

# Innovation – protecting the UK's long-term competitiveness

## Dealing with the Downturn Series

Innovation is as important during a recession as it is during times of growth, although its focus and nature shifts. Companies that focus exclusively on short-term priorities will be less able to compete when recovery comes.

The Management Consultancies Association estimates that 90 percent of UK private sector organisations have already cut their capital expenditure (one measure of the amount spent on innovation) by between 10 and 50 percent and that two thirds of organisations will cut it by at least another 10 percent in the next 12 months. Over the last two years, innovation has slipped far down the corporate agenda in around half of all organisations. More than 80 percent of consulting firms responding to the MCA's survey<sup>1</sup> felt that organisations' long-term competitiveness is being compromised by their lack of investment.

This paper analyses the barriers to remaining innovative during a recession and argues that reversing this trend of declining investment requires inspirational leadership and economic incentives from government.



<sup>1</sup> Management Consultancies Association survey of member firms, March 2009

## Cutting costs is not enough

Caught in economic winter, organisations hibernate. It is not such a bad strategy: big companies, with sizeable financial and reputational reserves, can often afford to wait for the thaw. But, as history shows, firms that hunker down for the duration may wake to find their customers have abandoned them and that their products and services have been bettered by entrepreneurial upstarts. General Electric was born out of the Panic of 1873, a six-year depression; HP was founded in a Palo Alto Garage at the end of the Great Depression with the heady start-up capital of \$538. Hyatt Hotels and Burger King were offspring of the Eisenhower recession in 1957-58; FedEx and Microsoft, of the 1973 oil crisis. Recessions are rare moments when people are willing to challenge accepted thinking: when any idea, however maverick, will be considered.

Ryanair expanded quickly in 2001, just when most established airlines were struggling to adapt to the aftermath of 9/11. It offered a different type of service which people paid for in a different way. At a point when most other airlines were cancelling routes, Ryanair was adding new ones. Offering an innovative product which really chimed with people's needs allowed the airline to take centre-stage. It didn't have to compete for attention as it would have done beforehand and that enabled it to play a pivotal role in the evolution of the low-cost airline travel business.

### A recession like no other Martin Smith, PA Consulting

The advantage of a recession is that the classic barriers to innovation are easier to overcome: scepticism has to cede to a willingness to explore new ideas. But that advantage is offset by different problems: recessions are difficult periods to obtain financing for new ventures, not simply because money is short, but also because it's hard to calculate the return on investment. To overcome these new barriers, the way organisations innovate needs to change. Innovation has often been a quasi-clandestine activity, taking place in secret and away from the main hub of organisational activity. That needs to be replaced by a much more networked approach in which managers exploit much more effectively the range of expertise and resources at their disposal, not only within their own organisations but also in the organisations they work with.

**“Recessions are rare moments when people are willing to challenge accepted thinking: when any idea, however maverick, will be considered.”**

Cutting costs – the traditional response to a recession – may secure an organisation's survival, but it will only ever be part of success. The lion's share of a typical company's sales and profits come from innovation. Thus, a manufacturing company's new, hot product will earn it a much higher margin than its second best product, and a new handset will win a mobile phone operator new customers.

Despite this, a recent MCA survey, based on consultants who work with 90 of the FTSE100 companies, estimates that private sector capital investment is likely to fall by an average of 25 percent. Applied to R&D budgets, this would suggest a fall of £3.9 billion in 2009<sup>2</sup>. This is despite the fact, recognised by nine out of ten respondents to the survey, that innovation and investment are crucial tools in mitigating the effects of the recession.

<sup>2</sup> The UK Business Enterprise Research and Development 2007 survey, published by the Office for National Statistics in January 2009 (<http://www.statistics.gov.uk/pdfdir/berdo109.pdf>), put overall expenditure on R&D by the UK private sector at just over £16 billion.

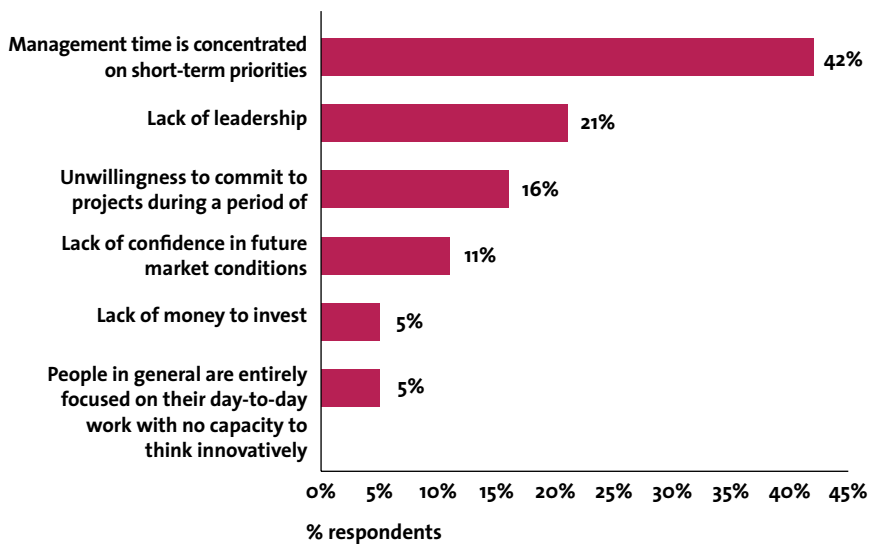
## The barriers to innovation in a recession

Liquidity and access to funding are always more difficult during a recession, but for those organisations that still have access to funding, there are five barriers to innovation:

- **Industry drivers:** Companies operating in sectors such as telecoms, high tech and media, where innovation plays an important economic role, are much more likely to protect their research and development expenditure in a recession. In sectors where the reverse is true, the fact that innovation is not part of what organisations habitually do makes it doubly hard for them to change during a recession.
- **Internal barriers:** In a recession, managers become even more protective of their territory as they strive to achieve their departmental targets. That makes it harder for them to use all the available data and make connections between different ideas and initiatives. Moreover, innovation is often seen as a distinct process, to be carried out by select parts of the organisation rather than being the responsibility of all.
- **Out of touch:** A growing economy often lulls organisations into thinking they understand their customers' needs. Managers who are buoyed by rising sales make less of an effort to keep their ears to the ground, only to discover that, when recession hits, the market has moved on.
- **Fear of failure:** Innovation necessarily involves risk and people are far less likely to invest time, effort or money in something which may cost them their job.
- **Herd mentality:** Despite the need for competitive advantage and differentiation, organisations often copy each other, waiting for a boom market to make acquisitions at premium prices, selling assets when prices are low.

However, the MCA research suggests that all these reasons are dwarfed by the fact that management time is concentrated on short-term priorities (Figure 1). This was four times as likely to be the critical issue as fear about uncertainty and eight times as likely as lack of money to invest. Managers are pulled in too many different directions at once because they lack the clear criteria that allow them to cancel existing projects, and are unable to stand back because they are in the midst of responding to a huge number of immediate problems.

**Figure 1**  
**What do you see as the most important barrier to innovation during a recession**



**The new sourcing paradigm**  
**Paul Teather, Compass Management Consulting**

Innovation plays a critical role in cutting costs; indeed, it's often easier in a recession to adopt radical approaches which people would find unthinkable in better times. However, the situation is complicated as people have become change weary from their experiences of past initiatives that have failed to yield the expected benefits. A lot of attention at the moment is focused on consolidating IT costs and outsourcing is one tool that becomes particularly prominent during a downturn. Organisations have been outsourcing for over 30 years, yet mutually satisfactory relationships between clients and vendors are rare. Cutting IT costs and outsourcing therefore need as great an injection of innovative thinking as new product development or marketing does. The key here is for organisations to understand exactly what they're trying to achieve, informed by an accurate baseline of their existing operations and an appreciation of what the external market can provide, to develop a more equitable and transparent relationship in partnership with their suppliers.

## Seizing the opportunity

But the current recession also differs from past ones, not only in its severity, but also in the extent to which there are new opportunities, many of which lie in exploiting new technology and new sources of information.

Connectivity is now a ubiquitous phenomenon and we have unimaginable and unprecedented volumes of data, all of which can be harnessed to create value. But the key obstacle here is that the people in business who decide which technology to invest in rarely come from the generation that uses it, whether as customers or employees. Most decision-makers are out of touch and have no idea how to tap into the thinking of people who have grown up in the internet age. Most importantly, they still think knowledge is power while the up-coming generation sees it for what it is, something that increases in value the more people contribute to it and use it.

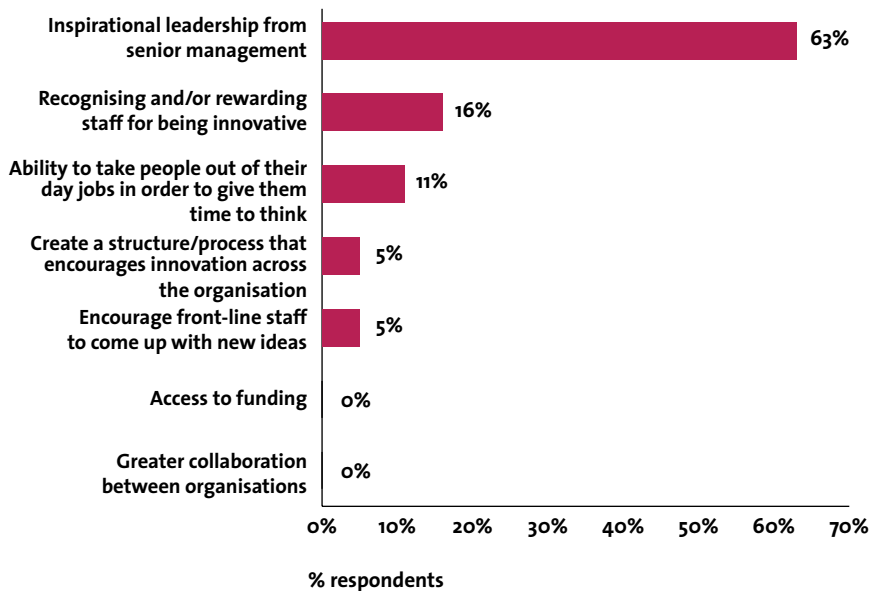
Spotting something genuinely different you can do for your customers depends on being able to bring together disparate sources of information. Identifying similarities between processes in two sectors requires knowledge of both. Yet innovation is often treated as an isolated activity. The parts of an organisation which make the ideas a commercial reality – sales and marketing, for instance – rarely get involved but it is this connection which is critical to successful innovation. But in any recession, there is a tendency for everyone to keep their heads down. They can't see what the future looks like; the business radars they're accustomed to relying on aren't working. Of course, the challenge is even greater if they're laying people off: how can they justify talking about, let alone investing in, innovation in times such as these?

**“Spotting something genuinely different you can do for your customers depends on being able to bring together disparate sources of information.”**

The MCA survey shows that seizing the current opportunities and ensuring that people's attention and commitment is fully engaged relies overwhelmingly on one factor: leadership. As Figure 2 shows, this was five times more likely to be rated as crucial as the next most important factor (recognising and rewarding people for being innovative). Other factors paled by comparison.

**Figure 2**

**What do you believe is the single most important factor in ensuring that organisations continue to innovate, even during a recession?**



**Organisational innovation**  
**Sally Russell, Right Management**

Organisations will need innovative thinking to help them through the recession. Retaining their best people may involve asking them to work a two or three day week, paying them for four, recouping the money over time, when the recovery comes and they are back working five days. Cutting costs doesn't have to involve cutting people if you think laterally. Recessions also provide an opportunity to re-think the relationship between employer and employee at a fundamental level. With unemployment rising so sharply and people afraid they may lose their jobs at any minute, the psychological contract between organisations and individuals has been fractured. Now is a good time to talk to people about how they fit into the long-term objectives of the organisation and how they can work most productively. Organisations with foresight will seize this opportunity. Those that don't, that continue to believe that their employees should think themselves lucky if they still have a job, will find themselves in the future with employees who are simply serving out their time until they can move elsewhere.

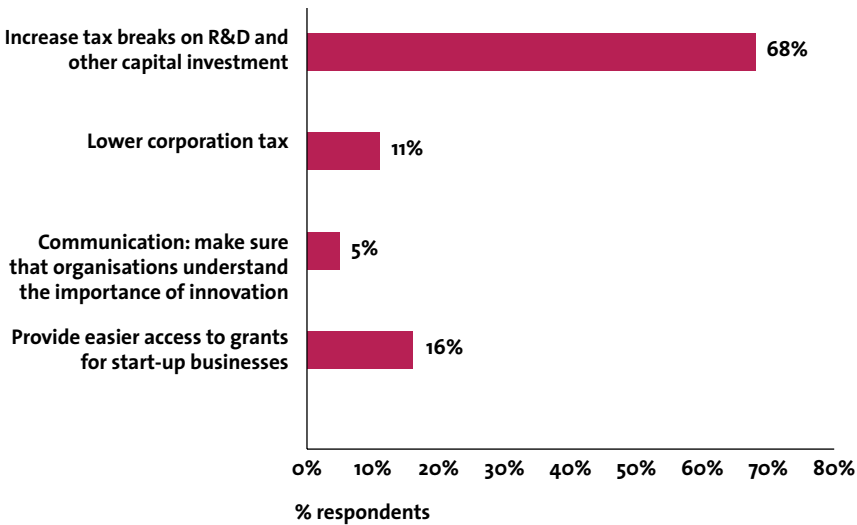
## What can government do to help?

Government, too, needs to provide inspiration and leadership. In some respects, it is already leading by example: recent efforts to modernise public services have been driven by a combination of needing to restrict costs while improving their quality and accessibility. Accustomed to working with tight budgets, civil servants have been at the forefront of finding innovative ways to get better value for money.

However, as our survey makes abundantly clear, the other key role of Government is to provide direct financial incentives to business. Asked what they thought the Government could do to most encourage firms to invest in innovation, more than two thirds of consulting firms believe that the Government should increase tax breaks for research and development and for other areas of capital investment, far ahead of any other initiative (Figure 3).

Figure 3

What is the most important action the government could take in order to encourage innovation?



The Government needs to ensure that corporate Britain does not fall behind the rest of the world in terms of innovation and investment, as these are the keys to long-term prosperity and growth.

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