Ten Rules for Strategic Innovators

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Introduction

All companies realize the need for sustained growth through innovation. Yet, few find it easy to achieve this in practice. Growth becomes difficult to come after a certain stage. Microsoft, Intel, IBM and P&G are all going through a phase of slowing growth. This book is how companies can succeed in creating sustained growth by launching new businesses. The book provides a detailed blue print on how to conceptualize, launch and grow new businesses through strategic innovation. The authors point out that strategic innovation, which goes beyond process or product innovation, involves major challenges. At a most basic level, strategic innovation addresses three fundamental questions:

a) Who is the customer?
b) What is the value the company offers to the customer?
c) How does the company deliver that value?

Strategic experiments

Strategic innovation must not be left to chance. It must be viewed as the outcome of strategic experiments which have ten common characteristics:

a) They have high revenue growth potential
b) Typically, they target emerging or poorly defined industries
c) Such experiments are launched before any other competitor and before any profit making formula has been established.
d) They depart from the company's proven business definition and its assumptions about how the business will succeed.
e) These experiments leverage some of the corporation's existing capabilities and assets in addition to capital.
f) They need some new knowledge and capabilities
g) They involve discontinuous rather than incremental value creation.
h) They involve greater uncertainty across multiple functions
i) They may remain unprofitable for several quarters or more.
j) Such experiments give no clear picture of performance early on.

Strategic innovations may include innovations in process or product but always involve unproven business models. Companies that are good at strategic innovation change the rules of the game and delight investors with sustained growth. Their business models are difficult to imitate.

Implementing Strategic Innovation

The real contribution of the authors is in explaining in great detail, the challenges involved in implementing innovation. An innovation goes through three stages - a beginning, a middle and an end. Creativity dominates the beginning of the innovation process. Efficiency is important towards the end of the innovation process. The middle involves unique challenges. There is a forgetting challenge, a borrowing challenge and a learning challenge.

The new initiative must forget the parent company's business definition, assumptions, mindsets and biases to develop new competencies to exploit new business possibilities.

The new initiative must learn how to borrow assets from the parent company. These may include manufacturing capacity, expertise, sales relationships, distribution channels, etc.

The new initiative must learn and constantly improve its predictions of business performance. It must be able to resolve various critical unknowns in its business plan and zero in on a working business model as quickly as possible.

The new initiative's DNA must be different from that of the parent company. DNA consists of four key elements – structure, systems, people and culture. The new initiative must have more of creators and inspirers, have a flat hierarchy, a focus on learning and have greater risk tolerance.

The forgetting challenge

The forgetting challenge must be tackled by addressing the following questions.

a) Who are our customers?
b) What are they looking for?
c) How do we deliver value?
d) What areas of expertise does the new initiative need?
e) What is the relative importance of each?
f) How does this differ from the parent company?
g) What kinds of predictions and forecasts are appropriate for the new business?
h) On what basis can managers be held accountable?

The forgetting challenge is much more difficult than we may think. People's instincts are guided by what has worked for them in the past. The established patterns of interactions among managers are also difficult to forget. Areas of expertise that have traditionally enjoyed a higher status, cannot be marginalized overnight. Performance appraisal systems are also difficult to realign.

The most difficult transition that organizations must make while managing strategic experiments, is adjusting to higher levels of uncertainty. Falling short of plans should not be equated with failing. The focus should be more on learning and coming up with better predictions, than on accountability.

To overcome the forgetting challenge, a strategic experiment must shape an unique organizational DNA. Staff, structure, systems and culture must be handled carefully. The initiative must hire an adequate number of outsiders, focus more on learning and shape a culture of experimentation and risk taking. The performance metrics for the new initiative must be chosen carefully.

The degree of intensity of the forgetting challenge is linked to both fundamental drivers and organizational intensifiers. Fundamental drivers include serving an unfamiliar customer, a new value proposition, fundamentally different processes, new competencies and significant environmental uncertainties. The organizational factors which intensify the learning challenge include a strong culture of accountability, heavy dependence on one business model, tradition of promoting from within, a strong well defined culture and well established standards of business performance.

The borrowing challenge

The new initiative can borrow in 6 ways:

a) the output of an existing process
b) coordinate its process with that of the core company
c) work jointly with the parent company to crate a new business process
d) brands
e) expertise
f) physical assets.

Tensions arise when the new venture tries to borrow from the parent company. This happens especially when the parent company believes that the new initiative may cannibalise existing businesses, make obsolete a core parent company competence, damage parent company assets such as brands, etc. Tensions may also arise if the new initiative gets wide coverage in the press or receives strong endorsement from the CEO. These tensions become aggravated during a recession when competition for scarce resources intensifies. If the new initiative wants to alter the core processes of the parent company, tensions may again intensify. Anticipating tensions is important if the borrowing challenge is to be overcome. Tensions are likely to be the highest during the growth phase.

Overcoming the borrowing challenge involves the following:

a) Selecting the right links between the parent company and the new initiative.
b) Establishing a cooperative environment
c) Intervening from time to time to keep the tensions healthy and productive.

Borrowing should be selective. Links should be created only where the new company can gain a competitive edge. These links should be created early on as integration becomes progressively difficult with the passage of time. Links should be avoided where the conflicts can become acute. Links to support departments, though convenient and tempting, should be minimal. This is because support functions strongly influence the DNA of the new initiative.

The two factors that determine the intensity of the borrowing challenge are: the total number of links between the parent company and the new initiative and the presence of fundamental drivers of tension between the new initiative and the parent company.

The learning challenge

In a strategic experiment, the winner is not necessarily the company that starts with the best plan. It is the one that learns and adapts the quickest. The crux of the learning challenge, is improving the ability to predict the performance of the new venture. To improve predictions, the new initiative must systematically resolve a handful of critical unknowns including market, competition and technology.

The learning objective for the head of a strategic experiment is to refine the theory of a business so that predictions of business performance improve over time. Predictions lie at the heart of the learning process. They should be treated with care. Predictions fall victim to four specific learning disabilities:

- Predictions are ignored
- Predictions or performance perceptions are manipulated
- Predictions become rigid
- Predictions and incomes are analysed poorly

The most basic root cause of learning disabilities is an unwillingness to make a serious investment in planning. Managers often make plans hastily. They argue that since business is so uncertain, why bother about planning? Some believe that time should be spent on doing, not planning. What managers overlook is that they cannot become better at predicting, by avoiding planning. A strong culture of accountability also acts as a learning disability. When outcomes fall short of predictions, the prediction is assumed to be right and the managerial underperformance is criticized. The authors emphasize that in strategic experiments, the learning objective must be not to improve performance until it reaches proven standards, but rather to discover what standards are possible. In other words, the objective is to bring predictions in line with performance, not the other way around.

Accountability is important, even in strategic experiments. But the basis for accountability must change from performance against plans to learning. In short, the planning system must be viewed as the testing mechanism for new business models. Senior executives must invest their time disproportionately in strategic experiments. As the requirements are so different, planning meetings must be held separately for the parent company and the new initiative.

Learning requires transparency. Information, especially about surprises and negative outcomes, must be collected and shared with openness and candor. Predictions must not be manipulated. Predictions should be modified only following an analysis of the disparities between predictions and outcomes. When the learning process is healthy, predictions are generally modified, as evidence is gathered. The most dangerous predictions are long term. Long term predictions do not serve as the basis for learning. It takes too long for evidence that can concretely confirm or reject these projections. Short-term revisable predictions serve as the basis for ongoing learning. Bold long term goals can be used but they need to be coupled with rational short-term predictions that are used to support learning.

The two factors that determine the degree of difficulty of the learning challenge are the range of critical unknowns and organizational factors that intensify the learning challenge.

Critical unknowns refer to the following:

- Major technological uncertainties
- Various competitors from different industries
- Lack of clarity about what the customers value and how much they will pay
- The internal capabilities needed to address the market opportunity

The learning challenge intensifies under the following circumstances:

- The new initiative is in a rush to get to the market first
- The company has a tradition of very detailed and meticulous planning
- The company emphasizes standard planning templates across units
- The experiment demands large one time investments
- Performance data are available only with a lag
- There is a culture of penalizing managers if they fail to meet their targets
- The measures of performance viewed as important throughout the company, do not apply to the initiative.

Leadership
The essence of good leadership in strategic experiments is to keep revaluating strategy. People must be motivated by sending the right signals. When people perceive that performance is either near the aspired level or near failure, they are least likely to maintain an experimental mindset. They become risk averse and less open to questioning their overall plan. The right way to motivate people is to reinforce the perception, “We have a long way to go and it is not at all clear how we are going to get

there." Such a statement is both honest and humble given the uncertainties involved. It can also motivate employees and engage them in both hard work and in learning.

A new approach to planning

Planning can be done in various ways. In conventional planning, detailed plans are prepared. Such details may, however, not be possible in strategic experiments. Conventional planning emphasises some trends but much broader trends may have to be studied in strategic experiments.

In Discovery driven planning, greater importance is paid to the uncertainty involved. The unknowns are reduced to specific parameters such as cost per sale, manufacturing cost per unit and market price that have a direct bearing on the income statement. These parameters are identified in advance and managers gather evidence to firm up estimates. As estimates are refined, managers have a better picture of whether the strategy will succeed or fail. This approach may be appropriate when the industry is established, the business model is well known and the business uncertainties can be reduced to a set of operational parameters. But strategic experiments face much higher levels of uncertainty.

Venture capitalists have a different approach to evaluating and monitoring projects. They too do not have too much of hard data while preparing business plans. But the venture capital approach is not really planning. It is essentially a technique that attempts to limit losses from failures. It is too simple an approach to support learning.

The authors advocate the use of a different approach to planning. Theory focused planning (TFP) is better suited for strategic experiments. It involves building a theory and testing it. Theory building also helps in identifying performance metrics. TFP involves the following steps:

- Describe how the business works
- Identify metrics
- Establish goals
- Create spending guidelines
- Predict performance
- Identify critical unknowns.

TFP differs from conventional planning in several ways:

- Predictions are revisable. As more information is gained and learning takes place, plans are revised.
- Critical unknowns are emphasized. The focus is not on details but on a handful of critical unknowns during each review of business performance.
- The theories underlying the predictions are made explicit.

- Predictions are of trends. Plans compare extensively predicted trends and actual trends.
- Revisions are frequent, not on an annual basis as in conventional planning.
- Plans emphasise leading indicators.

Conclusion

The authors summarise the challenges involved in planning and executing strategic innovation:

- In all great innovation stories, the great idea is only the beginning.
- Sources of organizational memory are powerful.
- The ability to leverage existing assets and liabilities is important.
- Strategic experiments face critical unknowns. Research cannot resolve these unknowns before the business is launched.
- The new organization must be built from scratch with a unique staffing, structure, systems and culture.
- The senior management must handle tensions effectively.
- The new initiative must have its own learning process
- Care must be taken to ensure that interest, influence, internal competition and politics do not disrupt learning.
- The new initiative must be accountable for learning and not results.
- Companies must build a capacity for breakthrough growth strategic innovation by developing skills in forgetting, borrowing and learning.

This book will be useful to both students and practitioners of business innovation. Though this is not the first book on innovation, it brings a refreshingly different approach to the subject. The book combines the right blend of theory & practice. Important concepts are explained in detail and illustrated through live case studies.