ALEXANDER PROUDFOOT
people • productivity • profitability

Global Advisory Board
Point of View

Innovation and growth are competencies...

At Alexander Proudfoot, we believe that companies must reprioritize innovation, reengineer growth and rebalance the tactical focus on day-to-day operations to be competitive. Companies that fail to build and sustain necessary innovation and growth competencies will eventually fall behind.

Today's Environment

The modern corporation is compelled by the rules of reporting short-term earnings. The cadence is relentless. As soon as one quarter is complete, there is a lull and the process starts again; culminating with board, leadership, all-hands meetings and the analyst call. External and internal critics, as well as opportunists, assess corporate leadership results from top to bottom with little or no remorse. They focus on lagging indicators, such as revenue, profitability (operating income or earnings before interest and taxes) and free cash flow. The leadership team that delivers consistent, predictable results most often is rewarded with a strong share price and an overall higher valuation. The game is relatively simple, but for those who cannot deliver a consistent and predictable return on investment, financial punishment is inevitable.

It is no surprise that companies and their leadership are focused on day-to-day execution. The tighter the results are to forecast, the more leadership tends to focus on execution. It can be a vicious cycle. The company must follow the rules and pace of the game, even if it means that sacrifices are made. These sacrifices often come in the form of sales, operations and near-term results. Tactical execution often consumes a business and the entire team. Eventually, less time and strategic priority is allocated to new business development, strategic marketing, research and development, and innovation. The net result is the sub-optimization of growth potential that undermines the two most important corporate activities – *innovation and growth*.

Jean Peyrelevade (France), former CEO Credit Lyonnais: "We know since Schumpeter that innovation is the key for competitiveness. Knowing that, most people focus on research and development and new products. This is correct but one should never forget other areas for innovation. In the production process, innovation can bring a huge advantage in terms of productivity and lower cost. Commercial innovation may also be decisive, especially with the surge of online techniques. How can we protect and develop our relationship with our existing clients and prospects? Where are the threats and where are the opportunities? In a word, the modern CEO should look for innovation everywhere across his organization."

David Turnbull (Hong Kong), former CEO Swire Pacific and Cathay Pacific Airways: "Historically, US and European companies have been tremendous innovators, starting with the Industrial Revolution until quite recently. Despite healthy balance sheets, management are now tormented by quarterly returns and shareholder demands. Clearly in the long run, a lack of innovation means being left behind. I feel this is an area where the independent directors of a board could be helpful in encouraging management to look ahead and be braver in R and D spend and willingness to implement new methods. The board can be helpful in approving investment and supporting management when, from time to time, some things fail."

Challenges

We reviewed five-year financial summaries of the leading companies within the Fortune 1000; examining each company's revenue, profit margin, research and development spending, operating income, capital expenditure and free cash flow metrics. On average, these companies delivered roughly 4.4% compound annual growth between 2009 and 2013, and 5% growth in EBITDA through the same with 12% EBITDA margins against revenues. For reference, the Fortune 1000 five-year compound annual growth average is nearly 8%. Most companies have some investments in research and development, between 1 - 6% of revenue (with the average slightly above 1%), healthy capital budgets and a strong focus on new product development (stated in their annual reports, as well as various investor summaries).

This actually looks pretty solid. It is conservative, but solid, right?

Not really. International players are aggressively availing lower cost solutions and displacing traditional product lines in mature companies. This competitive threat is slowly eroding profit margins and accelerating the maturation of product lifecycles. For example, more than 50% of companies had less than 2% compound annual growth rates between 2009 and 2013, despite having reasonable net income returns. Companies then enter the vicious, tactical execution cycle to maintain net income. The first reaction often involves covering up the problem by delivering cost take-out initiatives that invariably reduce SG&A in key revenue growth functions, such as strategy, new business development, marketing and even product development. It also has the potential to reduce or limit capital spend to enable new products and new markets.

Now, more than ever, companies need a strong innovation and growth engine.

The strategic attack on conservative, main street companies coupled with a core competency focus on operations, financials and quarterly results is a pending disaster for this segment of the industry. To effectively counter this threat, companies must reprioritize revenue growth and reengineer the growth enterprise by making investments in key functions and enable the growth culture, discipline and execution of the business.

This is not necessarily news to senior executives. The vast majority of them place growth and innovation as the number one corporate imperative. Many see this competitive threat on the horizon, but nearly all struggle with mechanics and execution.

Bob Lutz (United States), former Vice Chairman of General Motors: "The tyranny of quarterly results is one of the main factors in the relative decline of the American industrial sector. It is interesting to note, in a variety of industries, that family owned and controlled businesses, with few or no shareholders, manifestly ignore quarterly results and simply run their operations with a strong view to long-term competitiveness and game-changing innovation in both product line and manufacturing technology. Their success against similar publicly owned companies is testimony to the effectiveness of the balance they have achieved.

But most C-Suite executives operate in a publicly owned environment, (and those of us who have served in family-owned companies will testify that entails its own set of negatives), so the leader has to provide the right long-term/short-term balance, often in the presence of extreme pressures from both sides.

The list of 13 things that a successful company must do is excellent, although some of the commands (e.g. number 10 'Develop an Innovation Culture') fall into the 'no kidding' category, much like 'Be Successful' or 'Ensure Product Excellence.' Easier said than done!

A successful leader MUST, if the company is to survive and grow in the long term, place innovation and growth at the top of the list for which he or she is personally responsible for. The CEO must convince the team (including finance and investor relations) of the primacy of these objectives. He or she must also convince the board, and must be able to communicate the blended long-term/short-term strategy to analysts and the market in a convincing manner.

But overcoming the powerful, instinctual corporate urge to achieve a 'blow-out' quarter, even if it means deferring costs to and pulling revenue from the next quarter, is a difficult task and one for which many financially trained CEOs are ill equipped."

Companies ask us how to do the following:

- Eliminate distractions
- Constructively enable creativity in the organization
- Find or hire the right people
- Efficiently execute new ideas
- Prioritize potential activities and manage associated risk
- Create a predictable outcome
- Shorten the development life cycle and time to market
- Impact net income in a short period of time
- Sustain success
- Repeat successes

Stimulating Growth

We believe that it is possible for companies to design, develop and deploy a successful growth and innovation engine. Companies should target >20% sustainable, annual growth targets to stay in front of competition and related business threats. The talent inherent to this industry sector is highly educated, creative and under-utilized.

It is possible for companies to develop a growth engine with the same execution discipline of sales, operations and the supply chain. Some of the core principles of innovation and growth are:

1. It all starts with resources. Find the right revenue growth leader. Dedicate him or her to the agenda. Give them authority.
2. Dedicate staff to key focus areas.
3. Develop a strong SWOT analysis.
4. Find the adjacencies in markets and products.
5. Develop a growth hypothesis.
6. Allow for exploration and trial and error.
7. Encourage customer investigation and feedback.
8. Govern relentlessly, the stage gate.
9. Celebrate success.

Warren Holmes (Canada), former CEO of Hudbay Minerals: "Managing corporate innovation and growth is critical to a company's success, as is optimizing the entire activity chain from sales to customer delivery and the indirect support activities. Success requires clear definition of the innovation and growth objectives, the process and management system required to achieve the goal, and then disciplined plan execution. While success requires this same discipline and creativity in all aspects of the business, each part of the business requires its own focused and specialized team to be successful."

Cledorvino Belini (Brazil), President of Fiat Chrysler Group Latin America: "Contemporary companies must have innovation embedded in their DNA. In order to focus on innovation, companies need to abstract from common short-term objectives such as sales and profitability goals. They should pursue beyond product portfolio renovations by seeking innovative business models and solutions. This new approach demands a transversal view of the company, reducing internal barriers and consequently permitting various areas that have different types of professionals and profiles to work together with a common goal. Corporate culture should constantly stimulate the creativity and idea generation of these teams. Therefore, it is essential to review processes and work for discontinuity aiming at renewing the company strategy, structure, techniques and demonstrating solid results."

Roger Kenny (United States), Founding Partner of Kenny Boardroom Consulting: "In order for a company to have sustainable growth, it must stress innovation which is the ability to convert ideas into new offerings for their customers. This requires keeping a sharp focus on the customer by designing and supporting a company-wide social system that will harness the skills and insights of the employees. It recognizes that only a collective effort will succeed. As A. J. Lafley, CEO of Procter and Gamble comments, 'Effort can make innovation work. It's a real game changer, because the customer is the boss.' "

10. Develop an innovation culture.

11. Create heroes and heroines.

12. Make the review process as rigorous and important as quarterly reporting.

13. Expect results, differentiate compensation and reward results.

Innovation and growth are difficult…

Less than 7% of the Fortune 1000 delivers better than a 20% CAGR over the previous five years (2008-2013).[1] It is one thing to show double-digit growth quarter over quarter or even year over year, but a five-year compound annual growth rate of more than 20% demonstrates that a company and its leadership own the top line.

Innovation and growth are competencies. Through disciplined execution, clear processes, effective management operating systems, as well as sustainability efforts through training, skills and cultural reinforcement, allow companies to build a world-class innovation and growth engine that delivers consistent, predictable and repeatable outcomes. The net effect makes the quarterly results process more about what is to come, higher earnings, greater total investor satisfaction, higher shareholder value and successful careers.

Gordon Peeling (Canada), former CEO of the Mining Association of Canada: "Innovation is a multi-headed Hydra that requires thoughtful, focused leadership that can identify new, innovative management practices, step changes in process technologies, and changes that provide marginal improvements to both. The challenge is to identify these innovative changes, adopt and adapt them to the specifics of the corporate need and then execute them with consistent and efficient outcomes. The benefits of being a leading-edge adopter of new innovative technologies often get dissipated through a lack of focused execution and maintenance inefficiencies. Being at the front edge of innovation is not enough; disciplined execution is the key to the capture of the benefits that innovation brings."

Manfred Maus (Germany), Founder and CEO of OBI Group: "The world is changing rapidly and dramatically. Realizing the needs and consequences in time is the key. In retail, for example, if you are slow to respond to current trends, you are at serious risk of going out of business, as the traditional retail model is becoming obsolete."

Peter Cawdron (United Kingdom), former Chairman and non-executive director of several UK companies:

"I was the strategy director of a large company that needed to restore margins and return the business to an acceptable level of growth after a pretty dull period under the previous CEO. We developed a vision and then introduced six values to be embraced by the business and become part of its culture. This was done as a means of moving the executives away from constantly taking the short-term route on decision making and profits. One of the six values was innovation, another was trust and another was leadership. Part of the annual bonus awards were based on the success of the executives in introducing each of these values and thereby reshaping the culture of the business.

The market was pleased by the company's change in attitude and accepted a level of investment spend to support the strategic program (i.e. they raised our market rating). However, what we found difficult to convey to the market was the message that the steps being taken would enable the company to achieve a growth rate of 20%. It was the market's belief that 20% sustainable growth over an extended period would eventually harm the company, and there was evidence of this with other businesses. They told us that, since a share price is calculated by reference to expected future results, there would be no difference in our share price if our future objective was 10% - 15% sustainable growth. The reason for this was the element of disbelief in a 20% growth target over an extended period of time."

For other Global Advisory Board Insights – click here.

[1] Source: Alexander Proudfoot internal research of corporate earnings data

Copyright © 2014 Alexander Proudfoot. All rights reserved. GA 30656 US