

# P&G's New Innovation Model

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For decades, Procter & Gamble fueled its consumer products engine from R&D inside its own walls. But as its markets have matured, P&G has directed its search outward. An excerpt from *Harvard Business Review*.

by Larry Huston and Nabil Sakkab

*Editor's note: Procter & Gamble has operated one of the greatest research and development operations in corporate history. But as the company grew to a \$70 billion enterprise, the global innovation model it devised in the 1980s was not up to the task. CEO A. G. Lafley decided to broaden the horizon by looking at external sources for innovation. P&G's new strategy, connect and develop, uses technology and networks to seek out new ideas for future products. "Connect and develop will become the dominant innovation model in the twenty-first century," according to the authors, both P&G executives. "For most companies, the alternative invent-it-ourselves model is a sure path to diminishing returns."*

*This excerpt from a March 2006 Harvard Business Review article focuses on the company's assessment of its aging innovation process and the development of connect and develop.*

From R&D to C&D

Most companies are still clinging to what we call the invention model, centered on a bricks-and-mortar R&D infrastructure and the idea that their innovation must principally reside within their own four walls. To be sure, these companies are increasingly trying to buttress their laboring R&D departments with acquisitions, alliances, licensing, and selective innovation outsourcing. And they're launching Skunk Works, improving collaboration between marketing and R&D, tightening go-to-market criteria, and strengthening product portfolio management.

But these are incremental changes, bandages on a broken model. Strong words, perhaps, but consider the facts: Most mature companies have to create organic growth of 4 percent to 6 percent year in, year out. How are they going to do it? For P&G, that's the equivalent of building a \$4 billion business this year alone. Not long ago, when companies were smaller and the world was less competitive, firms could rely on internal R&D to drive that kind of growth. For generations, in fact, P&G created most of its phenomenal growth by innovating from within—building global research facilities and hiring and holding on to the best talent in the world. That worked well when we were a \$25 billion company; today, we're an almost \$70 billion company.

By 2000, it was clear to us that our invent-it-ourselves model was not capable of sustaining high levels of top-line growth. The explosion of new technologies was putting

ever more pressure on our innovation budgets. Our R&D productivity had leveled off, and our innovation success rate—the percentage of new products that met financial objectives—had stagnated at about 35 percent. Squeezed by nimble competitors, flattening sales, lackluster new launches, and a quarterly earnings miss, we lost more than half our market cap when our stock slid from \$118 to \$52 a share. Talk about a wake-up call.

The world's innovation landscape had changed, yet we hadn't changed our own innovation model since the late 1980s, when we moved from a centralized approach to a globally networked internal model—what Christopher Bartlett and Sumantra Ghoshal call the transnational model in *Managing Across Borders*.

We discovered that important innovation was increasingly being done at small and midsize entrepreneurial companies. Even individuals were eager to license and sell their intellectual property. University and government labs had become more interested in forming industry partnerships, and they were hungry for ways to monetize their research. The Internet had opened up access to talent markets throughout the world. And a few forward-looking companies like IBM and Eli Lilly were beginning to experiment with the new concept of open innovation, leveraging one another's (even competitors') innovation assets—products, intellectual property, and people.

As was the case for P&G in 2000, R&D productivity at most mature, innovation-based companies today is flat while innovation costs are climbing faster than top-line growth. (Not many CEOs are going to their CTOs and saying, "Here, have some more money for innovation.") Meanwhile, these companies are facing a growth mandate that their existing innovation models can't possibly support. In 2000, realizing that P&G couldn't meet its growth objectives by spending more and more on R&D for less and less payoff, our newly appointed CEO, A.G. Lafley, challenged us to reinvent the company's innovation business model.

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We knew that most of P&G's best innovations had come from connecting ideas across internal businesses. And after studying the performance of a small number of products we'd acquired beyond our own labs, we knew that external connections could produce highly profitable innovations, too. Betting that these connections were the key to future growth, Lafley made it our goal to acquire 50 percent of our innovations outside the company. The strategy wasn't to replace the capabilities of our 7,500 researchers and support staff, but to better leverage them. Half of our new products, Lafley said, would come *from* our own labs, and half would come *through* them.

It was, and still is, a radical idea. As we studied outside sources of innovation, we estimated that for every P&G researcher there were 200 scientists or engineers elsewhere in the world who were just as good—a total of perhaps 1.5 million people whose talents we could potentially use. But tapping into the creative thinking of inventors and others on

the outside would require massive operational changes. We needed to move the company's attitude from resistance to innovations "not invented here" to enthusiasm for those "proudly found elsewhere." And we needed to change how we defined, and perceived, our R&D organization—from 7,500 people inside to 7,500 *plus* 1.5 million outside, with a permeable boundary between them.

It was against this backdrop that we created our *connect and develop* innovation model. With a clear sense of consumers' needs, we could identify promising ideas throughout the world and apply our own R&D, manufacturing, marketing, and purchasing capabilities to them to create better and cheaper products, faster.

The model works. Today, more than 35 percent of our new products in market have elements that originated from outside P&G, up from about 15 percent in 2000. And 45 percent of the initiatives in our product development portfolio have key elements that were discovered externally. Through connect and develop—along with improvements in other aspects of innovation related to product cost, design, and marketing—our R&D productivity has increased by nearly 60 percent. Our innovation success rate has more than doubled, while the cost of innovation has fallen. R&D investment as a percentage of sales is down from 4.8 percent in 2000 to 3.4 percent today. And, in the last two years, we've launched more than 100 new products for which some aspect of execution came from outside the company. Five years after the company's stock collapse in 2000, we have doubled our share price and have a portfolio of twenty-two billion-dollar brands.

According to a recent Conference Board survey of CEOs and board chairs, executives' number one concern is "sustained and steady top-line growth." CEOs understand the importance of innovation to growth, yet how many have overhauled their basic approach to innovation? Until companies realize that the innovation landscape has changed and acknowledge that their current model is unsustainable, most will find that the top-line growth they require will elude them.

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