TO WIN WITH INNOVATION — KILL R&D

Superstar free-agents are the key to product innovation. How can you tap your industry's Michael Jordan?

BY CHARLES E. LUCIER AND JANET D. TORSILIERI

FAMILIAR ADVICE: improve product innovation. Innovate:

- Better — create breakout products, not just "me toos."
- Faster — reduce cycle times.
- More often and more efficiently.

Most companies try to achieve these urgent and important goals by sharing and adopting best practices in product development; re-engineering their research and development processes; improving cross-functional linkages; stimulating the creativity of their employees, and creating an innovative culture. And these efforts often yield large, measurable improvements.

Yet, consistently successful companies in the most innovation-intensive industries — those in which product life cycles are short and the need for breakout products is high — have pioneered a radically different approach to innovation. By thinking "outside the box," these innovators recognized that they couldn't rely solely on internal sources of innovation. Their new approach — unbundling innovation by leveraging the talents of superstars who are not employees — enables "breakout" in two ways: dramatically improving the likelihood of blockbuster products, and changing the rules of the game by restructuring the industry value chain.

We believe that this alternative innovation strategy is so powerful and will become so pervasive that all companies should ask: Is this alternative strategy likely to be advantageous enough that we should pioneer its introduction in our industry? Are competitors adopting this strategy and trying to change the rules of the game? Even if the entire strategy is not appropriate, should some of its elements be combined with a more conventional approach to innovation?

KEY LESSONS FROM THE ENTERTAINMENT INDUSTRIES

The industries with the shortest product life cycles and the greatest dependence on blockbuster products provide a valuable window into the future of innovation. In our experience,

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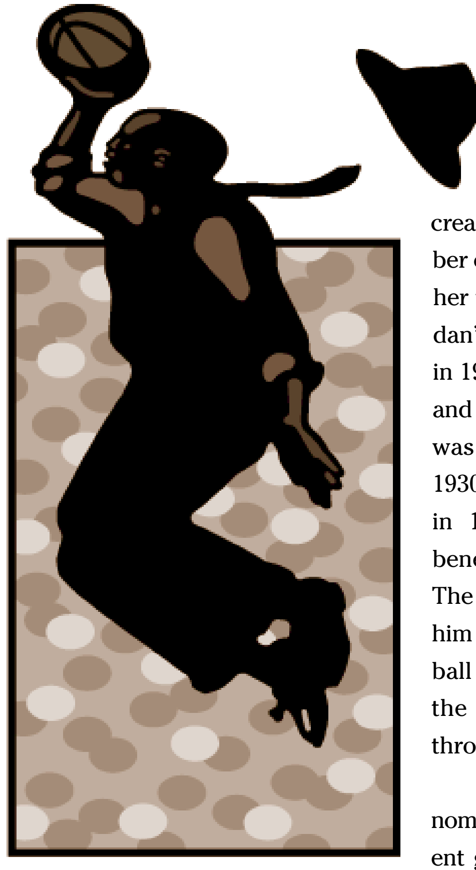
the entertainment industries (e.g., sports, movies, television, radio, publishing and music) are the most demanding of innovation. As Chris Rock quipped on an MTV Music Video awards show: "It used to be that music was here today and gone tomorrow. Now it's here today and gone today."[1]

Despite some important differences, the entertainment industries share five characteristics:

- Success in the industry depends on a handful of blockbuster products (and brands), not only to gain market share but also to increase the size of the market. For example, in 1977 worldwide sales of video games were only about $400 million. The first blockbuster, the Super Mario Brothers characters, has alone generated more than $5.8 billion of revenue.[2]
- The industries believe that only a small number of talented superstars create blockbuster products, although many people can produce pretty good products.
- Individual superstars move from company to company (or team to team) — sometimes on a project-by-project basis (e.g., movies, books), more often after the expiration of a multi-year contract.
- Each of the superstar talents — whether entertainers, athletes, authors or even coaches — becomes



a brand recognized by the industries' customers.
- Since creation of a truly breakout product is always uncertain — however great the past success of the superstar talent — contracts between talented individuals and companies increasingly involve risk-sharing. For example, although Stephen King originally asked for a $17 million advance for "Bag of Bones," he ultimately received a $2 million advance plus 50 percent of the profits.

Sherwin Rosen, in an article in the American Economic Review, laid out the basic economics of superstars: The value created and captured by a superstar increases with scope, i.e., with the number of people who benefit from his or her talent. For example, Michael Jordan's $78.3 million of compensation in 1997 ($31.3 million from the Bulls and $47 million from endorsements) was nearly 100 times Babe Ruth's 1930 compensation (about $800,000 in 1997 dollars). Michael Jordan benefited from much greater scope: The 160 million people who watched him during the 1998 National Basketball Association playoffs exceeded the number who saw Babe Ruth throughout his entire career.

The implications of superstar economics are profound. First, the best talent generally wins, like Michael Jordan's Bulls and Babe Ruth's Yankees. Second, when bidding for the services of free agent superstars, a company earns superior profitability only if it can leverage a superstar to create value better than its competitors can — generally by increasing the superstar's scope more than competitors do.[3]

Hence, in the most intensely competitive, product-driven industries, *the value chain is restructured into superstar individuals and small teams who compete on the basis of creating products, and large firms that compete on the basis of increasing the scope of breakout products (i.e., of commercializing and marketing).*

[1] Quoted in Michael J. Wolf, "The Entertainment Economy: How Mega-Media Forces Are Transforming Our Lives" (Times Books, 1999), p. 73.

[2] Ibid.

[3] In theory, a company could also earn superior profitability by a superior ability to select, target, motivate or coordinate a team of superstars. In practice, there is little evidence that companies can sustain profitability on these dimensions.

Illustration by Neal Aspinall

IRONICALLY, THE MORE IMPORTANT TRULY INNOVATIVE PRODUCTS BECOME IN THE MARKETPLACE, THE MORE CRITICAL ARE THE MOST TALENTED PRODUCT DEVELOPERS, AND THE MORE IMPORTANT IT IS FOR LARGE COMPANIES TO BUILD COMPETITIVE ADVANTAGE IN MARKETING, NOT INNOVATION.

Ironically, the more important truly innovative products become in the marketplace, the more critical are the handful of the most talented product developers, and the more important it is for large companies to build competitive advantage in marketing and commercialization, not innovation.

INCREASING THE SCOPE

The Walt Disney Company pioneered the breakout strategy of expanding scope in the entertainment industry. Disney excels at marketing a hot product like "The Lion King" not only to movie theaters in the United States and around the world (both initially and in re-release) but also to:

- TV and cable.
- Video.
- Sound track CD.
- Toys and other merchandise both for sale and for promotions (e.g., Burger King used "The Lion King" characters in a promotion).
- Books.
- Theme park parades, shows and walk-around characters.
- A Broadway show.

Each expansion of scope generates an additional stream of revenue far in excess of the incremental cost, enhances the brand of "The Lion King" product (creating more opportunity for line extensions like "Simba's Pride"), and makes Disney a desirable marketing partner for other leading brands such as Kodak, McDonald's and Mattel. Because so much value is created by leveraging a breakout product across so many revenue streams, Disney can spend aggressively to create the next blockbuster — not only when bidding for the services of the most talented product developers but also when marketing the initial "The Lion King" movie.

In recent years, Disney has moved beyond "breakout" scope expansions to unbundle its innovation process, increasingly relying on contracts with superstar individuals and small teams. For instance, Disney partnered with technology innovator Pixar Studios for the hits "Toy Story" and "A Bug's Life." After a distribution fee of 12.5 percent to defray costs, Disney splits all profits 50–50 with Pixar (including merchandising and royalties, box-office receipts and video sales). Similarly, Disney relies on the talents of the trio at Imagine Studios (Ron Howard, Brian Grazer and Tony Drantz) for creating television hits "SportsNight," "Felicity" and "The PJs." Disney's ability to expand scope makes it a powerful magnet for superstar innovaters.

This radically different strategy of unbundling innovation and expanding scope has proven to be very successful. Returns to shareholders of publicly traded media and entertainment companies were significantly greater than the market from 1988 to 1996; Walt Disney shareholders received 95th percentile returns for more than a decade.

BEYOND ENTERTAINMENT: TOYS AND FOOD

The precondition for this dynamic of unbundled innovation and expanded scope — that a small number of talented superstars are responsible for most breakout products — is found in most industries. For example, Nintendo game developer Shigeru Miyamoto (now assisted by a team of 200) was responsible for the megahits Super Mario Brothers, Donkey Kong and Legend of Zelda; Fidelity's Peter Lynch and Berkshire Hathaway's Warren Buffett sustained legendary records of investment success; superstar designers such as Ralph Lauren, Calvin Klein and Martha Stewart became brand names in the fashion and textile industries. The dominance of a small number of superstar product developers is not new. Consider inventors such as Thomas Edison in the 19th century; General Motors' Charles Kettering in the early 20th century, or designers such as George Nelson, Isamu Noguchi and Charles Eames, who created Herman Miller Inc.'s breakout commercial furniture in the 1960's.

Of course, not all of these companies exhibit a Disney-like unbundling of innovation and expansion of scope. Nintendo and Berkshire Hathaway remain integrated. Although Fidelity Investments (now offering some funds managed by others) and fashion and textile manufacturers unbundle some of their innovation, they have not focused on an expansion of scope.

But an increasing number of companies emulate Disney. For example, none of Hasbro Inc.'s hot toys — Furbies, Teletubbies and Pokemon dolls — were developed in-house; Hasbro recently licensed a new line of Star Wars figures from George Lucas, compensating him with both a guaranteed $600 million in royalties over nine years and warrants to buy more than 7 percent of the company.[4] Hasbro is starting to focus on increasing the scope of its existing products and brands, through 36 licensing deals for Monopoly (e.g., Napa Valley Monopoly) and through chocolate and cookie dough, video games, promotions at McDonald's and even slot machines. Similarly, the Starbucks Corporation is expanding its scope not only by opening new restaurant locations, but also by selling beans, coffee and even ice cream in supermarkets, in wholesale clubs and over the Internet — while partnering with others expert in product development and distribution (e.g., Kraft).

We believe that other industries will evolve as entertainment has. For example, in the pharmaceutical industry, Pfizer Inc. was one of the first to recognize that it couldn't rely on internal innovators alone. Pfizer's innovations in commercialization and marketing (a "blitz" approach to product launch and a top-rated sales force) enable it to increase scope more than its competitors and have made it a magnet for smaller companies with potential blockbuster products (e.g., Warner-Lambert with Lipitor and Monsanto with Celebrex) to form co-marketing arrangements. This year, Pfizer's strategy of being the "Co-marketer of Choice" is expected to bring in more than 10 percent of its pharmaceutical profits.

Might the pharmaceutical value chain unbundle, with major pharmaceutical companies curtailing their research activities and focusing on increasing the scope of "advantaged molecules" through superior design and management of clinical trials, product launch, life-cycle management and sales? What additional innovations in commercialization and marketing might large pharmaceutical companies employ to expand scope? Might superstar teams of researchers at biotech, genomics and small pharmaceutical companies remain focused on the creation of "advantaged molecules," forgoing investments in their sales and marketing infrastructure?

CHANGING THE GAME

What is causing the increase in the unbundling of innovation and the focus on increasing scope? The increasing importance of breakthrough (as opposed to incrementally better) products in crowded global markets is part of the answer. But the central cause is a three-step dynamic that is transforming some industries.

First, where talented superstars can move easily, the competitive advantage enjoyed by the companies with the greatest scope increases over time, in a reinforcing cycle of increasing returns:

- Companies with the greatest scope hire the most talented superstars.
- The most talented superstars tend to produce superior results — results that are further improved by the greater scope.
- Superior results enhance the return on further increases in scope, provide the cash to make the investment and attract other superstars.
- Companies with the least scope fall progressively farther behind as their less talented stars produce weaker results and as they invest less in expansion of scope.[5]

Take baseball, for example: "Last year roughly half of all teams had payrolls of less than $45 million, and none of those teams appeared in the playoffs…. In 1998, baseball's richest

[4] Joseph Pereira, "Hasbro Strikes Back: Hot Toys Help Firm in Battle With Mattel," The Wall Street Journal, April 15, 1999.

[5] This cycle of increasing returns is strongest — and an industry is most likely to evolve like the entertainment industry — when the most talented superstars are highly likely to produce a superior product, and when the difference between the values of a superior and an average product is large.

teams had revenues four times as great as the poorest teams (before revenue-sharing payments). The player payrolls of baseball's financial elite, which for 1998 surpassed $70 million for several clubs, exceeded the total revenues of many of the other clubs. And approximately two-thirds of all ball clubs were unprofitable."[6]

Second, because this reinforcing cycle of competitive advantage is so powerful, companies best equipped to increase scope (often those superior in commercialization and marketing) have a strong incentive to change the rules of the game in the industry and unbundle innovation. Some of the benefits of increased scope are realized immediately, through increases in the value of purchased assets and through "first-mover" advantages like control of unique resources and relationships with the most talented superstars. For example, in 1976 Ted Turner purchased the Atlanta Braves and started the TBS Superstation — immediately increasing the Braves' scope and their economic value. The purchase of the MGM film library provided Mr. Turner another opportunity to use the scope-expanding potential of cable television to immediately create value.

Third, once some companies start to increase scope and change the rules of the game, other companies are almost compelled to follow. The expansion of scope raises the standard of performance in the industry by opening new market segments, increasing the compensation of superstar innovators and elevating the expectations of shareholders. Further, even with innovative compensation and management arrangements, the increasing difference in market value between the most talented superstars and the average employee makes it difficult for large companies to maintain internal equity in compensation and retain their superstars. Finally, simultaneously innovating in a series of scope expansions and developing breakthrough products strains the financial and managerial resources of firms that try to remain integrated: Focus enables innovation.

Of course, the unbundling of innovation will not occur in all industries; the three-step dynamic is more powerful in some industries than others. And even if some unbundling of innovation occurs, many companies will rely on a mix of in-house research and development (e.g., for line extensions and "me too" products) and superstar individuals and teams (for breakthrough products). Classical music may prove to be a common model for innovation. Most classical musicians work in symphony orchestras where they perform as an ensemble. A handful of superstars are not members of an orchestra; they perform where their unique individual talents are most apparent: as soloists, in small groups or in concertos with orchestras.

The experience of the entertainment industry suggests some tough questions for all companies. Are a small number of superstar innovators responsible for most of the breakout innovations in the industry? If so, what is required to retain access to superstar talent? As new technologies become more important, will a handful of superstars become even more important? How can you best gain access to tomorrow's superstar innovators? What is the best combination of strategies — process improvements, best-practice sharing and using superstars — to become more innovative? How can you drive increases in the scope of your best products and brands? Would a redefinition of the innovation value chain help you become the industry leader? Are competitors likely to redefine the rules of the game in the industry?

If the 1950's were the decade of the "organization man," the first decade of the 21st century will be the era of the talented innovator — both superstar and ensemble player. But, while top talent is strategically critical, the path to superior profits for companies still lies with their capabilities. The winners will drive industry restructuring around innovation: creating marketing powerhouses that expand scope and add value during commercialization — leading the redefinition of the industry value chain and mobilizing and targeting superstar innovators who are not full-time employees. SB

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[6] John Moores, "Bring Competition Back to Baseball," The Wall Street Journal, April 5, 1999.