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Strategy & Corporate Finance Practice

# Investing in innovation: Three ways to do more with less

In times of disruption, many organizations freeze their innovation spending despite its critical importance for long-term growth. Here's how to avoid that trap.

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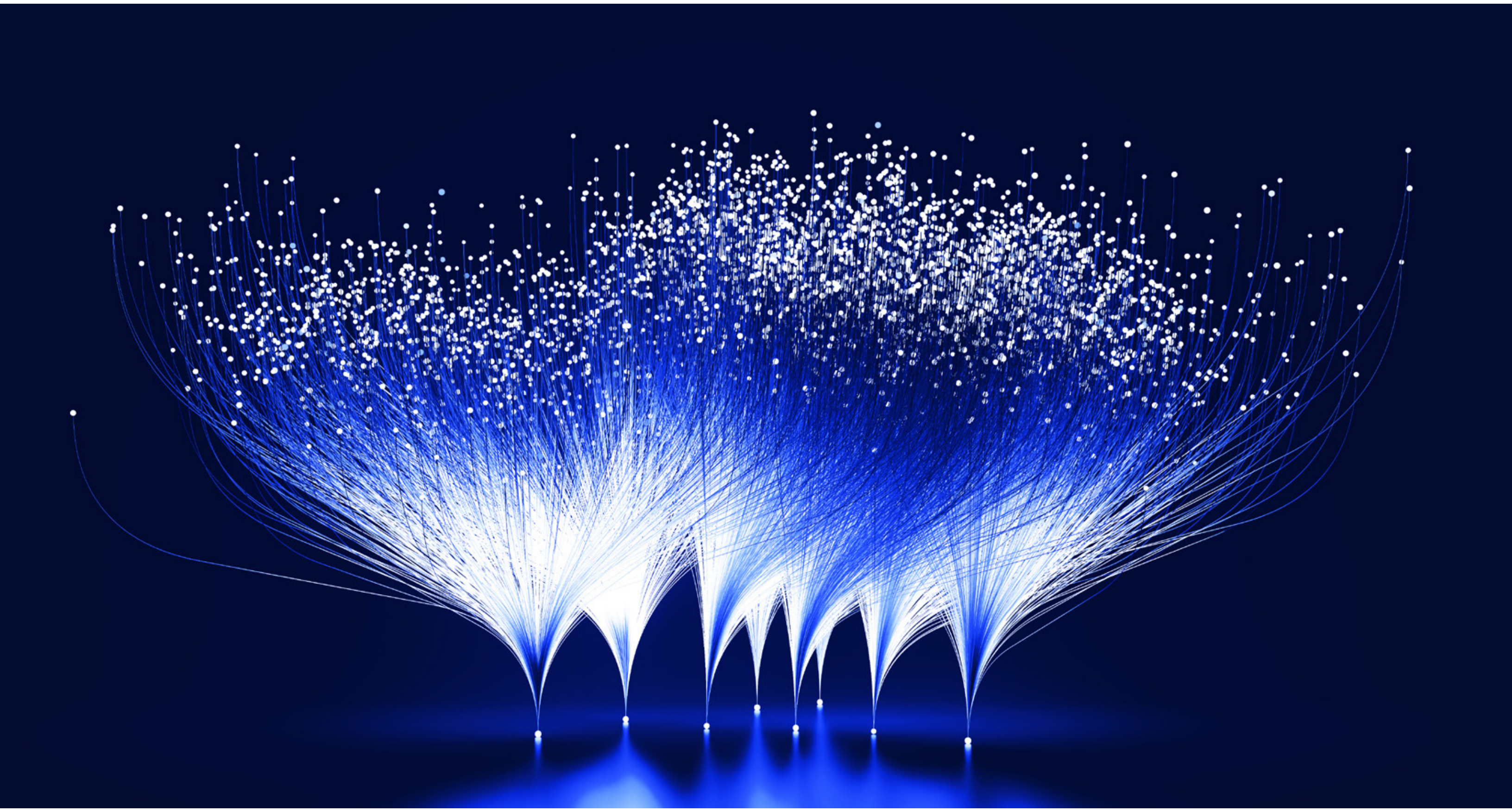

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**Executives view** innovation as their companies' primary source of competitive advantage for delivering growth. However, in many sectors, that belief doesn't align with companies' spending on innovation or the returns they get on those investments, the latest McKinsey Global Survey on innovation finds.[1]

During times of economic volatility, business leaders tend to focus on short-term profitability, often putting longer-term projects designed to spur growth on the back burner. Yet as our long-standing research shows, companies that take a through-cycle approach to investing in growth and innovation consistently outperform their peers.[2]

In fact, innovation can be a solution to weathering uncertainty. When it's unclear, as it is today, what the "next normal" will look like, organizations that seek ways to adapt their business models or processes and develop pathways for future growth can gain a competitive edge that often lasts through the recovery. In short, companies can't afford to wait until the world is calmer before investing in growth—especially since the duration of current volatility is impossible to predict. Instead, they should adapt their short-term decisions to the shifting conditions while striving to maintain a portfolio of investments that will fuel their long-term success.

## Rising expectations for getting more from less

In late 2024, we surveyed 1,017 executives across industries and regions to understand how they are approaching their innovation investments. The responses clearly indicate that companies are looking to generate higher returns on innovation spending without increasing budgets. Nearly 60 percent of respondents say they are either freezing or cutting their spending on innovation. Another 30 percent are holding funding for innovation flat (Exhibit 1).

Notably, top economic performers[3] are 61 percent more likely than others to increase their innovation investments. Additionally, some industries—including healthcare and pharmaceuticals, consumer goods, and technology—show higher willingness to invest in innovation.

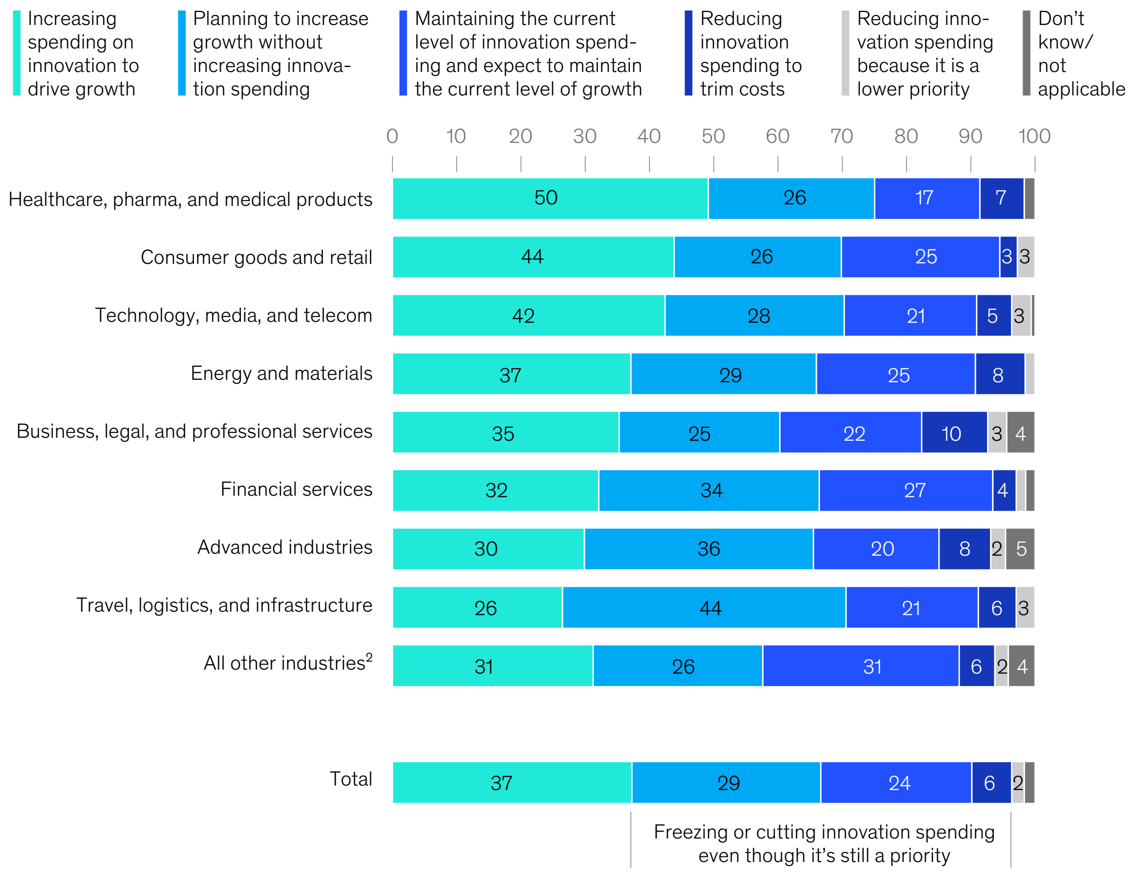
**Organizations that seek ways to develop pathways for future growth can gain a competitive advantage that lasts through periods of uncertainty.**

[1] The online survey was in the field from October 15 to 31, 2024, and garnered responses from 1,017 C-level executives and senior managers in 99 nations representing the full range of regions, industries, company sizes, and functional specialties.
[2] Rebecca Doherty and Anna Koivuniemi, "Rev up your growth engine: Lessons from through-cycle outperformers," McKinsey, May 27, 2020.
[3] Companies whose executives report increases of at least 15 percent revenue and EBIT over the previous three years.

Exhibit 1

## Most companies are freezing or cutting innovation investments despite considering innovation essential to growth.

**Changes in organizations' innovation investments over the coming 12 months,**[1] % of respondents




Note: Figures may not sum to 100%, because of rounding.
[1]In healthcare, pharma, and medical products, n = 115; in consumer goods and retail, n = 73; in technology, media, and telecom, n = 165; in energy and materials, n = 194; in business, legal, and professional services, n = 68; in financial services, n = 137; in advanced industries, n = 87; in travel, logistics, and infrastructure, n = 34; in all other industries, n = 144.
[2]Other industries include public sector, real estate, and social sector (including not for profits), among others.
Source: McKinsey Innovation Survey, 2024–25, n = 1,017

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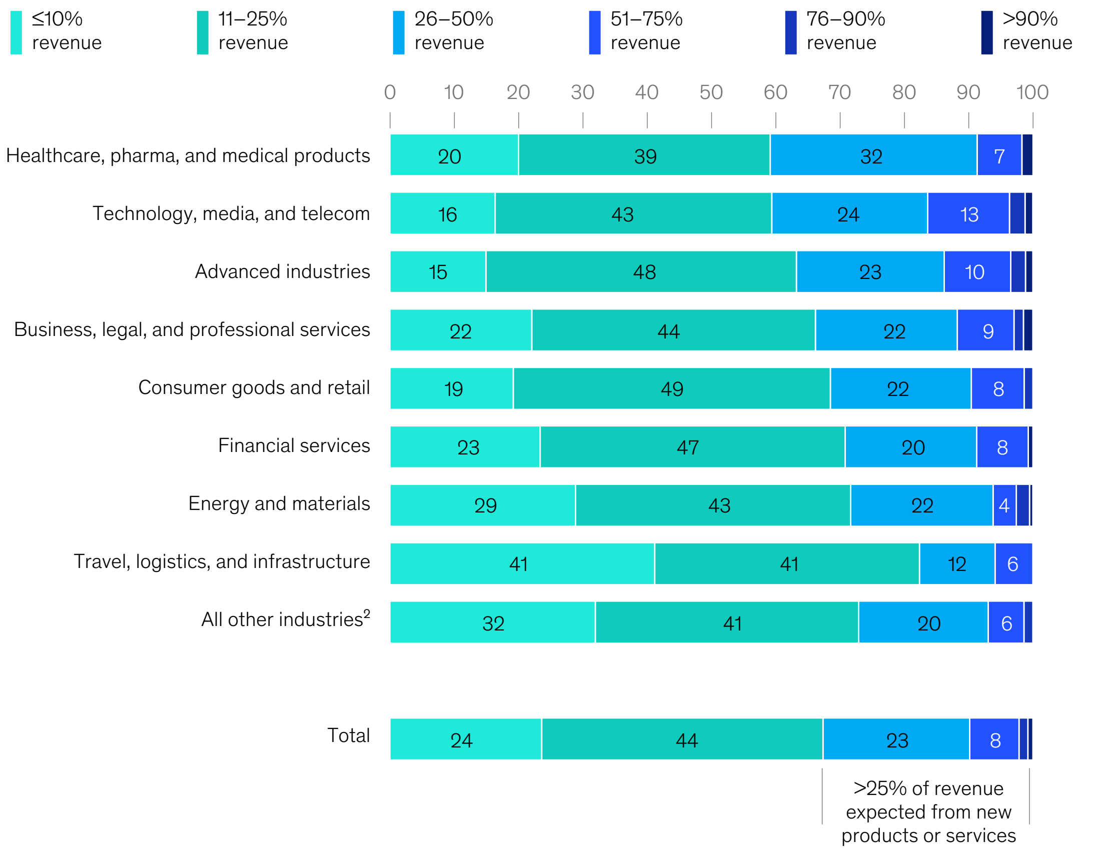
Even as they curtail innovation spending, however, many companies view innovation as essential to growth. A third of surveyed executives expect more than a quarter of their companies' revenue in the next three years to come from offerings not yet on the market (Exhibit 2). This expectation of innovation-fueled growth is highest in healthcare and pharmaceuticals, technology, and advanced industries.

Additionally, approximately 60 percent of respondents state that their companies would significantly underperform market expectations if they stopped investing in innovation. Nearly half also report that they will need to significantly innovate their current business models to remain financially viable over the next three years.

Exhibit 2

## A third of companies expect more than a quarter of their future revenues to come from new offerings.

**Revenues in 3 years' time that respondents expect to come from new products or services not yet on the market,**[1] % of respondents




[1]In healthcare, pharma, and medical products, n = 115; in consumer goods and retail, n = 73; in technology, media, and telecom, n = 165; in energy and materials, n = 194; in business, legal, and professional services, n = 68; in financial services, n = 137; in advanced industries, n = 87; in travel, logistics, and infrastructure, n = 34; in all other industries, n = 144.
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Source: McKinsey Innovation Survey, 2024–25, n = 1,017

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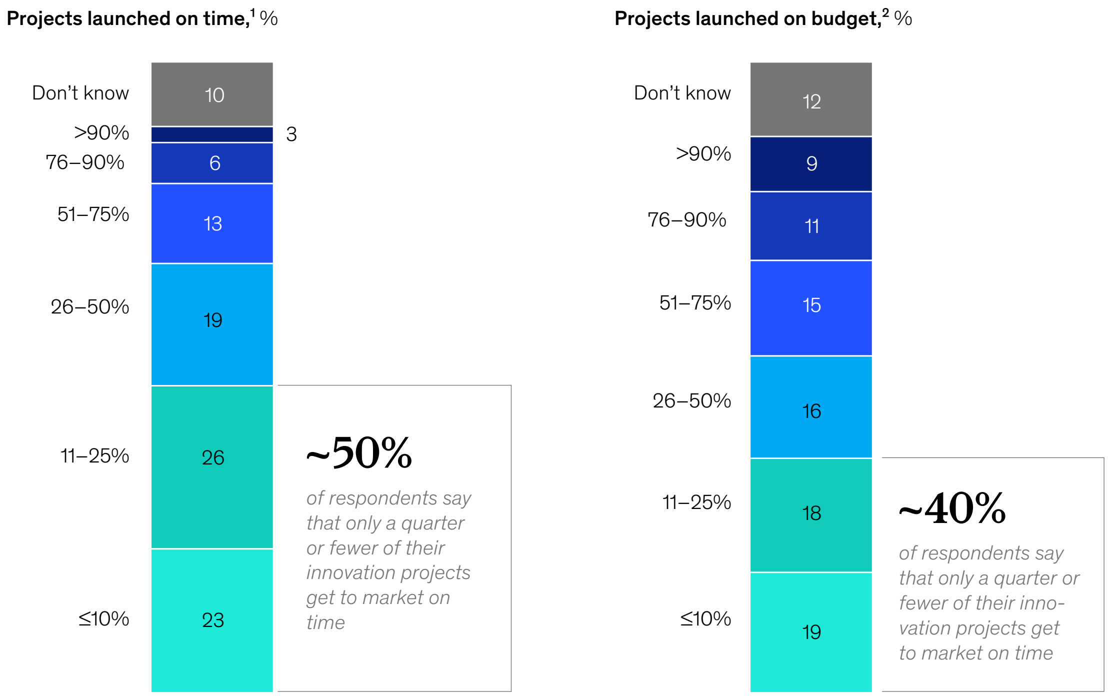
## Growth ambitions undercut by missing innovation basics

The feasibility of executives' aspirations to generate higher growth at current spending levels is doubtful given the success rate of their existing innovation portfolios. For example, nearly half of respondents say that only a quarter or fewer of their innovation projects get to market on time, and about a third say they see a similar low rate launch within budget (Exhibit 3). This is true even for incremental innovations, which are typically more predictable than investments in breakout moves. What's more, many executives are unable to estimate how much additional value innovation initiatives would deliver over the offerings they would replace. This lackluster track record, combined with plans to lower innovation spending, could produce a significant gap between companies' expected and actual growth.

Exhibit 3

## Companies struggle to get innovations to market on schedule and within budget.

**Share of projects that get to market on time and within budget**




[1]Meets projections for first customer delivery for all projects launched within the past 24 months.
[2]Meets budget projections for all projects launched within the past 24 months.
Source: McKinsey Innovation Survey, 2024–25, n = 1,017

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When asked how their organizations' innovation practices align with our long-established eight essentials of successful innovation,[4] the surveyed executives' responses highlight four areas in which the majority of organizations consistently struggle (Exhibit 4). In each area, fewer than 10 percent of respondents say that their companies perform strongly on the criteria for mastery of the corresponding essentials, and more than half identify them as capabilities in which their organizations are deficient.

When we looked deeper at companies whose executives report strong performance on these four practices, we found that they are more than twice as likely as those with the lowest-decile performance on these factors to find white space ahead of their peers and have more than half of their innovations launch within budget. They also report being up to three times better at scaling new businesses or offerings, attracting and retaining key innovation talent, and launching innovations on time.

[4] Marc de Jong, Nathan Marston, and Erik Roth, "The eight essentials of innovation," *McKinsey Quarterly*, April 1, 2015.

Exhibit 4

## Four elements of the innovation process are the biggest hurdles to delivering growth.

**The 8 essentials of innovation and the specific practices survey respondents struggle with the most**

| Aspire → Choose | Discover → Evolve | Accelerate → Scale | Extend → Mobilize |
|---|---|---|---|
| We don't have an accurate way to compare the expected future value of initiatives that have different levels of associated risk or different times to payout. | We don't sufficiently prune investments that have low ROI and high investment requirements prior to piloting. | We haven't connected our M&A function with our innovation process to accelerate strategically important initiatives where we have low existing capabilities. | We have too many exceptions to our resourcing processes to ensure we maximize our innovation spending at the portfolio level. |

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The biggest disparity, however, is in respondents' understanding of how their innovation projects perform. When asked whether incremental innovations tended to deliver more value than the offerings they replaced, more than a third of executives whose companies perform poorly on the four factors report that they do not know, compared with fewer than 10 percent of respondents from companies that perform well.

A similar pattern exists in executives' understanding of the time and total investment that new innovations require: Up to a third of respondents whose companies do not follow these four innovation practices say their organizations have no visibility into whether their offerings launched on schedule or within budget. When organizations are flying blind on their innovation investments, maximizing value from them is nearly impossible.

## Three steps to getting more growth at no extra cost

Whether business leaders are seeking to get more growth from their existing innovation investments or planning to increase their spending, transparency and accountability are imperative. One of the most critical (and most common) bottlenecks in the innovation process stems from ineffective allocation of resources—not because of insufficient funding but rather because of unclear or inaccurate definitions of how resources will be deployed and what kinds of returns they are expected to generate. This can result in low-performing initiatives being funded at the expense of higher-performing ones or critical initiatives failing because some teams deliver on their work while others don't.

Companies can take three immediate actions to improve the performance of their innovation investments without additional cost: conduct a detailed assessment, or "teardown," of the current innovation portfolio; encourage risk-taking while managing risk; and restrict who can freeze projects.

**Perform an innovation portfolio teardown**

Innovation portfolios are where business leaders' commitment to their growth strategy is put to the test: If organizations aren't funding a portfolio of initiatives, their leaders' aspirations mean little. As our survey results demonstrate, most organizations struggle to make trade-offs between short- and longer-term initiatives, as well as among projects with different risk profiles. This inhibits their ability to align resources with business goals, particularly across multiple growth horizons. To better understand what their innovation dollars are funding and the returns these projects are expected to bring, business leaders can do a portfolio analysis, or teardown. The process involves applying an analytical methodology, as outlined below, to make better-informed decisions on innovation spending and improve ROI.

*Is innovation spending aligned with strategic objectives?* This analysis assesses the degree to which innovation spending aligns with expected growth areas, strategic priorities, and shifts in competitive advantage. Companies often continue to fund innovations for markets they had earlier decided to exit. This happens especially often during times of economic disruption when relative market attractiveness might change quickly, leaving the pipeline out of sync with new priorities.

It is also critical to align the portfolio with the company's risk appetite. For example, organizations that aspire to be "first movers" or market leaders need to have a higher share of bold innovation projects than more conservative organizations that focus on incremental improvements have. Without this alignment of risk profile and growth demands, business leaders may end up disproportionately cutting high-risk, high-reward projects, leading to a portfolio dominated by relatively low-growth projects. Alternately, overprioritizing higher-risk innovation initiatives can leave companies exposed if their riskier bets fail. When the business environment is changing rapidly and risk assessments lag behind reality, companies are particularly prone to overestimating the stability of past trends.

*Can the innovation portfolio meet growth expectations?* Organizations with several business units sometimes lack a clear understanding of how one unit's high-potential initiatives stack up against another's low-potential initiatives. After all, one business's low-hanging fruit can deliver higher growth for the overall organization than another's highest-potential bet. Without this enterprise-level view, business leaders may defund initiatives with high growth potential in the service of equally allocating resources across business arenas rather than optimizing funding for the overall portfolio's returns. Similarly, a lack of visibility into how business unit leaders make trade-offs between near-term and longer-term priorities can cause the enterprise to overweight short-term ROI versus long-term growth.

Before conducting a portfolio teardown, business leaders should consult their finance colleagues on how to weigh different risk levels or payout times. A single business unit or function, such as corporate R&D, can serve as a test case to ensure the math works. Shortfalls in the portfolio's ability to meet growth expectations can then be filled organically by launching new businesses or offerings or through acquisitions.

*Have underperforming initiatives been sufficiently pruned?* Once business leaders have instituted a rigorous way of evaluating and comparing the likely performance of different types of initiatives, they can compare the projects' net present value (NPV) to the resources needed to deliver it. This analysis generally reveals a long tail of low-ROI initiatives that are soaking up resources that higher-performing projects could better employ. Establishing stage gates can allow decision-makers to cut underperforming initiatives early in the development funnel.

Consider the experience of a global producer of baking ingredients that found its R&D portfolio crowded with initiatives but delivering disappointing returns. The company appointed a “project killer”—an individual with deep knowledge of both food technology and the business aspects of the industry—to rein in project creep. This person maintained a database of all active projects, noting areas of repeated inefficiency, lack of success, or lack of market opportunity, and based on these criteria, built a dispassionate case for why a project should or should not continue.

*Do gaps exist in the resource allocation process?* Many organizations have performance expectations that are out of sync with past reality, leading to inflated growth projections that leave the companies exposed to missed growth targets and budget overruns. A methodical review of the reasons why recent innovation projects succeeded or failed can enable leaders to better vet the assumptions behind revenue projections and time to launch for initiatives in the pipeline. A postmortem can also flag breaks in the innovation process, such as high rates of exceptions being made for pet projects or “shadow spending” that doesn’t go through the standard approval process.

A portfolio teardown can identify significant opportunities for better resource allocation. One consumer electronics company ended up rebalancing its innovation portfolio, which freed up 20 percent of the budget, and identified opportunities for a 10 percent ROI increase at the portfolio level. Consumer-packaged-goods and chemical companies that followed a similar process freed up 20 percent and 12 percent of their R&D budgets, respectively, to deploy in higher-performing projects.

**Encourage risk-taking while managing downside risk**

Fear is an innovation killer. Corporate cultures and policies that are too risk averse can stifle innovation and lead to portfolios that deliver only incremental gains. Business leaders should dedicate explicit time and resources for teams to innovate, provided the projects meet the organization’s risk appetite. Setting targets that build in an allowance for failure and establishing processes for learning from those failures helps foster more innovation.

A corollary to allowing more risk-taking, however, is the need for visibility into a project’s progress. Companies that quickly halt unproductive initiatives can take more risks up front because they manage the downside. Failure to do so often leaves organizations with bloated pipelines of underperforming initiatives that deliver no growth.

**Eliminate exceptions and restrict who can curb funding**

A project isn’t a real priority if it isn’t funded. If the CEO or CFO considers an innovation initiative strategically important, they should ensure that the budget reflects it. Many organizations cite frequent exceptions to the resourcing process as an obstacle to their ability to deliver strong performance from their innovation portfolios. These exceptions stem largely from influential leaders promoting pet projects and shifts in business context that outpace the existing planning processes. Raising the company’s metabolic rate by increasing the frequency of updates to annual and quarterly plans might be required, but companies shouldn’t rely on frequent exceptions as a correction mechanism, as it can lead to inefficiencies and underperformance of the portfolio.

Companies that frequently pull funding from high-performing, longer-term initiatives to hit short-term targets sacrifice future growth and overall performance. It’s a tough choice that every management team needs to make at times, but it’s a call that the CEO should fully own. Things change—the past few months have clearly shown that. Exceptions to funding rules can multiply in times of uncertainty, especially if the resourcing process doesn’t include scenario planning.

If such decisions are made on an ad hoc basis or, worse, through internal politics, the result could be a rapid erosion of the performance of the company's innovation portfolio. It's therefore important to categorize which projects will be funded (or defunded) as resource availability changes, existing initiatives fail to perform, or the business context shifts. Tying decisions to scenarios or contingency plans enables organizations to pivot faster when disruption happens.

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In times of volatility, innovation can provide companies with options for growth in different future circumstances. While it may be tempting to freeze innovation spending during such periods, companies that do so risk sacrificing their future for the present. A better path is to maximize returns on innovation investments while minimizing risk by conducting portfolio teardowns, encouraging risk-taking, and applying rigor to how projects are funded.

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