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Unlocking Value through Intrapreneurship

How to Drive Growth from Within

Corporations are very good at maintaining, defending and refining existing business models, and they're pretty good at extending existing models by identifying adjacencies. But corporations are weak, and have become weaker, in identifying new disruption opportunities." *Steve Blank*

Sentiments like the one above pervade the conversation on innovation and growth. Numerous innovation experts support this enticing view that large companies cannot innovate. Clayton Christensen puts it this way: "The very decision-making and resource-allocation processes that are key to the success of established companies are the very processes that reject disruptive technologies." And John Hagel speaks of "Innovation Antibodies" that form within incumbent organizations to destroy new ideas.

At Outthinker, we have spent the last three years seeking to understand why large companies have such difficulty driving disruptive change. We discovered, however, we were asking the wrong question. A wide range of research and experience shows that large companies not only can innovate but, indeed, they have been and will continue to be the drivers of the innovations that have most impacted humankind.

In this white paper we briefly outline our findings from more than 120 in-depth interviews of experts and corporate entrepreneurs, a broad survey of academic research, and our experience helping incumbent organizations identify and pursue innovative growth opportunities.

Our conclusion is this:

Incumbent companies have been the innovators that have mattered most, and if they manage the barriers to innovation, and leverage the unique assets and capabilities that they bring to bear, they can continue to drive organic growth and unlock internal entrepreneurship ("intrapreneurship"), and thereby impact the world. To seize these opportunities requires abandoning the myth that only small, agile organizations can effectively drive change and addressing three sets of barriers and levers that unlock intrapreneurship.

30 MOST TRANSFORMATIVE INNOVATIONS IN LAST 30 YEARS

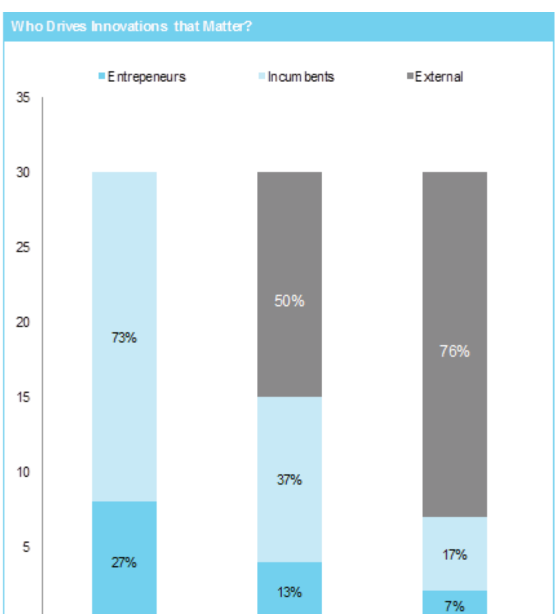
- Internet, broadband, WWW (browser and html)
- E-mail
- Media file compression (jpeg, mpeg, mp3)
- Stents
- Anti retroviral treatment for AIDS
- Open source software and services (e.g. Linux, Wikipedia)
- DNA testing and sequencing/ Human genome mapping
- Magnetic Resonance Imaging (MRI)
- Large scale wind turbines
- Bio fuels
- Photovoltaic Solar Energy
- Graphic User Interface (GUI)
- Bar codes and scanners
- ATMs
- SRAM flash memory
- Online shopping/ecommerce/ auctions (e.g. eBay)
- Liquid Crystal Display (LCD)
- Non-invasive laser/robotic surgery (laparoscopy)
- PC/Laptop computers
- Fiber optics
- Digital photography/ videography
- Social networking via the internet
- Genetically modified plants
- Mobile phones (personal handed phone)
- Microprocessors
- Office software (spreadsheets, word processors)
- Light emitting diodes
- GPS systems
- Microfinance
- RFID and applications (e.g. EZ Pass)

THE OPPORTUNITY AND CHALLENGE ARE THE REVERSE OF WHAT YOU THINK

It's commonly believed that while large companies have difficulty conceiving breakthrough innovations, they are effective at scaling them. Many large organizations essentially outsource innovation activities to the entrepreneurial community. They monitor emerging start-ups and, once a start-up proves its idea effective, a large company acquires and scales it.

This viewpoint is logical. A proven innovation can ramp up far more quickly when plugged into the sales force and supported by the operational scale of large organizations. Research shows that the companies that most benefit from innovations are not those that develop the idea but usually those that control access to the market that allows the idea to scale. Incumbents have access. Peter Drucker argued the ability to scale essentially as the key rationale for an acquisition. He argued you should acquire a company with "common core of unity" – either a common technology or market or, in some situations, production processes – and think through your firm's potential contributions of skill to the acquired company because there must be a contribution that is more than money.

The idea that large organizations can scale more effectively, however, is not supported by the facts. At least for truly transformative innovations, the truth is precisely the opposite.



We analyzed the 30 most transformative innovations over the past 30 years, as judged by a panel of professors from Wharton Business School, culled from about 2,000 submissions. The list includes DNA sequencing, MRIs, e-mail, and the internet. For each we researched (a) who conceived of the idea (was it an incumbent or an entrepreneur), (b) who developed the idea into a working innovation, and (c) who scaled the idea.

The results, shown in the graph to the right, offer two counterintuitive conclusions. First, incumbents, not start-up entrepreneurs, have conceived of the vast majority of ideas (73%) that have most impacted humanity. Second, they fail to scale the idea, allowing most innovations to be taken over by external players.

The question to ask, then, is not why can incumbents not innovate, but rather what can they do to unlock and capture the value of their innovativeness?

INNOVATION

FOUR INNOVATION ADVANTAGES INCUMBENTS HAVE OVER START-UPS

There is considerable evidence to support the fact that as companies scale, they lose entrepreneurship and innovativeness. This trend is natural and even necessary. After a company finds a solution that works well, it should seek to put in place processes and oversight to ensure it can repeatedly produce its desired result. We don't want automotive line-workers improvising new ways to install tires on our cars.

Companies start up as innovative, willing to take risks and rethink accepted approaches.

But, if successful, they eventually want innovation to stop. They seek predictability. So they establish bureaucracy, narrowly define tasks, tightly monitor behavior, and develop a risk-averse stance. All of these work to create predictability. You want people to experiment less and repeat more. But they also, as corollary, suppress entrepreneurial behavior and hinder internal innovation.

Because scale decreases innovativeness, it is tempting to believe the inverse relationship between the two continues linearly. The bigger you get, the slower and more rigid you become. However, numerous studies show a more interesting dynamic at play.

Once companies reach a critical scale, they experience a renewed ability to innovate because four factors come into play:

1. **Scale:** Larger sales forces, valuable brands, production and distribution capabilities give you a platform on which you can scale innovations more rapidly than smaller firms. Amazon.com's unparalleled scale at operating servers and ecommerce technology gave it a formidable advantage in entering cloud services. Its Amazon Web Services (AWS) offering grew into a $10 billion business in just seven years.
2. **Capabilities:** You build unique capabilities that you can leverage to give you an advantage into new businesses. For example, Disney's capabilities around storytelling and character development, established through animated movies, gave it an advantage in entering into theme parks.
3. **Innovation resources:** With a core business producing more cash than it needs to reinvest, you can funnel resources (both financial and human) into new opportunities to a degree smaller companies can only dream about. The most innovative companies today invest between 5% and 20% of their revenue in innovation. Even Apple, recognized as investing relatively little among innovative firms, has an annual innovation budget of over $8 billion.
4. **Ability to diversify innovation risks:** While start-ups must put all of their innovation eggs in one basket, larger companies can diversify. They can thereby create more predictable returns. Jeff Bezos wrote in an investor memo that "Given a ten percent chance of a 100 times payoff, you should take that bet every time." If you can make 10 such bets you can statistically expect a 10x payoff.

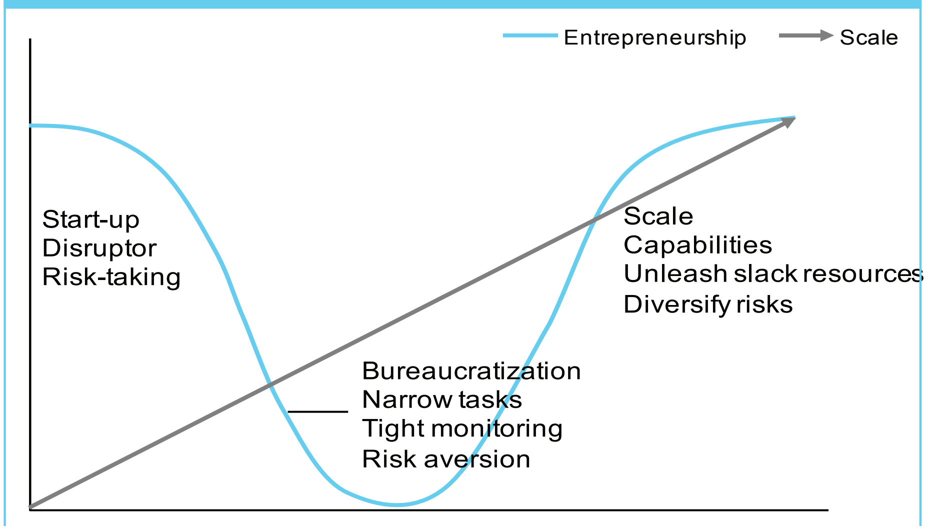
The graph below illustrates how, if managed properly, these four factors can actually turn scaled organizations into more innovative ones than they were when they started.

The key to seizing the innovation opportunity of scale is to appreciate and carefully manage how you apply scale, capabilities, slack resources, and the ability to diversify risk, using these to create a context that encourages innovative behavior.

At Outthinker, we believe that in addition to formal innovation programs, organic growth comes from using these four factors to activate and empower intrapreneurs. The scaled organizations are most successfully driving organic growth and embracing new ways to encourage internal entrepreneurial behavior. Richard Branson put it this way:

"Many millions of people proudly claim the title 'entrepreneur.' On the other hand, a title that hasn't gotten nearly the amount of attention it deserves is entrepreneur's little brother, 'intrapreneur': 'an employee who is given freedom and financial support to create new products, services and systems, who does not have to follow the company's usual routines or protocols.' While it's true that every company needs an entrepreneur to get it under way, healthy growth requires a smattering of intrapreneurs who drive new projects and explore new and unexpected directions for business development."

Size can drive innovation

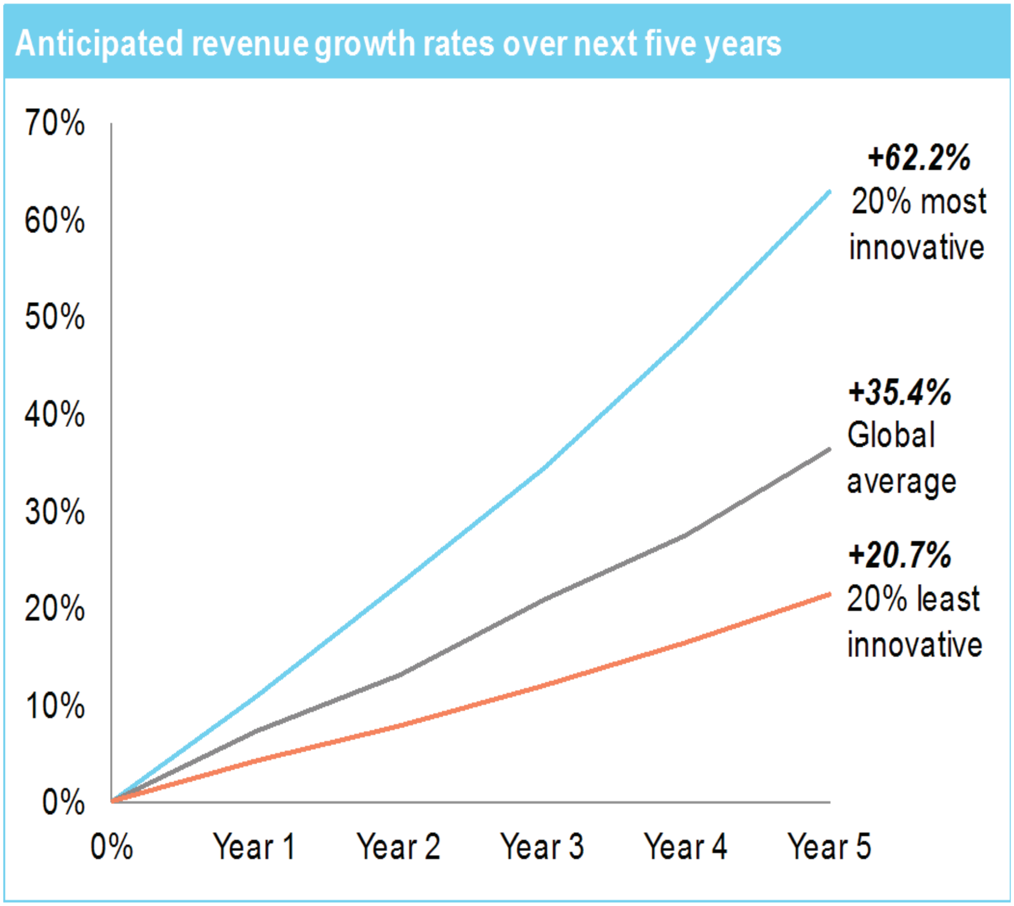


Proven Benefits of Increasing Intrapreneurial Intensity:

1. **Accelerated growth**
2. **Improved EVA**
3. **Increased TRS**

ASSESSING YOUR CURRENT STATE

As organizations begin to embrace their unique ability to drive innovation, they increase their level of "intrapreneurial intensity" (or "II"). This gauge has been established by several studies and measures the frequency with which an organization exhibits entrepreneurial behavior and the degree to which those actions are entrepreneurial. Degree is measured by innovativeness, risk-taking, and proactivity.



1 PWC Breakthrough innovation and growth

Our studies of II support many other studies that show a correlation between II and firm performance. If you can increase II (by increasing the frequency and degree of entrepreneurial behavior throughout your organization) you will:

- Accelerate growth rates (see PWC finding to the right)
- Improve economic value added (EVA)
- Increase total return to shareholder (TRS)

You must measure what matters

A lot of mythology floats around about what it means to be innovative. Numerous lists of the "most innovative" companies exist from Fast Company, BCG, Forbes, Fortune, Thomson Reuters, and various national and regional publications.

However, our research indicates that these lists do not measure the full breath of the variable that matter. In "the drivers that actually matter," below, we compile the factors that academic research has shown actually impact firm performance. To understand the extent to which existing "most innovative" lists measure the factors that matter, we tested whether companies that appear on such lists outperform their peers. We took all companies that have appeared on the BCG or Forbes lists over the past five years, tracked 10 years of performance, and compared the performance of those companies to their closest peers (as defined by their being in the same industry and producing similar revenue). Companies that have appeared on "most innovative company" lists most frequently include Walmart, SoftBank, Amazon.com, Hyundai, Marriott, Intel, and Coca-Cola.

Firms with successful innovation programs should grow faster, generate higher margins, and greater shareholder returns. Greater innovation should lead to more growth opportunities, which deliver faster growth. If the innovations are strategic, they should lead to differentiation and result in higher margins. If the the innovations are valuable, they should be recognized as such in company valuations.

FIRMS WITH SUCCESSFUL INNOVATION PROGRAMS SHOULD GROW FASTER, GENERATE HIGHER MARGINS, AND GREATER SHAREHOLDER RETURNS.

Our findings were surprising:

- Companies that appear on “most innovative company” lists do grow approximately two times faster than their peers over a 10-year period (this supports the PWC finding shown above)
- And they do enjoy higher P/E multiples (about two times as high as their peers)
- But they do not deliver higher margins
- And though one would expect companies that appear on such lists for multiple years would outperform their peers more significantly, there is no such relationship. A company need only appear on a list once.

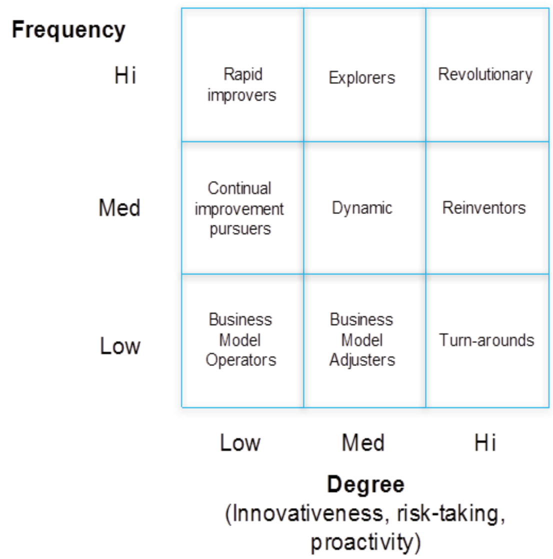
We concluded that while the variables included in such lists may drive faster revenue growth, such growth is not strategic, in that it does come with higher margins. Competitive advantage should result in the ability to extract superior rents. It should deliver superior margins. Appearance on “most innovative” lists, however, has no statistically significant relationship to margins.

Investors seem to understand this as well. The higher P/E multiples they award “most innovative” companies seem entirely driven by top-line growth, with no expectation of higher profit margins.

If you want to understand what is hindering innovation performance, you should measure a more comprehensive set of variables. It appears that such lists may offer a helpful start but do not adequately isolate the sufficiently complete set variables that drive profitability.

The journey begins by understanding where you are today on the II map to the left. By measuring the innovation factors proven to correlate with firm performance, you can accurately assess where you are today and what areas you should most focus on to reach the position that would maximize your performance. This model suggests nine types of firms, from the least innovative (Business Model Operators) to the most (Revolutionary). Not every firm needs to move to the top-right, “Revolutionary” corner of the map. Not every firm needs to be an Amazon.com or Google. Companies that operate in industries that demand extremely low margins of error, such as Lockheed Martin or United Technologies, where the need to prevent failure supersedes the need to take risk, are better served being Rapid Improvers or Explorers.

Intrapreneurial Intensity Map



United Technologies, for example, is moving in that direction. It is actively looking at how it can shift a deeply embedded cultural value of being “flawless” so that it applies that priority only in the right places (e.g., elevator or spacesuit design) and not in places where perfection is less important (e.g., experimenting with new human resource policies).

By assessing your market, what your investors demand, and your aspirations, you can identify your desired end-state and begin designing a holistic plan to get there.

We have compiled a comprehensive assessment, pulled from proven research, to measure an organization’s current II position. Contact us if you would like to discuss applying it to your organization.

THE KEY TO SEIZING THE INNOVATION OPPORTUNITY OF SCALE IS TO APPRECIATE AND CAREFULLY MANAGE HOW YOU APPLY SCALE, CAPABILITIES, SLACK RESOURCES, AND THE ABILITY TO DIVERSIFY RISK USING THESE TO CREATE A CONTEXT THAT ENCOURAGES INNOVATIVE BEHAVIOR.

DECIDING WHERE TO PLACE YOUR INNOVATION AND GROWTH INVESTMENT

In 2015, corporations spent $3.8 trillion in acquisitions.[1] That was the highest level of activity since 2007. In the right market environments, M&A offers a fast approach to buy growth in a way that investors can understand.

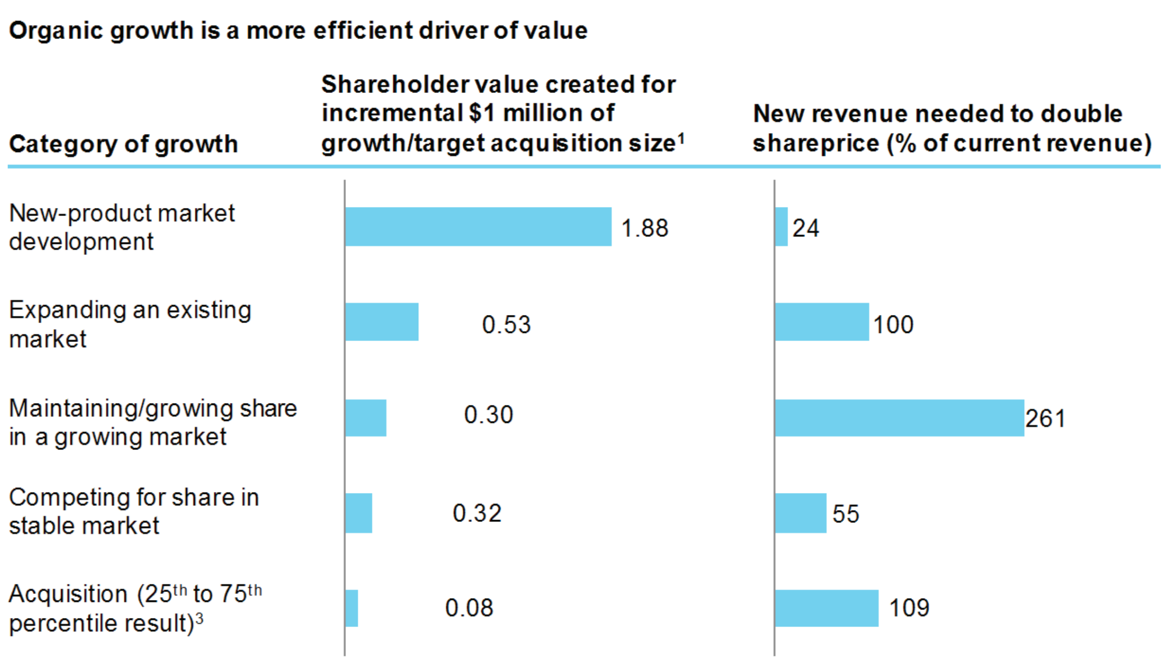
However, if your goal is to increase shareholder value or your internal rate of return, M&A activity is one of the least attractive options. A company's growth investment will likely always include acquisitions, but if not counterbalanced by a commitment to organic growth, it will at best produce inferior returns and at worst destroy value.

A 2004 McKinsey study sought to compare the business impact of investing in M&A with other organic options. It showed that a $1 million investment in M&A could expect between -5% and +20% in shareholder returns. In other words, every dollar invested in M&A could create as much as 20 cents in shareholder value but could also destroy value by 5 cents.

That same dollar, if invested in organic growth, would yield far more attractive returns. Investing it in efforts to steal market share from competitors could yield as much as a 40-cent return. Investing the same dollar in growing share in a growing market could yield as much as a 50-cent return. But investing it in a new product or an initiative to develop a new market could yield as much as a $2.00 return.

The study also showed that if your goal is to double your share price, you can achieve it far more affectively by investing in organic growth initiatives. Doubling your share price through developing a new product or market would require that the initiative increase your revenue by at most 26%. To double your share price through acquisition would require that the acquisition increase your revenue by as much as 217%.

While this study focused on consumer products companies, the wide variance in returns must lead us to the conclusion that companies that lean heavily on M&A for growth, at the cost of investing in organic innovation, are misallocating their resources. A balanced approach, one that optimizes investment between M&A and organic growth initiatives, will lead to superior firm performance. Once you have decided the optimal allocation, the next challenge is to figure out which drivers of organic innovation your organic investment should target.



1 Stylized results based on consumer products examples. 2 Assumes a $50 billion market cap, all-stock company with $23 billion of revenue expected to grow at GDP rates and constant return on invested capital (ROIC). 3 Examination of 338 deals revealed short-term value creation for acquirer of 11% for 75th percentile deals and -1% for 50th percentile deals.

Note: 1 McKinsey Why the biggest and best struggle to grow

Source: McKinsey analysis

Source: Bloomberg, January 5, 2016

THE DRIVERS THAT ACTUALLY MATTER

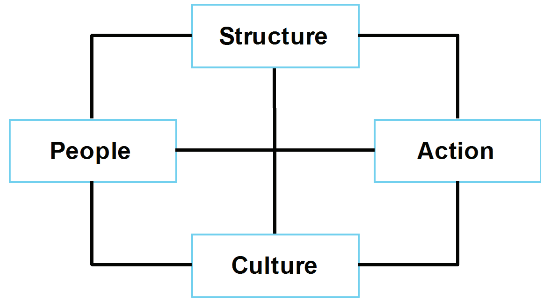
One reason many companies prefer M&A is that it offers a lever management that investors can understand. One can follow a process to identify, price, and acquire growth. Even though integrating acquisitions into the company is fraught with uncertain success, the effort nonetheless is documented. We can find textbooks and MBA courses outlining the key steps and issues.

Driving organic growth, increasing II, is considered by many to be more art than science. As one CEO put it to us, "I don't know what I'm going to get if I invest in internal ideas."

But in reality, a considerable amount of well-documented findings can inform our efforts to drive internal growth. Often the issues and answers are readily available, just not understood by managers.

We have sorted through the validated findings identifying the key drivers that will allow you to predictably unlock internal innovation and thereby drive organic growth. We have interviewed internal innovators and collated what they cite as the major barriers to acting innovatively from within. Bring these two sets of findings together and a remarkably clear model emerges. We don't have the space here to detail all of the findings, but we offer a framework that you can apply to help untangle the issue restraining your organic growth.

The framework involves three interconnected sets of drivers of innovative behavior: people, culture, and structure. If you focus on just one of these, your effort is likely to lose steam. Many companies, for example, have introduced formal structures like ideation programs and innovation incentive programs, but because they fail to support those with cultural change efforts, their programs prove short lived. Other companies introduce "people" programs such as identifying managers with innovative potential, hiring (or acquiring) entrepreneurs, or training managers to innovate, but soon after the newly activated innovator starts seeking to pursue disruptive ideas, they hit structural and cultural barriers that erode their early enthusiasm. Yahoo!, for example, sought to drive innovation by acquiring smaller companies, but found it difficult to later retain the entrepreneurs whose companies Yahoo! acquired. Other companies begin with cultural change programs to promote innovation, but after employees realize they are being asked to "be innovative" while their formal incentive



structures continue to reward short-term, incremental improvements, they become disillusioned ... then disengaged.

It is possible, however, to isolate the most critical drivers to address across people, culture, and structure and thereby drive value-creating innovative behavior when you understand which drivers truly matter. Companies that have done this successfully in recent years include Whirlpool, MasterCard, and Microsoft. The key is to accurately evaluate how your organization performs against the drivers proven to encourage intrapreneurial action:

1. **People:** which employees have a natural tendency toward intrapreneurship and have you activated them?
2. **Structure:** which of the most critical structural requisites of innovative behavior are you underperforming in and what is your plan to address those?
3. **Cultural:** which of the cultural norms proven to encourage intrapreneurial behavior does your current culture hinder and how will you address such conflicts?

CONTRARY TO COMMONLY ACCEPTED DOGMA, INCUMBENT ORGANIZATIONS CAN INNOVATE. INDEED THEY ARE THE DRIVERS BEHIND THE INNOVATIONS THAT HAVE MOST IMPACTED OUR WORLD

CONCLUSION

Contrary to commonly accepted dogma, incumbent organizations can innovate. Indeed they are the drivers behind the innovations that have most impacted our world. They can out-innovate start-ups because they bring to bear innovation resources, scale, capabilities, and the ability to diversify risk that smaller companies cannot. Companies that embrace these levers and counterbalance their M&A spend with smart investments in organic innovation grow faster, generate greater shareholder value, and generate greater EVA. To achieve this – to unlock the latent intrapreneurial value of your organization – requires that you identify where you are today and then work across three sets of issues – people, culture, and structure – to evolve into an intrapreneurial organization.

For more information or a consultation, visit www.outthinker.com or email Charmian@outthinker.com.