

McKinsey Explainers

What is innovation?

Innovation is the systematic practice of developing and marketing breakthrough products and services for adoption by customers.



When you think of innovation, what springs to mind? Maybe it's a flashy new gadget—but don't be mistaken. There's much more to the world of innovation, which extends far beyond new products and things you'll find on a store shelf.

If products alone aren't the full story, what *is* innovation? In a business context, innovation is the ability to conceive, develop, deliver, and scale new products, services, processes, and business models for customers.

Successful innovation delivers net new growth that is substantial. As McKinsey senior partner Laura Furstenthal notes in an episode of the *Inside the Strategy Room* podcast, "However you measure it, innovation has to increase value and drive growth."

As important as innovation is, getting it right can be challenging. Over 80 percent of executives surveyed say that innovation is among their top three priorities, yet less than 10 percent report being satisfied with their organizations' innovation performance. Many established companies are better operators than innovators, producing few new and creative game changers. Most succeed by optimizing existing core businesses.

Why is innovation important in business?

Some companies do succeed at innovation. Our research considered how proficient 183 companies were at innovation, and compared that assessment against a proprietary database of economic profit (the total profit minus the cost of capital). We found that companies that harness the essentials of innovation see a substantial performance edge that separates them from others—with evidence that mastering innovation can generate economic profit that is 2.4 times higher than that of other players.

How can leaders decide what innovations to prioritize?

Successful innovation has historically occurred at the intersection of several elements, which can guide prioritization efforts. The three most

important elements are the who, the what, and the how:

1. *An unmet customer need (the 'who')*: Who is the customer and what problem do they need to solve? Are macro trends such as automation driving changes in customer needs?
2. *A solution (the 'what')*: Is the solution compelling and can it be executed?
3. *A business model that allows for the solution to be monetized (the 'how')*: How will the solution create value? What is the business model?

Successful innovation requires answers to each of these questions.

An example from inventor and businessman Thomas Edison helps illustrate the concept. "In every case, he did not just invent the what, he also invented a how," says Furstenthal in a conversation on innovation. "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."

How do organizations become better innovators?

McKinsey conducted research into the attributes and behaviors behind superior innovation performance, which were validated in action at hundreds of companies. This research yielded eight critical elements for organizations to master:

1. *Aspire*: Do you regard innovation-led growth as critical, and have you put in place cascaded targets that reflect this?
2. *Choose*: Do you invest in a coherent, time- and risk-balanced portfolio of initiatives, and do you devote sufficient resources to it?
3. *Discover*: Are your business, market, and technology R&D efforts actionable and capable of being translated into winning value propositions?

4. *Evolve*: Do you create new business models that provide defensible, robust, and scalable profit sources?
5. *Accelerate*: Do you develop and launch innovations quickly and effectively?
6. *Scale*: Do you launch innovations at the right scale in the relevant markets and segments?
7. *Extend*: Do you create and capitalize on external networks?
8. *Mobilize*: Are your people motivated, rewarded, and organized to innovate repeatedly?

Of these eight essentials, two merit particular attention: *aspire* and *choose*. Without these two elements, efforts may be too scattershot to make a lasting difference. It's particularly crucial to ensure that leaders are setting bold aspirations and making tough choices when it comes to resource allocation and portfolio moves. To do so successfully, many leaders will need to shift their mindsets or management approaches.

What are examples of successful innovators?

Real-world examples of successful innovation, related to some of the eight essentials listed, can highlight the benefits of pursuing innovation systematically:

- Mercedes-Benz Group invested extensively in digitizing its product development system. That allowed the company to shorten its innovation cycles significantly, and its capabilities for personalizing cars have improved, even as assembly efficiency rose by 25 percent.
- Gavi, a public-private partnership founded to save children's lives and protect their health by broadening access to immunization, used nonfinancial targets to help drive its innovation efforts—and this helped the organization broaden its aspiration for impact in a way that was bold, specific, measurable, and time bound.

- Lantmännen, a large Nordic agricultural cooperative, faced flat organic growth. Leadership created a vision and strategic plan connected to financial targets cascaded down to business units and product groups. Doing so allowed the organization to move from 4 percent annual growth to 13 percent, on the back of successfully launching several new brands.
- The information services organization RELX Group brought discipline to choosing its innovation portfolio by running ten to 15 experiments in each customer segment in its pipeline every year. It selects one or two of the most successful ideas from the portfolio to continue.
- International insurance company Discovery Group mobilized the organization around innovation by creating incentives for a thousand of the company's leaders using semiannual divisional scorecards. Innovation isn't a choice; it's a requirement and a part of the organization's culture.

These examples aren't necessarily what you may think of when you imagine disruptive innovation—which calls to mind moves that shake up an entire industry, and might be more associated with top tech trends such as the Bio Revolution. Yet these examples show how committing to innovation can make a sizable difference.

How can my organization improve the volume and quality of new ideas?

Steps to help aspiring innovators get started include the following:

- *Hold collision sessions*: Cross-functional groups gather in a structured process to think through the intersection of unmet customer needs, technology trends, and business models, bringing creativity and specificity to the process of idea generation. Then, a venture panel considers these ideas and iterates on them, prioritizing what to do.

- *Challenge orthodoxies:* Participants gather and describe beliefs that are common but that prevent the organization from innovating for customers. Examples of these orthodoxies include statements such as “budgets are limited” or “we don’t have the digital capabilities to pull it off.” Once the orthodoxies are laid out, teams brainstorm after being prompted to consider if the opposite of the statement were true.
- *Make analogies to other industries:* A team might create a list of companies with unique value propositions. Then, they systematically apply these value propositions to their ideas to see if the analogy can create new sources of value or fresh opportunities.
- *Apply constraints:* Rather than searching for blue-sky ideas, tighten the constraints on an idea’s business or operating model and explore potential new solutions. What if you served only one type of customer? What if the only channel you could access was online?

In the words of chemist Linus Pauling, “The way to get to good ideas is to get lots of ideas and throw the bad ones away.”

What is an innovation portfolio?

An innovation portfolio is a thoughtfully curated bundle of potentially innovative initiatives, with clear aspirations and required resources defined for each. Managing the portfolio this way helps find new opportunities and determine the appropriate number and mix of initiatives, including the following:

1. confirming the total value of the portfolio needed
2. evaluating existing innovation projects based on incremental value delivered, risk, and alignment with strategic priorities
3. getting comfortable saying “no” to stop projects that are dilutive, and resisting the siren song of

incremental initiatives that are unlikely to pay for themselves

4. reallocating resources—including competencies and skills—to new initiatives or to current ones that additional support can accelerate or amplify
5. identifying portfolio gaps and defining new initiatives to close them

How to measure innovation?

One way to measure innovation is to look at innovation-driven net new growth, which we call the “green box.” This phrase refers to how you quantify the growth in revenue or earnings that an innovation needs to provide within a defined timeframe. This concept can help clarify aspirations and influence choices on the innovation journey.

While many imagine that innovation is solely about creativity and generating ideas, at its core, innovation is a matter of resource allocation. To put it another way: it’s one thing to frame innovation as a catalyst for growth, and another to act upon it by refocusing people, assets, and management attention on the organization’s best ideas.

The green box can help to solidify a tangible commitment by defining the value that a company creates from breakthrough and incremental innovation, on a defined timeline (say, five years), with quantifiable metrics such as net new revenue or earnings growth. Crucially, the green box looks at growth from innovation alone, setting aside other possible sources such as market momentum, M&A, and so forth. And once defined, the growth aspiration can be cascaded into a set of objectives and metrics that the company’s various operating units can incorporate into its individual innovation portfolios.

It’s useful to note that some organizations may find that measures not solely financial in nature are more appropriate or relevant. For instance, metrics such as the number of subscribers or patients—or customer satisfaction—can resonate. What’s critical is selecting a metric that is a proxy for value creation. A large US healthcare payer, for example,

looked to spur innovation that would improve patient satisfaction and the quality of care.

Separate from the concept of the green box, two simple metrics can also offer surprising insight about innovation vis-à-vis the effectiveness of an organization's R&D spending. Both of these lend themselves to benchmarking, since they can be gauged from the outside in, and they offer insight at the level of a company's full innovation portfolio. The two R&D conversion metrics are as follows:

- *R&D-to-product conversion*: This metric is calculated by looking at the ratio of R&D spending (as a portion of sales) to sales from new products. It can show how well your R&D dollars convert to actual sales of new products—and it might reveal that spending more doesn't necessarily translate into stronger performance.
- *New-products-to-margin conversion*: This metric considers the ratio of gross margin percentage to sales from new products. It can indicate how new-product sales contribute to lifting margins.

While no metric is perfect, these may offer perspective that keeps the focus squarely on returns from innovation and the value it creates—often more meaningful than looking inward at measures of activity, such as the number of patents secured.

How do you create a high-performing innovation team?

Innovation is a team sport. Experience working with strong innovators and start-ups has helped identify ten traits of successful innovation teams. Those fall into four big categories: *vision*, or the ability to spot opportunities and inspire others to go after them; *collaboration*, which relates to fostering effective teamwork and change management (for instance, by telling a good innovation story); *learning* or absorbing new ideas; and *execution*, with traits that facilitate snappy decision making even when uncertainty arises.

Being strategic about the composition of an innovation team can help minimize failures and bring discipline to the process.

What innovation advice can help business leaders?

One broad piece of advice centers on creating a culture that accounts for the human side of innovation. When people worry about failure, criticism, or the career impact of a wrong move, this can keep people from embracing innovation. In a recent poll, 85 percent of executives say fear holds back their organization's innovation efforts often or always—but there are ways to overcome these barriers.

Here are some perspectives from leading experts who have helped their organizations tackle inertia and unlock bold strategic moves. If you are looking for words of wisdom, their insights can help spark inspiration to innovate:

- *Naomi Kelman, CEO, Willow*. "Creating a safe environment for innovation is really what you need to do to get the greatness out of the people who work with you, which is ultimately what drives growth."
- *Safi Bahcall, author, Loonshots*. "Most of the important breakthroughs failed many times before they succeeded. That is where 'fail fast' goes wrong. Most companies are too impatient."
- *Amy Brooks, chief innovation officer, National Basketball Association*. "You can use data or examples to convince people about what is working in the market or what other industries are doing. We like to share best practices within our own leagues and within sports, but we also pay attention to every other industry that sells to consumers."
- *Tanya Baker, global leader, Goldman Sachs Accelerate*. "If someone knowledgeable thinks what you are doing is a bad idea, make sure they have a seat at the table. Put them on your board; make them one of your advisers so you don't have any blind spots."

- *Neal Gutterson, former chief technology officer, Corteva.* “[A] key skill is being able to hold two divergent thoughts and approaches in your brain and in your team at the same time. The great companies will be ambidextrous innovators, able to disrupt themselves in the future while serving the core [business] today.”
- *Anjali Sud, CEO, Vimeo.* “What keeps me up at night is execution and, within that, focus. Because when you are in a market like ours, at a time like now, the opportunity is huge. We are this nimble, fast-growing, fast-moving company, and everywhere I look I see opportunity. But am I providing enough focus for my teams so that we can truly be great at something? You don’t want to miss a big boat, and it’s hard sometimes to say no to valid, exciting ideas that could be transformative.”
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- “Innovation—the launchpad out of crisis,” September 15, 2021, Laura Furstenthal and Erik Roth
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