

## Grounding the Front End of Innovation in Business Strategy

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July 2005

How can a firm distinguish between blockbusters and money-pits in the front end of innovation? It is widely accepted that there is too much noise in the front end to link concepts<sup>1</sup> in this stage to financial outcomes. But what if you could build a process that is linked to the *drivers* of financial outcomes rather than the financial outcomes themselves?

The purpose of innovation is to create profit growth. Profit growth is generated by competitive advantage. Therefore, the innovation process should be designed to allow the firm to leverage its assets, capabilities and competencies to create a sustainable competitive advantage in the marketplace. While these principles are generally applied to business-level strategy, they can be distilled into a methodology for screening and evaluation to distinguish between blockbusters and money-pits in the front end of innovation.

Traditionally, the screening and evaluation process has focused on two primary questions to prioritize concepts in the front end of innovation: (i) is there a significant consumer/end user benefit? and (ii) can we supply this benefit profitably? These two questions are necessary but not sufficient to determine the drivers of financial outcomes. There are two additional questions that highlight these drivers:

- Is the concept aligned with our strategic direction?
- Will the concept create or enhance a sustainable competitive advantage?

These two related questions are not often examined systemically in the front end screening and evaluation processes despite being paramount in determining the drivers of financial outcomes.

### Is the concept aligned with our strategic direction?

Economic theory, notably Core Competencies<sup>2</sup>, has identified four building blocks for a company's strategic direction:

- *Assets* are any resources that the firm owns or controls. These resources can be physical (e.g. – plant equipment, location, access to raw materials, etc.), human (e.g. - training, experience, decision-making, management, relationships, knowledge, etc.) or organizational (e.g. culture, reporting structures, control systems, informal relationships, etc.).
- *Capabilities* are bundles of assets or resources that are used to perform business processes. All firms have capabilities; however, most firms will only focus on certain capabilities.
- *Competencies* are the most important capabilities of a firm – those that allow the firm to execute its business strategy and gain an advantage over the competition. Competencies are a company's

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<sup>1</sup> *Concept* used in this paper refers broadly to product/service improvements, new products/services, and new business models

<sup>2</sup> Prahalad, C.K. and Gary Hamel, "The Core Competence of the Corporation", Harvard Business Review, vol. 68, no. 3 May - June 1990, pp. 79-91

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strongest and best performing internal capabilities. They are central to a firm's strategy, competitiveness and profitability.

- *Distinctive Competencies* are competitively valuable capabilities that a company performs better than its rivals. Distinctive competencies are the basis for sustainable competitive advantage.

Assuming that your company's business strategy has been defined correctly (that is, it has been developed to leverage distinctive competencies), it is important to distinguish how concepts align with the company's strategy.

## Will the concept create or enhance a sustainable competitive advantage?

Identifying concepts that are aligned with the firm's business strategy is not enough. Concepts must also contribute to the firm's ability to create, maintain and leverage a sustainable competitive advantage.

The Resource-Based View<sup>3</sup> (RBV) of the firm provides a credible framework for evaluating whether the concept can create advantage. The RBV theory makes it clear that profit can be earned from resources to the extent that they are *valuable, rare, imperfectly imitable, non-substitutable* and *exploitable*. Note that these criteria are based on the *resources* of the firm leveraged to supply a product rather than the product itself.

### Valuable

Capabilities are valuable when they enable a firm to create or implement strategies that improve efficiency or improve effectiveness. Improved efficiency is based on the value of the ratio of inputs to outputs. Improved effectiveness enables some new capability not previously held, for example, serving a new consumer or customer segment. Sources of value must also be aligned with business strategy. That is, firms with a low-cost provider strategy will leverage increased efficiency as lower cost per unit of output whereas high-quality providers will increase output quality per unit of input cost.

### Rare

Valuable resources or capabilities that are shared by large numbers of firms in an industry are, by definition, not rare and cannot be sources of sustainable competitive advantage. Indeed, some research indicates that only organizational assets can be rare. In screening concepts in the front end, it is important to identify if a broad or limited number of firms have capabilities or resources required to create, distribute or market the new product.

### Imitability

Valuable, rare resources can only be sources of sustainable competitive advantage if firms that do not possess them, cannot obtain them. They must be "imperfectly imitable." In other words, it must be impossible to perfectly imitate those valuable, rare resources. Research has identified three principal ways imitation can be avoided: unique historical conditions, causal ambiguity and social complexity.

- Unique Historical Conditions :: an unusual evolutionary pattern of growth that has contributed to the development of competencies in a manner that is unique to those particular circumstances. For example, Disney created Mickey Mouse when animated motion pictures were new. It would be difficult to create a character as iconic today.
- Causal Ambiguity :: resources that create a sustainable competitive advantage are not widely known (sometimes not even by the firm owning them). Imitating firms cannot duplicate the strategy since they do not understand why it is successful in the first place.

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<sup>3</sup> "A Resource-based View of the Firm", *Strategic Management Journal* 5, no. 2, April-June, pp. 171-80, 1984.

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- Social Complexity :: occurs when the firm's capabilities are the result of complex social phenomena such as interpersonal relationships, trust, friendships among managers, or a firm's reputation with suppliers and customers. For example, a competitor could hire everyone from Apple and relocate them to a new facility but the dynamics, culture and atmosphere would not be the same.

It is important to recall that these criteria should be applied to the *resources* of the firm used to supply a product rather than the product itself.

## Non-Substitutability

Non-substitutability with respect to resources, requires that there are no equivalent resources that can be exploited to implement the same strategy or to create, distribute and market the new product. Another way to think of non-substitutability is through capabilities that do not have any strategic equivalents, such as firm-specific knowledge or trust-based relationships.

## Exploitable

The first four criteria identify and describe the resources that the firm *has* but exploitability addresses what the firm can *do* with what it has. It is important to assess if the firm is organized to exploit the full competitive potential of its resources and capabilities to create, distribute and market the concept. In addition, we must evaluate if systems are in place to support the execution of a particular strategy.

The innovation screener should be developed to leverage these characteristics to evaluate if the opportunity will create and sustain any advantage. In other words, to evaluate how a concept will contribute to the drivers of financial outcomes.

## The Idea Screener

These highly theoretical characteristics can be combined into a highly practical tool for screening concepts in the front end of innovation. The screening tool should be comprised of three components: screening criteria, a rating and calibration methodology and a market-based rating model.

## Concept Screening Criteria

The screening tool itself should be relatively short and easy to use while, at the same time, addressing the primary criteria of strategic alignment and the resource base (i.e. - *valuable, rare, imperfectly imitable, non-substitutable* and *exploitable*). The first step in building the tool is to distill these criteria into brief statements tailored to the unique business context of the firm. Next, criteria questions should be weighted. One of the most effective methods to establish the weightings is to have the key stakeholders individually assign weights to each question. The final weighting is then the average weight assigned by these stakeholders. This is intentionally not a consensus process but rather an averaging process that will support the Market-based Rating Model (see below).

## Rating and Calibration Methodology

Ratings methodologies can range from simple to mathematically complex. Many firms make the mistake of adopting a more mathematically complex process in an attempt to create a more accurate ranking that expresses slight differences among concepts. Often this is false accuracy. The accuracy can be improved by creating a rating methodology with less precision. The most effective approach is a simple reference comparison, where respondents rate each idea as "below," "equivalent to" or "above" the performance of a known reference. This approach is less precise but more accurate and has the additional benefit of self-calibrating across participants by comparing each new idea to a known reference product. For example, Apple may create a screening question that asks if a new concept is "more," "less" or "about the same" on a particular criterion (i.e. - aligned with strategic direction, valuable or imitability) with the iPod.

## Market-based Rating Model

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While it is more practical to have a small, highly qualified team making decisions about which concepts will be moved to the next stage, we recommend that as many people as is practically manageable are involved in the idea screening process. In his recent book, *The Wisdom of Crowds*, James Surowiecki describes how crowds (which range from small corporate groups to entire capital markets) can repeatedly arrive at much better decisions than small groups of experts when they have the right environment in which to operate. According to Surowiecki, there are three necessary factors to creating an environment where crowds will reach better decisions: independent thinking, diversity of thought and a decentralized aggregation mechanism. These factors highlight the importance of including a broad spectrum of inputs. We recommend the participation of people from across and outside the organization (i.e. – agency partners, those with little exposure to the industry and even customers and consumers) to participate on a regular basis in the screening process.

## Summary

The innovation process should be designed to create concepts that will allow the firm to leverage assets, capabilities and competencies to create a sustainable competitive advantage in the marketplace. While these principles are traditionally applied to business-level strategy we've used these concepts to guide our thinking in developing a methodology for screening and evaluating concepts in the front end of innovation that are focused on evaluating the drivers of financial outcomes.