



## ***Innovation imperative*** Keeping your company relevant

*Three-quarters of US private companies are prioritizing innovation, with growth as their top objective. Is your company among them?*





## ***GYB***

is published by PwC's Private Company Services (PCS) practice. Here we discuss the challenges privately owned businesses face and where the opportunities lie, suggesting how you can effectively make the most of both.

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## ***Innovation imperative: Keeping your company relevant***

Three-quarters of US private companies are prioritizing innovation, with growth as their top objective. Is your company among them?

In today's world of emerging technologies, emerging markets, and emerging consumer demands, companies must emerge too—out of old molds and into new ones—if they are to survive and thrive. For some companies that means reinventing themselves. For others, it's about seeking innovative ways to make their business newly relevant.

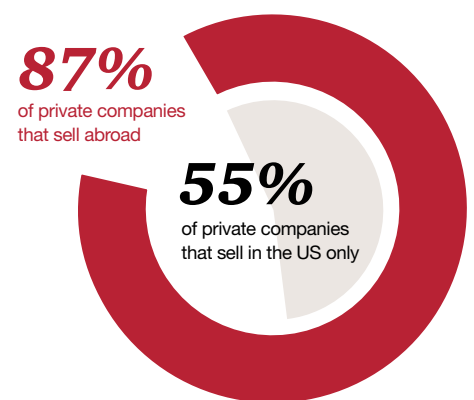
US private companies are keenly aware of this imperative. They don't view innovation as a “nice to have” but instead see it as a critical means of staying in the game. No wonder that 75% of private-company chief executives we surveyed say they're making innovation a priority. Within that group, roughly half the companies expect innovation to have a significant impact on the way they do business over the next few years.<sup>1</sup>

As for the one-quarter of private companies that are forgoing innovation, they may come to embrace it yet. Sticking to business as usual in what remains a slow-growing US economy can be a distinct disadvantage for non-innovators when up against innovating peers, not to mention up against new, aggressive competitors from outside the United States—all of them vying for US customers.

These are often the same competitors that US private companies face as they seek new customers abroad, including in fast-growth

markets where an emergent middle class is giving rise to new consumer demands. Success in those markets increasingly depends on taking novel approaches, such as reverse innovation,<sup>2</sup> and leveraging rapidly evolving technologies.<sup>3</sup> While such moves may appear risky to some private companies, the alternative is even riskier: standing still while innovative competitors race past.

### ***Demographic snapshot: Who's making innovation a priority?***



Source: *Trendsetter Barometer*, PwC, December 2011

<sup>1</sup> *Private Company Trendsetter Barometer*, PwC, December 2011 (a survey of 226 US private-company chief executives)

<sup>2</sup> Reverse innovation involves creating products for markets abroad, test-driving them there, and then adapting those products for home markets.

<sup>3</sup> For example, mobile devices are the primary way to reach large consumer populations in places such as India, where first-time users of technology are leapfrogging straight to the latest digital options.

## Going for growth But not necessarily going it alone

Innovation supports a long list of private-company goals. At the top of that list are increased profitability, higher revenue, and greater market share. While cost containment is also among the innovation objectives that private companies hope to meet, it is secondary to growth.

“Innovation is growth these days,” says Robert Shelton, managing director of the Growth and Innovation practice in PwC’s PRM Management Consulting Group. The proof is in the numbers: Private companies that have made innovation a priority are growing faster than their non-innovating peers, forecasting a revenue growth rate of 8% over the next year, compared with 5% for non-innovators. For companies prioritizing innovation to a “great extent,” the expected growth rate is even higher, at 10%.<sup>4</sup>

An emphasis on innovation can also help a company grow its talent base so that the business attracts and retains precisely those kinds of employees that spawn and sustain innovation. Once a company has been recognized as having a high “innovation quotient” in the larger corporate ecosystem, innovative workers will be seeking out the company, rather than vice versa.

Still, doing innovation entirely in-house can be limiting for some companies (even for those with a strong innovation track record and plenty of innovation dollars to spend), which is why a fair number of them are joining forces with partners. “Truly innovative companies know the importance of leveraging external resources,” says Shelton. “The benefits include better quantity and quality of ideas, execution support, access to distribution and sales channels, and lower innovation costs—all of which deliver higher returns on innovation.”

For instance, 29% of the private companies we surveyed say they plan to co-develop innovations with suppliers to make their supply chains more flexible—the better to manage risk and respond to new opportunities as supply chains become increasingly complex, particularly in markets abroad.<sup>5</sup> Here, again, having a reputation for innovation is beneficial, since it eases the way to finding worthy collaborators.

“Companies mastering external collaboration—including co-development with customers—may end up having higher growth rates and lower costs,” notes Shelton. Private-company innovators are well aware of this, with the majority saying they plan to engage customers in developing and improving their products (e.g., via crowdsourcing and other web-enabled methods).<sup>6</sup> That trend will surely continue as technology finds ever-better ways of allowing direct consumer input.

### Top business objectives for private-company innovators



Source: *Trendsetter Barometer*, PwC, December 2011

**Companies mastering external collaboration—including co-development with customers—may end up having higher growth rates and lower costs.**

<sup>4</sup> *Private Company Trendsetter Barometer*, PwC, December 2011

<sup>5</sup> *Ibid*

<sup>6</sup> *Ibid*

## Innovation is a team sport

### Innovators forecast higher revenue growth rates than their peers

Projected 12-month growth rate

**10%**

Prioritizing innovation to a great extent

**8%**

Prioritizing innovation to any extent

**5%**

Not prioritizing innovation at all

Source: *Trendsetter Barometer*, PwC, December 2011

### Innovator demographics

Which private companies are most focused on innovation? The ones who are investing in growth.

Planned activity	Innovation emphasis*	
	Some	Great
 New hiring	<b>45%</b>	<b>59%</b>
 IT	<b>33%</b>	<b>48%</b>
 R&D	<b>10%</b>	<b>32%</b>
 New products	<b>28%</b>	<b>51%</b>
 Major new capital investments	<b>34%</b>	<b>51%</b>

\*Percentages show the extent innovation has been prioritized.

Source: *Trendsetter Barometer*, PwC, December 2011

While there is no surefire template for executing innovation strategy, leading private companies do know that a linear, top-down approach is not the best way to go. Instead, they favor an integrated cross-departmental approach—one involving the marketing, sales, finance, and IT departments, among other key areas of the business.

A cross-departmental approach generally means that innovation efforts will be better grounded in market considerations and more likely to receive executive buy-in—as well as be supported by well-defined operational processes.

Such processes include those for identifying innovation opportunities, determining where in the business innovation is most needed, devising an execution strategy, and encouraging employees to propose innovations.

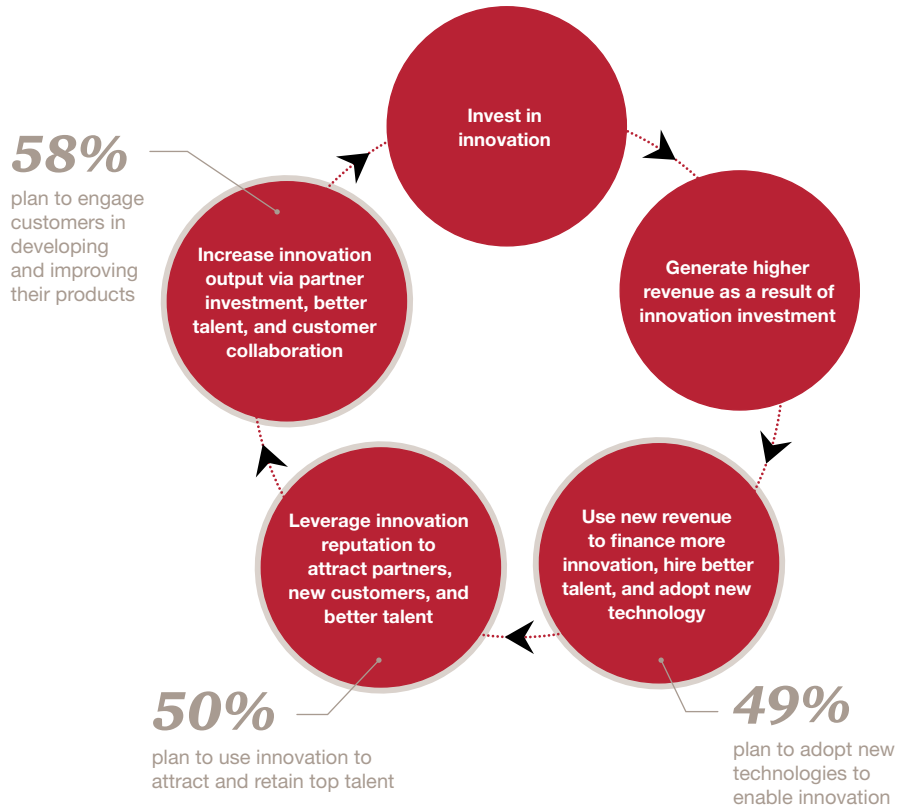
Well-defined operational processes may seem contrary to the free-ranging creativity that's essential to innovation—which could be why many private companies that innovate do so without any formal approach (55%).\* But the picture changes among private companies that prioritize innovation to a great extent—59% of them have a formal cross-departmental strategy, recognizing its importance to putting creative thinking to profitable use.\*

The importance of a cross-departmental strategy isn't necessarily lost on businesses that don't have one. One-quarter of private-company innovators say a chief impediment to innovation is their lack of a disciplined in-house process for driving and executing innovation.\* While creating those processes from scratch may seem challenging, it could be well worth the effort for companies that see innovation as a key path to growth and greater efficiency.

\* *Trendsetter Barometer*, PwC, December 2011

### Innovation's virtuous circle

Innovation begets more innovation



Percentages reflect private companies that are pursuing innovation.

Source: *Trendsetter Barometer*, PwC, December 2011

# 49%

Percentage of private-company innovators that say they will adopt new technologies to enable innovation

Source: *Trendsetter Barometer*, PwC, December 2011

*“We’ve been able to identify consumers’ personal preferences, buying triggers, and likely brand loyalty by bringing data analytics to bear on the information we mine through social media and other digital means.”*

Kent Kushar  
Chief Information Officer  
E. & J. Gallo Winery

## Doing more with less Turning your business into a fast company

For private companies, one of the biggest benefits of technology is the ability to do more with less, often to considerable effect. Don Wen, a partner in PwC’s Private Company Services practice, has observed this at a number of privately held companies: “They identify an aspect of their business that could be more efficient and then wrap technology around it to transform themselves into more agile and faster companies.” That doesn’t just mean *doing* things fast; it can also mean fast growth.

Take the software service industry, for example. There, a privately held business called ServiceSource<sup>7</sup> noticed that many large tech companies were achieving less than optimal renewal rates on their maintenance, support, and subscription contracts. Addressing this problem would have been time-consuming for tech companies, undercutting their main focus of developing and selling new products.

ServiceSource proposed an innovative solution: It would wed cloud computing with big-data management and sophisticated analytical tools to see which customers were most likely to renew their contracts—and then target those customers. Through this approach, ServiceSource increased clients’ renewal rates significantly, in return for a share of the increased profits.

Embracing new technologies such as cloud computing (which eliminated the costly and time-consuming investment of building new IT infrastructure) was a crucial component of ServiceSource’s success, enabling it to devise and implement its system swiftly and economically. That, in turn, allowed the company to deliver its solution to customers at an attractive price.

Not far from Silicon Valley, the California wine industry has also been harnessing technology for speed. Social media, in particular, has proved a fast, expedient, and inexpensive way for winemakers to position products and expand customer reach. An early adopter of this approach was Barefoot Wine, a brand acquired by E. & J. Gallo Winery in 2005. Shortly after the acquisition, Barefoot started using social media as a way to get the word out about its product. At that time, Barefoot had annual sales of 600,000 cases. By 2011, it was selling over 14 million cases a year.

Barefoot’s extensive use of social media did more than cast a wide publicity net for Gallo’s new brand—it also helped Gallo learn early on who was buying Barefoot’s wines and why. “Through this pioneering use of social media, Gallo was able to accentuate Barefoot’s successful brand characteristics, better appealing to niche markets and capitalizing on consumer tendencies there,” says Bo Parker, a managing director in PwC’s Center for Technology and Innovation.

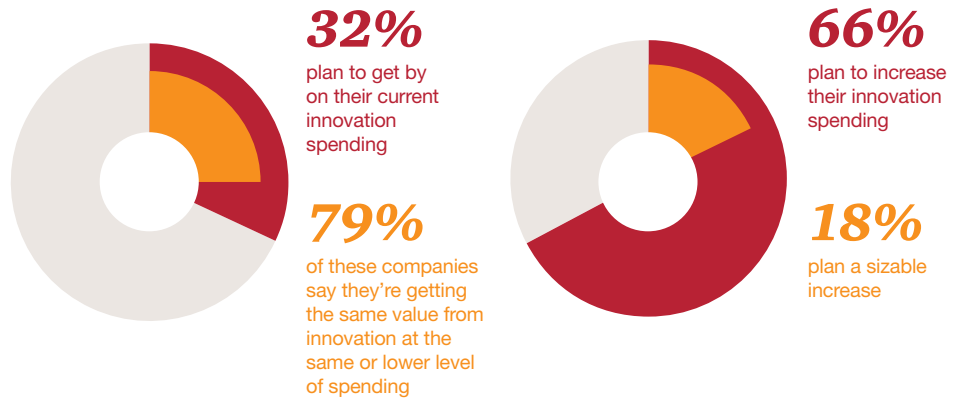
Gallo has applied this approach to its business overall. “We’ve been able to identify consumers’ personal preferences, buying triggers, and likely brand loyalty by bringing data analytics to bear on the information we mine through social media and other digital means,” says Gallo’s CIO Kent Kushar. “These fact-based insights are instrumental in helping us improve customer experience, create new products, and drive brand differentiation.”

<sup>7</sup> ServiceSource has since gone public, making its initial public offering in 2011.

Technology-enabled innovation that focuses on customers is hardly endemic to Northern California—it’s an approach that’s characteristic of many private companies, regardless of where they’re located. Wen notes, however, that private companies generally like to be a few steps behind their public counterparts when it comes to buying new technology, preferring not to put their capital at risk that way. In most cases, they don’t have to wait long for new technology to mature into something they’re comfortable investing in. “Where private companies do want to be first movers,” says Wen, “is with their customers—*first* in delivering quality and solving problems. To do that, they need to understand the voice of the customer. A large part of innovation for private companies really comes down to precisely that.”

### Innovative spending

Private companies are getting more out of their innovation dollars



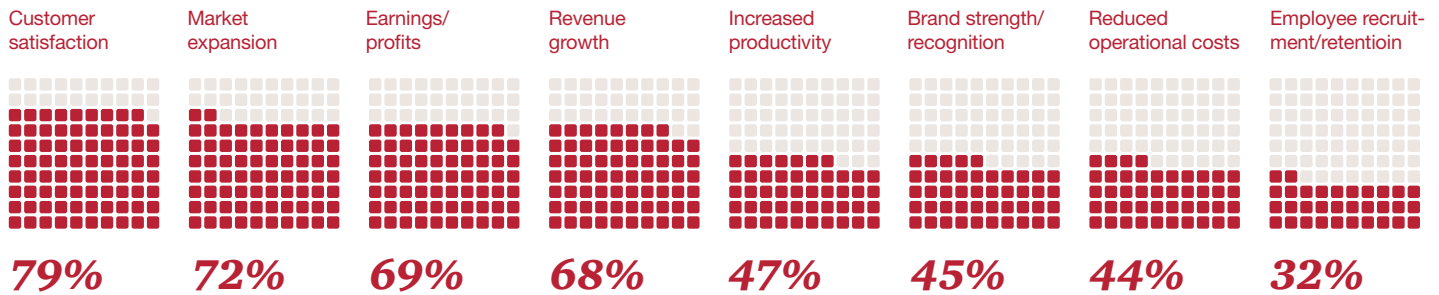
Source: *Trendsetter Barometer*, PwC, December 2011

### Mapping the metrics

How do you measure the success of your innovation?

Private companies gauge the success of their innovation efforts based on how well those efforts contribute to the following areas.

#### Metrics



Source: *Trendsetter Barometer*, PwC, December 2011

# Funding innovation

## Some businesses are more innovative than they're getting (tax) credit for

Innovation and experimentation are not the exclusive domains of science and high technology. Likewise, neither are tax credits for research and experimentation (R&E). Any company that is either creating new products, services, and processes or improving them is quite likely engaged in some form of research and experimentation — also referred to as research and development (R&D) — meaning they could qualify for an R&E tax credit.

“In short, you don’t have to be discovering new engineering principles or novel technologies to be eligible for an R&E tax credit,” says Mark Stevens, a tax partner in PwC’s Private Company Services practice. “However, to qualify, a company generally will need to exhibit some fundamental reliance on principles of the biological, physical, engineering, or computer sciences somewhere in its process of experimentation and development.”

### **The ABCs of R&E tax credits**

An R&E tax credit is an incremental research expenditure credit. There are two federal credits\* — the regular research credit and the alternative simplified credit. The regular research credit is 20% of a qualified amount of incremental spending. The alternative simplified credit is 14% of a qualified amount of incremental spending. Most states (40) have credits that can be added to the federal credits.

**How to claim:** Research credits are claimed on a federal or state income tax return. If your company is an S corporation or partnership, the credit may be claimed on the partner’s or shareholder’s individual tax return. In general, the credits may be filed

on a timely tax return or may be claimed on an amended return for a previous year, under applicable statutes of limitations.

**What’s involved:** Gather information on current-year R&E/R&D activities. Document wages, supply costs, and contracted research expenses generated by those activities. Companies will need to bear in mind that “incremental spending” is the total spending over a base amount. The base amount for the regular research credit is either the greater of a calculated historical base amount or 50% of the company’s current-year spending on qualified research. The base amount for the alternative simplified research credit is 50% of the average of qualified expenses over the prior three taxable years.

**Limitation:** A business has to be profitable and taxable to use the credit in a current year. The good news: Unused credits can be carried forward to future years.

### **Missed opportunities**

PwC’s R&E tax credit team has found that many companies are unaware of their eligibility for an R&E tax credit or significantly understate their qualified research expenditures.

One way to determine whether your company might be undertaking activities that qualify for an R&E tax credit is to look at your personnel. Do you employ people (including contractors) who have a scientific or technological background, such as engineers, computer programmers, chemists, biologists, or physicists? “If your company is relying on such workers to apply their scientific or

\*The federal credit officially expired at the beginning of the year, but Congress can reinstate it retroactively, as it has done nine times before.



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technological knowledge in the development or improvement of products, services and processes, it may qualify for an R&E tax credit,” says Stevens.

Many companies in the following industries take advantage of federal and state research credits: aerospace and defense, automotive, chemical, food and beverage, forestry and paper products, manufacturing, oil and gas, pharmaceutical, and high technology.

### **What’s eligible? What’s not?**

#### **Eligible activities**

Research activities that fundamentally rely on principles of the physical, biological, computer, or engineering sciences may qualify for an R&E credit. Such activities include the following:

- Development of new products/services
- Process improvements
- Product improvements
- Certain environmental and regulatory compliance activities

#### **Ineligible activities**

- Research conducted outside the United States
- Routine data collection
- Routine quality-control testing
- Adaptation of existing business components

A good rule of thumb when assessing eligibility for an R&E tax credit is to look at a product and the accompanying process(es) separately. For instance, a cosmetic change to a product does not in itself qualify for an R&E credit. However, if you have to revise your manufacturing process in order to make the cosmetic change, the research involved in determining how to make the process modification might qualify for the credit.

Similarly, routine activities a manufacturer must undertake to comply with government standards do not qualify as R&E. However, if regulatory compliance means that the company must change its manufacturing processes, then the research and development activities underlying the process changes could meet the definition of R&E for tax-credit purposes.

### **Getting started**

If you think your company is eligible for an R&E tax credit, here’s what you should do:

- Conduct a feasibility or benchmarking analysis of your company’s operations to determine their eligibility for the credit
- Estimate what the credit might be
- Gather enough information to establish eligibility for the credit

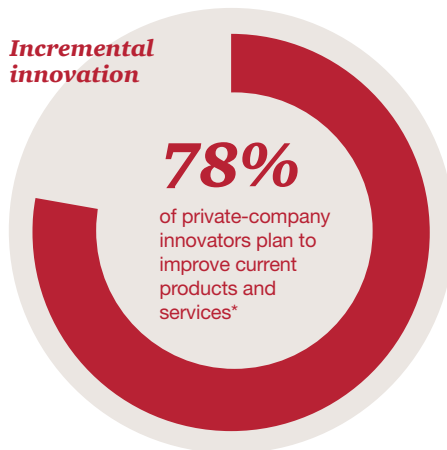
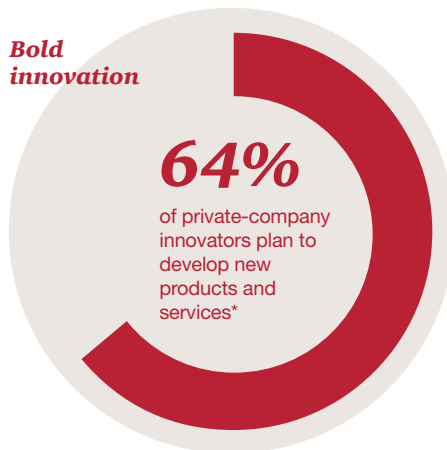
“Because the credit is against the amount of taxes owed, the taxpayer has the burden of proving entitlement to the credit,” emphasizes Stevens. “Documentation is critical.”

A company will need to furnish work papers that support their credit calculations. The initial burden of doing this should ease once a company institutionalizes processes for identifying R&E activities and for compiling the necessary documentation. For most qualifying businesses, the benefits far outweigh the costs.

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***Many companies are unaware of their eligibility for an R&E tax credit or significantly understate their qualified research expenditures.***

**Most companies will pursue some combination of incremental and breakthrough innovations.**



\*Source: *Trendsetter Barometer*, PwC, December 2011

## **Balancing act** Does your innovation portfolio contain the right mix?

Companies that are most successful at innovation tend to approach it as they would a portfolio of investments, striking the right balance between bold innovations and incremental ones.

Admittedly, when one thinks of innovation, the word *bold* tends to come to mind more readily than the adjective *incremental*, often accompanied by a mental image of people in lab coats bent over scientifically or technologically challenging research. Take the privately held BioBehavioral Diagnostics Company (BioBDx), which describes its mission as providing “tools for the diagnosis and management of neurological and psychiatric conditions, leading to a transformation of behavioral medicine.”<sup>8</sup> A couple of years back, the company devised a tool to help doctors objectively diagnose attention deficit hyperactivity disorder by measuring a person’s motion and analyzing shifts in his/her attention. One might point to this tool as a quintessential example of bold innovation.

Incremental innovation, on the other hand, emphasizes smaller improvements over riskier innovations. These often involve tweaking products or processes. Tweaking is the very thing BioBDx did after introducing its diagnostic tool—roughly a year later the company unveiled a portable version.

While incremental changes may be small, the rewards can be large. And they can just as easily be low-tech as high-tech: “A client of ours who’s a distributor cut back considerably on costs simply by reconfiguring its storage space, changing the way trucks load products, and using different machinery and racking systems to stack inventory,” notes Wen. The key is to pursue bold and incremental innovations in the right combination.

“Companies that are looking to grow more aggressively will have a strong core of breakthrough innovations in their portfolio,” notes Shelton. “But even high-growth companies will innovate incrementally in some ways, such as when they make continual yet small upgrades to operations, products, or services. So it’s not simply the case that one type of company is always bold in its innovation and another is always incremental. In reality, most companies will pursue some combination of incremental and breakthrough innovations that senior executives deem appropriate for their company’s particular market situation and level of risk tolerance.”

Indeed, the market situation for a particular industry can force otherwise bold innovators to resort to incremental changes for the time being. “We have to bear in mind that the larger economy is a collection of microeconomies,” says Parker. “Some companies are exposed to parts of the economy that are still contracting, which can severely constrain their cash flow and ability to invest.” Meanwhile other companies are exposed to faster-growing microeconomies, such as the resurgent automaker sector, where there’s renewed spending on innovations like electric and hybrid cars.

Ultimately, the portfolio balance between incremental and breakthrough innovations will depend on a company’s growth objectives. The higher the company’s targeted growth rate, the higher the percentage of breakthrough innovations the company will need to pursue, risk appetite permitting. Incremental innovations, meanwhile, help protect market share and margins of existing products and services, and in that way complement a company’s breakthrough innovations.

8 <http://www.biobdx.com/wp-content/uploads/2011/03/12132010-YoungStartUp.pdf>

## Taking innovation to the next level

### Finding your future growth engine

Private companies will need to up their innovation game if they want to extract enduring value from their innovation efforts. To do this, they will need to think beyond quick wins. Where does the company see itself 10 years from now? What will be the growth engine that keeps the company relevant and continues to propel it forward? Is the company's current business model up to the task?

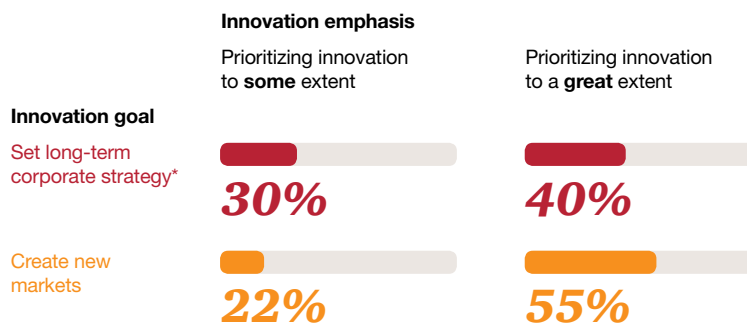
Too few companies are looking that far ahead. This may be dangerously short-sighted in a business landscape that's expected to evolve dramatically over the next few decades. Technological advances will change *how* companies do business, while the increasing importance of emerging markets will change *where* that business is done (as well as the nature of the services and products sold).

Unlike their public counterparts, private companies are not constrained by quarterly reporting requirements, and so they may be under less immediate pressure to show a return on investment in bold innovation efforts. This gives them more room to maneuver and take risks, which is critical to sustaining a culture of innovation at a company.

Indeed, more than one-third of private companies that prioritize innovation are doing so with long-term corporate strategy in mind. That number is even higher among innovation leaders (i.e., private companies that prioritize innovation to "a great extent"): Forty percent say their innovation efforts may result in entirely new business models. Fifty-five percent say they plan to use innovation to create new markets for novel products and services that are still in the idea or development stage, along with new modes of bringing those products and services to market. "Finding new ways to deliver the business model—and, certainly, new ways to finance

### Facing the future

Companies for which innovation is a high priority are looking beyond the here and now, setting their sights on long-term corporate strategy and future markets



\*Including adopting new business models

Source: *Trendsetter Barometer*; PwC, December 2011

it—means that companies are not only changing their technologies but are also actually changing the way they do business and whom they do it with," says Shelton.

## Conclusion

Regardless of whether they're looking to grow their business via new service offerings or seeking cost containment through process efficiencies, leading private companies know that innovation needs to be at the heart of these efforts. Here are core considerations they keep in mind while pursuing their innovation goals:

- Tie innovation strategy directly to your company's business goals, including long-term corporate strategy.
- How you spend is more important than what you spend. Develop an operating model that delivers the right mix of innovation to meet your company's goals.
- How you innovate determines what you innovate. Trying to drive breakthrough innovations with a process designed primarily to develop and commercialize incremental innovations is unlikely to yield positive results.

- Set organic growth targets based on an optimal mix of breakthrough and incremental innovation, then choose the levers for carrying out your innovation strategy (e.g., technology).
- Determine the roles that internal and external partners should play in the company's innovation efforts, as well as the right amount of R&D spend.
- Foster a company-wide culture of innovation. While company leaders should set the tone, successful innovation is ultimately a team effort.
- Incentivize innovation. People work hard for what they're measured by and rewarded for.
- Be sure your company's innovation strategy adequately reflects the business's risk tolerance.

### **More information**

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<sup>1</sup> 2011 Forbes America's Largest Private Companies List



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