PART I

WHAT'S WRONG WITH INNOVATION TODAY

CHAPTER 1

The New Economy: Different for Good

Most of the time, when you think about the term innovation, you think in terms of significant breakthroughs in technology—nanotechnology, biotechnology, energy, and so on. But the truth of the matter is that innovation is really about creating ways of delivering meaningful *net customer value*. And especially in today's challenging and competitive economic times, net customer value really rules (or should rule) the innovation universe.

Okay, you ask—what is net customer value? It's a fair question, and I'll come back to this concept again and again throughout *The Innovation Playbook*. Net customer value refers to the benefit customers receive from a product—real and perceived—relative to its cost. It's a hard thing to measure, but, like good architecture or good wine, you'll know it when you see it (or drink it).

Problem: It isn't so easy to see customer value (or taste it), right? Part of the reason net customer value is hard to quantify or measure, and part of what makes it such an important thing to understand for a business is that it's a multisensory experience. The best way to explain is by example.

A Better Beer, a Better Burger

One of the greatest restaurants on the planet, in my opinion, is a West Coast hamburger eatery—a fast food restaurant, if you will—called In-N-Out Burger. Now, In-N-Out Burger knows really special things about innovation. They know innovation really is about touching people. What does that mean? Touching people is about the fact

that we are multisensory beings. We have a sense of smell. We have a sense of vision. We taste things. We feel things. It's about the combination of those senses that creates a visceral determination about that experience. In-N-Out Burger is a perfect example of a company that understands this concept.

The Eyes, the Ears, the Nose Have It

To illustrate, In-N-Out Burger has specially designed exhaust fans that send out the smell of its mouth-watering fare in multiple directions for several blocks. Anyone on the West Coast knows if you drive anywhere near an In-N-Out Burger, you'll quickly pick up the scent of delicious food, which is no accident! They not only want you to *see* the restaurant but also *feel* it from a sensory point of view. But they also know that, in order for you to want to eat something there, the restaurant also has to be visually inviting.

So they created a simple, clean, and ultra-fresh environment that really indicates the quality and cleanliness of the food. They pay a lot of attention to the appearance of the restaurants, actually employing full time people to clean and pick up trash on the grounds. This might not seem like such a big deal, but if you want to eat something, it had better be visually inviting, so they create a simple, clean, and ultra-fresh environment that really communicates the quality and cleanliness of the food.

The fact that, when you're at an In-N-Out Burger, you don't see any trash on the ground may not seem like a big deal, but unfortunately, many other restaurants don't see that as a big deal either. Obviously, as consumers of food, we have a lot of options. When we inhale something that's clean, when we inhale something that smells great, we know that is part of an overall experience we, as multi-sensory beings, are going to enjoy.

But In-N-Out Burger goes far beyond that. For example, when you pull up to the restaurant drive-thru you'll see that the speaker is the size of a manhole cover. Why is that important? Most drive-thru restaurants have really small speakers, so communication between a customer service person and the customer is extremely tenuous and cryptic. This results in mistakes and increased pressure on the customer who must yell into the speaker, and stress and fatigue for the employees.

Such attention to detail shows In-N-Out Burger understands a very basic concept for the business: In order to get accurate orders and communicate properly back to customers, they needed a large speaker. I remember when early In-N-Out Burgers had something akin to a megaphone mounted on a pole—even this provided a tremendous benefit and would be considered an innovation.

But it continues to even get better. When you go to the restaurant and start to place an order, you have an intelligent and articulate person taking the order. They're able to communicate clearly what you're ordering and verify that they got it right in a super-friendly way that adds to the feeling of a good customer experience.

It continues from there. As you navigate the drive-thru, there's a gigantic plate glass window. Now that's not there so the employees can look out at the cars—it's so you can look into the kitchen—for three important reasons. First, they want you to see the cleanliness of the kitchen and their staff. The staff comes in impeccably clean, and if their clothing becomes soiled on the job, they have to change immediately. The second thing you see is a clean eating area. Picked up, wiped down, no food left lying around.

Magical Theater

Thirdly and finally, there's one other magical theme in the theater, and it is performed every day in every In-N-Out Burger across the country. They have one of their employees, behind this gigantic plate glass window, producing french fries by hand. None of that frozen food service stuff—they actually press freshly peeled potatoes through a french fry press by hand. Now why's that important? Because you know for a fact that those french fries were just made. They came from fresh potatoes. That is a tremendously important value perception for you. That the environment is clean is also an extremely important value perception.

Now when you get to the pick-up window to collect your box, you're greeted by another clean, well-dressed, intelligent, articulate, smiling employee. "Let me make sure you're order is right. Have a great day." They make sure you have enough napkins and the right condiments and straws for the kids. You feel as though they really care and that they're paying attention to detail.

But the essential magic really is, not surprisingly, that they have created a simple, delicious hamburger. They produce great products. Their hamburgers are good. Their french fries are good. Their milk shakes are good. They realize that they have to produce all of these things right to create the perfect customer scenario—which they rightly recognize as being the perfect scenario for success. A great environment, a clean environment, a quality environment, and a tasty environment are all necessary elements of the total experience—all are prerequisites—to get you to come back.

In-N-Out Burger is, in my opinion, a perfect example of a wonderful innovator. They understand that their omni-directional fans will deliver an appealing aroma that is very pleasing. They create, externally and internally, a visually clean and pleasing environment. They also know you can hear them and they can hear you through an amazingly simple but ingenious intercom system (in how many other drive-thru fast food places have you seen such a thing?) that insures a wonderful communication dialog that is not stressful. (Like you might expect from a waiter in a fine restaurant.)

One Plus One Is Three

They know that when you pull up to the window, you're continuing to build on what I call the *service cycle*. They know that you're adding more and more ingredients to your overall opinion of them, as you take in things visually, as you smell, as you listen and talk, as you pay and eat, as you observe. This is all part of what innovation is about—the ability to look, the ability to feel, the ability to sense an environment in a way that adds real value to the customer.

In-N-Out Burger is a perfect example of masterful innovation and, as a result, they're one of the most successful restaurant chains on the West Coast. But there's far more to the story than innovation as it pertains to the creation and implementation of ideas and technologies. Like most of our examples, In-N-Out Burger pays their employees more than most restaurant chains—particularly fast food chains. They also treat and train their employees extremely well.

Remember, great companies develop great technologies. Great companies also add value every step of the way, from employees to their community to their valued customer. While the innovations may seem to be simple, "gee-I-should-have-thought-of-that" ideas, In-N-Out Burger is definitely a world-class innovator.

Would You Like Something to Drink?

It's interesting to me to see how many resources go into trying to create and replicate these processes and systems when it really has to begin with creating a great company. Another great example is a company called Sierra Nevada Brewing Company, located in Chico, California and founded by a gentleman named Ken Grossman. Here's a guy who loved beer, and he loved it so much that his goal was to create the best product in the world. The truth of the matter is—as hard as that challenge is, the real challenge is to try to *scale up* that commitment.

So many companies have lost their competitive edge in the process of trying to go from a hand-crafted, customer-connected product to one that really has to be McDonald-ized and distributed worldwide. But Grossman's commitment continued. So he hired great people, and he treated them extremely well, and he continued to grow his business with one principal goal: Make the best beer in the world. In the meantime, he made it a point to honor everyone he touched, from his local community to his global community, including his employees, and especially his valued customers.

What's interesting about Sierra Nevada is that they're now the sixth largest brewery in the country. As a beer connoisseur myself, I have to say their beer is absolutely exceptional. If you know and love beer, you will love Sierra Nevada. If you're not a gourmet beer person, you too will love Sierra Nevada.

Great Companies Care

In fact, several large brewers across the country have tried to do what I call McDonald-izing the process of what Grossman has done—make lots and lots of products but maintain an ongoing commitment to developing new products and staying connected to the customer. Sierra Nevada, for example, has made a commitment to being a sustainable and globally environmentally conscious company because of Grossman's commitment, like that of all great companies, to be a good global and local citizen.

As a result, his brewery has the second largest solar array of any company in the state of California—second only to Google—producing some 80 percent of the brewery's electricity requirements. Not only does this ultimately help his bottom line, but it also shows

his commitment to sustainability and community. But if you work there—if you're lucky enough to work at Sierra Nevada—it gets even better.

Like all companies I talk about in this book, they're great to their employees, because great companies care about their employees as much as they care about their customers and their global and local communities. If you work there, part of your compensation package is—you guessed it—a massage. You also get, with every paycheck, something they call a "beer buck." Each beer buck allows you to get a case of the exquisite beer they produce.

When you take the tour of Sierra Nevada Brewery, you see something that seems to be lost at so many companies—an amazing sense of pride. I can only describe that, consistent with all of the great companies we talk about in this book, there's such a pride in what Grossman does. You see it in the cleanliness of his operation. You see it in the efficiency and just the passion of every employee he has working there. They absolutely love working for him, they absolutely love working for Sierra Nevada, they're proud of their brand, and, not surprisingly, they love beer.

They also have a great restaurant called the Sierra Nevada Tap Room. It has tasty food, and often, even in a small town (albeit a college town) like Chico, you have to wait hours to get in. But wait many people will, because it is such a great experience. Grossman understands that, and the food and the entire restaurant experience is emblematic of his pride and his commitment to being multisensory.

From the design of his bottles to the variety of beers he produces, Grossman has earned his success. From the very select and conscientious way he distributes his beer to his commitment to the global and local community and to his beloved employees, again, that's how Grossman has earned success. I would say Grossman is another example of someone who has become bulletproof by doing the right thing for all people in his sphere of influence.

The Darkest Hour

Sierra Nevada and In-N-Out may be making it on the basis of understanding—and delivering—net customer value. But there's no doubt that business conditions during the "Great Recession" were a huge wake-up call for virtually every business and organization in the country—in the world, for that matter. The severity of the

recession and its effects on employment, corporate profits, and general business morale hardly bear additional coverage here.

But the way I see it, the most recent downturn was really a symptom of economic maladies that had been building up for a long time. As Warren Buffett put it so well: "When the tide goes out, you see who's been swimming naked." And we sure saw a lot of naked swimmers: Eastman Kodak, Blockbuster, Circuit City (which I'll talk more about below), GM, and Chrysler, just to name a few, and not to mention entire industries like the U.S. financial services industry.

Yes, there were colossal failures and near-failures. Sure, at the time of this writing, Eastman Kodak and Blockbuster are trying to hang on, but their business models have essentially been reduced to shreds by, in the first case, a failure to keep up with technological changes, and in the second, a failed business model. But outside these big names, there are signs of failure everywhere in businesses large and small, and even entities in the public sector. What happened? How did these organizations lose their way, often knowing full well that better technologies and more competitive business models were emerging and, frankly, knowing that customers wanted something else?

Will the Great Pumpkin Return?

What's different about these failing companies that make them fail? What lessons are there to learn? I believe companies that continue their R&D spending during downturns will be better positioned to grow when the economy comes back. I also believe economic downturns force a better focus in R&D efforts—at least for those companies that get it.

But I also believe that a great many companies fail to get it, doing R&D for R&D's sake, or worse, letting R&D efforts languish in order to reduce short term expenses. These companies in particular are vulnerable because they're relying solely on the resurgence of the economy—the next "up" cycle—to bring them back. I call this the "Great Pumpkin Syndrome"—one may recall the images of Peanuts' Linus waiting in the pumpkin patch for the Great Pumpkin that never came. I believe those organizations that simply wait for the return of an economic Great Pumpkin will find themselves similarly waiting in vain by the pumpkin patch while others around them succeed and prosper.

Do Recessions Kill R&D Spending?

One might justifiably wonder what the economic downturn did to R&D expenses at U.S. and global corporations. Companies, of course, used the downturn as a reason to cut spending in a lot of areas, including R&D. As the economy climbs out of the recession, the next question is: "Will corporations that did cut R&D restore it?"

At the time of this writing, the facts are still arriving. Statistics published by the Battelle Memorial Institute indicate that U.S. research and development spending decreased in 2009, but it is expected to rebound in 2010 with the economy. According to their report, overall U.S. R&D spending is expected to rise 1.7 percent in 2010 to $395.9 billion after accounting for inflation. In the industrial sector, 2009 R&D spending in the United States actually fell 4.8 percent to $275.3 billion from $289.1 billion in 2008, but is expected to rise to $283 billion. Globally, R&D spending is expected to increase 4 percent to $1.16 trillion from 2009's $1.11 trillion and 2008's $1.12 trillion.

The real news may lie in the behavior of specific corporations and economic sectors. In the first nine months of 2009, Microsoft Corp. and International Business Machines Corp. cut R&D spending by 5.7 percent and 9.3 percent, respectively, while Apple increased R&D spending by 19 percent. Pfizer Inc. and Johnson & Johnson each cut their R&D spending by more than 10 percent. But there was a big surge in R&D among certain drug and biotech companies. According to a table published by *BusinessWeek*, Merck & Co., Gilead Sciences, Biogen Idec, and Monsanto increased theirs by more than 10 percent—in some cases, by as much as 30 percent. I'd not only say these companies are keeping a clear eye on the future, but they're probably also getting their research done at a reduced cost. Not a bad idea, in my view.

Not Your Father's Economy

One thing that we all must realize, in the wake of the Great Recession, is that the economy—and the role of innovation in the economy—have both changed, and changed for good. The biggest change is really in change itself: Everything changes faster.

What do I mean by this? The cycles of change, the ups and downs, are getting swifter, and may hit with little warning. Economic and business boom-bust cycles themselves are getting shorter. But more than that, technology and product cycles—the length of time a

technology lasts in the marketplace—are getting shorter. Customer preference cycles are getting shorter—new things go out of style more quickly. So the key questions are: How are companies adapting to this? How should they be adapting to this? Should they spend more on R&D? Should they spend it more wisely? Should they spend it faster? We'll examine those questions, but first, a little more on the ups and downs today's businesses face.

A Faster Roller Coaster

Not so long ago—in the twentieth century and before—boom-to-bust business cycles may have been 20 years long, or longer. Although the cycles in those days were quite pronounced, with the Great Depression representing the granddaddy of them all, they were less frequent. They were pronounced because there was little that central banks, governments, or business leaders could do about them. Moreover, important safeguards like banking and securities laws hadn't yet been put into place. So people—and businesses—were literally wiped out in those days without ever knowing what hit them.

Today's business cycles are more frequent, generally shorter, and generally turn faster. More potent economic management through monetary and fiscal policy tends to reverse the cycle more quickly. But the biggest change over the years is the change in the *speed* of business—the rapidity in which business decisions are made and products and services are developed and sold. The pace of information about those products, as well as the economy as a whole, has become so much more rapid that entire sectors of the economy can change on a dime, in much the same way in which the latest military conflict or supply change can change the energy industry.

Technology and Product Cycles

Put simply, new technologies of yesteryear last longer than their counterparts of today.

Railroads, the great new technology of the nineteenth century, had a huge impact on business and commerce nearly everywhere. Their dominance as a transportation technology lasted more than 100 years. Fast forward to radio. As a major communication and advertising medium, its dominance ran for 40 years until eclipsed by TV. Fast forward to PCs and their key components. Seen a 3 1/2-inch floppy disc lately? Then there's VHS video. Dial-up Internet service.

The Internet itself—how long do products last these days before they must change or evolve?

The obvious answer: not very long. In almost all industries—even industries where the *product* doesn't change (like coal mining) but the *process* does—companies must deal with change, and rapid change at that. Not only does the speed of business make change happen faster within the enterprise, but the quantity and facility of rapid communications between customers and businesses have also played a role. The Internet has increased customer awareness, expanded feedback, and provided a medium for customers to share experiences *with each other*—all serving to level the playing field among large corporations and much smaller companies in many aspects of their business. The Internet has also increased pricing transparency, enabling customers to make price comparisons at a speed that was unheard of 30 years ago.

There are two upshots. First, combining the availability of product information, price information, and peer review of many key products, customers have become far more conscious of the net customer value they might expect to receive from a purchase. Second, competitors can copy or imitate even the most breakthrough technologies very rapidly. Trendy or market-leading products risk becoming obsolete almost instantly, and as the world becomes a global marketplace, competitive pressure is both wider and faster.

This isn't an economics book, but it's clear that innovation must respond to this environment. And it may not be enough to respond. True innovation success—and I'll argue this point in good times or bad—means that successful organizations must drive the environment. The good ones will pace the change, not just respond to it, in good times and bad.

Creative Destruction

The process of natural business and technological evolution and destruction was appropriately labeled "creative destruction" by economist Joseph Schumpeter. The forces of creative destruction, especially during economic downturns, tend to speed the passing of older, less efficient businesses and technologies (especially without the intervention of policymakers, as exemplified by U.S. automakers). The dot-com bust hastened the demise of legacy phone switching technologies, independent bookstores, and the Oldsmobile, not

to mention thousands of Internet applications that probably served little to no economic purpose. As a result, corporate investments, which aren't so safe to begin with, become even riskier in a crisis if they are producing legacy products and services vulnerable to change.

These forces can be obvious or subtle, and technology evolutions are easy to confuse with business cycles; indeed, many fall to that temptation. Many thought the interurban railway—or rail travel in general—would come back after the Great Depression; in fact, it began a slow and inevitable decline because of the automobile. Now, it's the automobile itself that's in question; some wonder whether demand for SUVs or even traditional gasoline-powered cars will ever resume previous levels—or will future demand shift permanently toward hybrids, alternative energy, and smaller cars? Similarly, many are now wondering whether the standalone PC will survive the advent of cloud computing, and in what form. PC sales may decline because of the business cycle; every time they do, people wonder whether the change is temporary or more permanent. The wealth sustaining investor must make these calls, remembering Joseph Schumpeter's "creative destruction" occurs more rapidly these days and often with little advance warning.

Likewise, the solid stars of the last decade, best exemplified by Microsoft with its near monopoly and gigantic cash margins from low production costs, seemed unassailable, and investors treated it so. But now with Linux and Ubuntu community-enhanced freeware threatening its operating system monopoly, cloud applications and free alternatives like StarOffice threatening its Office applications, and Mozilla and Google knocking at the Internet browser door, the Microsoft fortress doesn't look so formidable.

On the other hand, Apple is running on all cylinders today, although it already endured one decline. But now the company has realized otherworldly success from the digital music business. That said, this level of success is hard to project even two to three years down the road as digital music and smartphone competitors sharpen their offerings. To be sure, no business or business model is safe. One might even question the long term viability of electric utilities in these times. What if solar panels got simple and cheap, so you could buy them and install them simply in just one day, replacing two-thirds of your electricity purchase from your electric utility? That would signal huge and disruptive change for the electric utility business.

Solid and regular cash generators like Coca-Cola and Procter & Gamble have had their ups and downs and have endured competitive threats, but nothing is guaranteed even there. Technology isn't the only thing that changes—consumer tastes change, too, and Coke has been forced recently to introduce whole lines of new products to stay in front of the shift towards healthier drinks. As a result, any investor in any business, or any investment dependent on a business, must take these risks into consideration. Those who thought, for instance, that the industrial demand for silver would be forever supported by the photography industry were in for a surprise.

The Great Recession: A Tipping Point

Arguably, the recent Great Recession was a tipping point for many companies already on the brink, and/or who had already fallen behind their technology cycle. A company on a short financial leash, with no new innovations coming to market, will simply be forced to watch while more nimble and forward-looking competitors eat its lunch. Some companies, unable to cope with change or deliver innovation, simply go into bunker-down mode, cutting costs and hoping for the best. I can think of no better example than consumer electronics retailer Circuit City.

Short Circuit

Circuit City filed for bankruptcy in November 2008. I think Circuit City is a great example of what can go wrong when you take your finger off the customer service pulse, and moreover, depart from the principles of using innovation to deliver net customer value. That's where the real war is waged, in the area of net customer value.

Let's take a closer look at Circuit City's failures to innovate in customer service. Circuit City was originally formed in the 1940s as a television retailer. Like many other consumer electronic retailers, it went through several changes as it attempted to chase the changes—the rapid changes—in the consumer electronics industry. The problem at Circuit City was simple: It completely and totally lost its connection to its customer. Beyond that, it had no platform to innovate and create the changes that were necessary in order to adapt.

One of the biggest concerns a customer would have going into a Circuit City was the lack of knowledge among its salespeople.

That lack of knowledge was actually fatal. Once this genie of less knowledgeable and trustworthy salespeople was out of the bottle, there was no getting it back in.

What they should have done was create certified computer specialists, certified audiovisual specialists, certified car audio specialists, you name it, with a level of training sufficient to give confidence to the customer. But they didn't get that. They thought they were in the box-of-electronics for $X amount business—and they were dead wrong. In fact, if you were to put "Circuit City customer complaints" into a search engine, you'd find thousands—*millions*—of complaints about this organization's lack of service.

But—it got worse. As it often does, the worse it got, the worse it got. Because they were so disconnected from the problem, without a core ability to invent solutions for their customers, in a highly competitive industry with razor-thin margins to begin with, they started to run into financial problems. Customers simply were not persuaded that employees at Circuit City could direct them to the right products or right solutions—losing ground even to the relatively distant and impersonal Internet sales channel.

So what did they do? In March of 2007, in the face of falling business trends, they fired all of the higher-paid employees and kept all the lower hourly paid employees, assuming reduction of costs would save the day. Employees who knew something about the products were gone, replaced by less motivated employees who knew nothing about the products (It should be noted that that same year their CEO made $7 million in compensation.)

The worse it got, the worse it got.

Parenthetically, I should add that cost cutting, the apparent strategy here, is seldom a strategy. Strategies should be about delivering customer value, not just about more internally focused efforts to reduce cost. In most situations, if cost cutting is warranted at all, it should be a tactic to achieve a focused customer strategy of delivering better value. But I digress. . . .

So, back to the Circuit City story. Their actions were clearly focused on internal concerns, not their customers. They could have created informational kiosks to give customers valuable information about the products. They could have created a "certified specialist" program in every department to make sure they had the efficacy to communicate with customers to help them get what they were looking for. They could have had pamphlets or tip sheets to help their

customers. They could have developed strategic partnerships with their vendors to assure they were seen by their customers as experts in consumer electronics.

They did none of that. And to my knowledge, they implemented no other innovation solutions that would have created amazing solutions that would have allowed them to save the day.

In a down economy, down companies are out. In a down economy, great companies survive. Why? Because they deliver great customer value, and they create *devotees*, not just customers.

Customer Value *Is* Business Value

Today, we tend to revere most companies based on numbers—revenues, profits, head count, inventory turnover, fixed costs, debt levels. There's a rationale to that. But the sharp analyst, looking for value in a company, will focus on value delivered to its customers—knowing full well that when a company delivers value to its customers—the cause—the other numbers fall into line—the effect. Good financial performance is a result of good market and customer performance—not an end in and of itself. We may be using the wrong indicators to determine who's going to win and who's going to fail. Think about it.

Beginning of the End, or End of the Beginning?

As we move forward, it will become obvious that companies should not be judged based only on their financials, but also on their innovations. I like to describe it this way: We should be looking at the breadth and depth of every company's innovations. That is, are they just about products? Or services, processes, employee practices, environmental practices, and so forth? At the end of the day, it's what a company is doing to invent new solutions regularly for its customers, either directly or indirectly.

The book *Good to Great* (Jim Collins, HarperBusiness, 2001) is a great example of a book that looks at companies based on what I believe can be the wrong success drivers—or at least, they fail to tell enough of the story. Collins postulates that "great" companies focus on the things they're good at, avoiding mindless diversification. That may be true, but it doesn't go far enough in my opinion.

For me, "great" happens when that focus is on the success drivers of innovation and customer value. By Collins's definition, a company that made great buggy whips might be considered a great company—again, for me it goes deeper. The fact that Collins cited Circuit City, with Fannie Mae, Wells Fargo, GE, and others supplies further evidence that business excellence may be driven by something else quite unseen—at least until now.

There is a major thing that happens in a down economy with corporations. It is what former Intel CEO and author Andrew S. Grove refers to in his excellent book *Only the Paranoid Survive* as a *strategic inflection point*—in other words, a fork in the road. This fork in the road begs the question: "Do we continue to innovate?" or do we focus on cost reduction, and get into what I call the "bunker-down syndrome"—in the hope that we can stop spending money so that if we're in the fallout shelter, eventually all of the economic adversities that are happening will simply go away.

History has shown us that going into bunker-down mode is the beginning of the end for most companies. The question that's most commonly asked of me by clients is: "Should we increase or should we decrease our research and development spending?" And the answer I usually give is: "How much money are you spending on R&D?" True, it violates the simple protocol of not answering a question with a question, but that aside, they don't understand what the question means.

The point, of course, and the explanation I give is again in the form of a question: "Are you really good at spending that money, and do the successes justify the investment?" If you're making a return on the R&D dollars spent, then of course it makes sense to spend the money, perhaps spend even *more* money. Why? Because, for the most part, a dip in the business cycle does not mean a permanent change in customer interests, beliefs, or need for product or service value. According to a recent Nielsen report appropriately titled "What's the Role of Innovation in a Slow Economy?" (December 2008), there is no reason to believe consumers aren't still attracted to new innovations even in a down economy. The first sentence says it all: "Based on data from the U.S. and U.K. over the past 20 to 30 years, consumers' purchase interest and value perceptions for new products do not change significantly with changes in the economic climate." (To read the full report, see http://cn.en.acnielsen.com/site/documents/Innovation_en.pdf.)

Can Bad News Really Be Good News?

So we know for a fact that in business-to-consumer, business-to-business—really, all industries—customers are looking for new solutions. In fact, for many businesses the best opportunity might be in a down economy, where there is a stronger imperative to create innovations that really deliver value and serve customer needs. A good example is the advent of frozen foods during the Great Depression and the infrastructure to distribute them; the advent of board games like Monopoly serves as another example. Both delivered customer value at a time when such value was dictated by the bad times.

Here's the basic question companies need to ask themselves. Can we take advantage of the current economic environment to create new innovations to help our customers address the challenges *they* are experiencing in a down economy? Or do we pull the lever of the bunker-down syndrome where the focus changes to reducing our own cost, including the cost of delivering meaningful new innovation to our customers that will benefit them in this down economy?

The answer lies in appraisal of two things about your business: First, what are the right new products to innovate to help customers the most in tough times; and second, can those innovations be delivered efficiently? Does the R&D function work efficiently and effectively to produce these products, or is it a money pit that, even if it could hit the mark for the customer, would cost too much and/or take too much time to get a product to market? Is the real problem that your R&D function is operating at a fraction of its efficiency? This is what you as a manager of a business must figure out, and Part I of this book is largely devoted to helping you make that appraisal.

Failure is Not an Option

I believe the answer to the question: "Why do companies fail?" is pretty straightforward. First of all, to answer that question, we have to go back and redefine the term "innovation."

Innovation is such a generic term that it doesn't really mean anything to many companies any more. In fact, many of the least innovative companies in the world use the term "innovation" in their tag line, and they're under the impression that putting the words

"leaders in industrial innovation" or some such *by itself* makes them top-notch innovators.

And so again, why do companies fail in a down economy, and what is the role of innovation? Well, true innovation, in my view, is first and foremost a phenomenally strong and accurate connection to what your customers want. The world famous business guru Peter Drucker said that there were three questions you need to answer about your business: (1) What is my business? (2) Who are my customers? and (3) What do my customers value?

I would argue that Drucker's definition is really one of innovation. What is my business? You need to know what you do. What your core values and efficacies are. You need to know who your customers are—really know who they are—not just from a demographic analysis, but who they are in terms of *what they really care about*. Knowing who your customers are and what they value *is* innovation.

The Difference Between Invention and Innovation

Many people, without thinking, use the two words interchangeably and, I would argue, inappropriately. When one thinks of an invention, one thinks of a shiny whizbang new product based on some sexy new technology to do something new or do something better. A handheld GPS device is an *invention*. An innovation is a higher level, more conceptual success that *may be* developed around an invention, but is something that really serves a customer need and delivers customer value in excess of what it costs, that is, *net customer value*. A GPS device that uses a well-designed global GPS system to deliver the right information customers need when they need it at a reasonable price is an *innovation*.

As an exercise, take a few minutes to look at products or services around you to determine whether they are inventions or innovations. A stand-alone iPod might be an invention (a very good one) but an iPod bundled with iTunes as a complete digital music platform? That's an innovation. An In-N-Out Burger, fries and milkshake, on the other hand, would hardly be considered an invention, right? But the way it's delivered? Even without an invention, In-N-Out is a clear example of an innovation.

Most companies don't know the answer to the third question: "What do my customers value?" Why? The main reason is this: The people who have the greatest authority—and make all the decisions

about what a business delivers to its customers—have the least amount of customer contact. Conversely, the people in an organization who have the greatest amount of customer contact almost always have the least amount of control over what is delivered to the customer. Even worse, companies rarely provide a regular venue to allow high customer contact people to be able to communicate ideas to the people who do have authority to make decisions.

Innovations—and businesses—fail in this economy due to the lack of customer contact. Circuit City is but one example—do we really think the managers who made the decision to fire all the expert level employees were fully aware of the needs of their customers?

Thriving on Chaos

So back to the basic (implied) question: Are bad times necessarily the death of innovation? Do bad business conditions seal the fate of bad businesses, destroying any chance that they might innovate their way to prosperity? Do bad times eliminate the funding and focus necessary to innovate? Should firms be expected to cut back on innovation during bad times?

I would argue that good businesses thrive during times of economic turmoil. Sure, there are painful choices to be made. But if you look at the course of history, some of the best businesses—and business ideas—have started their trajectory during bad times.

GE started during the panic of 1873, Disney started during the recession of 1923-24, HP began during the Great Depression, and Bill Gates and Paul Allen founded Microsoft during the recession of 1975. Several companies benefited from aggressive marketing at a time when their rivals were all cutting back. A good example is Kellogg besting C.W. Post during the Depression. Customers didn't stop spending during that time; most just looked for better deals. The companies providing those better deals came out stronger after the economy began picking up. And, consumer loyalty remained after the fact.

Some companies find that economic downturns provide better markets for innovations already made, because it brings their value proposition closer to the true needs of the customer. Here's a great example—the story of Clarence Birdseye, the innovator of store-bought frozen foods.

In the early 1920s, Clarence Birdseye invented a new freezing system for fish products, called a "double belt" freezer, where cold brine chilled stainless steel belts carried fish in packages, freezing it almost instantly. His company, General Seafood Corporation, operated out of Gloucester, Massachusetts, and he got a U.S. patent for his invention. He got additional patents for mechanical improvements to reduce the size of ice crystals formed on the product, and in 1927 he expanded the process to freeze meat, poultry, and what became his trademark: vegetables.

Birdseye did quite well, and in fact was able to sell his company, equipment and patents for the tidy sum of $22 million in 1929—to Goldman Sachs and the Postum Company. Postum eventually became General Foods, which in turn founded the Birds Eye Frozen Food Company as a subsidiary. It was a clever and successful innovation in the late 1920s, but it became an even better one in the Depression-ravaged 1930s. Frozen food products were seen as a good and less expensive alternative to fresh foods, especially out of season or outside their native geography. Simultaneous development of frozen refrigerated transport and home food storage obviously helped. As these technologies evolved, the company conducted customer tests and experiments on numerous frozen food products, which took off well. Given the economic and technology environment of the times. Today, Birds Eye Foods remains a leading frozen-food brand.

Innovate or Get Out

The Birds Eye example makes clear that continued innovation helps build on success, especially when the environment is right and other technologies are evolving simultaneously. It also highlights the potential folly of stopping—or selling out—too soon.

The example offers further evidence that companies should continue to pursue innovations not just during good times or during bad times, but at all times. An innovation that might be ahead of its market in good times may suddenly find itself dead center for a market in bad times; typically the interest in these innovations persists once good times return, because people make the adjustments and come to expect the value delivered even when times are better.

Many businesses that do well in tough times do well because they continue advertising and marketing as though the public still

had money to spend. They didn't wait for the product demand to rise again; they created that demand even during tough times. Those companies who diminished or cut advertising altogether lost existing customers to more aggressive competitors and, in many cases, lost investors no longer interested in participating in invisible companies.

Success in these instances—really in all of business—requires a strong and relentless customer focus, an awareness of the external environment, a commitment to the long term, and avoidance of barriers to success. The next two chapters explore some of those barriers to success—and what to do about them.

Chapter Takeaways

- Innovation is not just about products or technologies; it is about the entire customer experience. Companies like In-N-Out Burger show us that even small details like cleanliness, aroma, and pleasant greetings matter.
- Bad times should be perceived as good times for innovation. Those that avoid the temptation to cut back are often rewarded, those that do cut back often seal their fate.
- The current business climate of rapid change and short business cycles strengthens the case for innovation more than ever. Companies must keep up with—or lead—the change, and those that continue to innovate through the short cycles will be rewarded more quickly.
- An *invention* is a new process or technology, while an *innovation* is something that really serves a customer need in a new way. An innovation may or may not include an invention.