

## **Open Innovation:**

*Forging strategic partnerships to win in the competitive market*

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*Thomas Bornemann, managing partner of the Consumer Products practice at Clarkston Consulting, discusses why open innovation is critical to your company's long-term growth, as well as the factors you should consider as you pursue an open innovation strategy.*

Globalization, new technologies, fierce competition and a consumer-driven economy have created a brand new set of challenges for the consumer packaged goods company. At the core of each company's survival—including yours—is the ability to innovate. But where will your next profitable idea come from? What will differentiate you from your competitors? How will you balance the cost efficiencies demanded by your shareholders with the need for faster development of the right products? In the end, will your ability to innovate keep up with the demands of the marketplace?





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### Introduction

**Innovation.** It's the word du jour among global business leaders. But in the consumer packaged goods (CPG) industry, innovation is more than just a buzzword—it has major implications for one very simple reason, behind high technology, the CPG industry has the highest rate of new product introductions.

For decades, CPG companies have relied on their own marketers, scientists, engineers, designers and idea makers to create new products. Today, however, the way goods are generated and brought to market is undergoing a fundamental change—companies are looking outside the walls of their own organizations for sources of innovation. The companies that are able to adapt quickly to this new model will become competitive winners. Those that fail to change will be at a significant disadvantage and risk declining market shares and below average corporate performance.

Known as open innovation, this new paradigm does away with the closed, vertically integrated model of product development that has prevailed since the beginning of mass production of consumer products. Where once companies relied on their own resources to research, develop, manufacture, market and distribute their ideas themselves, this new model builds on a company's core R&D competencies and adds external ideas and partners to the mix. Leading companies such as IBM, Kimberly-Clark, Kraft Foods and Proctor & Gamble are among those embracing open innovation. Through this approach, they are able to debut more compelling products faster and at less cost, boosting sales and profits and seizing market share.

According to Henry Chesbrough, author of *Open Innovation: The New Imperative for Creating and Profiting from Technology*, the closed, vertically integrated innovation model has eroded primarily due to four factors:

- Increased mobility of skilled workers;
- Expansion of venture capital;
- External options for unused technologies; and
- Increased availability of highly capable outsourcing partners.<sup>1</sup>

Furthermore, a survey conducted by IBM Research in 2006 found that companies are experiencing significant challenges in

leveraging their internal R&D labs to drive innovation. More than 750 CEOs from around the world ranked their R&D organizations as only their eighth highest source for new ideas. Interestingly, employees, business partners and customers ranked as the top one, two and three sources, respectively—meaning that two of the top three sources for innovative ideas are now external.<sup>2</sup>

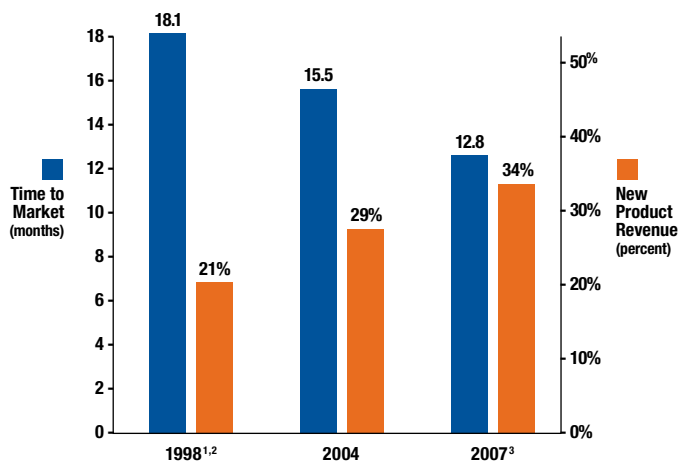
And while shorter product life cycles are already making it harder for CPG companies to recoup their R&D investments, research shows that as a result of market pressures new product development cycles will only continue to contract. The impact of this will surely be felt. Here's why. A successful launch of an innovative new product without any real competition can give a company a nine to twelve month head-start before the product enters the maturity phase and loses its uniqueness, brand supremacy, premium pricing and high margins. These margins help feed the R&D pipeline and allow the company to continue introducing new products and services, creating a sustainable competitive advantage.

In the next few pages, we share with you why successful companies are leveraging open innovation to slash the time it takes for new products to advance from the drawing board to store shelves. Instead of developing new ideas in R&D and purchasing assets to commercialize them, today companies are buying both raw ideas and market-ready products invented outside their organizations and outsourcing the production to businesses that already own the necessary manufacturing capability. We also explain how the most powerful factor of all—increased consumer-driven market demand for better products faster and cheaper—is driving companies toward the open innovation model.



*As CPG companies contend with global competition, rapidly changing technology, 24x7 communication and increased pressure from Wall Street to grow margins, they must be smarter than ever about their R&D strategy.*

The Time-to-Market / Revenue “Squeeze”



Consumer products companies are feeling the squeeze as industry pressures shrink time-to-market while new products account for an ever-increasing share of their revenues.

Source: Deloitte Global Benchmark Study<sup>3</sup>

### Consumer-driven innovation

While many consumer products companies recognize the importance of innovation, new product development and product life cycle management, their consumer-focused priorities are often diluted by the more immediate demands of their retail customers. Innovation is often left to the R&D and marketing departments while the rest of the organization focuses on manufacturing and customer service delivery.

However, as more and more companies are coming to realize, focus on the consumer should be the primary driver behind innovation for the entire organization. According to Forrester Research, there are three major shifts in consumer behavior that are undermining traditional go-to-market approaches and shrinking profits of consumer products companies:

**Changing consumer expectations.** Today, consumers are price-sensitive, regardless of income level, and have come to expect the everyday low prices offered by discount retailers like Wal-Mart and Costco. At the same time, they are used to and expect high standards of value—price and value are equally important.

**Private label threat to brand names.** Consumers are increasingly abandoning big brand names for retailers' ever-expanding lines of private labels that offer good quality at a lower price. Whether it's Safeway SELECT frozen foods or Costco's Kirkland brand, these products are shifting market share away from traditional brands. Another strong indicator that this shift is real is the recent Publix example of bundling a national brand with a private label brand in a buy-one get one free campaign.

**Globalization.** At the same time, international companies must contend with the consumer-driven challenges presented by the global marketplace. Both retailers and consumers in emerging markets have very different needs and buying criteria than those in mature economies. To remain competitive, consumer products companies must be able to meet the demand in these emerging markets while also supporting the changing needs of consumers in the United States, such as those of the aging baby boomer population.<sup>4</sup>

### The startling reality: innovation facts & figures

- By the end of 2007, new product sales are expected to comprise 34% of total revenue, compared to 21% in 1998.
- Only about 2% of new brands and brand extensions reach \$100 million in the first year of sales.<sup>5</sup>
- Over the next 6 years, products representing more than 70% of manufacturers' sales today will be obsolete.
- Companies have shortened the time to market for new products from an average of more than 18 months in 1998 to less than 13 months in 2007.
- Consumer products companies introduced a record 33,678 new items in 2003, up 6% from 2002 and up 94% from 1993.
- A 2004 study of 50 leading companies found that 90% of managers said innovation was critical to achieving their strategic objectives.

### Aligning the organization

Consumer-driven innovation shifts a business' strategic focus to the final consumer while also keeping the immediate retail customer satisfied. Therefore, to achieve world-class consumer-driven innovation, companies need to move quickly to assess gaps in their operations and realign their organizations to take



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advantage of current relationships, processes and technologies across their entire value chain. Often this approach entails better integration of consumer and customer programs that starts with defining consumer micro-segments, trends, demographics and needs that will ultimately drive business performance.

To align your organization with consumer-driven innovation you must:

- **Define innovation as a core business driver.** Improving innovation performance should be a consistent and ongoing priority of senior management. It is critical for everyone in your organization to recognize that senior management is committed to innovation as a core business driver, and that innovation aligns with a long-term growth strategy. An innovation framework should encompass your company's culture, strategy, organization, people, processes and financial metrics. It must be collaborative and offer flexibility and visibility across the entire enterprise. In addition, senior management must be willing to accept innovation failures in order to allow your organization to be creatively free to innovate and invent effectively.
  - **Open innovation to the consumer.** As companies look beyond their R&D labs for new ideas and technologies, they should bring direct interaction with consumers into the mix along with retailers, suppliers and other organizations. Companies have worked with consumers in focus groups for years, but their role must be expanded. To bring them into the innovation process, you need to find creative ways to connect with consumers to better understand their buying patterns and needs, and learn how products are used and consumed. With planning, consumers can become active participants in process redesign, product development, packaging and pricing strategies. Kraft Foods, for example, has an innovation Web site that invites consumers to share their ideas with the company—and an Innovations Team that reviews the ideas and follows up on the good ones within six weeks.
  - **Integrate demand and supply.** Today's demand and supply processes are focused on the retail customer, but a consumer-driven company will rebuild their demand and supply activities so that end-consumer needs drive the company's operations. For new products to contribute to market share growth, the quality of the product and its delivery to both retail customers and consumers must outperform the competition. This would mean that innovative CPG companies develop the capabilities to rapidly test launch many new products simultaneously, evaluate responses, and learn what works best. An incremental learning organization that can actually react to inputs quickly is the very core of an innovative company.
- **Complete the consumer feedback loop.** Companies need to augment their traditional market research sources with new channels that are available today and provide direct contact with the consumer, such as e-mail, call centers, point-of-purchase kiosks, Web-based surveys and blogs. More than ever before, successful companies are concentrating heavily on determining what consumers in specific segments want, their buying habits and brand loyalty. They are trying to identify what unmet needs exist and what new features on existing or future products might meet those needs.
  - **Engage employees.** Innovation is no longer the sole responsibility of the R&D function as it was in the closed innovation model of the past. Rather, every employee should feel some responsibility for understanding consumers' perceptions and uses of their brands, as well as your major competitors' brands. Your employees can gain this knowledge by simply observing consumer-buying behavior in the marketplace and taking note of the habits of friends and family as they go about their daily lives. Most importantly, your organization must develop a process to capture this body of knowledge in a way that is useful to the innovation teams.
  - **Align technology tools to the innovation process.** Companies need to take advantage of tools that help drive innovation and connect to the consumer. Technologies such as customer relationship management solutions will help to integrate sales, customer service and technical support to give not only a common view of the retail customer, but insight into the consumer as well. Business analytics will help to drive consumer behavior by integrating point of sale information and other market research data. Other tools such as Web sites and in-store kiosks can help increase the points of contact with the consumer and support the consumer feedback loop. However, with these new points of consumer contact, there must be systems in place to transform data into knowledge that can be applied to the innovation process.
  - **Expand from products to service offerings.** Successful consumer products manufacturers are becoming more than simply producers of tangible goods. Companies like Sony and



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Apple are now taking on the role of retailer as they open up product stores. P&G has launched a hotel-cleaning service that specializes in using the brand's household cleaning products. Kraft Foods publishes a free magazine that includes engaging articles and recipes that use its products. And both Kraft and P&G have Web sites that help consumers solve everyday household problems. These alternative channels allow the companies to get closer to their end consumers and increase brand awareness and loyalty.

- **Build a culture that fosters innovation.** Companies must define clear expectations for innovation in their organizations' goals. Just as important as linking research and development labs to consumer needs, consumer products companies must recalibrate employee incentives to emphasize creativity and reward innovation.

Bottom line: your organization's ability to learn from its constituents, create new ideas and translate those ideas swiftly and profitably into successful, innovative products is one of the most important market differentiators to acquire today. Producing a product that creates intense consumer demand will put your business in an unassailable position of strength from which you can dictate pricing and stocking levels.

#### Applying innovation across the business

With the increased demand on innovation programs, the ability of the R&D function to turn new ideas into sought-after products has become a key driver of top-line performance. An effective short- and long-term innovation plan enables growth and efficiency across the entire enterprise from R&D, to supply chain and manufacturing, to the brand and marketing organizations. Ultimately—as a company realigns its organization around consumer-driven innovation and opens up its R&D process to include resources outside its organizational boundaries—a culture of innovation is born.

To this end, there are four key areas where innovation must be infused into the business: products, processes, technology and channels.

**Product innovation** is the lifeblood of leading consumer products companies and includes both new products and extensions to existing products that create new markets and

generate demand. Crest Whitestrips™ is an example of a product that created a new category of mass-market teeth whitening products for Procter & Gamble, while Cherry Coke™ and Black Cherry Vanilla Coke® are brand extensions of existing products.

**Process innovation** focuses on new ways to bring products or services closer, faster, better and cheaper to the consumer. Henry Ford's assembly line is a classic example of how process innovation led to a mass market for cars. Michael Dell is a pioneer of process innovation with Dell's make-to-order model. As he so eloquently pointed out, "Ideas are a commodity. Execution of them is not."<sup>6</sup> And of course Wal-Mart changed the face of retailing with its focus on efficient supply chain management and every day low prices. According to author Annette Bernhardt, the Wal-Mart model is the leading retail strategy, and perhaps the leading business strategy in any sector to emerge since the 1970s.<sup>7</sup>

**Technology innovation** deploys tools, technologies and systems that help optimize business processes and drive a competitive advantage. For some companies, building a solid foundation of an integrated enterprise resource planning system is the first step in technology innovation. Adding more sophisticated applications for supply chain integration, trade promotion optimization and business analytics can position a consumer products company to elevate their supply chain processes, improve service delivery and increase profitability. Some companies use technology to collaborate with their customers and change the consumer experience. For example, Behr Process' ColorSmart™ interactive program, which can be accessed through a kiosk in The Home Depot paint aisle or over the Internet and allows consumers to experiment with thousands of color combinations, helps to increase consumer intimacy and maximize sales.

**Channel innovation** is finding new sales and distribution channels to interact with consumers. Some companies such as Clinique have online stores where products can be purchased directly and consumers are directed to local retailers holding bonus sales or in-store consultations. Nokia is opening Experience Centers in malls that feature its full product line, allowing consumers to understand and engage with the newest wireless features and interact with product representatives in a non-sales environment.



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### Strange bedfellows

With market forces shifting the tide toward open innovation, organizations that were once unlikely partners must now collaborate. Companies have to look outside their four walls and form strategic partnerships with university labs, government institutions, small inventors, start-ups and even competitors.

P&G and Clorox are a great example of long-time competitors that have established a successful strategic alliance. The two companies have teamed up to form the Glad® products joint venture, which holds exclusive intellectual property rights such as patents, trademarks and proprietary technologies for products like trash bags, food containers and wraps. Since the launch of the partnership, the two companies have introduced hugely successful products, such as Glad® Press 'n Seal™ wrap and ForceFlex™ trash bags.

More progressive companies are forming internal venture groups or acquiring start-ups to power their innovation process, while other organizations are putting in place departments to capture ideas submitted by consumers and employees. Georgia-Pacific, for example, has created an online system to streamline the idea submission process and, years ago, Maxwell House implemented an awards program to recognize employees that put forward viable revenue-generating or cost-saving suggestions.

This is a dramatic about-face in philosophy for most CPG companies. Ideas submitted from employees and individual consumers have traditionally ended up in the trashcan because companies have not had efficient systems in place to evaluate them or deal with the copyright or legal issues that can arise. In addition, many companies have fostered cultures where adopting ideas from the outside is frowned upon. As a result, an incalculable amount of time and money has been wasted for companies to reinvent those very same ideas themselves, often much more slowly and at higher cost.

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### *Keys to implementing an open innovation program*

- Require critical executive-level sponsorship to lead corporate vision and change management
  - Implement a program management process supervised by senior management to help identify and prioritize top projects as well as interface with the external innovation teams
  - Align, train and deploy “early adopter” project leaders
  - Create a rigorous process to review outside ideas and solutions
  - Establish collaborative financial performance metrics for overall accountability and ROI
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### *Recent innovations from the consumer packaged goods industry*

- Clorox® Ultimate Care™ Premium Bleach
  - Crest® SpinBrush™
  - Pringles® Prints®
  - Scrubbing Bubbles® Automatic Shower Cleaner
  - Single-serve coffee makers
  - Splenda®
  - Swiffer®
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### **Case Study: Pringles® Prints®**

Most experts point to Proctor & Gamble as the industry front-runner in implementing a successful open innovation strategy. According to the Harvard Business Review article, “Connect and Develop: Inside Proctor & Gamble’s New Model for Innovation,” P&G’s open innovation initiative is responsible for generating more than 35% of the company’s new products and billions of dollars in revenue.<sup>8</sup>

This new approach—combined with the company’s laser-like focus on the end consumer—has resulted in both bringing unique products to market and infusing new life into long-time consumer favorites. Take for example the Pringles® potato crisp. In 2004, the company launched a new line of crisps called Pringles® Prints®, which are imprinted with pop culture images and words such as pieces of trivia and jokes.



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Instead of shouldering all of the cost and risk itself, the company looked externally for a ready-made solution. Sure enough, through its global network, the company found a small bakery in Bologna, Italy, run by a university professor who had invented an ink-jet technology capable of printing edible images on cookies and cakes. P&G was able to adapt this technology to its manufacturing process in much less time and at significantly less cost than it would have required had the company developed this ability internally.

Most importantly, the product has been a huge success—so much in fact that P&G credits this one innovation as helping “the North American Pringles business achieve double-digit growth over the past two years.”

### The critical ingredient

As much as embracing a consumer-driven, open innovation approach is necessary for consumer products companies to survive the competition, their ability to implement and effectively manage a strategic alliance program is equally important. In fact, this will be the critical ingredient that differentiates those companies that succeed with an open innovation model from those that do not.

To make strategic alliance relationships work, CPG companies must put in place the right people with the right skills supported by the right processes. These individuals must be supported all the way from the chief executive down and be empowered to drive innovation across the organization. Alliance managers have to be business-savvy and understand how each alliance fits into the company’s overall growth strategy.

The entire organization must subscribe to a disciplined alliance management approach. To begin, companies must develop a systematic method for seeking out partners and technologies that fit with their business model—they must know for what it is they are looking. Once found, each idea will need a team supporting it, and each partner’s role and the key steps in the R&D process should be clearly defined and agreed to. All sides also must agree on who owns the intellectual property. And, very importantly, companies must be prepared to address critical questions, such as: How much will we invest in this relationship? How will we measure our results? And at what point do we call it quits?

### Staying power

The industry’s most innovative leaders are designing, implementing and selling products that the end consumer wants and needs. Consumer products companies are learning to live in a consumer-driven environment, where all activities, products and services are aligned to respond to consumer needs in the quickest, most innovative way possible.

Manufacturers are starting to realize that one size does not fit all and, in order to obtain and sustain a competitive advantage, they will need to redesign the supply chain by starting with demands of the individual consumer who desires niche products. In the near future, inventory will be replaced with shelf-level behavior information of each and every buyer through the use of cutting-edge technologies. Companies will then be able to apply this detailed information to their R&D pipeline and create products that consumers will pull through the value chain.

In the race to differentiate products and services, companies will increasingly collaborate with external thought leaders, as well as customers, suppliers and consumers. They will combine external intellectual capital with their own knowledge to transform their product development and life-cycle management processes. Doorways to a new world of potential solution providers will be opened, and companies will gain awareness of emerging technologies, validate internal approaches and create a valuable network of strategic partners.

Cheryl Perkins, former chief innovation officer at Kimberly-Clark, has said that “open innovation, and the resulting management of third party alliances will be as critical to the consumer products company this decade as project management was for the last 20 years.” We wholeheartedly agree. Consumer-driven, open innovation will enable companies to not only grow their portfolio and profit, but also deal with the intense market demands due to smarter consumers, increasing retailer pressures and the need for speed to market. Indeed, the competitive landscape has been forever changed—no longer will spending the most R&D dollars necessarily win market share. Now it is the company that is innovative in all parts of its business, executes its strategic alliance program with precision and delivers quality products that consumers want that will have real staying power.

For more information, visit: [www.clarkstonconsulting.com](http://www.clarkstonconsulting.com)

### **About Clarkston Consulting**

*Clarkston Consulting is a different kind of management and technology consulting firm. We deliver a unique experience for market leaders within the Consumer Products and Life Sciences industries. Considering professionalism, expertise, and value as prerequisites, we take service a step further through our unyielding commitment to the success of people as individuals, both our clients and our employees. By combining integrity, adaptability, and a whatever-it-takes attitude, we have achieved an extremely high rate of referral and repeat business and a client satisfaction rate of 97% over the past five years as measured by the Conference Board.*

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