforce spurred the sharing economy, among other things. The lesson is that those who innovate through a crisis come out stronger (exhibit).

Sean Brown: How do you determine if your organization has the capabilities it needs to innovate successfully?

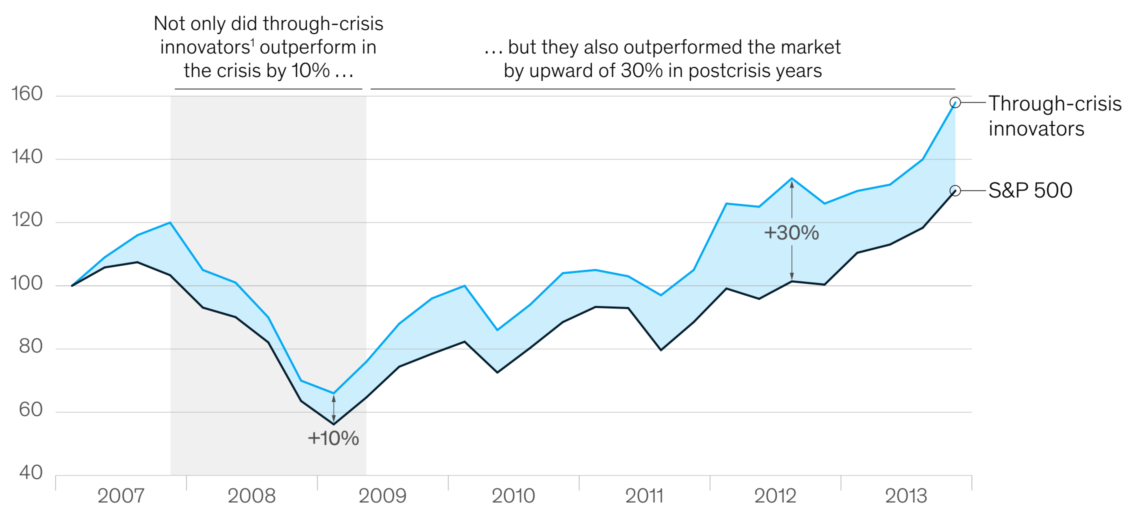
Erik Roth: Innovation is a context-specific sport. However, our research on about 5,000 companies over the past seven years has identified about 100 activities that we know promote, support, and enable innovation, and that research allows us to quantitatively understand the state of play in terms of an organization's innovativeness. Those activities are grouped into eight categories that we call the "eight essentials of innovation," and they in turn fall into four buckets. One is about strategy and portfolio, and another is about the ability to create distinctive value propositions that are not only products but business models and other forms of value creation. Launching and scaling up is another bucket, which refers to accelerating those innovations' paths to market and making them as big as they can be. The last one is about mobilizing your culture and external partners so you get reinforcement and celebration of success.

Normally, organizations track their R&D spending or patents or other indirect indicators of innovation. We instead looked at how public companies stack up in terms of economic profit creation when they

Exhibit

History suggests that companies that invest in innovation through a crisis outperform peers during the recovery.

Normalized market capitalization, index (Q1 2007 = 100)



[1]Identified as companies on the *Fast Company* World's 50 Most Innovative Companies list for ≥2 years through a crisis, normalized to 2007.

apply those essentials. Organizations that satisfy up to seven or eight of the essentials generate 2.4 times the amount of economic profit as their competitors.

Sean Brown: Can you offer any examples that illustrate what these activities involve, and how companies can determine whether they have those capabilities?

Erik Roth: Each essential has a test question. For "aspire," for example: Does your organization find innovation or net new growth critical to meeting its future objectives, and has it cascaded those objectives down to the right parts of the organization? If you answer yes, then you are probably well on the way to meeting the biggest challenge of innovation, which is reallocating resources to the best opportunities. Why is that so hard? We use a heuristic to assess whether an organization is prepared to be a great innovator: Does it have a green box? The green box represents the gap between your aspiration and what your organization can expect to deliver on its regular growth trajectory. Say on one side you have today's revenue and on the other is revenue you want five years out. There are four ways to get from one side to the other. One is selecting the right market segments. If you did nothing else but get the average growth rate in those segments, that tells you your baseline. You could then outperform your competition through all the activities in your annual plan and some incremental innovation, such as ingredient changes or functionality improvements.

If you only do those two things, how close do you get to the five-year aspiration? Is it a small gap, no gap, or a big gap? Companies that have no gap are the ones that struggle the most with innovation. No matter how many times executives make speeches to inspire people to innovate, if the business model and the growth model tell employees, "Just keep doing what you're doing," they will cheer at the speech, then keep doing what they were doing—because there is no green box. The business can achieve its objectives by performing those first two steps. Sometimes M&A fills in the gap, which is the third way. But unless there is a green box designed into the strategic plan that only innovation can address, it is hard for an organization to reallocate resources toward risky propositions like innovations.

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What is interesting is that when organizations don't have a green box and their executives get frustrated, they start creating appendages like accelerators and corporate venture-capital units and incubators that are meant to satisfy the green box but actually sit on the side and struggle. They might create interesting things but the core business does not need them to satisfy its growth ambition.

Sean Brown: How can companies identify the innovations that will fill that gap the green box represents and meet the threshold you mentioned of being substantial?

Erik Roth: Great innovation, as Laura said earlier, starts with a valuable problem to solve. It starts with the outcome, or the value of a potential opportunity. Then we use a formula. How many customers are excited about that outcome? How much do they pay today and how frequently does that occur? The most important thing, which is often forgotten or never asked, is the customer's frustration level with the existing solutions. If that level is high, the likelihood of the customer switching and being willing to pay more goes up. You can quantify the opportunity using this formula and understand which problems are valuable and the degree of difficulty in solving them.

Sean Brown: So if I am a leader frustrated with the lack of innovation in my organization, Laura, what should I do tomorrow?

Laura Furstenthal: First, make sure you are reallocating toward the future. As we say, innovation is not an ideas problem, it is a resource reallocation problem. COVID-19 has caused a massive disruption and customer needs have changed. You probably have a long tail of innovation initiatives in your organization, and there is an opportunity to redeploy those resources toward a few big, bold moves that will really move the needle.

Secondly, embed flexibility. It is important to put a structure in place where it is not okay to say, "This is the way we've always done it." You need to find the "way we now do it" and role-model that in your organization. Finally, hack your processes. Over time people develop a compliance mindset, risk aversion, and process discipline. They put in place various things that get in the way of what is at the core of innovation, which is finding ways to delight the customer.

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