Federici Business Group

Launching Great Ideas Into Great Businesses

Procter & Gamble Re-Ignites Growth— XBD & Open Innovation Make It Happen

WHITE PAPER

INTRODUCTION

Procter & Gamble, the venerable consumer goods company famous for Crest™ toothpaste, Charmin™ bath tissue, Tide™ laundry detergent and Pringles™ potato snacks, got a frightening wake up call in 2000. Their R&D productivity had leveled off and the fraction of new products meeting financial objectives had stagnated at 35%. They were being squeezed by nimble competitors and lackluster new launches, and were missing quarterly earnings goals. Ultimately, P&G saw its stock plunge from $118 per share to $52 per share, a loss of more than half of its market capitalization (1).

That year, the Procter & Gamble Board appointed A.G. Lafley as the new CEO. He, in turn, challenged the staff to re-invent the company's innovation business model. By 2002, Procter & Gamble had re-organized its entire business to focus on the global growth of its famous brands and to add new products ahead of competitors. Today, sales top $38 billion annually (2).

The company re-ignited its growth by pursuing two radical strategies:

- To aggressively introduce products into high growth markets far from its traditions, but close to its expertise
- To exploit the new and untested open innovation marketplace.

In 2000, the market for luxury goods was the bastion of a few old, but strong, specialty firms. Procter & Gamble's genius was to recognize that its own expertise in middle market cosmetics and, particularly, fragrances, could be molded into products attractive to the luxury customer. Procter & Gamble understood that they had a unique expertise in fragrance formulation.

The company also astutely recognized that its vast experience in consumer marketing was not going to be helpful in the luxury marketplace. To overcome this challenge, P&G began forging partnerships with some of the world's legendary high fashion houses (3). By late 2007, Procter & Gamble's stable of relationships included fashion icons Giorgio of Beverly Hills, Gucci, Valentino, Dolce and Gabbana, Lacoste, and Hugo Boss. P&G's Prestige Fragrances business was delivering double digit sales growth, too (4).

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Andy Grove, Intel's co-founder, recently wrote in Portfolio magazine about some observations he has made concerning hugely successful companies. (5)
There are some successful companies that grew to leviathan sizes only to find that their successes stymied continued growth. The operative question for these leviathans is, what more can you do when you already own 45% market share? Mr. Grove also observed that sometimes these same firms can create growth spurts for themselves by entering entirely different industries. The name Mr. Grove has given to this phenomenon of renewed growth is cross boundary disruption, or XBD.

In this Portfolio article, Mr. Grove cited WalMart's recent opening of in-store healthcare clinics as an especially good example of cross boundary disruption at work. When Procter & Gamble crossed out of its middle market comfort zone into luxury fragrances, it was making itself a model for XBD. This was well before WalMart opened healthcare clinics or Andy Grove gave the behavior a name.

When Mr. Lafley took the helm of Procter & Gamble, open innovation was a very new, but also not an entirely unheard of, concept. A few forward-looking companies, like IBM and Eli Lilly, were already exploring its possibilities. The essence of open innovation is that knowledge and know-how are now so widely distributed, that companies can't afford to rely entirely on their internal resources alone to fuel future growth. Operatively, this means that a global market has developed in which to buy and sell new and promising technologies (6).

Embracing open innovation to jumpstart renewed growth was a very daring decision for P&G. Large uncertainties loomed. Were significant technology advances really available for sale from outside vendors? Procter & Gamble already employed some of the world's most talented scientists and engineers. These very important technologists were rightly proud of their contributions and maintained a culture of resistance to ideas not conceived by themselves. By pursuing open innovation, Mr. Lafley exposed Procter and Gamble to the significant risk that the company's cadre of technologists would revolt rather to have to accept and champion development projects coming from outside. Mr. Lafley and his management team accepted the risks and created the "Connect and Develop" program based on open innovation.

This program has inside and outside components.
On the inside, each one of P&G's business units is asked every year what consumer needs, when addressed, will drive the growth of their brands. These consumer needs are compiled into a single list for the company. Examples of needs that might appear on the company wide list are "reduce wrinkles, improve skin texture and tone", "improve soil repellency and restoration of hard surfaces" and "create softer paper products with lower lint and higher wet strength". The items on the needs list are then deconstructed into descriptions of the underlying scientific questions. The identified scientific questions are developed into technology briefs, which are written in a way to protect the company's proprietary interests because they are going to be circulated outside of the company.

The outside "Connect and Develop" components are global networks of technology entrepreneurs, suppliers and technologist-to-P&G matchmaking organizations. Open innovation works by circulating the technology briefs around in the networks and soliciting network members to respond with proposals for the solutions of the scientific questions described in the briefs. Solutions are contributed from members of the open innovation networks and carefully evaluated internally by P&G. The solutions selected for further investigation are given to P&G's external business development group to contact the products' manufacturers and begin negotiations for licensing, collaboration or other deal structures.

The open innovation mechanism differs from outsourcing innovation, that is contracting with outsiders to develop innovations for P&G. Outsourcing R&D typically just transfers work to lower cost providers. "Connect and Develop" is about finding good ideas and bringing them in to enhance and capitalize on internal capabilities. Also, appreciate that open innovation includes development of business deals to license technologies developed in P&G labs to outside companies.

One brilliant success of the "Connect and Develop" open innovation program is Pringles Prints, the potato crisps that have jokes, pictures and trivia questions printed on them. The technical questions were: How do you write on the fragile snacks without breaking them and How do you formulate edible inks? The corresponding technology brief was picked up by a bakery in Bologna, Italy. There, a university professor was selling cakes and cookies with writing on them. The professor had developed an ink jet printer mechanism that used edible inks and colorants.

Another huge success for "Connect and Develop" is the Mr. Clean Magic Eraser. The underlying material is a melamine resin foam manufactured by the German chemical giant BASF for use as soundproofing and insulation in the construction and automotive industries. An open innovation technology entrepreneur saw the BASF foam for sale in Japan as a household cleaner, recognized its potential for Procter & Gamble and posted their discovery on P&G's internal 'eureka catalog'. In 2002, P&G contacted BASF for purchase of its melamine resin foam and for further co-development. By 2004, P&G and BASF had jointly developed the Magic Eraser Duo, a blockbuster product.

The out-licensing side of open innovation has also scored big successes for Procter and Gamble. One of these was a deal to license a low cost microneedle technology to a specialty drug delivery company. This business arrangement means that P&G is earning money through application of the microneedle technology in its own products and also through the license to the drug delivery company. A nice double win!

The great new products described above came to market because the P&G management nurtured and rewarded an internal cultural transition from not-invented-here rejection of ideas discovered through open innovation to enthusiasm for a provocative stream of new product projects to work on. The R&D staffs were not cut, as feared. Neither did the company, as a whole, lose important capabilities. The achievement rewards for employees are the same for successful products whether they were initiated internally or externally. To the extent that employees are recognized for the speed of product development, the reward system favors innovations developed from outside ideas because these are often introduced into their marketplaces quicker.
The risks associated with investing in each of these initiatives were very big in 2000.

What does the ROI look like today?

Reporting from Procter & Gambles' February 1, 2008 10Q SEC filing (7), for the six months preceding the end of the quarter:

- Net sales are up 8% to $41.8 billion. Organic sales are up 5%
- Unit sales volume is up 5%. Organic volume grew 6% with every reportable segment and region posting year-on-year organic volume growth.
- Net earnings are up 14% to 6.3 billion.

Operating cash flow was $7.4 billion, up 36% from 2006. Also, Prestige Fragrances are delivering double digit growth (4).

Clearly, the ROI on A.G.Lafley's risky investments is positive and very big!

References

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(3) Byron, Ellen, "P&G's Push Into Perfume Tests a Stodgy Marketer", Wall Street Journal , November 12, 2007, page A1.

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(5) Grove, Andy, "Think Disruptive", Portfolio December 2007.

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