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INSIGHT, EXPERIENCE & IDEAS FOR EXECUTING STRATEGY

ON BALANCE

Part Two of a Two-Part Series

Measuring and Managing the Innovation Strategy with an Innovation BSC

By Holger Koehler, Cofounder, Innovation Management, Inc., a Monitor Group Company; and Scot MacGillivray, Senior Vice President, Palladium Group, Inc.

In Part One of this series (March–April 2007 issue), Ronald Jonash and Barnaby Donlon introduced a tool that can help companies execute their innovation strategies: the Innovation Balanced Scorecard, or iBSC. Through a case study, Holger Koehler and Scot MacGillivray, who, along with Jonash and Donlon, lead a Monitor Group/Palladium partnership on the iBSC, articulate an innovation strategy and key themes, define measures and targets, and identify key innovation initiatives. They also offer recommendations for getting started with your own iBSC.

First, let's revisit an important concept about innovation. The ultimate financial outcome of a well-implemented innovation strategy is known as the "innovation premium": the valuation premium investors accord to firms that they believe can deliver ongoing innovation for sustained growth—whether in the form of new products, processes, business models, or consumer experiences. Such firms are consistently able to increase profits through a combination of revenue growth from new and existing sources as well as from reduced costs and efficiencies. The innovation premium has four components:

1. ***Shareholder component:*** the higher long-term growth rate investors expect over the company's competitors.
2. ***Customer component:*** customers' preference for doing business with the company.
3. ***Employee component:*** current and potential employees' perception of the company as an innovative, thus more exciting, place to work. Such companies (think Apple, Google, Procter & Gamble) attract innovation talent.
4. ***Supplier/partner component:*** the company's status as a preferred customer. For example, in automotive OEM-supplier relationship surveys, innovation leaders such as Toyota, BMW, Mercedes, and Audi lead the rankings as companies that suppliers want to do more business with.

Innovation leaders not only capture financial rewards but also earn more loyal customers and more engaged employees and partners who bring new ideas and innovative approaches—advantages that, in turn, fuel the shareholder component of their innovation premium.

Although innovation is typically associated with new products and services, it can also issue from existing products and services, new processes, and efficiencies. To reinforce this point, we chose as our iBSC case study a financial services company that follows a disciplined and multifaceted approach to innovation.

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An Innovation BSC Case Study

A leading commercial bank with multiple lines of business and more than 4,000 branch offices nationwide found itself in a paradoxical situation with respect to its performance. Despite increasing its operating earnings by more than 50% over five years and achieving a higher operating margin than most of its competitors, it had disappointing total shareholder return, and its P/E ratio lagged behind that of its peers. Wall Street had little faith that management could sustain the profit improvements the bank had achieved. Senior management realized that in order to increase the firm's value and improve shareholder returns, they needed to change how investors viewed the firm's long-term growth potential.[1] This meant that they needed to identify new areas of growth and find new ways to grow the existing portfolio of businesses (and related products and services).

They soon identified several promising opportunities. Some represented incremental improvements: consolidating customer service numbers to facilitate customer interactions with the company; speeding ATM processing time to boost customer satisfaction. Others were major innovations: a breakthrough approach to measuring and managing salesforce performance; an IT-based mortgage processing system that would halve the cost of producing a mortgage.

Mapping the Strategy

As they do in a traditional strategy map, the objectives of an innovation strategy map must reflect the overall logic of how the strategy (here, the innovation strategy) will create value for the firm and its shareholders. Innovation's purpose is to drive sustained growth in revenue and profits, and its ultimate financial goal is to create an innovation premium.

Here, we will focus on two elements of the bank's innovation strategy: its radical new way of expanding its core consumer business, and the innovative mortgage processing system it transformed into a new growth business.

After analyzing the bank's core retail business, executives realized that although the bank was competitive within its industry, its customer satisfaction levels and sales performance did not come close to those of leading retailers—normally not an aspiration of banks, but one for this institution that, rather innovatively, thought of its business in retail terms, not just as a financial services business. They calculated that by performing at the level of leading retailers, the bank would achieve growth two to three times its current (and the industry's average) rate. They first defined a target growth rate of 10%-plus for the core business. To achieve this rate, they needed to achieve four goals: (1) focus on "achieving the numbers" instead of on "growing the business"; (2) institute coaching programs (especially for weak performers); (3) achieve a more consistent quality of leadership; and (4) reduce the great process and performance variability in the branches and throughout the sales force.

Of these goals, the fourth became the focal point of senior managers' innovation-related thinking. They tackled it through a radically new and innovative approach to measuring and managing the bank's branches and sales associates. Borrowing from the principles of Six Sigma, the new approach focused on reducing the gap between the worst and the best performers by setting specific growth targets for the lower quartile of performers, instead of on setting revenue targets based on historical performance or projected overall industry growth.

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This represented a radical shift in people management at both the branch and regional levels. Rather than incentivizing top performers to ever-higher levels of sales to "make the numbers," management now focused on the bottom quartile of the salesforce to significantly raise its performance to narrow the gap between the best and the worst. As a result, sales growth rates in the branches improved from the low single digits to 20%—more than even the biggest optimists had predicted.

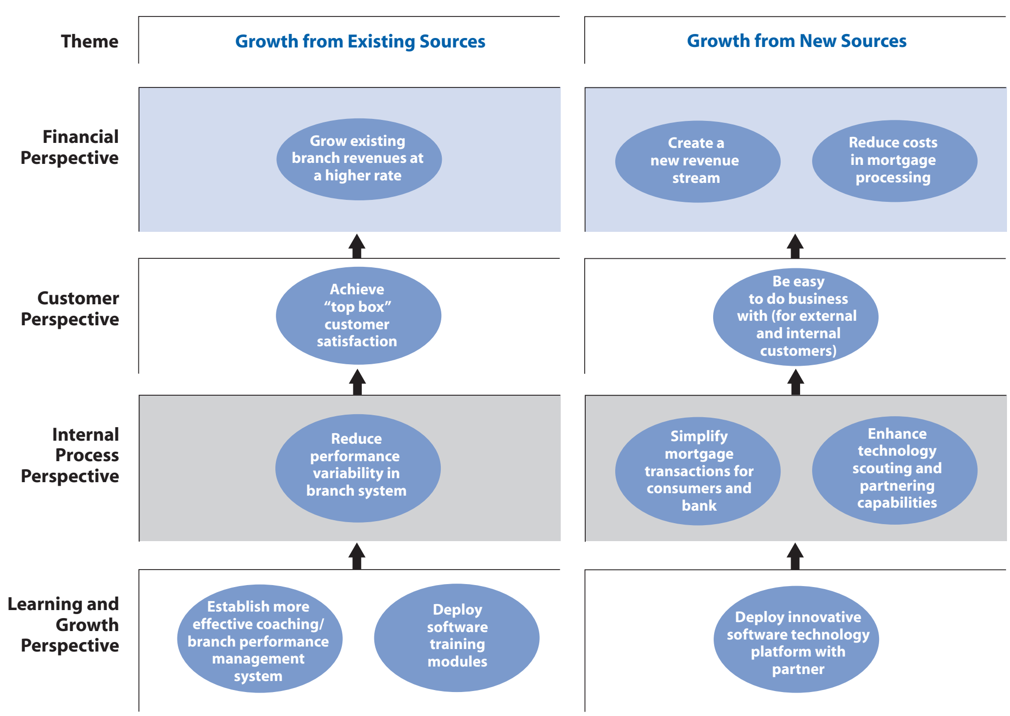
Another innovation evolved from a process innovation that brought both revenue and profit growth to the company's mortgage business—and created a whole new product area. Management knew it needed a fresh approach to the bank's mortgage business, one that could turn the business—which was a player in the industry but, thanks to its lackluster performance, was considered a candidate for divestiture—into a growth business. A project team began to rethink the mortgage sales process to find ways to simplify mortgage transactions for customers as well as for the bank. The team sought innovative ideas from within the company as well as from external sources. It established a partnership with a small software company that had developed an innovative software program for mortgage processing. Together the partners created a mortgage processing solution that significantly changed the way the bank sold mortgages. Originally conceived as a cost-reduction strategy, the new system quickly proved to be an engine of growth. It enabled the bank's 10,000 branch employees to sell and process mortgages, rather than just referring customers to the bank's network of 1,000-plus mortgage brokers. As a result, the bank could change its performance incentives for mortgage sales, requiring much higher origination targets from its mortgage brokers. The company had thus turned a no-growth business into a 25%-plus investment business. Customer and employee satisfaction soared, and direct mortgage production costs were cut in half.

But the bank did not stop there. It decided to turn the new mortgage solution into an external revenue-generating business by selling it to external brokers.

Defining the Themes

Figure 1, a simplified iBSC strategy map, depicts the bank's two broad innovation strategic themes—"Growth from Existing Sources" and "Growth from New Sources"—along with the themes for each perspective. Growth from Existing Sources captures the bank's goal of boosting its consumer business growth rate from the low single digits to more than 10%, a goal that requires consistently high customer satisfaction. This outcome, in turn, requires the bank to reduce performance variability in the branches through more effective coaching and performance management programs as well as new software training modules. In the Growth from New Sources theme, the bank

Figure 1. Mapping the Strategy and Defining the Themes



This simplified iBSC strategy map shows the bank's two broad innovation themes and the cause-and-effect relationships throughout the four perspectives that support them.

Figure 2. Sample Innovation Measures by Type and by Perspective

	LAGGING	REAL-TIME	LEADING	LEARNING
Financial Perspective	• Revenue/profit margins • Market value added • Total shareholder return • Return on invested capital	• Investor growth expectations • Percent of growth targets covered by innovation	• Coverage of strategic goals • NPV of portfolio • Strength of development pipeline	• Improvement in return on investment • Increase in percentage revenues from new products
Customer Perspective	• Price premium to competition • Contribution derived from new products/ services • Market share • Customer loyalty • Brand equity	• Blogging traffic/ market buzz • Customer fulfillment (order, service, etc.) • Product launch (timeliness, availability, plan vs. actual)	• Customer satisfaction • Customer purchase intent • Consumer response to new concepts	• Improvement in referral rate among customers • Change in brand positioning
Internal Process Perspective	• Number and quality of new patents granted each year • Time to market for new products/process (per risk complexity category) • Number and strength of partnerships • Partner loyalty	• On-time new product/ service/process • Within-target costs of projects • Within-target performance • Number of gateway returns • Number and quality of ideas captured • Number and quality of patent applications • Extent of outsourcing • Extent of insourcing	• Forecast project completion times per category • Number and quality of ideas by portfolio category	• Reduction in breakeven time • Within-target sales/ profits
Learning and Growth Perspective	• Innovation staff turnover • Customer/supplier survey results • Spend on innovation as percentage of sales • Number of FTE innovation staff • Strength and extent of innovation network	• Current staff satisfaction • Number of idea lodgers (internal and external) • Project spending leverage	• Staff motivation • Networking (frequency/ duration of contact) • Innovation climate scores • Number of codevelopment/ funding applications lodged/negotiated • Number of experienced innovation team members/leaders • Forecast resource utilization • Competitiveness in pacing and emerging technologies/ capabilities	• Year-on-year strengthening of core competencies • Percentage reduction year-on-year in new product/process development time/cost

Companies should limit the number of measures they use to a total of about 20, and only use measures that are meaningful and actionable—e.g., quality of, not just number of, new patents granted each year.

is focused primarily on reducing costs in mortgage processing, while also recognizing the opportunity to create a new revenue stream. To do this, it must satisfy the need of internal and external customers alike that it be easy to do business with—a goal supported by the simplified mortgage processing procedure, which allows branch employees to process most mortgage applications. Furthermore, enhanced technology scouting and partnering capabilities accelerate the creation and implementation of an innovative software platform developed with an outside partner. Like any strategy map, the innovation strategy map clearly highlights the broad cause-and-effect relationships by looking at the "what"—financial outcomes and customer value proposition—and the "how"—internal processes and learning and growth capabilities.

Defining Measures and Targets

Measures and their associated targets are at the heart of the strategy map because they, in effect, describe the means to execute strategy. The same is true for the innovation strategy map: measures connect innovation objectives with specific innovation initiatives. Most of the metrics companies use focus on results; they are lagging indicators of company performance. A preponderance of lagging indicators is especially problematic with the iBSC, as it can take years to see the results of an innovation program. In addition, innovation typically creates significant organizational change and risks, so its outcome must be measured in a way that accounts for these changes and risks. As a result, lagging indicators alone are insufficient for guiding and managing innovation. Companies also need real-time and forward-looking (leading and learning) indicators.

Figure 2 shows examples of common innovation measures, grouped within four basic types (lagging, real-time, leading, and learning) by BSC perspective. *Lagging* measures capture, of course, end results, for example: Did we earn a return on our capital invested in innovation? Get new products to market quickly and effectively? *Real-time* indicators measure the progress of the innovation strategy and related initiatives to ensure they are on track to deliver results. For example: Are our product launches timely? Are new products and services available when they need to be? *Leading* indicators help predict the effectiveness of and the value created by innovation; e.g., the net present value (NPV) of the innovation portfolio, and customer response to innovative concepts. *Learning* indicators measure the improvements made in any given measure, such as reduction in breakeven time (internal) or year-over-year strengthening of core competencies.

The number and mix of measures is unique to a company's BSC, and is especially so with the iBSC. For some companies, tracking the NPV of the innovation portfolio can be very useful because it's a way of testing the assumptions of the innovation model. Elsewhere, it is no more than a manipulation. As a rule, companies should use a limited number of measures, balanced across the categories—say, two lagging and one each of real-time, leading, and learning measures for each perspective, for a total of about 20 measures. The OSM is well suited to facilitating the measure definition and coordination process, which requires tapping multiple sources and systems, and garnering the support of the CIO and IT organization to do so.

In addition, beware of choosing metrics just because they are easy to track, such as "number of patents granted." "Quality of patents"—reflecting newness, breadth, and relevance of claims—is a more meaningful indicator of innovation performance. To effectively guide the execution of the innovation strategy, metrics must be both meaningful and actionable. Unfortunately, companies are often not set up to capture the data that yield meaningful metrics. But they should make the effort to put systems in place to capture this data; in the long run, this effort will pay off.

The bank established two different innovation tracks, each of which required different measures and targets though they shared a similar logic. *Figure 3* highlights the measures, targets, and initiatives utilized for a selected internal process objective from each innovation track. For Growth from Existing Sources, the organization focused on traditional outcome measures for the financial perspective (same-store sales growth) and the customer perspective (customer satisfaction scores), but it set significant stretch targets (10%-plus, versus the traditional "industry growth + 1% to 2%"). For the internal process objective "Reducing performance variability in the branch system," the bank relied on lagging, leading, and learning measures to provide a more balanced view of the progress made against the innovation initiatives. These measures included the gap between the top and bottom quartile performers, the percentage of the salesforce using the new process, and the percentage of the salesforce trained in the new process. Likewise, for the Growth from New Sources theme, the bank also focused on traditional outcome measures for the financial perspective (mortgage origination margin) and customer perspective (market share), while establishing stretch targets (two to three times historical rates). For the internal process objective "Simplify mortgage transactions for consumers and the bank," the organization relied on a mix of lagging, leading, and learning measures, such as mortgage volume, customer satisfaction, and percentage of the salesforce using the new process.

Determining the Initiatives

As with a traditional BSC, a company must define initiatives—the specific projects that will enable it to achieve targets and meet objectives. The iBSC enables an organization to ensure that innovation initiatives are aligned with innovation objectives: Are we making the right level of investment to achieve our innovation goals? Are we we making the most of our existing initiatives? Could any initiatives be eliminated or consolidated to free up capital for more critical initiatives?

Figure 3. A Slice of the Bank's iBSC

	OBJECTIVE **What the strategy is trying to achieve**	**MEASURE** **How performance against an objective is monitored**	**TARGET** **The level of performance or rate of improvement needed**	**INITIATIVE** **Processes and programs required to reach the target**
Growth from Existing Sources	**Reduce performance variability in branch system**	• Lagging: gap between top and bottom quartile • Leading: percentage of salesforce using new process • Learning: percentage of salesforce trained in new process	______ ______ % ______ %	• Sales playbook • Enhanced reporting • Coaching program
Growth from New Sources	**Simplify mortgage transaction for consumers and bank**	• Lagging: mortgage volume • Leading: customer satisfaction • Learning: percentage of salesforce using new process	______ ______ ______ %	• IT platform for mortgage processing • New training program • New incentive system

The measures, targets, and initiatives for a selected internal process objective from each of the bank's two innovation tracks.

The bank established a number of innovation-related initiatives. Initiatives designed to help execute its new consumer banking approach in the Growth from Existing Sources theme included:

- Creating a sales playbook to establish standard practices and reduce process variability among branches and sales associates
- Developing a daily sales reporting system to enable real-time tracking and comparison of branch and sales associates' performance
- Redesigning training and coaching programs for sales associates
- Redefining leadership to emphasize authority, accountability, and coaching

Initiatives resulting from its mortgage innovation program in the Growth from New Sources theme included:

- Developing an end-to-end IT platform for mortgage processing
- Instituting a new mortgage solutions training program for branch employees
- Redesigning the performance measurement and reward program for mortgage brokers
- Establishing sales channels for selling new mortgage solutions to third parties

Since most innovation initiatives require some form of cross-functional collaboration and team-based execution, companies can easily create too many projects and teams. That can become difficult to manage and coordinate. When implementing an iBSC, it is particularly important to not overload the organization with initiatives. As with a traditional BSC, use the iBSC as a means of vetting initiatives. Map your existing initiatives to your iBSC objectives. This will help you evaluate the alignment of your current initiatives to your innovation goals and highlight any investment gaps.

How to Get Started

To put an iBSC in place, we propose a three-step approach:

1. Conduct an innovation diagnostic to determine the right content for your iBSC. Establish the appropriate themes, objectives, and measures for your innovation strategy. The components of a diagnostic typically fall into two broad categories:

- *What to do*: Are you pursuing the right things (innovation platforms, concepts, partners) to achieve your growth and innovation objectives?
- *How to do it*: Do you have the capabilities and competencies in place to make innovation happen (e.g., leadership alignment, an innovation culture, the right processes, adequate resources)?

The innovation diagnostic helps highlight the "what" and "how" gaps in your existing approach, providing the information you need to develop a road map. As with any major change program, it is important to develop a fact-filled baseline and a clear vision before embarking on the new program.

2. Align senior leadership on innovation strategy and establish an executive-level scorecard. The iBSC is an important tool for articulating and managing the innovation strategy as a complement to the organization's corporate strategy. For those companies in which innovation is a critical dimension of competition, the corporate-level BSC may suffice. For others, the iBSC can serve as a useful tool for elaborating on the innovation theme in a corporate map that may also emphasize operational excellence and customer relationships.

3. Cascade the scorecard through the organization, put the tools in place, and develop the people to optimize innovation execution. Executing an innovation strategy is challenging because in most cases no single individual or discrete unit owns innovation. The iBSC can provide clear direction throughout those areas of the organization involved in innovation—R&D, business development, corporate development, marketing—to manage innovation across these functions. Some organizations create a small, cross-functional innovation organization or committee, akin to an OSM, that facilitates and supports innovation throughout the company. You might also want to establish a cross-functional innovation team for each major innovation platform or concept. Because both types of teams own large, integrated portions of the iBSC, they help ensure wide-scale execution of the innovation strategy. ■

1. Although investors' expectations are shaped by improved performance, our research has shown that innovation—the ability to successfully create and grow new businesses—is a key driver of investors' long-term growth expectations. Performance improvements are considered more short-lived, especially with regard to outperforming competitors. Innovation/new business building is therefore a greater driver of shareholder value than performance improvements. Our Monitor Group colleague Tom Copeland has shown that changes in long-term growth rates drive shareholder value. See Tom Copeland and Aaron Dolgoff, "Expectations Count: The Evidence," chap. 2 in *Outperform with Expectations-Based Management* (New York: John Wiley, 2005).

TO LEARN MORE

See Part One, "Connecting the Dots: Using the BSC to Execute an Innovation Strategy," by Ronald Jonash and Barnaby Donlon (BSR *March–April 2007, Reprint #B0703A); "Managing Innovation," by Robert S. Kaplan* (BSR *January–February 2003, Reprint #B0301A); and "Creating Value from Organizational Alignment," by Robert S. Kaplan and David P. Norton* (BSR *November–December 2005, Reprint #B0511A).*

Reprint #B0707A