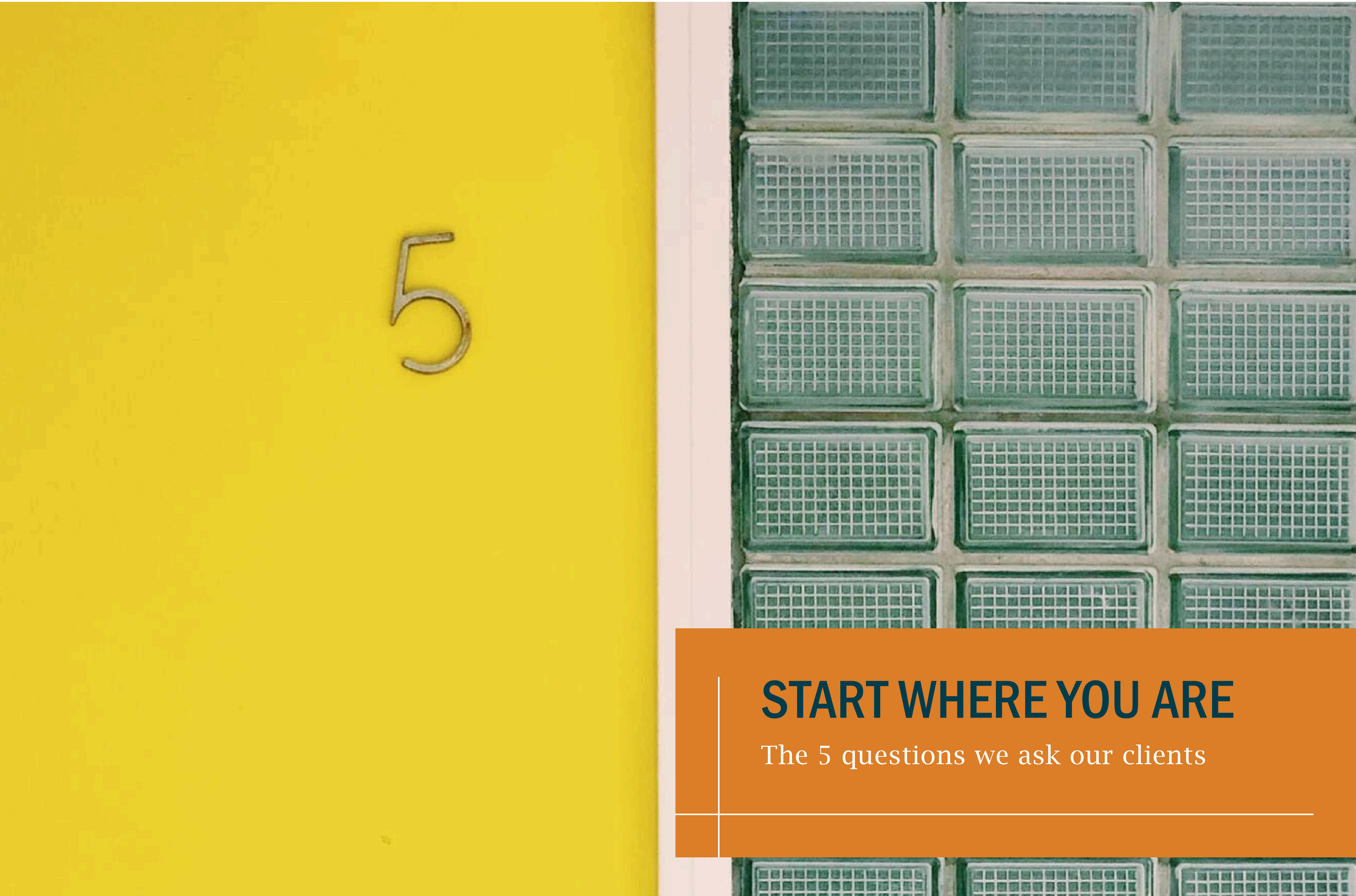
INNOVATING BETTER

AN INTRODUCTION TO FRONTIER'S INNOVATION FRAMEWORK AND RECENT CLIENT STORIES

frontier economics



START WHERE YOU ARE

The 5 questions we ask our clients

'WHY ARE WE SO BAD AT INNOVATION?' IT'S SOMETHING THAT CLIENTS REGULARLY ASK US, FROM BANKS TO RESTAURANT CHAINS TO RETAILERS.

And it's no wonder – innovation is as hard as it is important. You can't just ask customers what they will want in the future, and you can't be good at it without failing once or twice along the way.

But framing the question in a negative way can do more harm than good, leading to a focus on superficial fixes – when the answers often lie in the economic model at the heart of the business.

That's why we've developed five questions that we ask all clients who want to innovate. These questions allow us to get to the underlying economics behind a business's innovation needs, and demonstrate how they affect innovation decisions at all levels.

This approach helps our clients innovate faster, better and in areas that create more value. And it's flexible too, able to support individual product innovations or more strategic overhauls.

Let's take a look at the five questions.

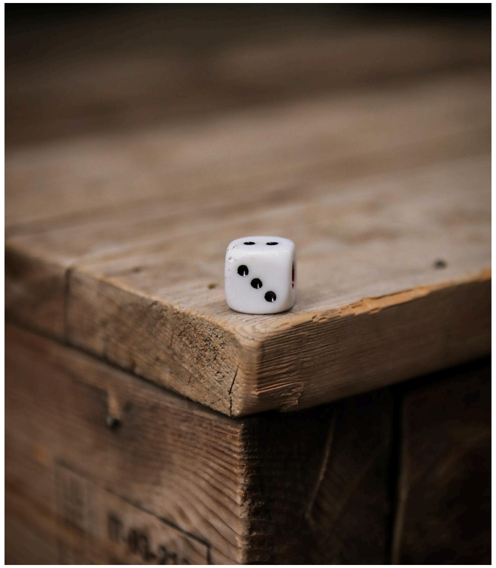
1. WHAT TYPE OF INNOVATION DO YOU WANT?

Before you start any innovation journey, you need a sense of where you want to go. There are some key steps to take in setting your innovation goal:

- **Find a balance between big bets and incremental changes.** Innovation is often associated with a blockbuster new product or service that radically changes consumer behaviour. And sometimes you do need those disruptive bets. But innovation isn't just about re-inventing the wheel – it's also about conceiving new ways of using it. As big companies know, there's a lot of value in incremental change: making mobile banking a few clicks faster, or optimising routes for delivery drivers. Finding a balance between these smaller tweaks and the bigger bets is crucial.

- **Decide if innovation should reduce costs or drive revenues – or both.** Pursuing innovation without a specific revenue or cost objective makes it very difficult to judge trade-offs. Is it more valuable to improve logistics efficiency by x%, or to open up a growth market that could be worth y% in five years' time? The answer depends on the market you're in, the technology you have and the competitive advantage you're protecting.

- **Work out the level of risk you're willing to take.** If you haven't set a risk appetite upfront, it's tricky to assess the value of different ideas. Let's say your competitors are collecting increasing amounts of customer data, and betting on future technology. But use cases are not yet clear. How much are you willing to invest in collecting customer data too? Many innovative businesses have the right mix of risk profiles and time horizons to create value over time. That's a great first step – and one that should be revisited regularly to ensure changes in the market are considered.



2. HOW DOES INNOVATION FIT WITH ECONOMICS AND CULTURE?

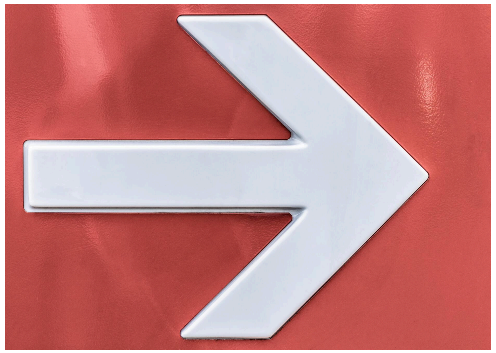
Businesses often start with an ambition to change their 'innovation culture'. But while culture is an important driver of behaviour, it's rarely the root cause of innovation blockages.

Instead, we have found that a business's economic model tends to determine what type of innovation it's good at (and what type it isn't).

That's not to say culture doesn't matter. But culture is driven by incentives – like how people are paid and how bonuses are set; and goes beyond that into social norms, defaults and psychological reward. And incentives tend to align with economic models.

Assessing your model means understanding how you make money today, but also what your market might do tomorrow and how your competitive advantage will see you through that. The model determines the processes, defaults and behaviours that teams follow, including in innovation. This means there's some important knowledge to arm yourself with:

- **Know what type of innovation your economic model is good at.** Different economic models suit different types of innovation. Large, successful companies find disruptive innovation difficult, fearing damage to their brand if a big bet falls flat. But companies like these are great at high-frequency, incremental innovation. Their processes are set up to do it efficiently, reducing risk of unwanted customer outcomes to almost zero.

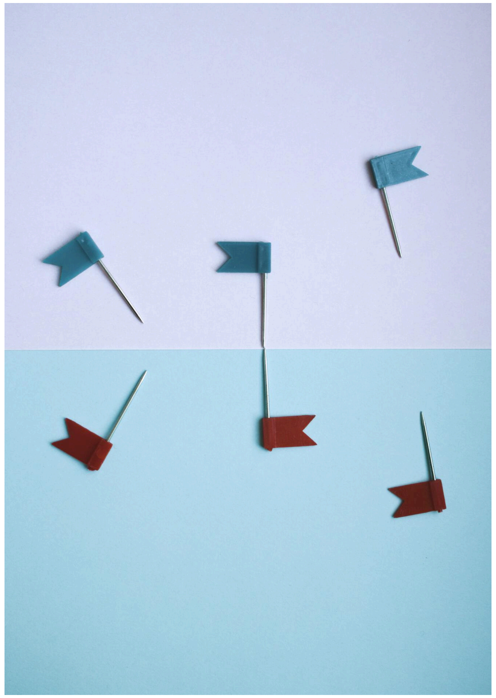


- **Identify natural weaknesses – and turn them into strengths.** Sometimes, the innovation you need won't be reflected by your natural strengths. But recognising these obstacles doesn't mean you can't overcome them. Understanding your economic model can help to create positive situations from potential blockages. A risk-averse business, for example, may have instilled the need for perfection among its staff, and would fear this as a block on innovation. But recognising that supposed weakness could help the business convert it into a strength – by setting targets for running the 'perfect' innovation trials.

3. WHAT TYPE OF PROCESS DO YOU NEED?

Companies need the right systems for innovation – ways to create, explore and filter the ideas they want to pursue. One size does not fit all, and the right option depends on the type of innovation you want to pursue. There are two important things to get right:

- **Define where you should use default processes.** Lots of businesses innovate through a small number of default processes. They're usually dictated by economics – the time period within which innovation needs to pay back, the risk profile you're willing to accept, the standard assumptions that need to be made. A retailer, for example, might expect their product innovations to reach scale within 12 months, create a growth rate within an expected range and hit an average margin. Default processes like this can be a very efficient approach, guiding employee behaviour and speeding up decision making and approvals.



- **Recognise risk and value in your assessments**. In some cases, default testing processes won't be suitable. Standard business plans may be suitable for evaluating investments where future revenues can be projected with confidence – but what if you're placing a bet on an innovative product with an uncertain outcome? In that case, you'd need to estimate opportunity costs and option value, instead of forecasting revenue – which may require a different team and a new approach. In other cases, the challenge may be about exploring many alternative ideas at once (rather than gold-plating one) and more dynamic business sprints might work best.

We've found that businesses who use a wider toolbox of processes make more robust innovation decisions, and maximise their chances of creating a well-balanced portfolio.

4. SHOULD YOU DO IT YOURSELF OR WITH A PARTNER?

Partnerships can be helpful in bringing specific innovations to market and in navigating innovation strategy. But partnerships (or acquisitions) shouldn't be treated as a shortcut to innovation – because if you can buy something, so can your competitors. Two key steps have the highest impact here:

- **Pick a partner for the right reasons.** Economics has a lot to say about whether a partnership is the right choice. This can be the case if:
  - it is faster (and / or cheaper) to buy innovation than build it;
  - the partner has technology or skills that you do not have (and cannot easily acquire); and
  - they operate with a culture / incentives / approaches that you need in order to create innovation.

- **Define a fair share for both partners**. Partnering works best when it's win-win. Economics can dictate how to define the details of the relationship in order to create and share value. The best version of this should incentivise all parties to make the pie as big as it can be, and share it fairly in the long run.

5. HOW WILL YOU MAKE IT WORK IN PRACTICE?

After months or years of development, many innovations fail here – at the point of implementation.

Of course, no change is without risk, and many innovations are simply not strong enough to take off. But often propositions that do have potential still fail to bear fruit, as a result of misguided implementation.

Again, this often boils down to economics. Incentives, KPIs and targets must be judged correctly if teams and individuals are to implement innovation plans properly.

If you know a new launch will be slow to grow, for example, you should avoid linking managers' bonuses to a profit target. The same could be said if the new product will cannibalise an existing product that those same managers are in charge of.

Small tweaks to incentives at this stage can make a big difference – so bear this in mind before returning to BAU in the face of a perceived implementation failure.

frontier economics

CASE STUDY 1: WHAT TYPE OF INNOVATION DO YOU WANT?

Innovating through analytics in the travel sector

Our client was under competitive pressure from online holiday-booking channels and digital-only providers. In response, it wanted to link together its vast, dispersed datasets and create an analytics hub, so it could better target and serve its customers.

If an airline knows a traveller's favourite destinations, and the likes of Booking.com know their taste in hotels, then our client – a package holiday provider – had a much richer trove of information, capable of producing a comprehensive picture of its customers' preferences – right down to the excursions they like.

STITCHING THE DATA TOGETHER

The task was to stitch together the data, some of it housed in legacy IT systems and gathered from a sprawling network of physical branches, and analyse it to spot patterns, predict trends and come up with tempting holiday offers.

This was a massive undertaking. Hiring an army of specialists in artificial intelligence and machine learning would have appealed to advocates of big-bang innovation. But AI and ML are only as good as the data you feed them, which in this case was not fit for purpose. So the all-important strategic decision was that the task should be accomplished in smaller steps.

Our client wanted to measure the expected impact of different enhancements and prioritise the bigger prizes. It quickly became apparent to us that some of the steps, even if they entailed only incremental changes, were hugely valuable.

A small improvement in the company's ability to convert CRM analysis into bookings through better personalisation and targeting would generate close to 20,000 additional bookings a year, translating into €75 million of extra revenue.

CAPITALISING ON EXISTING INFORMATION

The company held much more data than its rivals, yet had failed to capitalise on this advantage. Ultimately, the analytics innovation was to address this shortcoming by better exploiting existing information, rather than investing heavily in new systems or data from Google and Facebook.

The business incurred fixed costs in upgrading its in-house data capabilities. But now, once it identifies a return visitor to its website or app, the marginal cost of marketing to that potential customer is zero.

Less expense, more value: successful innovation in action.

ENGAGE IN OUR POLL ON THE NEXT PAGE >

WHEN DO YOU MOSTLY THINK ABOUT THE VALUE FOR THE BUSINESS IN THE INNOVATION PROCESS?

- When selecting ideas
- When deciding direction of the strategy
- Both
- Never

POST ANSWER

frontier economics

CASE STUDY 2: HOW WILL INNOVATION FIT WITH ECONOMICS AND CULTURE?

Disruptive innovation for a fast food giant

We worked with a large fast food company whose leadership was frustrated at slow and patchy innovation. They were used to their top-down initiatives, like marketing campaigns, being rolled out successfully. So they couldn't understand why innovative new ideas ended up going nowhere, even with their endorsement.

'Why,' they wanted to know, 'can't we be as innovative as a start-up?'

DIAGNOSE, TARGET, CREATE, TRIAL, ROLL-OUT

We discovered that at every stage of the innovation process (Diagnose, Target, Create, Trial, Roll-out), the company's approach was determined by their economic drivers. As a large business, this meant their approach to innovation looked very different to that of a start-up.

In particular, there was an ingrained aversion to risk – a worry that big changes would make things worse, not better. The business had a big customer base and reputation to protect.

As a result, incentives were aligned to make sure solutions could be integrated with maximum efficiency. This led to a focus on incremental changes – a stark contrast with the big risks a start-up is prepared to take.

Where a smaller fast food company might jump into creating a new plant-based product, for example, an established one would be more comfortable making tweaks to an existing recipe – like developing a spicy version of a classic dish.

HARNESSING THEIR STRENGTHS

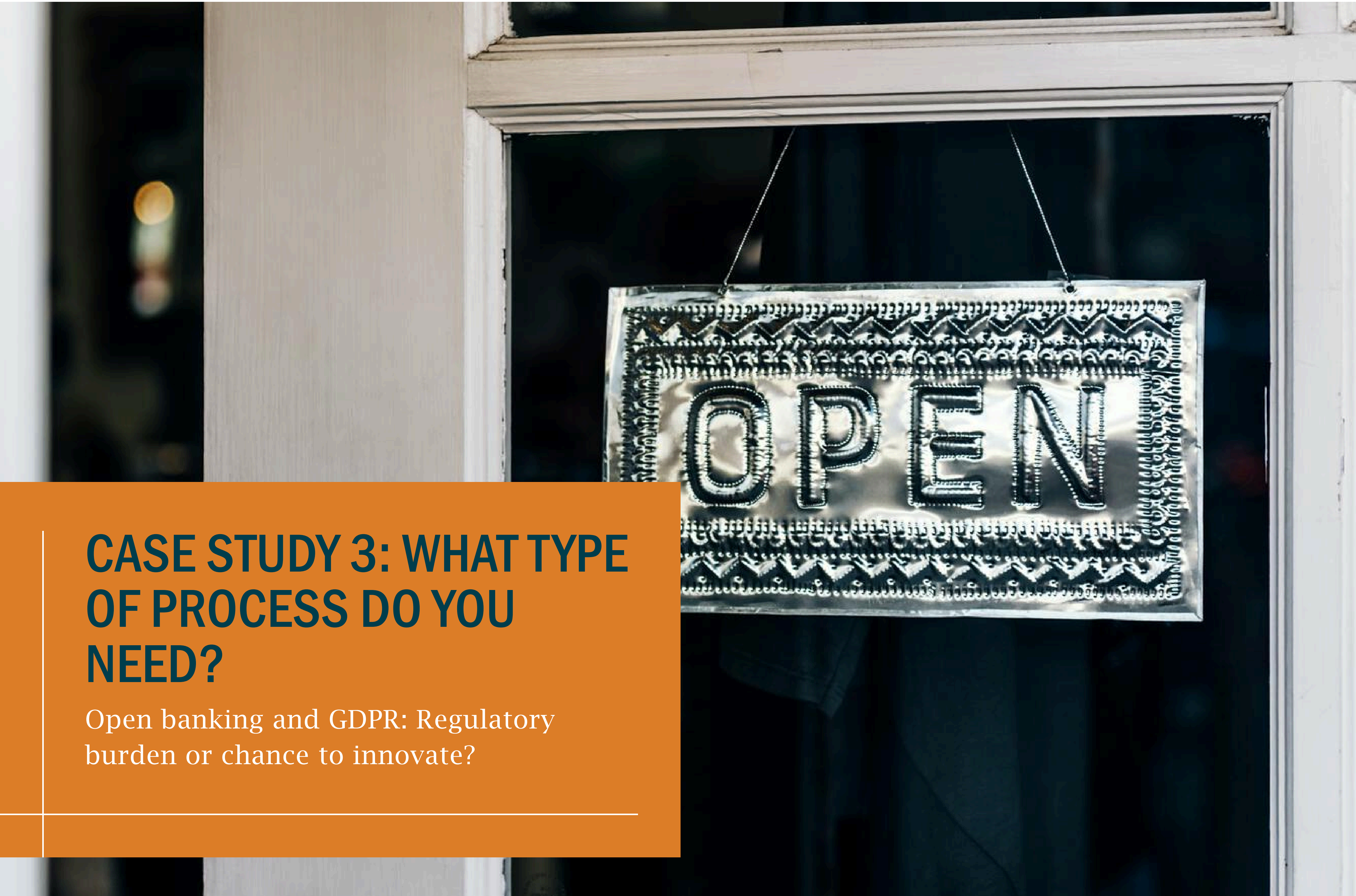
In the case of our client, the right solution was not about 'being more like a start-up' – it was about building a form of disruptive innovation that made the most of their strengths.

That included setting perfection targets – the type of thing the company was great at – for disruptive innovation mechanisms: a target number of big ideas developed each year, more testing of alternatives and building an evidence base of what worked and why.

HOW WELL DO YOU UNDERSTAND THE STRENGTHS AND WEAKNESSES OF YOUR INNOVATION PROCESS?

- Very well
- Just about well enough
- Not very well

POST ANSWER



CASE STUDY 3: WHAT TYPE OF PROCESS DO YOU NEED?

Open banking and GDPR: Regulatory burden or chance to innovate?

When big regulatory changes were ushered in with Open Banking and GDPR, our client wanted to explore how it could make the most of the opportunities arising.

The bank's leadership was enthusiastic about turning what initially seemed to be a regulatory burden and a source of risk into a chance to develop innovative aggregation services and payment products.

DIVING INTO COMMERCIAL PROPOSITIONS

Working alongside the innovation and product teams, we carried out deep dives into specific commercial propositions via a series of business model sprints.

After creating a priority list of strategic opportunities, the teams drew on inputs from other parts of the bank to develop three main outputs for each sprint:

- High-level business model and outline of the economics behind the proposal.
- Prototype of the proposed innovation with initial customer feedback.
- Roadmap to building it and the big implementation considerations.

While business model sprints are not always the best process to explore innovation, in this case they proved an efficient way to test the opportunities that had been identified.

In particular, they set an expectation of urgency on contributing colleagues outside the sprint team, and on senior managers too.

IMPLEMENT, ABANDON OR SAVE

As a result, the teams were quickly able to develop a portfolio of opportunities, to the stage where decisions could be made on whether to implement, abandon or save for later.

And because there was no requirement to gold-plate each idea before it reached the decision point, the bank was able to pursue a broader range of potential opportunities.

WHAT PROCESS DO YOU USE TO ASSESS AND FILTER INNOVATION IDEAS?

- Usually a fully worked up business case
- Proof of concept/business sprint
- Depends on the idea
- Other

POST ANSWER

CASE STUDY 4: SHOULD YOU DO IT YOURSELF OR WITH A PARTNER?

Updating your drinks portfolio: build, buy or partner?

Our client was a market leader in gin, but it had a gap in its portfolio: it didn't have a brand to meet the growing demand for exotically flavoured craft gins.

It needed to innovate, and that presented a strategic choice: should it build, buy or partner?

Having explored its options, the company decided to purchase a small, premium brand who made their gin from potatoes. Several factors shaped the firm's decision.

HITTING THE JACKPOT

Firstly, uncertainty. It is quite easy to launch a spirit brand. The barriers to entry are low. But it's difficult to create something that actually takes off. Just a handful of the UK's hundreds of high-end gins manage to sell significant volumes.

It takes around five years to build a brand to the level our client needed. The company would need to place bets on a number of new gin products in the hope of eventually hitting the jackpot. Conversely, buying a more established brand would both eliminate uncertainty and save time.

Secondly, a small brand like the one acquired has a significant competitive advantage: as a family business distilling a field-to-bottle liquor, it has a compelling backstory that a large multinational cannot match.

And the deal was mutually beneficial. Beyond a certain point, small brands cannot afford the significant outlays needed to achieve scale. Our client, by contrast, could call on its large sales team and relationships with distributors to quickly raise the profile of its newly acquired brand.

PARTNERSHIP VS ACQUISITION

For all of these reasons, our client operates a division whose role is to scout the market for similar opportunities. Once the right partner is identified, the question arises of how best to execute the deal.

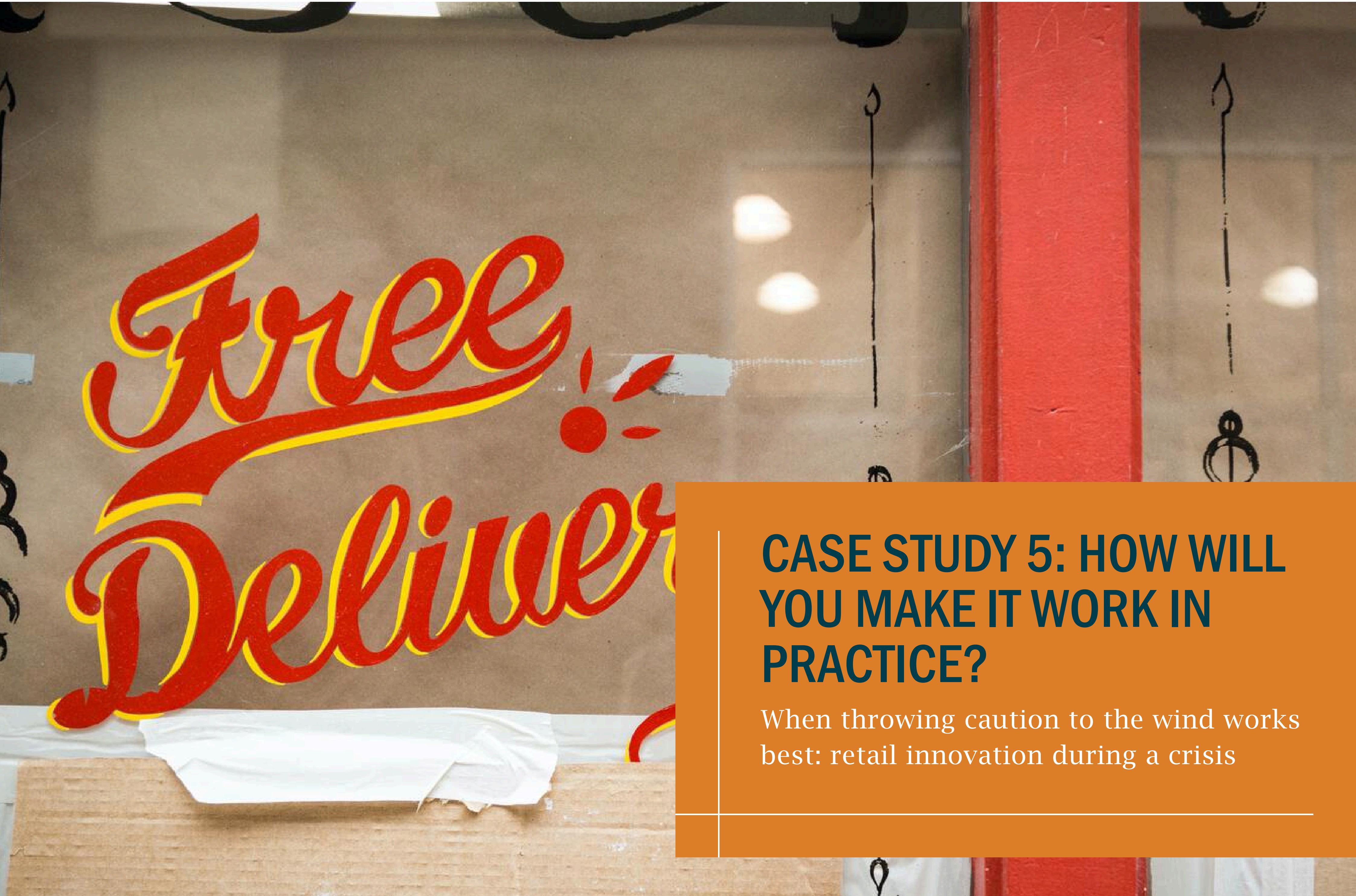
In the case of the gin company, the best way forward was a full acquisition. In other cases the value of the partnership may be split, with the ownership shares reflecting the bargaining power of each party and how risks are allocated in the contract.

ENGAGE IN OUR POLL ON THE NEXT PAGE>

WHAT DO YOU FIND MOST DIFFICULT IN WORKING WITH PARTNERS?

- Testing if there are complementary skills/assets
- Finding a cultural fit
- Setting the right incentives for both parties
- Getting the most out of negotiations
- Adjusting as the partnership evolves

POST ANSWER



CASE STUDY 5: HOW WILL YOU MAKE IT WORK IN PRACTICE?

When throwing caution to the wind works best: retail innovation during a crisis

Some big companies resist rapid change not because they're incapable of it, but because the economics of their business dictate a more cautious approach.

But in a crisis, even market leaders can push through major innovations in short order.

RESPONDING TO THE COVID-19 PANDEMIC

We worked with one of the UK's biggest retailers, which saw a huge spike in the demand for its online delivery services when Covid-19 hit. It responded rapidly, implementing a series of innovations that doubled its delivery capacity and boosted online orders from 9% of total sales to over 16%.

In normal times, our client would have been nervous about innovation of this type, fearing it would come at the expense of quality. But the initial stages of the pandemic were no time for caution, and the business was willing to compromise on quality in order to quickly ramp up capacity. And customers accepted a drop in the quality of the delivery service given the circumstances, which diminished potential innovation risks. It widened delivery time windows, and stopped selling some frozen produce to free up space. And it significantly compressed new-driver training, to reduce the time it took to get drivers on the road.

MAKING RAPID CHANGE HAPPEN

Those were just some examples of the many quick changes the businesses implemented. An important part of the equation was setting the right incentives for staff to make it happen. All frontline employees received a 10% bonus. But non-monetary rewards were also crucial: workers were rightly made to feel that they were providing an essential service to help the country in a time of need.

ACCELERATING INNOVATION

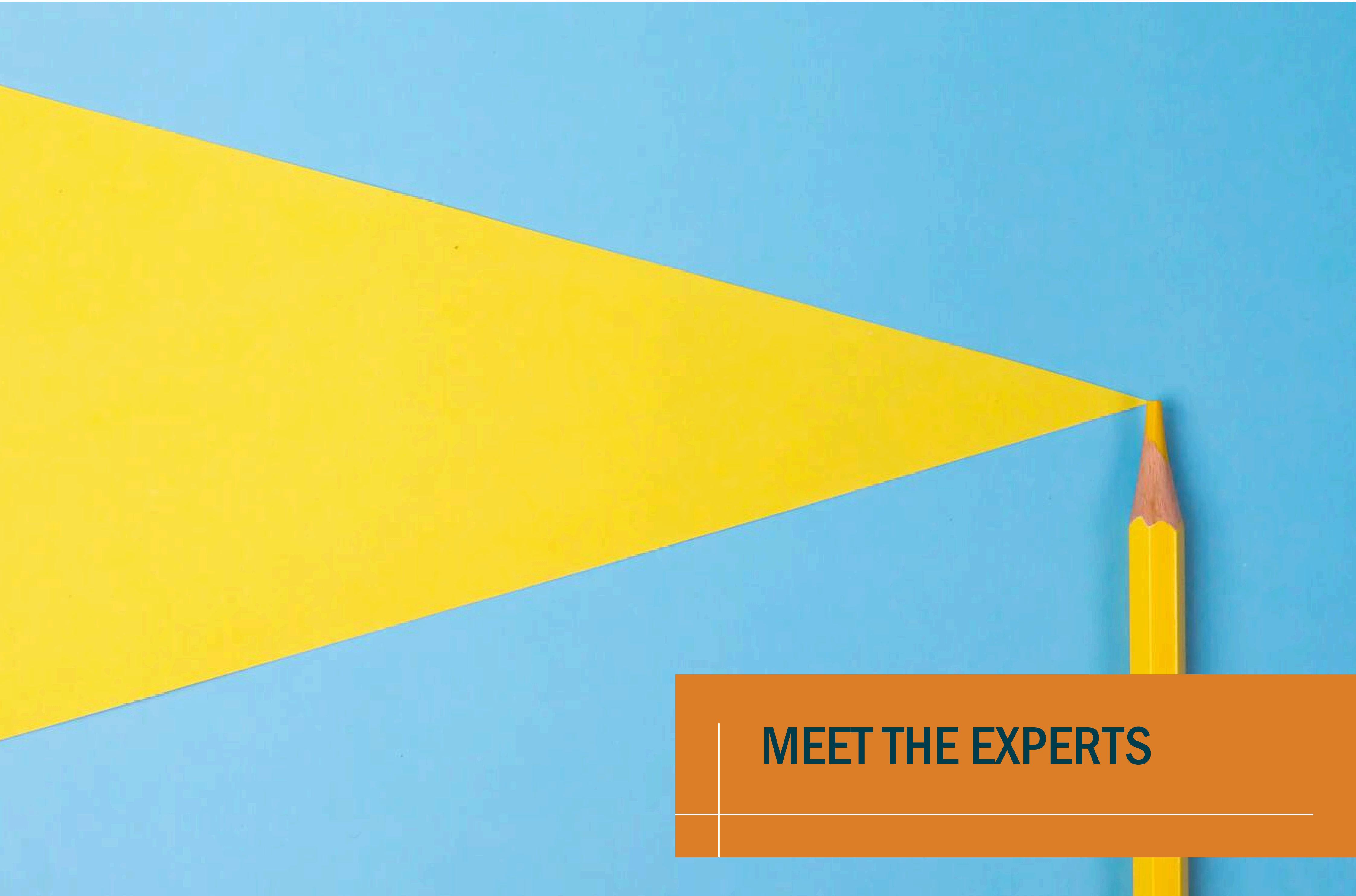
With people pulling together, swift decision making and strong leadership by the CEO, innovation was quickly accelerated, rather than being met with resistance.

In this case, playing a part in the fight against Covid was its own reward. But behavioural motivation only takes you so far. Ultimately, the retailer started doing things differently because a fundamental economic driver of its business had changed.

WHAT IS THE KEY BARRIER TO INNOVATION AT YOUR COMPANY?

- ○ Poor ideas
- ○ Too much risk aversion
- ○ Lack of impetus to roll out well
- ○ Other

POST ANSWER



MEET THE EXPERTS

Laura Petschnig, Manager

Laura works in Frontier's strategy practice, where she advises leading European companies in the consumer and financial industries.

Her work focuses on business strategy, innovation and regulatory strategy. As an expert in behavioural economics, Laura also advises clients on how to use behavioural insights to support strategic choices – both for commercial propositions and regulatory action.

Kalina Kasprzyk, Consultant

Kalina works in Frontier's strategy practice, advising clients in the financial services and consumer industries.

Her work covers strategy in the commercial, regulatory and innovation space. She uses her expertise in behavioural economics and data analysis to help clients design commercial propositions and regulatory responses. She also has experience in Frontier's other practice areas, including public policy, competition and the utility sectors.

THANK YOU FOR READING

INNOVATING BETTER

For more insights please visit our website:
https://www.frontier-economics.com/uk/en/home/