Innovation for Long-Term Growth and Value Creation: Building the Future While Preserving the Core

IE Briefing Report

Innovationedge

1526 S Commercial St Ste 200
Neenah, WI 54956
www.innovationedge.com

920-967-0470
ie@innovationedge.com

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Overview – The Challenge

To survive in today's hyper-competitive world, you and your company must stay on top of constantly changing markets, technologies, and socioeconomic factors. To be profitable, you must continually enhance and/or add offerings while controlling costs.

To *grow*, however, your company must go further – you must have a forward-looking strategy and the infrastructure to execute it. You must focus on the top line as well as the bottom line. This means developing products and services that are entirely new to your company and perhaps to the world which create significant value and competitive edge. In short, you must innovate to survive in the *future.*

The challenge is a tug of war between survival and growth – with Marketing and R&D on the front line. The pressure to meet short term profit goals and shareholder expectations often overrides the long-range plan.

A recent pulse survey[i] conducted by **Innovation**edge indicates that **short-term thinking, shifting priorities,** and **leadership expecting pay-off sooner than realistic** are among the biggest barriers**.** For smaller firms, resource constraints are an additional barrier. (Figure 1)

Figure 1

Anecdotally, 'fire-fighting,' not knowing how to judge projects without hard numbers, lack of team consensus, and aiming for quarterly earnings reports are common distractions.

Furthermore, innovation is often managed as *"a collection of ad hoc, stand-alone efforts that compete with one another for time, money, attention, and prestige instead of managing for total innovation."* *Harvard Business Review*[ii]

This IE Briefing Report looks at how to achieve an optimum balance between short-term profit and long-term growth.

Innovationedge has identified six key success factors:

1. **Leadership** – creating and communicating a compelling strategic vision
2. **Pipeline and Portfolio Management** – choosing the best current and future opportunities to pursue, those that solve a problem worth solving
3. **Three Horizon Framework** -- ensuring balanced resources across core, adjacent, and breakthrough business activities
4. **Funding** – investing in new growth areas continuously and sustainably
5. **Metrics** – measuring performance of each horizon appropriately
6. **Teams and Talent** – assigning the right people with the right capabilities, providing support

While overall balance is the objective, this paper emphasizes long-term success factors as these are the most difficult for companies to adhere to. In particular it focuses on the economic and leadership support required to deliver.

The Case for Long-Term Thinking

The first step in overcoming short-term thinking is making a strong case for the long term. The economic case is clearly described by McKinsey[iii]**,** Bain[iv] & Company, and others[v].

1. **Bain & Company** points out that ready access to low-cost capital means business leaders should think about the relative value of improving profit margins versus accelerating growth. **Rather than curbing costs to boost margins, investing for the long-term yields higher returns**. "For the average company, defined as the equity-weighted average of the roughly 1600 companies comprising the Value Line Index, the cost of equity capital is just 8%. And the average long-term ROE is more than 25%, reflecting improved efficiency combined with greater reliance on financial leverage at most companies. **On average, the value created by accelerating growth by 1% far exceeds the value created by increasing pre-tax margins by 1% on a sustained basis. In fact, the multiple of value created by growth versus margins is more than four to one."** (Figure 2)

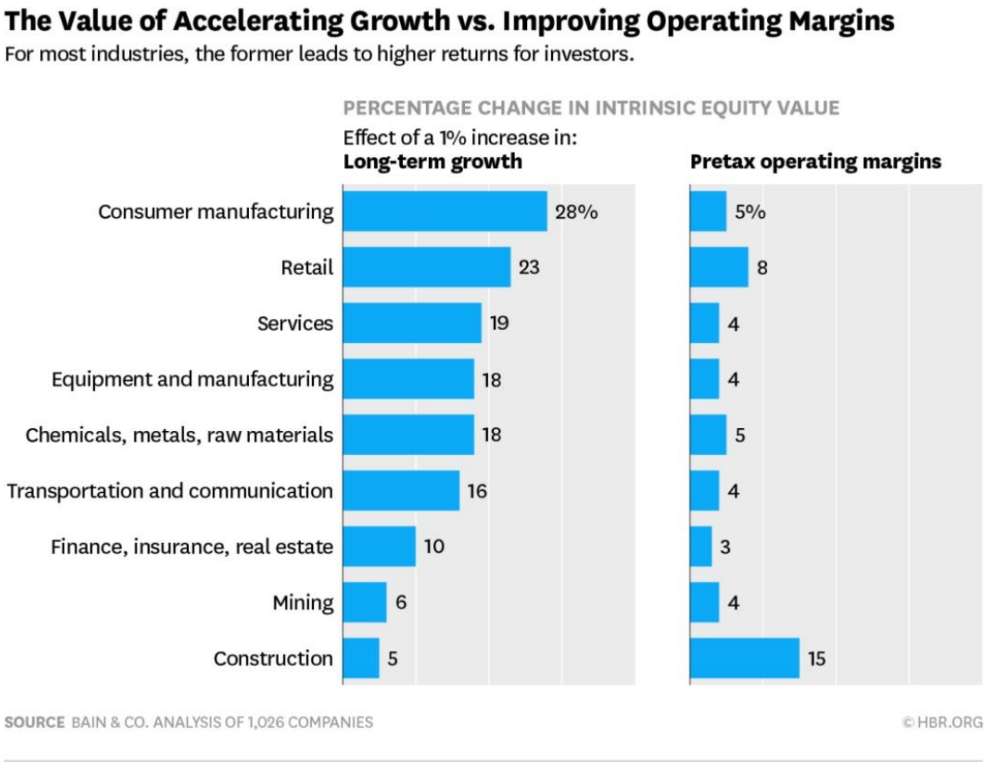

Figure 2

2. **McKinsey** used a five-factor [Corporate Horizon Index[vi]] (Figure 3) to compare relative performance of long versus short-term firms. It found:

   - From 2001 to 2014, the **revenue of long-term firms** cumulatively grew on average **47 percent more than the revenue of other firms, and with less volatility**. Cumulatively the **earnings of long-term firms grew 36 percent more** on average over this period than those of other firms, and their **economic profit grew 81 percent more** on average.

   - **Long-term firms invested more** than other firms from 2001 to 2014. Cumulatively by 2014, **long-term companies on average spent almost 50 percent more on R&D** than other companies. More importantly, they continued to increase their R&D spending during the financial crisis, while other companies cut R&D expenditure.

   - **Long-term companies exhibit stronger financial performance over time**. On average, their market capitalization grew $7 billion more than that of other firms between 2001 and 2014. Their total return to shareholders was also superior.

	Indicator	Hypothesis	Measurement approach
1	Investment	Long-term firms will invest more and more consistently than short-term firms	Ratio of capital expenditures to depreciation
2	Earnings Quality	Long-term firms will generate earnings that reflect cash flow, not accounting decisions	Accruals as a share of revenue
3	Margin Growth	Short-term firms are more likely to grow margins unsustainably in order to hit near-term targets	Difference between earnings growth and revenue growth
4	Quarterly Management	Short-term firms will do whatever they can to hit short-term targets, whereas long-term firms are willing to miss them if needed	Incidence of beating EPS targets by less than 2 cents and incidence of missing EPS targets by less than 2 cents
5	Earnings-per-share Growth	Long-term firms are less likely to over-index on EPS rather than true earnings and act to boost EPS (e.g., with buy-backs)	Difference between EPS growth and true earnings growth

SOURCE: McKinsey Global institute Analysis

Figure 3

3. Finally, the ***Wall Street Journal*** cites a study[vii] where researchers found that a long-term outlook can improve a company's operating performance by **several measures—return on assets, operating profits, and sales growth—within two years. The passage of long-term incentives** for CEOs made a difference; companies boosted their efforts to innovate and pursue riskier forward-looking projects. More specifically, they increased their research and development spending, which led to surges in the number of patents they garnered.

In terms of pressure from shareholders, companies like Amazon, Tesla, and Netflix have demonstrated that growth over the long haul is just as - if not more - attractive to Wall Street than profit in the short term. Amazon has achieved massive revenue growth by focusing on growth over net income[viii], and investors have certainly realized the value. As of September 9, 2018, Amazon's market value reached $3 trillion!

James Dimon, JP Morgan CEO, advises[ix]:

> *"Quarterly earnings: they're a function of the weather, commodity prices, volumes, competitor pricing. And you don't really control that as CEO. Sometimes you're just like the cork in the ocean, but do the right thing anyway and you're going to be fine in the long run**...you should build the systems you need, you should do the R&D that you need and explain it to your shareholders and your board.** Of course, some of the CEOs will say it's the sell side, that we put pressure, but what I'm trying to say to people: **be free to drop it."***

Leadership

While economic substantiation helps justify the long-term view, strong leadership is crucial to delivering growth. You must decide how you want to build your growth pipeline and capabilities over time – you need to think about the next ten years as well as the next few quarters and communicate a vision that you can rally your team behind.

Not every company needs to develop breakthroughs or ‘moonshots,’ but you must do more than maintain status quo to survive. You must think about your future customers and new ways of delighting them. You must anticipate emerging technologies and trends. You must continually develop your company’s capabilities, knowledge, and intellectual assets. And you should be willing to consider even taking hits in the short term. As Sir George Buckley [former CEO] at 3M[x], said, *“The core of every business is dying.”*

Ongoing regeneration and seed-planting are essential. Of course, the appetite for and extent of innovation ambition will vary by industry, company size, startup or established, and lifecycle stage. The key is to **have a strategy, communicate it, and stay to true to it.** Course corrections are to be expected, but the big picture should be constant.

Leaders who exemplify long-term visionary thinking include Amazon CEO Jeff Bezos[xi] whose mission since launching the online bookstore twenty years ago was to offer *Earth’s biggest selection* and to be *Earth’s most customer-centric company.* Today it is the world’s biggest e-retailer of *everything* and the dominant cloud services provider, the number 2 video streamer, a major online and brick-and-mortar grocery, and a leader in digital personal assistant devices. Bezos is not afraid of risk; he continually reinvests money from operating cash flow into new areas that keep Amazon ahead of its competitors.

Like Amazon, Wayfair is spending heavily on its growth plan[xii], building out its warehouse and shipping capacity, expanding into more markets, and building its brand name with television ads. Jeff Naylor, a Wayfair board member explains: “We’re at a point in our history where it makes more sense to invest and grow.” Wall Street agrees. The company’s shares have appreciated about 42 percent a year, on average since going public in October 2014, significantly better than the returns of major stock indexes.

Some CEOs even invest for the long term by doing painful things in the short term. In 2006, **Ford** was a turnaround situation and then-CEO Alan Mulally[xiii] had to cut costs and lay off employees. He did it with growth in mind, however, securing a credit line for $23 billion so engineers could bring out better cars with greater market appeal. In the short term, the company had to take losses, but the strategy was long-term gain. He did what he had to for the right reasons.

While leadership styles and company situations differ, **Innovation**edge has observed the most successful leaders possess the following traits:

- Perseverance
- Focused Passion
- Courage
- Tolerance of Mistakes
- Comfortable to be a Minority of One
- Strong Image of the Future
- Creators of Positive Environment and Abilities

These traits are not just important for the CEO, but for anyone leading growth and innovation efforts. Ultimately, execution is everything and it takes belief, persistence, consistency, and ‘walking the talk’ in the face of daily pressures.

Summary/Takeaways

To summarize, balancing long-term growth with short-term profits takes commitment. As a leader, you must first articulate your forward-looking strategy; you must then keep this strategic vision front and center. The following factors will make a difference:

1) **Economic justification.** Keep in mind that Wall Street and shareholders gain higher returns from growth; the multiple of value created by growth versus margins can be more than four to one. A long-term outlook can improve a company’s operating performance by several measures—return on assets, operating profits, and sales growth. Avoid the quarterly earnings trap.

2) **Leadership.** To lead and motivate others, be steadfast, transparent, consistent, and willing to take hits in the short term if necessary. “Visionary’ is a relative term; the real key is setting, communicating, and sticking to **long-term objectives**. While adjustments may be necessary, do not lose sight of the big picture.

3) **Funding**. Long-term companies spend more on research, development and expansion into new growth areas than their competitors, and they continue to invest even in difficult times. The investment pays off -- long-term companies exhibit stronger financial performance over time and superior total return to shareholders**.** Do not underinvest, particularly if your company is high-tech. And do not expect immediate paybacks. The highest returns often come from new-to-the-company or new-to-the-world initiatives and these take time.

Glossary

CEO	Chief Executive Officer
IE	**Innovation**edge
R&D	Research & Development
ROE	Return on Equity
ROI	Return on Investment

*About **Innovation**edge*

Innovationedge is a global strategic innovation consultancy that works with Fortune 500 companies, small/medium enterprises and startups on strategy, leadership, and culture to drive their innovation agenda and deliver growth. The team's fearless champions of innovation break barriers to help executives define their business strategy, develop new capabilities, design a winning organizational structure, and deliver breakthrough innovations through a robust growth pipeline of solutions and new-to-the-world innovations. The company also gives inventors an edge by crafting winning business propositions and creating strategic corporate partnerships that deliver commercial success. For more information, visit **Innovation**edge (www.innovationedge.com).

End Notes

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