Strategy & Corporate Finance Practice

Innovation: Your solution for weathering uncertainty

When the times get tough, the tough get innovative and create paths to future growth.

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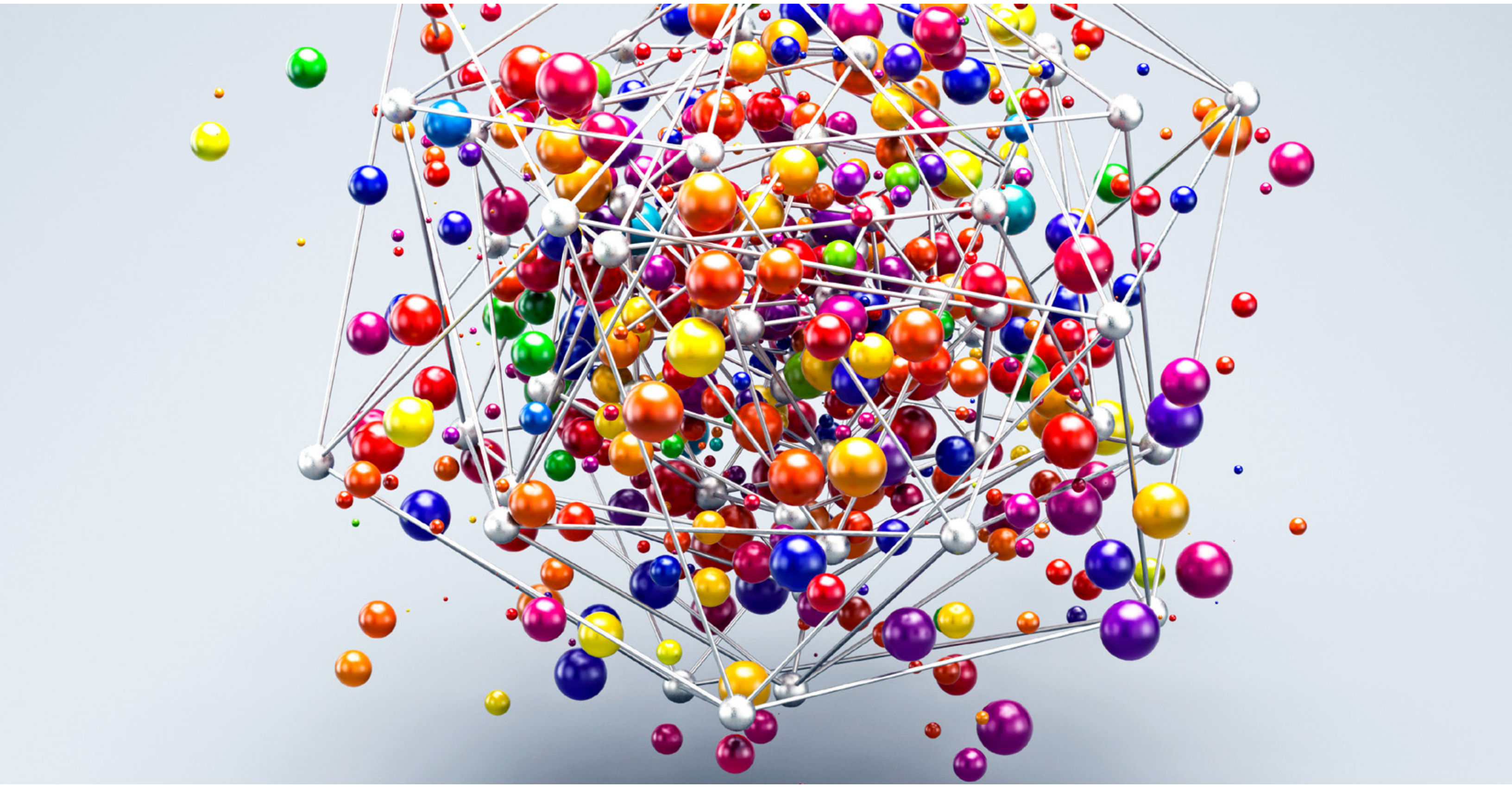

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In times of disruption and great uncertainty, most organizations tend to protect what they have and wait for a return to "normal." That's a high-risk strategy today because we may be on the cusp of a new era. Structural supply-chain issues, rising interest rates, and sustainability challenges are just a few conditions that have become the new norm and hold critical implications for business models. Amid this much change, merely trying to manage costs and raise productivity is unlikely to overcome the growth challenge that seven out of eight organizations face today. Instead, companies need to find emerging pockets of growth that can help them secure long-term success.

Innovation is critical to achieving that goal. Enduring outperformance requires management teams to refocus innovation efforts on fresh opportunities for growth and diversification—and to develop new products, invest in new business models, and forge new partnerships to seize those opportunities. By taking defensive measures such as conserving cash while also going on the offense, "ambidextrous leaders" create value despite volatility, setting up their organizations to thrive in a world that has likely changed in fundamental ways.

Indeed, our research and experience show that companies tend to fall behind if they focus solely on avoiding the downside. Since the start of the Great Recession in 2008, North American and European companies that controlled operating costs while also prioritizing revenue growth have delivered far more value to shareholders than their industry peers (Exhibit 1). To capture growth opportunities while creating more strategic options in a fast-changing environment, innovation is key. Many companies are already acting: in our 2021 New Business Building Survey, respondents reported that, on average, they expect half of their revenues in the next five years to come from entirely new products, services, and businesses.

Innovation has always been essential to long-term value creation and resilience because it creates countercyclical and noncyclical revenue streams. Paradoxically, making big innovation bets may now be safer than investing in incremental changes. Our long-standing research shows that innovation success rests on the mastery of eight essential practices. Five of these practices are particularly important today: resetting the *aspiration* based on the viability of current businesses, *choosing* the right portfolio of initiatives, *discovering* ways to differentiate value propositions and move into adjacencies, *evolving* business models, and *extending* efforts to include external partners.

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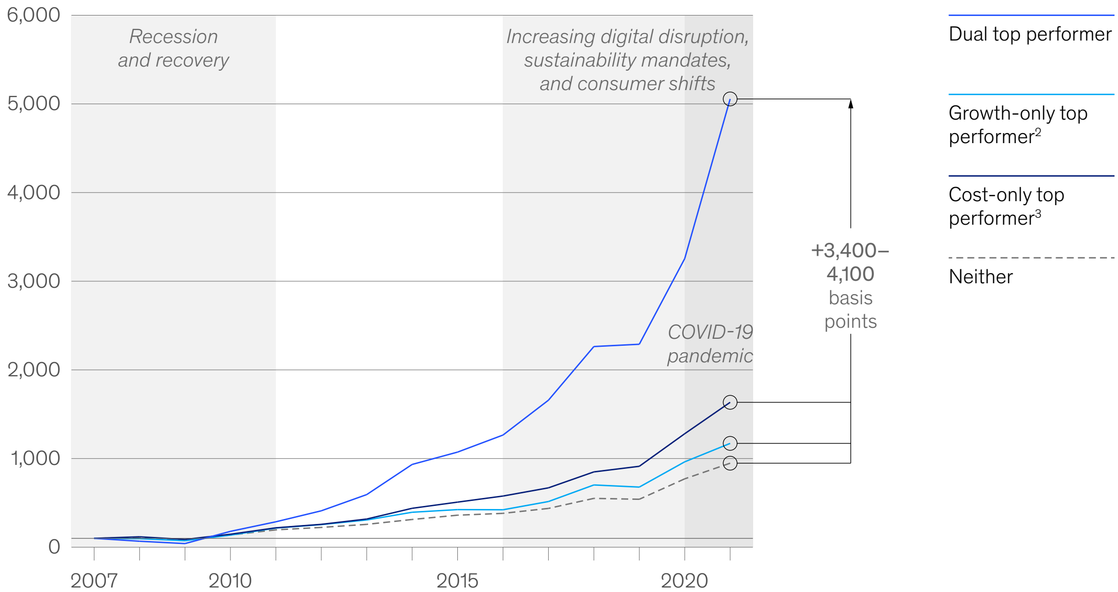
Exhibit 1

‘Sustained resilients’ that lead on both growth and productivity build the largest performance gap.

‘Sustained resilient’ total shareholder returns (TSR),[1] index (2007 = 100)



[1]Sustained resilients defined as top TSR quantile by industry (2007–11 and 2016–15), n = 126; TSR calculated as average of subsector median performance of "super resilients."
[2]Top TSR revenue growth by industry, 2007–21.
[3]Top TSR reduction of operating costs as a % of revenue, 2007–21.
Source: Top 5,000 companies by revenue in any year 2007–21, EU and North America only, >$10 million revenue in 2007 or 2016 (3,018 companies), Corporate Performance Analytics by McKinsey

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Raise your innovation aspiration to address new risks and opportunities

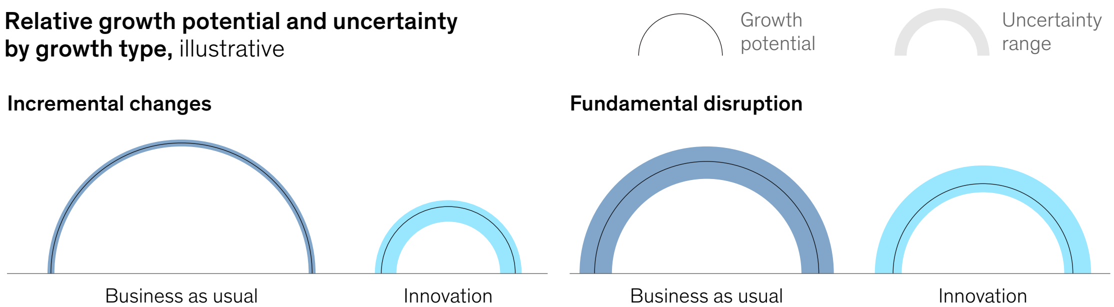
In recent years, the assumptions underpinning many business lines and growth initiatives have changed or broken down entirely. Companies with business models optimized to a specific set of global conditions are more vulnerable to the sea change underway and need to invest more, not less, in innovation to open new paths of viability. We have already seen this play out in the shortages affecting consumer goods, retail, and auto sectors, and as the energy crisis expands, disruptions are impacting more industries. Conversely, business models that address today's uncertainties through reshoring production or expanding into digital offerings, for example, can help companies ride out disruptions. In effect, the risks associated with business as usual versus bold innovation have been inverted: in times of fundamental change, shifting resources toward big innovation bets is an important hedge against uncertainty (Exhibit 2).[1]

[1] The impact will vary based on company, industry, and geographic context, potentially even exceeding business as usual.

Exhibit 2

As disruption increases, business as usual becomes riskier than innovation.

Relative growth potential and uncertainty by growth type, illustrative



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We saw this timeless pattern play out in earlier cycles. For instance, amid the 2002 downturn, Best Buy recognized it couldn't win on assortment breadth and competitive pricing alone so it invested in business model innovation, creating and scaling their Geek Squad consumer support service that other online and brick and mortar rivals couldn't easily provide. Two decades later, a European energy company likewise facing a declining core business recently opted to move into a high-growth and high-innovation segment by expanding into renewable energy in other markets.

The energy crisis is pushing even distant sectors to embrace innovation. Take beer: the carbon dioxide used for carbonation is a byproduct of ammonia production, an energy-intensive process employed mostly in the manufacture of fertilizer. High energy prices in Europe have stalled ammonia production, creating a shortage of carbon dioxide at the peak of the region's beer season. While some European brewers opted to shut down, others have instead embraced process innovation by exploring nitrogen or other means of creating beer foam.

Choose a balanced portfolio of short- and long-term innovations

In times of disruption or deep uncertainty, companies have to carefully balance short-term innovations aimed at cost reductions and potential breakthrough bets. As customers' demands change, overindexing on small product tweaks (that address needs which may be temporary) is unlikely to boost long-term performance. However, "renovations" to designs and processes can produce savings that help fund longer-term investments in innovations that may create routes to profitable growth.

For example, when a consumer packaged goods company found itself falling short of its growth and margin targets but lacked capital to invest in new offerings, a cross-functional team built road maps for both immediate and longer-term product offerings. Within four months, the company sized the financial impact and execution feasibility of cost-reducing quick wins such as package optimization and formula rationalization as well as more ambitious projects, including a shift to sustainable packaging and entirely new products. The cost reductions from the incremental innovations yielded funds the company could reinvest in longer-term growth ideas while an innovation process reduced product development timelines by 75 percent.

Similarly, when a global manufacturer of sinks and faucets found itself falling behind competitors, it conducted a review of its innovation portfolio. The company found it had a limited innovation pipeline to feed new growth and that 65 percent of employees were focused on largely incremental projects expected to contribute only 5 percent to the portfolio's net present value (NPV). The management team then sought to rebalance the portfolio toward bolder, higher-NPV initiatives, including bottom-up product redesigns to reduce the time to market. After reallocating resources to projects with higher commercial potential, the company saw a threefold increase in revenue and reduced the time to market for new products by nearly 40 percent.

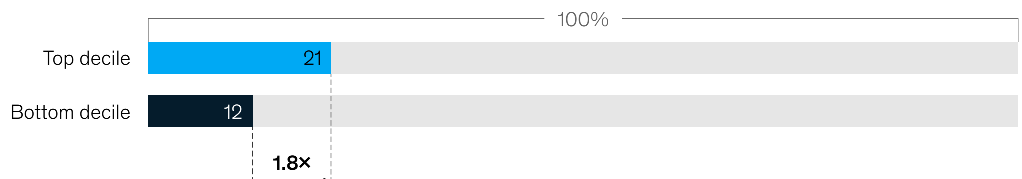
Discover and tap into emerging adjacencies

Pervasive uncertainty is a good opportunity for companies to look for diversification or expansion opportunities outside their core businesses. Economic shocks such as the COVID-19 pandemic, supply-chain disruptions, and geopolitical tensions have led numerous organizations to tap innovation opportunities in adjacent markets, such as grocers ramping up delivery options. Similarly, mobility-as-a-service providers have found a valuable new niche in delivering restaurant food, and some electric vehicle manufacturers are now monetizing battery production and recycling. A May 2021 McKinsey survey revealed that during the first 12 months of the pandemic, top-decile economic performers innovated nearly twice as fast as their low-performing peers in generating new products and services (Exhibit 3).

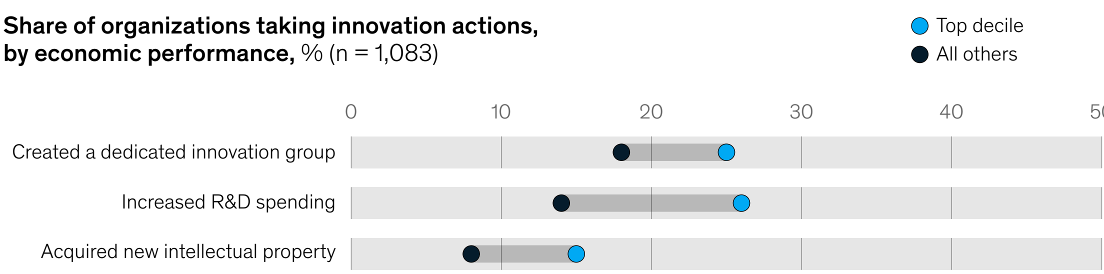
Exhibit 3

Economic outperformers innovated almost twice as fast as low performers did in 2020–21.

Share of sales from products/services that did not exist 1 year ago, by economic performance, % (n = 727)



Share of organizations taking innovation actions, by economic performance, % (n = 1,083)



Source: McKinsey Global Survey on digital strategy, Jan 2021, of 1,140 business leaders

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Our recent research shows that adjacencies closer to the core business and current competencies tend to be easier to capture but can still represent significant new sources of growth. Some agricultural companies, for example, have shifted from selling farming machinery and fertilizer to building ecosystems and providing insights to help farmers be more productive. Drug and medical device manufacturers likewise are increasingly looking beyond selling medications and machines to helping patients manage their conditions and live longer, healthier lives through end-to-end care journeys.

Today, the sustainability imperative is driving many such innovation bets. Consumers' concern about climate change is leading packaged goods companies to invest in sustainable ingredients and packaging, while some clothing manufacturers are recycling old clothes to make new ones. Sometimes, regulations can spur innovations in adjacent markets. For example, tax credits under 45Q, a section of the US federal tax code enacted in 2008, encourage investments in carbon capture and storage. The Inflation Reduction Act of 2022, meanwhile, creates opportunities in sustainable fuels and chemicals for firms that can leverage these incentives to build new businesses. Similarly, the European Union's decarbonization goals under Roadmap 2050 have created significant incentives to innovation.

As industry landscapes shift and customer demands evolve, incumbents should look for innovation opportunities with the mindset of start-ups. Expecting revenue or margin growth to continue as before can prevent bold action and invite attackers that view established companies' margins as opportunity.

Evolve business models for changing conditions

Capturing new opportunities—either by aligning with emerging trends or venturing into adjacent markets—often requires business model changes, which can have the added benefit of boosting resilience. Adopting new business models can enable companies to put more core competencies into play than investments further afield while also making the organization more adaptable and generating new growth. Such innovations can include evolutions of value propositions, economic models, production models, routes to market, and the use of assets and capabilities. For example, new ways to organize supply chains or ecosystems, shifting from selling products to offering services, or moving from B2B to B2C can give companies new strategic options as business conditions change.

Energy companies that pivoted to providing locally produced, renewable energy, for instance, are finding the shift insulates their operations from near-term swings in energy prices. Similarly, organizations moving to provide products to increasingly health-conscious consumers are by necessity diversifying their supply bases to acquire the needed ingredients, thus improving the resilience of their supply chains.

Such tactical gains often bring strategic benefits. For example, one shoe manufacturer is now offering recyclable shoes on subscription—a customer returns a pair at the end of the lease and the company uses the materials to construct the next batch.

Extend efforts to include external partners

Over the past three years, top economic performers have doubled down on investments in new partnerships (Exhibit 4). Alliances and joint ventures can enable large companies to rapidly scale new business models or offerings that would take a long time to develop organically.

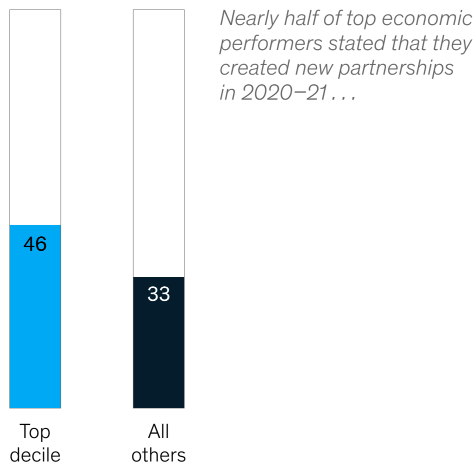
The current market volatility can provide fresh opportunities for large companies to extend their networks of business partners, or even acquire them. With many start-ups struggling and lower availability of venture capital, incumbents can help fill the funding gap while gaining access to important capabilities and technologies.

For example, a European energy management company teamed up with a private equity firm on

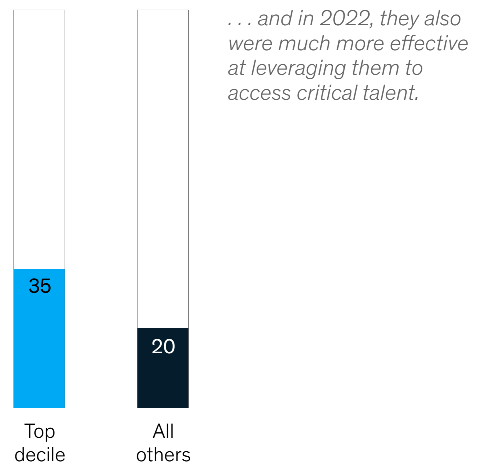
Exhibit 4

Top economic performers were more effective at partnering with other organizations from 2020–22.

New partnerships created by organization performance, 2020–21, % of respondents (n = 1,118)



Partnership very successful in accessing other companies' talent pools, 2022, % of respondents (n = 1,331)



Source: McKinsey Global Survey on digital strategy, Jan 2021, of 1,140 business leaders; Jan 25–Feb 4, 2022, of 1,331 business leaders

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a joint venture that builds and operates clients' energy infrastructure. The new business helps organizations make the transition to renewable energy sources, for example by helping fleet operators shift to zero-emissions vehicles.

In times of increasing disruption and uncertainty, continuing with business as usual can exceed the risk of leaning into the headwinds. To join the ranks of the truly resilient and enable through-cycle growth, now is the time to choose a new innovation portfolio, discover fresh insights and opportunities, and evolve your business models.

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