CEO Survey on Business Innovation

Judge Business School, Cambridge University

Author: Roger Camrass, Senior Associate

Summary of Findings

The Judge Business School, supported by Fujitsu Services, the University of Surrey, and the Monitor Group has undertaken a survey of top management opinion in the UK under the theme of Innovation. Fifteen Chairs and CEOs were interviewed from leading UK companies such as Astra Zeneca, BAA, BP, BT, Diageo, Goldman Sachs, QinetiQ, Legal & General, IBM, ICI, Standard Chartered Bank, Tesco and Unilever.

The views of these executives were almost unanimous – innovation is crucial to competitive survival yet it is the one capability that large companies find near impossible to master. Factors such as scale and complexity, cultural and system legacy, risk aversion and short-termism lead to organisational inertia in this respect. Innovation is rarely achieved through internal mechanisms alone. Instead, it takes place most often at the point of interaction between large companies and their external networks – from customers and alliance partners to suppliers and contractors.

The survey concludes that the single most important flow of corporate innovation today occurs through the main functions. For example, the CIO and related IT organisation accesses a wide range of technically driven innovations from global IT suppliers such as Fujitsu and IBM as well as small, innovative boutiques such as QinetiQ. The CFO organisation accesses new financial techniques by interacting with a myriad of financial services organisations from corporate finance specialists such as Goldman Sachs to leading international banks such as Standard Chartered Bank.

The CTO organisation, often viewed as leading innovation in an organisation, accesses new techniques, products, processes and services via well established external links with universities, customers and by developing the open source philosophy that is rapidly gaining currency.

We describe this phenomenon as 'Innovation Flux' when it is linked to interactions with third parties. In this respect the functional channels become 'Innovation Portals' that attract and channel new innovations into an organisation. Impediments to successful innovation often relate to inadequate functional capability – where CXOs become blockers of new ideas rather than active filters.

Outsourcing of corporate functions such as IT, HR, Finance and R&D can either amplify or diminish innovation flows. This largely depends on the nature

of the relationships with external partners and the contracts that bind them together. First generation outsourcing contracts based on fixed price, fixed term relationships have been responsible for inhibiting innovation in key areas such as IT and R&D.

New generation contracts based on open book, risk-reward principles tend to encourage continuous innovation through the lifetime of a supplier/customer relationship. As organisations seek to outsource ever larger elements of their operations – from manufacturing and logistics to shared services, this factor becomes ever more important to fostering innovation.

Here are the main findings of the survey and some relevant quotes from the respondents.

1. Innovation is a central factor in competitive survival

For all those interviewed the message was clear and direct: Innovation is core to competitive survival. Individual comments included:

- *“Innovation is the life blood of our company” (Chairman, Legal and General)*
- *“Innovation is about wealth creation — that is our only mission” (CEO, Astra Zeneca)*
- *“Two main themes dominate our board’s thinking: sharing of knowledge and accelerating innovation” (Executive Vice President, BP)*
- *“Innovation is about being in a high state of alert — not being complacent” (CEO, BAA)*
- *“We’re in danger of extinction . . . innovation is the key to survival” (CEO, BT)*

Some referred to the recent McKinsey study that forecasts the average life expectancy of Global 2000 companies to be around 25 years – compared to 90 years in the early part of the twentieth century. For this reason alone, Innovation remains high on the corporate agenda.

According to the survey the drivers for innovation are numerous. They include the growing commoditization of goods and services, induced by global competition and Internet-based markets. Pressure for improved returns from the financial community, in terms of revenues and earnings, is demanding more innovative approaches to business. Regulatory changes enable new responses in sectors such as pharmaceuticals and financial services, as do disruptive technologies. All contribute to pressure on the CEO and the Board to innovate his or her organization at an increasingly rapid pace.

“Life cycles are increasingly short before the onset of commoditization. The only hope for sustainable, high quality earnings is continuous innovation” (Unilever)

2. The focus for innovation is expanding

Innovation was focused traditionally on new products and services, and in many cases required large expenditures on Research and Development. Even today organizations such as Astra Zeneca, Fujitsu and IBM spend many billions of dollars on product development. However innovation has become a much more pervasive issue, especially as many of the companies interviewed belong entirely to the service economy.

Examples of market-driven Innovation include:

- Brand development and brand focus, as illustrated by recent efforts within Unilever to simplify and promote no more than thirty global brands and develop share holder value around these intangible assets
- Customer propositions that preoccupy IBM Global Services, where 20% of its revenues ‘fall off the edge of a cliff each year due to technological advances’ and need constant replenishment
- Customer relationships have risen recently in importance within Goldman Sachs as emphasis switches from a transaction culture to a relational one
- Product innovation remains the single driving force for business value in Astra Zeneca where multi-billion dollar funding is channeled into drug discovery

“Few if any companies really comprehend the customer’s needs or desires – we are all led by supply side thinking and related process” (BP)

A further focus for Innovation extends into the core processes and structures of a business. Organizations are experimenting with entirely new business models to drive higher share holder value as is the case with Astra Zeneca. The latter adopts a portfolio management approach to drug discovery, allocating the most senior executives in the firm to drive forward product development within tight clusters of medical science. In many ways this corresponds to a Venture Capital approach.

Some are considering new structures to shift innovation away from the line businesses towards functional competencies. BP has instituted tighter control of the business through its twenty two corporate functions, and is exploring the possibility of using these channels as the main route for corporate strategy and innovation. This philosophy is embodied in Lord Browne’s Green Book.

The majority of companies interviewed are continuing to transform internal processes in the expectation that this will improve operational efficiency and effectiveness. Few see this as a building sustainable competitive advantage – more a matter of staying in the competitive game.

“Traditional business structures and processes were designed for the era of manufacturing and steady state thinking – we need to revisit our value model” (ICI)

3. Removing the barriers to Innovation

Many of today's barriers to innovation relate to scale and complexity. Most of the organizations interviewed believe that size is no longer an advantage here, and may well be an obstacle to innovation in the future.

Top-heavy and bureaucratic structures can impede innovation, but these may be just the tip of the iceberg. Factors that reduce innovation most often include: centralization and control, scale and complexity, operational focus, silos of expertise, regional power barons and ineffective reward and recognition systems.

BP has done much to simplify its own business by reducing the size and scope of the corporate HQ – down from 6,000 staff in the eighties to just over 200 today. Unilever is pursuing a similar path by divesting authority away from the corporate centre to the lines of business (foods and personal care products).

"Size is both an opportunity but also an inherent barrier – it brings scale and leverage but generates inertia and risk-averse attitudes" (BT)

As well as inadequate structures, attitude, culture and behavior give rise to powerful and persistent barriers. Middle management can be complacent and risk averse. It can also be too short-term in its attitude, encouraging incremental behavior rather than more radical campaigns. Most cultures are designed to perpetuate the status-quo and often require wholesale change in senior staff to effect innovation. Such has been the case at Fujitsu Services in Europe following the near demise of its former subsidiary, ICL.

Companies like BP and Astra Zeneca rely heavily on external research partnerships to generate an environment of constant challenge and innovation. BP shut down its central research activities some ten years ago to encourage stronger external relationships with the best university laboratories. This has enabled it to progress rapidly against other Oil Majors whose research remains largely an internal function and has lost its vitality and edginess.

A leading question is "Can large organizations innovate from within, or are they becoming increasingly dependent on external parties" (BP)

4. Best practice in corporate innovation

The realisation that most large organisations are incapable of innovating on their own has given rise to an alternative hypothesis – that innovation takes place through the interaction of such organisations with external parties, ranging from customers and suppliers to alliance and partner members.

This hypothesis has been tested on several of the interviewees in debriefing sessions and gives rise to some important insights on the subject:

- **In-sourcing of innovation** can harness valuable input from external parties to bring best practice principles from the sector and elsewhere. Suppliers and customers can be rich sources of innovation
- **Partnerships, Alliances and Joint Ventures** can yield new opportunities to innovate businesses, especially where they involve reshaping or complimenting the existing value chain.
- **Out-sourcing partnerships** present a growing source of 'innovation flux' where contracts encourage co-development and continuous improvement

The model proposed above can be expanded further if we assume that large organisations are ultimately destined to blow apart into their constituent elements – a thesis that has been advanced by several leading academics and management consultants over the last ten years. See 'Atomic: Reforming the Business Landscape into the Structures of Tomorrow' by Roger Camrass and Martin Farncombe (J. Wiley, 2003).

"It is difficult to see the wood from the trees when organisations become so complex and diverse – ruthless focus around core competencies is the answer" (Astra Zeneca)

In an 'atomised' and highly connected post-industrial economy, corporations are predicted to evolve into networks of specialised units, each focusing on a particular competency e.g. product development, customer relationship management, transaction processing and risk management. These dedicated units will be sufficiently small and agile that they can innovate organically – stimulated from the many external trading partnerships that exist across the value network.

5. Exploiting 'portals of innovation'

The most radical hypothesis to emerge from the survey is the notion that functions rather than business units become the primary channel for corporate innovation.

Although business units are exposed constantly to the changing demands of their suppliers and customers (as well as other parties within the value chain), the functions interface with a more diverse range of expertise and innovation. The IT organisation has long been the point of entry for technology-driven innovation. IT departments interact with literally hundreds of IT suppliers from Europe, USA and Asia on a day-to-day basis. The majority of these external organisations seek to differentiate through innovative products and services.

CIOs are notorious in their quest to promote such external innovation inside their firms – frequently egged on by energetic and resourceful suppliers. The IT community has not been particularly successful in linking such new ideas to the internal organisation and receives a sceptical response in many cases. The CIO of BP has recently presented his case successfully to the Board that modern digital infrastructure can accelerate development of an integrated global business.

Other functional channels are exposed to continuous innovation from outside their organisation. For example, the CFO works closely with investment banks that bring world class capabilities in all aspects of corporate finance. Working with such institutions, the CFO can optimise a wide range of financial instruments to best suit the needs of the firm. The same has always been true for marketing – where advertising agencies provide expertise as part of their service. HR is becoming a recipient of similar external capabilities, as is procurement.

If functions become the primary ‘portal for innovation’, they carry with them an onerous responsibility to link such capabilities to the business as a whole. Alignment between business and function has always been an issue – especially in the world of IT.

“We continue to drive business performance through functional excellence and look to populate these areas with world class expertise from outside the retail sector” (Tesco)

Role of outsourcing in business innovation

In the pursuit of business simplification and efficiency improvement, many of the companies interviewed have turned to outsourcing large elements of their internal functions such as IT, HR and Finance. Early experience here has been mixed, with the majority of organisations reverting to different outsourcing partners at the termination of the initial contract. Fixed price, fixed term conditions leads to a static and adversarial relationship between supplier and customer – leaving little flexibility or inducement for change.

Today’s outsourcing market is shifting away from rigid, ten year contracts to a more flexible, open book environment based on risk-reward. Outsourcing customers such as BP are imposing short term, renewable contracts of 18-24 months to encourage continuous improvement. In turn, suppliers are working much harder to extend these relationships into 5-10 year engagements by demonstrating their ability to innovate and add value. This requires a continuous flow of service improvements, or innovations, that justify extensions to the contracts.

In the case of Terminal Five at Heathrow, BAA is transforming the entire construction and project management sector by imposing radically new contractual terms on its partners. Evidence so far suggests a more responsive and profitable relationship between customer and contractor on what is regarded as a high risk operation.

Survey conclusions

The innovation challenge facing large corporations today has never been greater. Market and share holder pressures demand innovation at an ever growing pace. However, large companies are held back by scale and complexity, organizational inertia, cultural legacy and short-termism. Western companies suffer more in the latter respect against their Asian counterparts.

The benefits of innovation are clear to all: survival and sustainability, wealth creation, high returns and associated P/E ratios and an attractive and stimulating work environment.

Our survey suggests that most large organisations find internally driven innovation almost impossible to achieve. Instead, they are learning to harness the constant interactions with external parties to generate 'innovation flux' into their organisations. The functional channel seems to be dominating as the most effective 'innovation portal' into the large corporation. The nature of external relationships will need to change as organisations seek to expand the rate of 'innovation flow'. For example, traditional outsourcing contracts can inhibit such valuable inflows. With an ever greater emphasis on externalisation of corporate activities, senior executives are re-examining the basis of these partnerships and challenging suppliers to demonstrate innovation capability.

Survey Team

The survey was conducted by a team of three experienced researchers:

- Roger Camrass, Senior Associate at the Judge Business School
- Dr Tony Hamer, Partner with the Monitor Group and director of Monitor's Innovation Management practice
- Professor Ken Taylor, University of Surrey