CHAPTER 1

How Innovators Leave Billions on the Table

A Tale of Two Cars

Let's begin with a story about two new cars launched by two well-known, established car companies. One launch went very, very well; the other went very, very wrong.

The first car in our story was launched by Porsche, a relatively small player in the multi-trillion dollar global automotive industry,[1] renowned for its 911 sports car that will take you down the road at nearly 200 mph.

In the early 1990s, Porsche was speeding off a financial cliff—if not at 200 mph, then pretty rapidly. Annual sales were a third of what they had been in the 1980s. The company's manufacturing processes were inefficient and defective. The new CEO, Wendelin Wiedeking, at 41 years old the youngest of a new generation of German auto manufacturing executives, decided to institute Japanese-style manufacturing techniques and quality improvements. Costs fell and sales rose, and the company was able to avoid disaster.

The new CEO had bought Porsche some time. He knew the company needed a fundamental change—something different, something new. It needed, as most companies eventually do, to innovate—or risk losing everything. It needed a new car.

In the second half of the 1990s, the company began planning an automobile that was far outside the sports car niche it had focused on

successfully for 50 years. Porsche decided to make a sport-utility vehicle—an SUV—a family car associated not with racing's checkered flags but with soccer moms and soccer dads slumped behind the wheel mournfully recalling their lost youth.

Porsche called its new car the Cayenne.

A Porsche SUV? It didn't make sense. The Porsche brand was about speed and power, daring and engineering, not about loading up the family car with groceries and taking Emily, Mike, and their little friends to their Saturday games. What did Porsche know about SUVs? It had never built one before.

But Porsche had done its homework. Specifically, it had designed and built the product—the Cayenne—around the price.

When most people hear the word "price," they think of a number. That's a *price point*. When we use the term price, we are trying to get at something more fundamental. We want to understand the *perceived value* that the innovation holds for the customer. How much is the customer willing to pay for that value? What would the demand be? Seen in this light, price is both an indication of what customers value and a measure of how much they are willing to pay for that value.

Porsche understood all this when it set about creating the Cayenne. Porsche's top executives knew they had a bold, perhaps even revolutionary, concept. They also knew the car would be a tremendous risk. They instructed their product team to rigorously determine what the customer wanted in a Porsche SUV and, importantly, how much they were willing to pay. The message was clear: If the customer was not willing to pay a price that would ensure success, Porsche would walk away from the Cayenne.

Long before the first concept car rolled out of the Engineering Group center in Weissach, the product team conducted an extensive set of surveys with potential customers, gauging the appetite for a Porsche SUV and evaluating prices to find an acceptable range. They were pleased to find that customers were enthusiastic. Analysis showed that customers were willing to pay more for a Porsche SUV than they would for comparable vehicles from other manufacturers. The potential for a hit was there.

This meant that Porsche could invest in building its SUV.

But what exactly should it build? Porsche wasn't about to risk creating a car with a bloated design. Every single feature stood trial before the customer.

Target customers wanted and were willing to pay for a high—and in this vehicle category, unknown—level of sportiness. They expressed an interest in a powerful engine and a handling performance close to a sports car (despite the size of an SUV). Porsche's famous manual six-speed racing transmission was not on the wish list. Out it went. But the voice of the customer convinced the Porsche engineers to include large cup holders, something Porsche was not used to. At every turn, the product team removed features the customers did not value—even if the engineers loved them—and replaced those with features customers were actually willing to pay for.

Porsche's masterstroke was thinking about monetization long before product development for the SUV was in full speed, then designing a car with the value and features customers wanted the most, around a price that made sense. The result was total corporate alignment: Porsche knew it had a winner, and had the confidence to invest accordingly.

Over time the Cayenne enabled Porsche to generate the highest profits per car in the industry—the whole automotive industry. Ten years after it hit the market in 2003, Porsche was selling about 100,000 Cayennes annually, almost five times as many as it did in the launch year. Today, the Cayenne accounts for about half the company's total profit, with the venerable 911 generating a third.[2] What's more, the Cayenne enabled Porsche to pay down a suffocating level of debt and increase its cash reserves.

By any and all measures, the Cayenne was a roaring success.

Why did Porsche succeed? It wasn't the company's engineering prowess, although the Cayenne drives quite nicely. And it wasn't a technological breakthrough that enabled Porsche to manufacture SUVs more efficiently or make consumer hearts beat faster. Porsche succeeded by designing the product around the price. This is what smart companies do.

Now, we turn to the second car in our tale. This car comes from Fiat Chrysler, a company that has six times the revenue of Porsche. In 2009, the massive automaker began working to bring something new into the world: a reimagining of the classic 1970s Dodge Dart.

The new Dodge Dart was a crucial entry in a crucial market segment for Fiat Chrysler: compact cars. Fiat Chrysler needed the Dart badly to make the company competitive in the category, a segment in which it had struggled for years. Compacts account for one in every six vehicles

sold in America. Every major automaker must succeed in the compact market, explained Fiat Chrysler CEO Sergio Marchionne in a March 2012 interview on *60 Minutes*. Any carmaker unable to succeed in the category was "doomed," he said.[3]

Marchionne didn't mince words within the company about the importance of the Dart. He told employees just what was riding on the car. "Our future hangs on how well we do here," he told workers in a 2012 visit to the car's Belvidere, Illinois, plant. He backed up his words with money, committing hundreds of millions of dollars to turn a very successful Fiat model (the Alfa Romeo Giulietta) into a Dodge Dart.

"Of all the cars I can get wrong," Marchionne said, "it ain't this one."

Both cars were equally critical to their companies' futures. However, Fiat Chrysler's approach to developing the Dart was radically different from Porsche's Cayenne. Rather than starting with a hard look at the customer, Fiat Chrysler took a hard look at the product.

As it documented in a 90-second TV commercial to market the car,[4] Fiat Chrysler's product development process was to design it, build it, rethink it, design it, build it, rethink it—until the engineering team, in its exclusive opinion, felt the car was ready to go. In fact, the advertisement announced proudly that the company was "kicking the finance guys" out of the development process. Money was not going to be an issue. The company would build prototype after prototype to get it right. The executive team "suits" would only interfere with designing the Dart. This car would be built to perfection, the commercial suggested.

"Perfection" as defined by Fiat Chrysler, not the customer.

Then a price was slapped on, and Dodge took it to customers to try to sell it.

Market performance was a disaster. In 2012, the year it launched, the Dart sold about 25,000 units[5]—a quarter of the total predicted by market analysts and a number that caused Dow Jones's MarketWatch to call the Dart the year's second biggest new product flop. The number one spot was given to Apple's buggy iPhone mapping software. That's right: The Dart was "Apple Maps bad."

Since then, the Dart has failed to lure most compact car buyers away from the two segment leaders, Toyota's Corolla and Honda's Civic, or even from Chevrolet's Cruze and Ford's Focus. By the end of 2014, sales were so disappointing that the company had to issue temporary layoffs at

its Belvidere plant. Ironically, these were the same workers who two years earlier had heard Marchionne say that Dart was the one car the company couldn't afford to get wrong. In the first nine months of 2015, Dart sales were only a seventh of the combined sales of the two compact segment leaders.[6]

Fiat Chrysler couldn't afford to get the Dart wrong, but it did.

The reason Porsche succeeded with the Cayenne and the reason Fiat Chrysler bombed with the Dart are the same reasons product innovations have succeeded or failed at so many companies in so many industries over the last 30 years: *Porsche placed customer needs, value, willingness to pay, and pricing in the driver's seat when it developed the Cayenne; Fiat Chrysler stuffed them in the trunk.*

This story is less about the cars than about the two different modes of thinking that went into launching them, and why one way produced a success that helped put its company on an accelerated growth path while the other produced a flop that led to layoffs.

Porsche designed its new car around the price—what the customer valued and wanted to buy; Fiat Chrysler did not.

This story illustrates the main theme of this book: How companies bringing something new into the world can leverage the science of monetizing innovation, increase the chances that their new offerings will succeed, and produce results that can be magical. The odds against successful innovation are always high. But, as you read, you'll learn how a focus on monetizing innovation can substantially increase your chances of financial success.

Unhappily, more new products in every industry go the way of the Dart, and far too few enjoy the success of the Cayenne. We see it all the time. But every company has a chance to create Cayennes and reduce the risk of Darts. The key is to rigorously determine the market for a new product long before the products are built, and making sure the market is willing to pay for that product before embarking on a long journey of productizing the innovation.

Why the Majority of New Products Fail

Each year, more and more of us find ourselves in Porsche's position. Success is defined by bringing new products to market, expanding our reach. The pace of change is accelerating worldwide. For many of us,

innovation is no longer a question of prioritization or investment; it's a question of survival.

Yet the failure rate for innovation is shockingly high. Nearly three out of four new products or services miss their revenue and profit goals. Many of those crash and burn entirely, and some take their companies with them.

It doesn't have to be that way.

That's what this book is about. For 30 years, we have helped companies develop strategies for successful innovation—including the launch of the Porsche Cayenne that we described. During that time, we have uncovered the patterns of failure that doom so many innovations. More important, we have forged, and empirically validated, a framework that has helped innovative companies ranging from startups to global brands to meet or exceed their goals.

New products fail for many reasons. But the root of all innovation evil—what billionaire entrepreneur Elon Musk would call the set of "first principles"—is the failure to put the customer's willingness to pay for a new product at the very core of product design. Most companies postpone marketing and pricing decisions to the very end, when they've already developed their new products. They embark on the long and costly journey of product development *hoping* they'll make money on their innovations, but not at all *knowing* if they will.

Price is more than just a dollar figure; it is an indication of what the customer wants—and how much they want it. It is the single most critical factor in determining whether a product makes money, yet it is an afterthought, a last-minute consideration made after a product is developed. It is so much of an afterthought that companies frequently call us and say, "We built a product—oops, now we need your help in pricing it."

To boil it down, these companies conduct product development this way: They design, then build, then market, then price. What we will teach you in this book is to flip that process on its head: Market and price, then design, then build. In other words, design the product around the price.

Think back to the last business case you or your colleagues were asked to write for a new product. How did you arrive at your prices? Did you compare your product to other products in the marketplace, or did you actually ask customers what they'd pay for it? Did you know in advance what would happen if you increased your price by, say, 20 percent—that is, how that would likely affect demand and thus volume?

If you are like thousands of companies that we've worked with over the years, you probably did not. Every one of them claims to have made an airtight business case to top management that vouches for their new product. But in only about 5 percent of those business cases can you find information on how much customers will pay for the product. This means their revenue estimates are, at best, a guess. When you think about it, that's stunning. The business case gives them a level of confidence they should *not* have. It leads them down the path to failure.

The most successful product innovators we know start by determining what the customer values and what they are willing to pay, and then they design the products around these inputs and have a clear monetization strategy that they follow through with. That's what LinkedIn did before it launched its Talent Solutions service for job recruiters, which now drives the lion's share of the social networking site's revenue and profits. That's what Porsche did with the Cayenne, and what Fiat Chrysler failed to do with the Dart. That's what a large, global pharmaceutical company has done with new products since the turn of the millennium, which has helped the company grow enormously over the last 20 years. That's what crystal maker Swarovski has done in developing new offerings for consumers, and for companies that embed its crystals in their products, to great financial success. That's what Dräger, a manufacturer of gas detection equipment, did in creating a hit new product that protects miners and other underground workers from gas leaks—a product whose sales were 250 percent higher than expected. That's what a six-year-old software-as-a-service firm called Optimizely did in creating a software to help companies improve their websites' abilities to sell their offerings, a software that has been used by thousands of customers. And that's what Uber has done in shaking up the world of public transportation, while watching its private valuation soar toward $60 billion at the end of 2015. We'll tell you much more about how LinkedIn, Porsche, Swarovski, Dräger, Optimizely, Uber, and an innovative pharma profited from designing and developing products around the price in Chapter 13.

This is the model that forward-looking, highly successful product innovators use—companies whose principles for monetizing innovations we will deconstruct in this book.

Successful Innovation Matters More Than Ever

Succeeding at product innovation is difficult, and it always has been. Every other year, Simon-Kucher & Partners conducts the world's largest survey on the state of pricing. Our 2014 report polled executives in 1,615 companies across the United States, Japan, Germany, and 37 other countries. The primary focus of the survey was to measure how well companies were monetizing their innovations across industries and geographies. The disappointing findings were reported in *Harvard Business Review*: 72 percent of new products introduced over the last five years failed—either to meet their revenue and profit goals, or failed entirely. These figures applied equally to startups and large businesses in every industry surveyed.[7]

Numerous other studies over the last decade have said your chances of developing a successful innovation are not even as good as winning a coin flip. For example:

- 65 percent of new products fail, according to the Product Development and Management Association. That rate of failure cost U.S. companies $260 billion in 2010, according to researchers at the University of Texas at Austin.[8]
- 75 percent of venture capital–funded startups fail, according to a Harvard Business School study of 2,000 companies between 2004 and 2010.[9]

These numbers show something is very wrong with the way companies bring new concepts to market. No one is immune. As painful as it is to consider, the odds are stacked against all of us.

Yet succeeding at innovating has never been more important than it is now. In the 2014 Simon-Kucher & Partners study, 83 percent of companies reported facing increasing downward pricing pressures. Most companies planned to innovate their way out of this dilemma: New products, new services, and new paths to growth. But innovators face an uphill climb for four primary reasons:

1. Traditional Research and Development (R&D) is becoming more expensive, not less. Costs are going up rapidly, without being offset by price increases.

2. Disruptive innovation now comes from smaller and smaller companies, with lighter and lighter capital requirements, meaning they can be nimbler than your firm and take bigger risks.
3. Product innovation is no longer the preserve of the Western world, as evidenced by the United States and Europe's declining shares of global R&D spending, and the growing share of China and other Asian countries. In fact, China is predicted to eclipse the United States in R&D spending by 2020.[10]
4. The rate of innovation is accelerating. A key signpost: Annual global patent applications leaped 2.5 times from 1995 to 2013, and in 2014 set a record for the number of patents filed internationally.[11]

Those statistics are harrowing. But with a 72 percent global new-product failure rate, you can take comfort knowing that if you are facing problems successfully launching innovations, you are not alone.

The Good News: Monetizing Innovation Failures Come in Only Four Varieties

This book is the product of the lessons that Simon-Kucher & Partners has learned over the last 30 years while becoming the world's largest pricing and monetization consulting firm, one with more than 900 employees in 32 offices around the world. Globally, we've conducted more than 10,000 projects for large multinationals, mid-size companies as well as start-ups across industries. We've seen what works and what doesn't, what succeeds and what fails in product innovation.

We've found recurring patterns in new product monetization failure. While you might think many types of flaws can cause products to flop in the marketplace, we actually have found that monetizing failures fall into only four categories:

1. Feature shock: cramming too many features into one product—sometimes even unwanted features—creates a product that does not fully resonate with customers and is often overpriced.
2. Minivation: an innovation that, despite being the right product for the right market, is priced too low to achieve its full revenue potential.

3. Hidden gem: a potential blockbuster product that is never properly brought to market, generally because it falls outside of the core business.
4. Undead: an innovation that customers don't want but has nevertheless been brought to market, either because it was the wrong answer to the right question, or an answer to a question no one was asking.

The fact that new product monetization failures come in only four varieties should give you comfort. Imagine having to do postmortems that could point to dozens or hundreds of factors!

You *Can* Avoid Failure—but Only If You Play by Different Rules

Our experience allowed us not only to diagnose these monetization failure modes but to cure them—or even better, avoid them altogether. In this book, we have boiled these secrets down into the following nine new rules for innovation success. The rules are contrary to what most executives have learned about product development:

1. Have the "willingness to pay" talk with customers early in the product development process. If you don't do it early, you won't be able to prioritize the product features you develop, and you won't know whether you're building something customers will pay for until it's in the marketplace.
2. Don't force a one-size-fits-all solution. Whether you like it or not, your customers are different, so customer segmentation is crucial. But segmentation based on demographics—the primary way companies group their customers—is misleading. You should build segments based on differences in your customers' willingness to pay for your new product.
3. Product configuration and bundling is more science than art. You need to build them carefully and match them with your most meaningful segments.
4. Choose the right pricing and revenue models, because *how* you charge is often more important than *how much* you charge.
5. Develop your pricing strategy. Create a plan that looks a few steps ahead, allowing you to maximize gains in the short and long term.

6. Draft your business case using customer willingness-to-pay data, and establish links between price, value, volume, and cost. Without this, your business case will tell you only what you want to hear, which may be far afield from market realities.
7. Communicate the value of your offering clearly and compellingly; otherwise you will not get customers to pay full measure.
8. Understand your customers' irrational sides, because whether you sell to other businesses or to consumers, your customers are people. You should take into account their full psyches, including their emotions, in making purchase decisions.
9. Maintain your pricing integrity. Control discounting tightly. If demand for your new product is below expectations, only use price cuts as a last resort, after all other measures have been exhausted.

We don't want to suggest this is easy. Real change never is. Some chapters will teach you tactics that will ratchet up your odds of success all by themselves. But the power of our nine-rule approach lies in how each rule reinforces the one before it. It is an integrated framework, meaning that the true potential of our approach, the real game changer, can only be realized if you commit, body and soul. To further enable the change we have created a website (http://www.monetizinginnovation.com) that provides additional material and diagnostic tools.

No matter who you are, where you are, what you make, or what service you provide, the stakes for new products and services are much higher than ever before. In the pages that follow, we'll give you the insights you need to dramatically improve the odds of new-product success—techniques that will help your new product avoid becoming one of the four Monetizing Innovation failure types and instead fit into a fifth category: the Big Success.