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Adjacent innovations: boon or bane for corporates?

Companies must actively disrupt their core and adjacent innovations. **By Arcot Desai Narasimhalu**

CAUGHT THEM NAPPING
Airbnb crept in from the blind side of market leaders Wyndham and International Hotel Group to disrupt the industry in 2008. By May 2015, it had more than one million rooms to offer – almost as many rooms as the top two hotel chains combined. PHOTO: REUTERS

COMPANIES are constantly planning the growth of their revenues and profits. And the best means of growing both revenue and profit bases is by creating a succession of innovations as a part of their product mix. Enlightened companies tend to manage this process by setting up an innovation portfolio managed in many cases by an innovation office.

When companies identify innovations to pursue, they often are comfortable creating new products or services that are adjacent to their current offerings. Adjacent innovations can contribute to the creation of a new product line thereby increasing the width of the product mix, and the length or depth of a current product line.

Adjacent innovations are generally defined as new products and services offered to existing customers, or current products and services offered to new customers. The implicit understanding is that current products and services often require some customisation to meet the needs of new customers.

Quite often, even companies with a well-managed innovation office tend to end up with a weak innovation portfolio that focuses mostly on "current products to current customers". Phil McKinney – president and CEO of Cable Television Laboratories, an innovation lab funded by 55 of the largest cable operators from around the world and a former CTO of HP who established its Innovation Programme Office – made the following observation in 2012.

"Like most large successful companies, once they achieve a significant market position, management retreats into a defensive mode. This includes how they make innovation investments. I'm willing to bet that if you 'follow the money', you would find Kodak's investment model for innovation over the past 10 years would fall into the range of 95 per cent to existing core products (film, chemicals, etc) and 5 per cent into anything new.

"When I arrived at HP, the investment model was 98 per cent and 2 per cent. It took three years to shift to a model of 70 per cent to the core, 20 per cent to adjacencies (new products to existing customers, existing products to new customers) and 10 per cent to new (new products to new customers)."

Clearly, great companies such as HP and Kodak had innovation portfolios but had not constructed them well. However, it took someone like Mr McKinney a good three years to make the changes that he did at HP. So a well-balanced innovation portfolio addressing core, adjacent and new opportunities, and supported by strong execution capability, are essential ingredients for the success of a company.

Those that were a boon

General Motors (GM) created two adjacent innovations: GMAC Financial Services, and OnStar. GMAC Financial Services was targeted at new customers for GM's then products, while OnStar was a new offering for its existing customers.

Establishing GMAC Financial Services allowed GM to sell cars to customers who could not pay the entire price of the car. This in turn increased the sales, revenue and profits of GM.

OnStar ensured the safety and security of GM car owners, thereby persuading more people planning to buy a car to prefer buying GM cars over those from its rivals. Once again, this led to increased sales, revenues and profits for GM.

Those that could have been a boon

Kodak had filed the early patents for digital cameras. If it had realised that its new customers would be using digital cameras, it might have created digital cameras as an adjacent innovation.

The storage companies that were market leaders in the personal computer market lost their market leadership because they did not realise the value of creating an adjacent innovation: smaller drives for the space-constrained laptops. This would be an example of current products for new customers.

Impact on current products and services

Creating an adjacent innovation may lead a company to exit from an existing product or service line.

IBM had hived off its personal computer division to Lenovo when it figured out that it wanted to focus on service delivery.

Intel sold the intellectual property (IP) rights to its 8-bit computing chips when it created the 16-bit and later 32-bit central processing units (CPUs).

Kodak would have had to exit from films for casual cameras if it had decided to manufacture digital cameras. It may still be around if it had made the transition from analog to digital cameras.

Adjacent innovations as a bane

One example of adjacent innovations going wrong is hotel chains. Hotel chains such as the Intercontinental Hotel Group, Marriott and Accor were busy focusing on building new brands to cater to the different target customer groups, from no-star hotels to five stars or more. They were true believers in adjacent service innovations. Their adjacent innovations were often newer brands that addressed an unserved or newly emerging customer base.

Wyndham hotel group was busy maintaining its lead as the largest group based on number of properties (7,043) in the chain, whereas International Hotel Group pursued adding more hotel rooms to maintain its leadership as the leading hotel chain based on the number of hotel rooms (619,851).

It is interesting to note that even as they were competing with each other using adjacent innovations as the vehicle for growth, Airbnb crept in from their blind side and disrupted the industry. Although Airbnb started only in 2008, by May 2015 it had more than one million rooms to offer. This was almost as many rooms as the top two hotel chains combined. And Airbnb achieved this with very little capital cost.

Another example of adjacent innovations going wrong is the rental car industry in the US.

Avis and Hertz were fighting for market leadership for the rental car market built around business travellers using adjacent innovations such as the fleet mix and fleet size. They worked with travel agents and airlines to offer their services to reach out to their customer base. Then came Enterprise Rent-a-Car, which disrupted the rental car market by working with insurance companies as channel partners. In 2014, Enterprise Holdings had revenues of US$12.85 billion – which was more than the sum of its next two competitors – and was expected to increase its 2015 revenue to US$13.88 billion.

These two examples clearly show that focusing entirely on adjacent innovations does not help companies continue to maintain their market leadership. While adjacent innovations are required to increase revenues and profits from current business models, companies need to look beyond adjacent innovations to create new business models in order to retain their market leadership. They should actively identify, pursue and manage innovations that are likely to disrupt their core and adjacent innovations. This would require an enlightened board and proactive C-suite executives.

So, adjacent innovations may be a boon in the short to medium term. But they could end up being a bane in the longer term if companies do not actively disrupt their core and adjacent innovations.

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