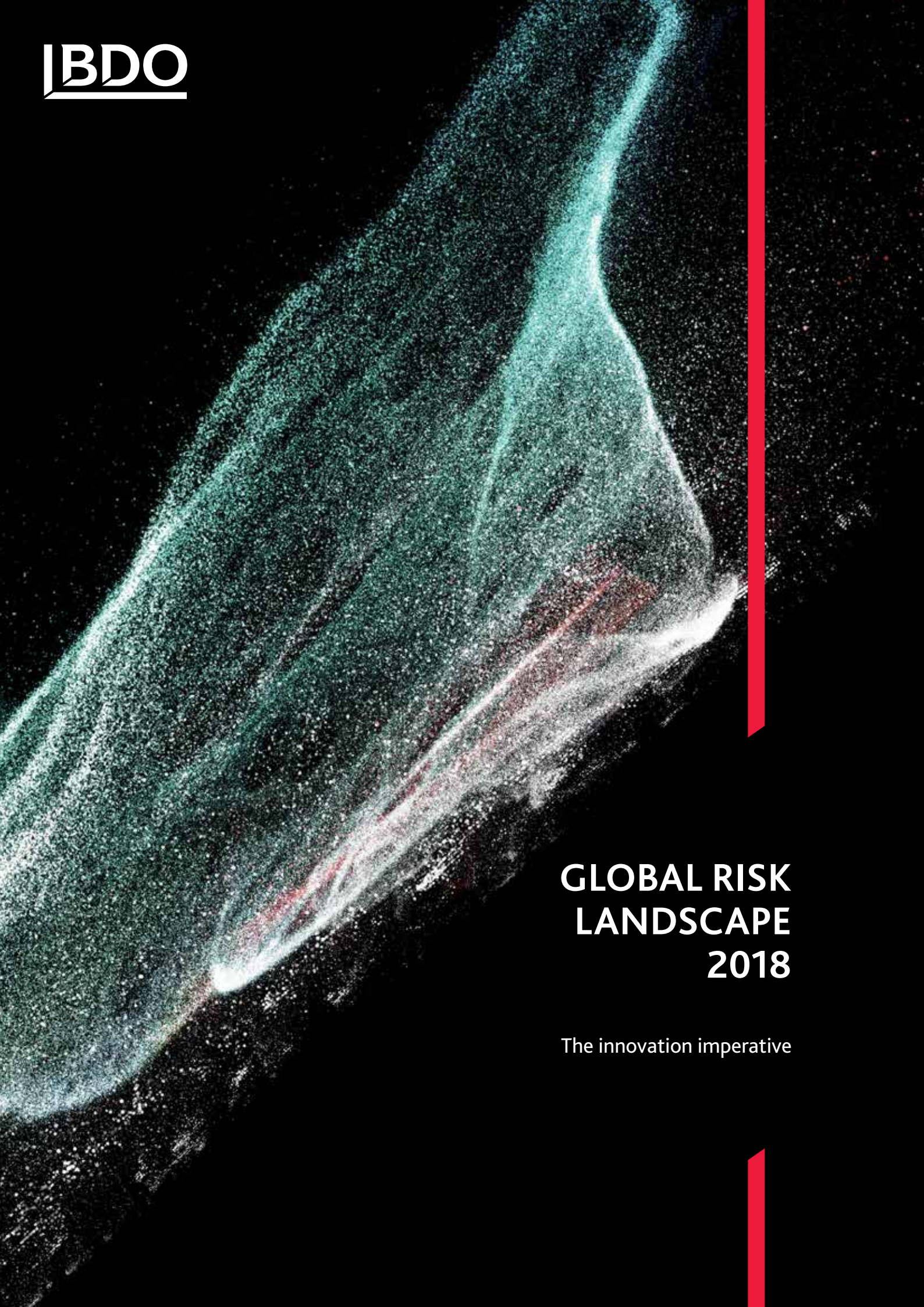


GLOBAL RISK LANDSCAPE 2018

The innovation imperative

CONTENTS

THE INNOVATION IMPERATIVE

Foreword by Nigel Burbidge, partner / global chair, Risk & Advisory Services, BDO.

PERFORMANCE LEVELS EXPLAINED

High performance (upper tercile)
Business exceeds the competition across all key performance metrics

Median performance (middle tercile)
Business achieves sustainable performance but struggles to eclipse the majority of competitors on key performance metrics

Low performance (lower tercile)
Business lags behind the majority of competitors on key performance metrics

The BDO Global Risk Landscape 2018 report has captured a defining moment in the evolution of the corporate landscape. The business world is being transformed in terms of barriers to trade, technology, political alignments and environmental concerns. Central banks are beginning to unwind a decade of economic experimentation, creating macroeconomic hazards that could blindside businesses that are used to the world of zero interest rates.

Digital businesses that have become de facto monopolies in their space are suddenly facing existential threats and challenges that arise from the very reason they exist – the capacity to analyse data and provide insights.

With businesses in sectors as diverse as shipping, automobile manufacture, retail shopping and fund management fighting the disruption from digitally enabled newcomers and innovative incumbents, the ability to adapt to the new environment has become a greater determinant of leadership in industry than size, or in some cases profitability.

While we have found that innovation and appetite for innovation correlate strongly with commercial success, it is the risk environment that makes them so important.

"Cultural reform needs to be a longstanding commitment as businesses seek to become more innovative"

High-performing businesses face a different type of risk from mid- to low-performing businesses; for them, "macro" risks are the greatest challenge, and they embrace innovation. For low performers, the capacity to innovate is reduced, and internal challenges are the more pressing issue.

Cultural reform needs to be a longstanding commitment as businesses seek to become more innovative, and the extent to which this reform has been successful is broadly what we see within the report. Reading its contents, the senior management of businesses will need to consider and reflect upon their own operations.

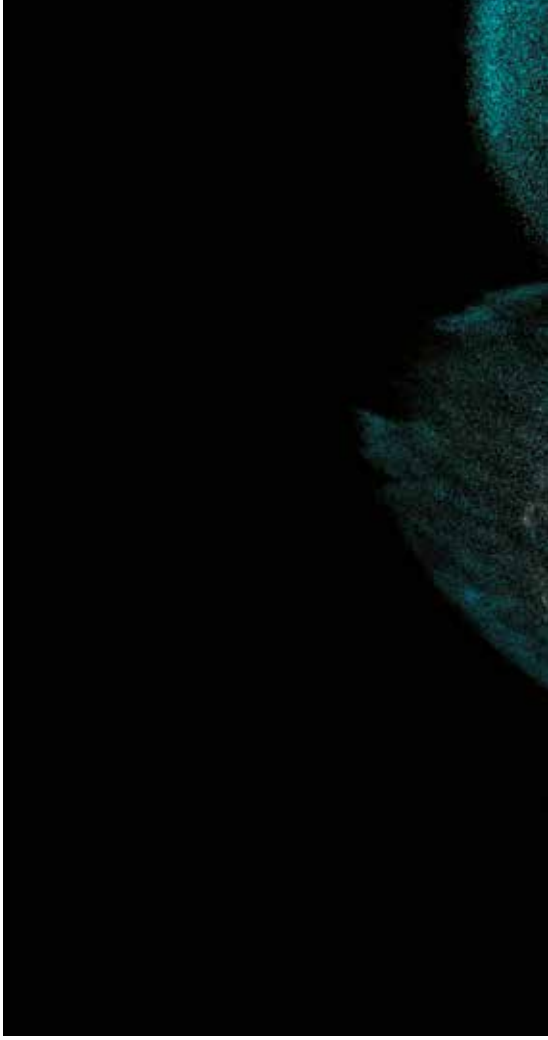
Making that happen is fundamentally a cultural issue, and it may require a firm's leadership to accept the discomfort of change in the short term in order to secure longevity.

We close this report by asking industry leaders to consider their businesses' risk profiles going forward by assessing their readiness to innovate and their ability to respond with agility. At a time of increased regulatory reform and economic upheaval, there is no doubt that the evolutionary pressures that threaten the existence of businesses are increasing in strength and number.

Complacency has always been a killer for the incumbent enterprise, while sustainability is the greatest challenge facing a small-to-medium enterprise. If a business is not agile right now, it may find that it is not a viable business in the medium to long term.

EXECUTIVE SUMMARY

In a changing landscape of risk, commercial leaders are the strongest source of innovation.



The pace of change, triggered by changes in demand and environment, has caught many business leaders by surprise, threatening their very existence. Over the past three years, our Global Risk Landscape reports have found that competition and an increasingly tough trading environment have squeezed margins so tight on existing business models that something had to give.

Although the range of risks that businesses face is familiar, there is a growing schism between the commercial leaders – innovators, who are more inclined to look at external risks – and those businesses whose commercial performance is weaker, and who are more challenged by operational risks. Businesses need to innovate, often technologically, in order to manage risk. Those that do not will face greater competitive pressure in addition to macro threats.

"From the very large businesses down to the smallest businesses, digital transformation is adding an additional risk challenge to board room knowledge," says Julia Graham, deputy CEO and technical director at risk management association Airmic. "They are not expecting the board to understand everything to do with the digital age. For me, it is the new finance; you have to understand enough to be able to play a role in making decisions about it in your business."

"Rules are increasingly being built around principles designed to futureproof them against changes in technology and commerce"

As this pressure increases, the business environment has begun to transform from one of longstanding brands based on physical infrastructure to increasingly incorporating a new set of players that are more flexible in a physical and commercial sense.

Consequently, we are seeing a divide opening up between those businesses that embrace change and actively engage in it, and those that are being forced to change. That gap is increasingly obvious when innovation levels are correlated with commercial success.

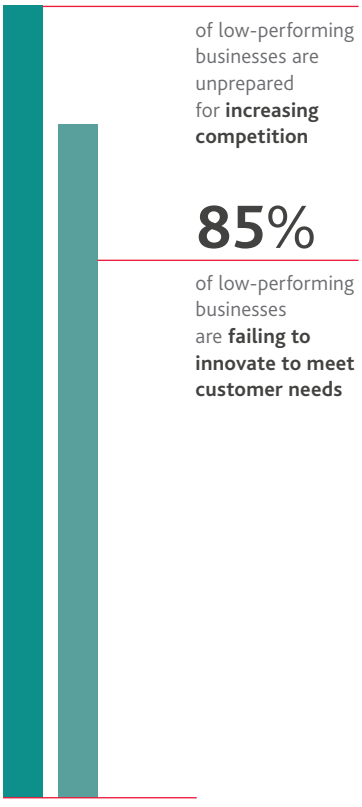
ADAPTIVE AGILITY

Businesses that favour agility, meaning the capacity to foster and harness innovation to evolve a business and generate value, are typically those that are also successful. Within our research, this notion is supported by the finding that 100% of businesses rated by respondents as "high-performing" (opposite) also had a greater appetite for agility. This is often represented by technology-led transformation.

For Graham, it is the risk environment itself that drives this phenomenon: "One of the top-three risks that I see is the failure to innovate and adapt to the opportunities presented by technology, because if you don't your competitors will."

This selective pressure is echoed by Nigel Burbidge, partner / global chair, Risk & Advisory Services at BDO: "If businesses do not demonstrate an ability to think outside the box, to innovate and to be agile they will get left on the scrap heap of history; they just won't exist."

BLINDSIDE RISKS: LOW PERFORMING BUSINESSES IN FOCUS

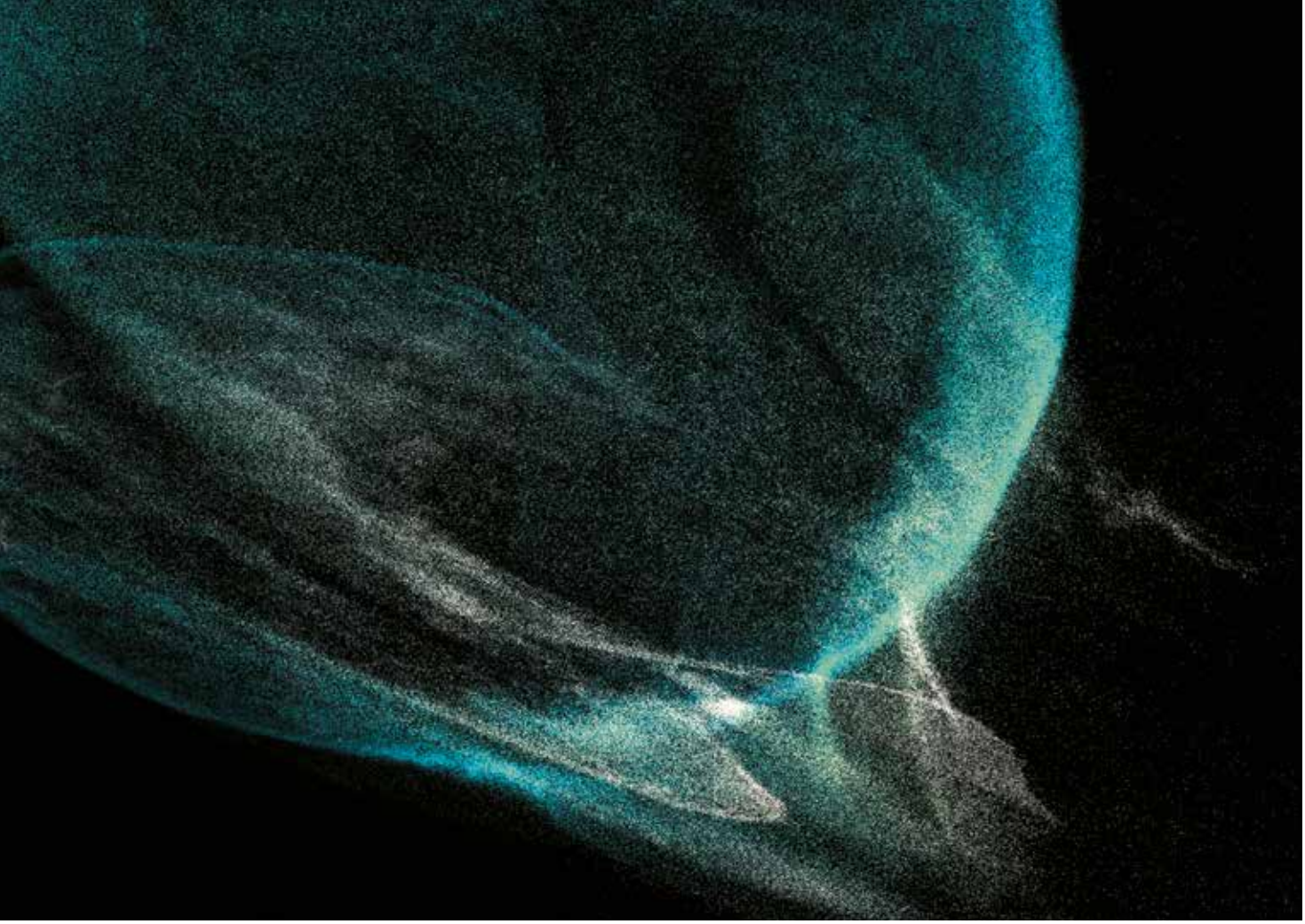


100%

of low-performing businesses are unprepared for **increasing competition**

85%

of low-performing businesses are **failing to innovate to meet customer needs**



The two areas of risk that have increased most since 2017 – supply-chain and environmental risk – are reflective of the wider risk environment. Politically, trade barriers are going up and environmental challenges are increasing.

The importance of agility reflects the changing patterns of behaviour among customers at not only retail and corporate levels, but also in terms of the capacity of businesses to manage both external risks and operational risks. Online information and accessibility to business counterparties has pushed competitiveness levels up the curve across industries, while new ways of developing and delivering products are challenging supply chains, geography and legal frameworks.

For business leaders, this can create additional pressures. As their innovations lead them to push against the barriers of existing regulation, authorities pull them back after corporate commitments have been made. Rules are increasingly being built around principles designed to futureproof them against changes in technology and commerce.

That creates a tension between innovation and the commercial imperative. Our research found that the primary impact of innovation for high-performing businesses is on their customer-centricity. This reflects their need to innovate in order to grow and strengthen existing customer relationships. Failure to innovate – even due to a regulatory barrier – means that business can be lost. It may move to a competitor with an alternative model, or even to a different jurisdiction in the 24/7, global business environment. As a result, it must be considered a critical risk to the business.

INNOVATING CHANGE

Businesses that are medium- or low-performing often face internal struggles as they attempt to build operations that match the rest of the industry. The risks they face typically concern resources and competition, requiring them to focus on the process of change and the management of stability without creating inertia. To begin to move forward, these businesses must understand, first, their current state and the challenges it creates, and, second, where they must get to. Finally, they must develop a strategy that will effect positive change.

The barriers to change can be financial or cultural, but inevitably they stem from senior management. Hesitancy about beginning a change programme – 46% of businesses say their strategy is only at the planning stage – can have serious long-term consequences

100%

of high-performing businesses have **appetite for greater agility**

91%

of high-performing businesses have **elevated innovation** on the boardroom agenda

#1

impact of innovation for high-performing businesses: **customer-centricity**

for the viability of the business. The challenge here is to understand which path to follow when change is occurring at such a rapid pace.

A serious risk is that change begins to unfold at uneven speeds within the business, and in different directions. If several definite futures are targeted by teams that lack a single, unifying vision, the business will not move as one. Rather than guessing at the future, the safest option is to become futureproofed through agility, enabling a business to cope with all possible futures and leaving the legacy models behind.

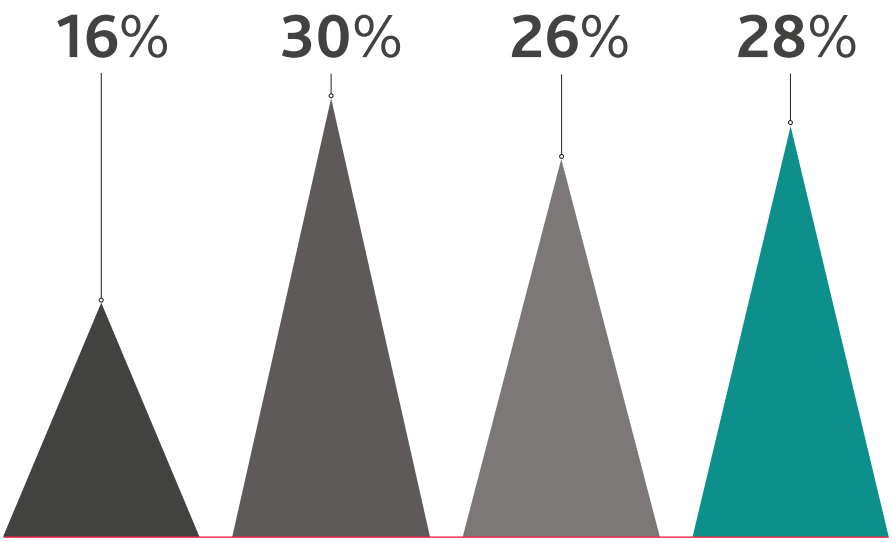
There is a tension between the organisational effectiveness of a business and the level of innovation it can commit to; it must at some point fix processes in order to achieve efficiency and generate a return on the investment it has made. Risk is not only a source of innovation – it can stem from innovation.

The greatest challenge that all businesses face is understanding how the customer, as an agent of change, will affect its future way of operating. Therefore, innovation must allow a business to support the feedback loop with its customer base, and to push that information into the change process.

It is tempting for business leaders to look at their businesses in the abstract, or to look at other businesses' models for guidance. In fact, to adapt culturally, a business needs to engage at the front line with customers and guide its operational teams with aspirational goals, so that its future model can be built into its DNA as a business. Embedding this process within the culture of a business determines an inherent direction of travel in strategic and tactical decision-making that can accelerate the process of change – but, most importantly, ensures that it is consistent across the business.

LEVEL OF FUTUREPROOFING

% of respondents

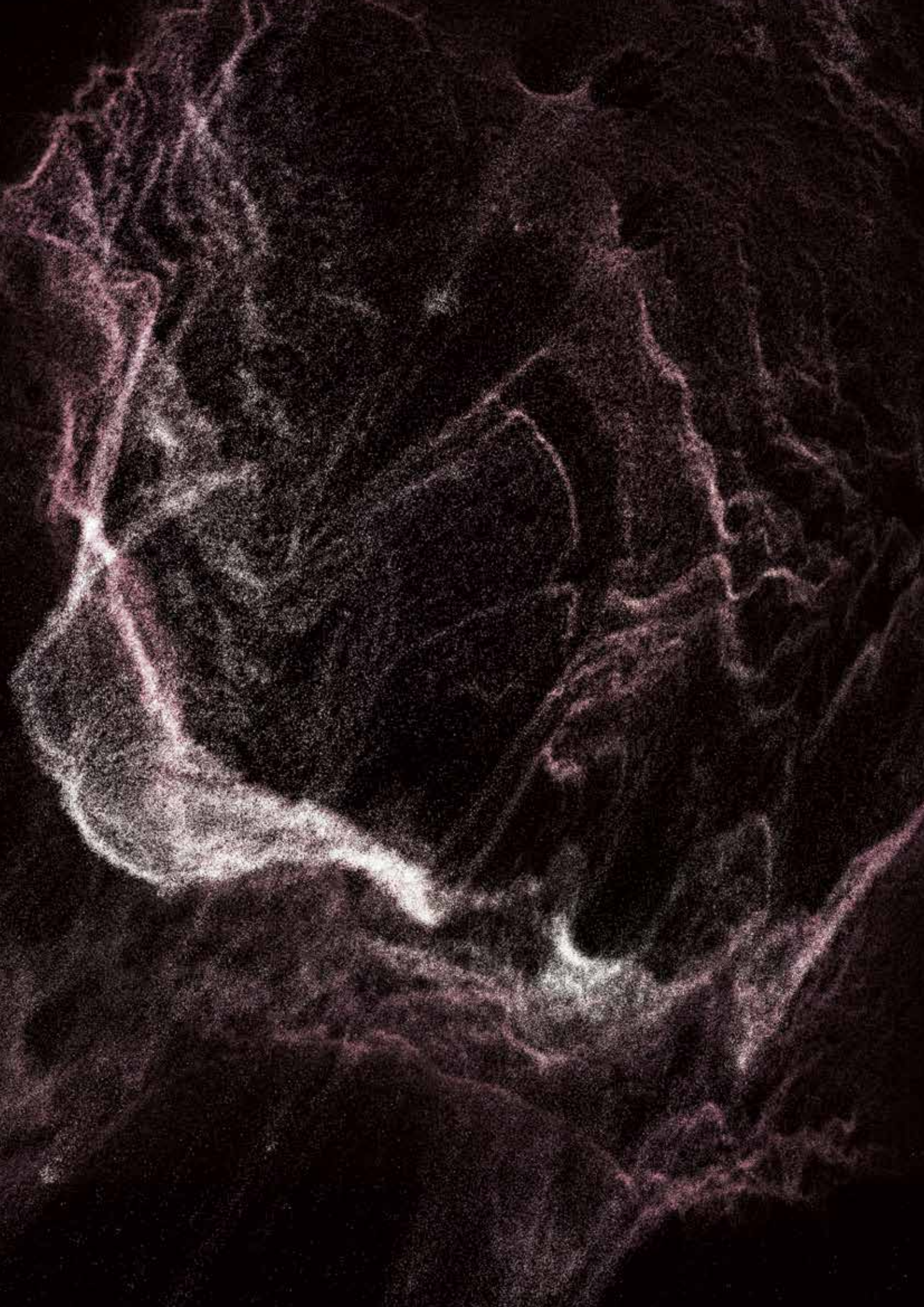


No current strategy for futureproofing – my business has an outmoded business and operational model and technological upgrade is still at the planning stage

Strategy for future proofing in development – my business has identified a sustainable business and operational model and has defined a strategy for upgrading technological capability

Futureproofing in process – my business is in the process of implementing a sustainable business and operational model and upgrading technological capability accordingly

Futureproofed – my business has a sustainable business and operational model in place and has invested in the right technology to ensure long-term success



A HAZARDOUS NEW ENVIRONMENT

In an increasingly pre-emptive regulatory landscape, regulation produces the most powerful blindside risk.

Change can create instability. In the reactive model of regulation, governments respond to instability with regulation. However, the pre-emptive model of regulation is increasingly common as authorities seek to manage the changing world in order to prevent instability.

The European Union (EU) does this out of necessity, as it harmonises rules across its member states in order to form a single market for different industries. Single jurisdictions, such as the United States and China, move towards pre-emptive regulatory models where they see the potential for negative disruption, for example with crypto-currencies.

Risks that cannot be predicted – blindside risks – cannot be prepared for. The only capacity a business can use to respond to blindside risk is its capacity to change the way it operates at speed: its agility.

Developing agility requires businesses to have already engaged in the process of innovation in order to give them options that other businesses do not have.

Given the current regulatory environment, it is perhaps no surprise that regulatory risk is seen as the greatest blindside risk by all respondents across geographies and industries, jumping one place since 2017. Authorities have the capacity to change the way a business can engage with its clients, the costs of doing so, and the costs of engagement ahead of the emergence of any real-world concerns.

Even for respondents classifying themselves as "futureproofed", this external risk factor was seen as a major concern, representing the highest risk for 66% of respondents.

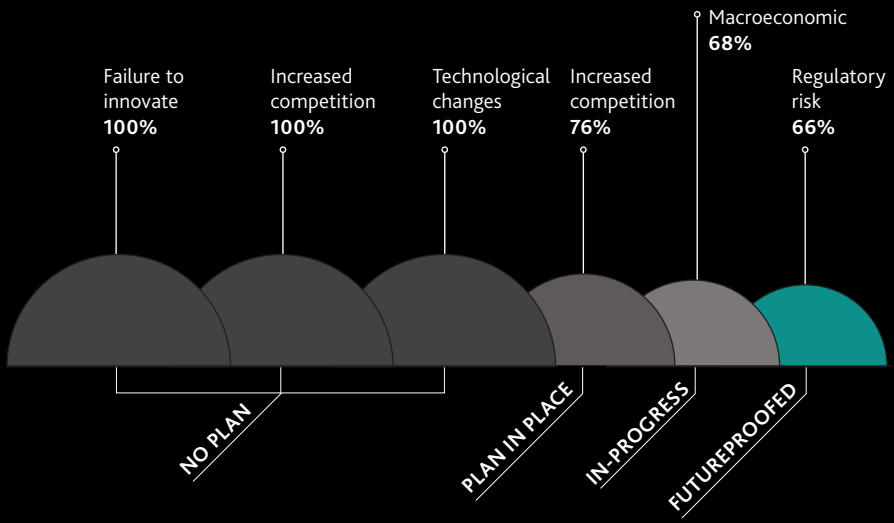
The movement of "people" as a blindside risk moved from 14th into the top ten, at seventh place, which is also reflective of the pace of change, and of the potential for businesses to find themselves without the right skills to manage in a transformed environment.

Macroeconomic developments – the second-highest-scoring concern across all respondents, up from third-highest in 2017 – can likewise have an existential impact upon a business, particularly as new trade agreements and barriers are established. Recent cases in point include the imposition of tariffs upon imports of metals into the US and the renegotiation of Britain's trading arrangements with the EU.

These direct measures not only affect specific businesses; the consequences for other trading arrangements can have major knock-on effects. These might range from impacts on other trade agreements and changes in economic status through to the creditworthiness of industries and entire countries.

#1 BLINDSIDE RISKS BY LEVEL OF FUTUREPROOFING

% of respondents



TOP 10 BLINDSIDE RISKS

% of respondents

The competitive pressure that medium- to low-performing businesses report as a major risk is reflected in the move of "increasing competition", which has jumped three places in the ranking, from ninth to sixth place.

Supply-chain risk – one of the two biggest climbers since our 2017 survey results – is naturally affected by the macroeconomic environment. The breakdown of free trade agreements as Britain leaves the EU, the renegotiation of the North American Free Trade Agreement, and the imposition of tariffs such as those affecting steel imports into the US are creating tensions. The other highest climber – environmental risk – owes its increased salience to an ever-increasing tide of concern about pollution and climate change.

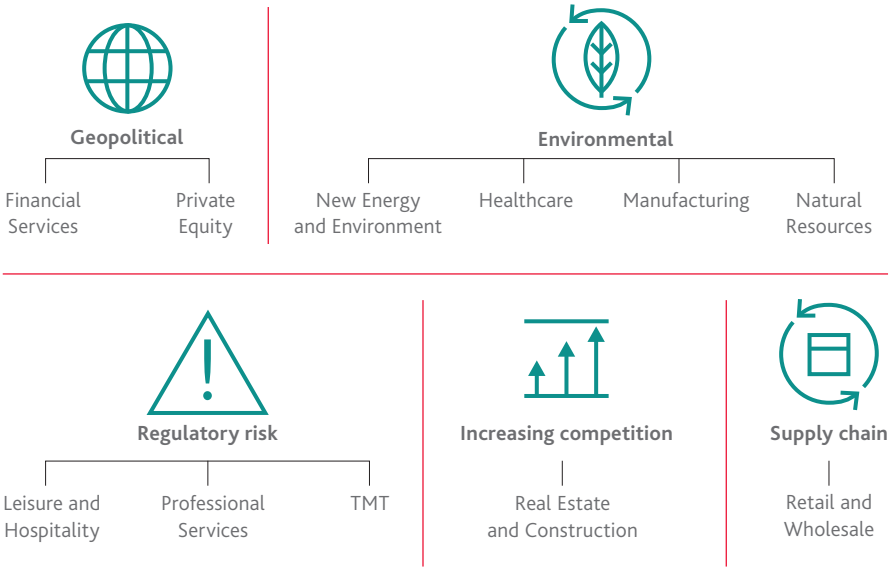
"Even looking at economies like China, which historically was relatively polluted, we see significant changes," says Burbidge. "There is an increasing recognition amongst governments and a lot of consumer groups that we only have finite resources."

Agility can assist in reducing the impact of macroeconomic effects. Whilst most direct impacts are typically sectoral, they can also affect elements of service and product. It is thus possible for a sector leader to anticipate such effects ahead of competitors, and to optimise client relationships and costs to better suit the new world order.

While ranking lower on the list of fears for all respondents, and in sector-specific analysis, greater competition, technological changes and a failure to innovate stood out as the most pressing concerns for businesses that did not see themselves as futureproofed.

The key thread uniting all of these factors is the element of change relative to other businesses. If businesses are facing a hostile environment, their key advantage will be in responding to that environment more effectively than the competition, and – regardless of specific environmental factors – without significantly increasing their costs as they do so. The institutionalisation of greater business agility should be understood not only as a response to the risks reported, but as a key strategy for securing the future success of a business.

#1 BLINDSIDE RISK BY SECTOR



"If businesses are facing a hostile environment, their key advantage will be in responding to that environment more effectively than the competition without significantly increasing their costs as they do so"

THE ABILITY TO NAVIGATE RISK

Strategic rather than tactical thinking is the key to agility in innovation.

If you are leading a shoal of fish, you navigate the environment to ensure your survival. Within the shoal, survival is determined by the guidance of the leaders and the size of the shoal.

Innovation is the capacity to react to evolutionary pressure; the actual reaction is determined by its agility. Tesla spends around twice as much on R&D as other car manufacturers as a proportion of sales (approximately 12%, according to Bernstein research). However, this amounts to around €1 billion a year, whereas VW has the greatest annual R&D spend in the business, at €14 billion – some €6 billion more than second-placed General Motors.

In September 2017, VW delivered plans to be the largest manufacturer of electric cars worldwide by 2020, fighting through its pollution scandal to deliver record sales in 2017. By contrast, rival PSA, which own Citroën, DS, Opel, Peugeot and Vauxhall, expects to be producing solely electric models only by 2025.

Analyst firm Forrester defines business agility as "the quality that allows an enterprise to embrace market and operational changes as a matter of routine". Returning to the shoal metaphor, a business that is not innovative is stuck in the centre of the shoal; it can only see and respond to its competition, not to pressures that threaten them all.

FORRESTER BREAKS AGILITY DOWN INTO THREE MAIN CATEGORIES:

MARKET (CUSTOMERS):

Market responsiveness
Detailed knowledge of customer preferences and ability to predict their needs

Channel integration
The ability to share information and deliver consistent experiences across channels

ORGANISATIONAL (PEOPLE AND CULTURAL):

Knowledge dissemination
Knowledge is shared accurately and efficiently, creating a unified understanding across the organisation

Digital psychology
High trend awareness and digital skill sets exist across the organisation

Change management
Culturally receptive to change, and with embedded change-management capability

PROCESS (IT AND SYSTEMS):

Business intelligence
Robust information management and distributed analytics

Infrastructure elasticity
High cloud awareness and embracement of cloud options

Process architecture
Developed process skills and core system independence

Software innovation
Ability for real-time experience and continuous, incremental development

Sourcing/supply chain
Agile sourcing processes and supply-chain-flexing skills

When respondents were asked to assess their own attainment across these dimensions, they corresponded clearly with performance levels (see Fig 02).

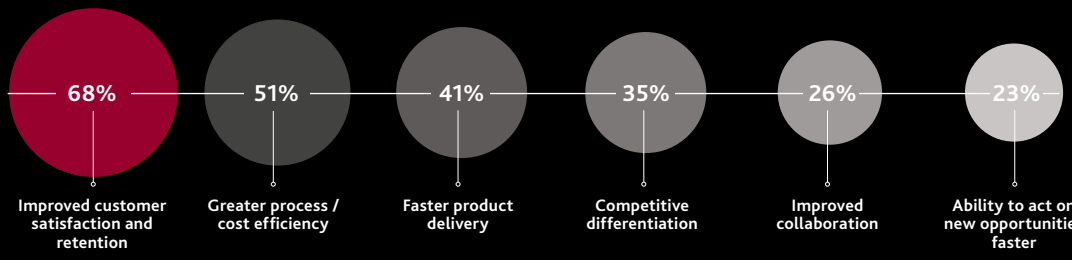
When Steve Jobs visited Xerox's famous Palo Alto Research Center in the late 1970s – as part of a deal that included Xerox taking shares in Apple – he saw technologies that would later make Apple a revolutionary personal computer business. By the time Apple launched its MAC computer in 1984, Xerox had still not commercialised these technologies, due to its focus on the copier and printer industry. It is a case study often recited as a warning to innovators, but contains elements that illustrate the challenge of transforming operational excellence into innovation.

"You have the innovators in one place, and they are valued for innovation," says Burbidge. "But then the good ideas must get captured and pulled into the mainstream part of the business to be delivered and grown. Whilst the innovators are still coming up with the new ideas, they are not necessarily in control of that business; they are a part of a team. The problem is that they do not always mix very well. Like oil and water, someone has to keep stirring the pot to keep the components in suspension with each other."

BENEFITS OF AGILITY

Fig 01

% of respondents



AGILITY BY PERFORMANCE

Fig 02

- High performance
- Median performance
- Stable performance

1 = Low agility – limited awareness / understanding and no ability to execute

2 = Moderate agility – moderate awareness / understanding but limited ability to execute

3 = Agile – high awareness / understanding but limited ability to execute

4 = High agility – high awareness / understanding and proficiency in execution

Based on Forrester's The 10 Dimensions Of Business Agility model

90%

believe agility would enable them to **respond to the risk of changing market conditions more effectively**

100%

of high-performing businesses have **appetite for greater agility**

13X

more likely to be **highly agile if a futureproofed business** versus one with no strategy

Clearly, there is a strong correlation between commercial success and agility. Of the businesses involved in the research, 100% of high-performing businesses had an appetite for greater agility. By contrast, 64% of low-performing businesses displayed the same appetite. Yet there are risks for businesses even if they have been agile up to this point.

According to Chris Haley, head of New Technology and Start-up Research at Nesta, "Over time, there is a natural tendency for [businesses' processes to become] more streamlined and better adapted to exploit the ordinary opportunities towards which the firm is focused, which inevitably means less flexibility for new or extraordinary situations. Changing this is hard, and typically means either breaking some existing processes, or else side-stepping them through the creation of new units."

Across all industries, the key benefit of agility was perceived to be improved customer satisfaction and retention (68%), followed by greater process / cost efficiency (51%) and faster product delivery (41%). In the on-demand, 24/7 environment in which digital businesses operate, real-time responsiveness can make the difference between fulfilling an order and enabling a transaction, or presenting a barrier to the customer that puts them off your business.

Whereas the thought leaders in industry have taken the philosophy of "customer-centricity" to heart, the commercial leaders have managed to operationalise that concept by investing in innovation. The opposite of agility is bureaucracy, which stifles the ability of businesses to respond to customer demands.

For Dr Angus Young, senior lecturer at the Department of Accountancy and Law at Hong Kong Baptist University, "The important thing is to get the entire organisation engaged, from the back all the way to the front line.

"The problem with bureaucracies is that they only care about the work that is done at their level. So if frontline staff are trying to be flexible, that will not succeed if work is then filtered through a bureaucratic department. They must have the freedom to act on decisions that have been made."

REFOCUSING RISK

Businesses that demonstrate agility are typically also those tackling risks imposed by the wider environment. They do not have to fear the capabilities of their rivals, and instead are focused on the dynamics that exist beyond the scope of their competition that nevertheless determine the viability of a business.

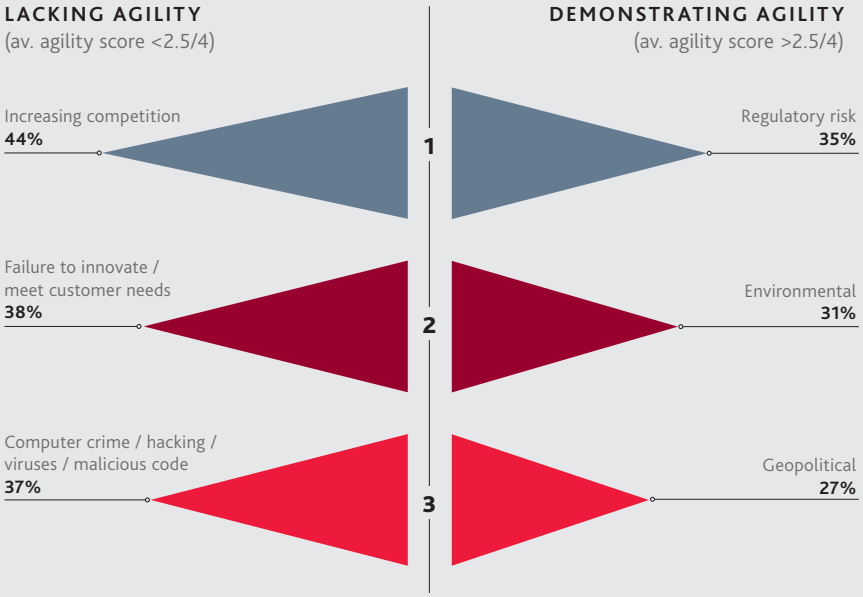
On the other hand, those businesses that are lacking agility are focused on localised risks, for example, failing to meet customer needs. The key difference between the two types of business is the level of strategic vs tactical engagement required by senior management.

If a business's leadership is struggling to make a business function as it ought to, it will have little capacity to lift its eyes to the road ahead. Likewise, businesses that are looking ahead need to have confidence that they can react to both the threats and opportunities that they see.

Agility is dependent upon innovation: a business needs to have a creative element if it is to change in line with the business environment; but it must also allow its management to concentrate on leading the business forwards on the field of play, instead of trying to get it in shape for the game.

TOP THREE BLINDSIDE RISKS BY AGILITY

% of respondents



BECOMING CUSTOMER-CENTRIC

The future belongs to businesses that embrace the new power of the customer in a global, direct and transparent marketplace.

#1
benefit of agility: improved customer satisfaction and retention

#1
positive impact of innovation for high-performing businesses: **customer-centricity**

70%
of high-performing businesses feel **changing customer behaviour** makes a successful innovation strategy critical

Customers buying anything, from mortgages to wholesale timber have, directly accessible to them, a world of data, which did not exist even 15 years ago, and which fundamentally influences the choices they make between suppliers.

Often, they also have direct access to suppliers. For old-fashioned providers of goods and services, this is a fundamentally disconcerting level of face-to-face contact. It is not optional, and it cannot be obfuscated. If you do not offer a decent price and a good service, it will be obvious to your customer base.

Some firms have embraced this. In China, for example, tech conglomerate and online marketplace Alibaba has used its customer data to support a fund-management offering, moving directly into a new industry through the innovative use of its strength to support diversity of products and services.

The marketplace is global, direct and transparent. This has three effects on competition.

First, building the capability to interact with customers on their own terms is crucial. If your business is accessed online, via mobile or via social media, you need to manage that function. Poor service at the front-end can lead very quickly to frustration and reduced confidence in the rest of the organisation.

Second, businesses must be aware of their clients and their competition. Senior management must therefore be plugged into a feedback loop from the front office and externally facing parts of the business, which guide product and service delivery. That is not to say a business should simply react to current client demand, since, by the time demand reaches critical mass, it can already be too late to service. In order to lead the field in any given industry, a business has to anticipate demand by reacting to the early signs of change, using data to build a picture of trends in behaviour.

The evidence is clear that, while all businesses found that changing customer behaviour means that a successful innovation strategy is critical to staying competitively relevant, this priority was stressed most forcefully by medium- and high-performing businesses.

Third, fast reaction makes for better service. A business must be aware of the potential financial returns that can be gleaned from innovation, and of the need for agility in bringing it to the forefront of the business. Respondents said that the greatest benefit of agility was improved customer satisfaction and retention.

As Dr Young noted, "The staff should not be trained to rely on familiarity and long-established practices as part of their job. Training should be about helping staff to think about customer or user experience. With this in mind, innovation includes ensuring that all customers have a positive experience when dealing with the staff and the business's products or services."

Among high-performing businesses, customer-centricity and competitive relevance were also seen as being far more important than efficiencies around cost and processing, which were picked out more often by medium- and low-performing businesses.

When these results are placed in context, it becomes clear that high-performing businesses seek to identify environmental factors that will impact their business, and adaptations that will support them in reacting to those factors. They are thus both far more attuned to their customers, and therefore able to become the provider that their customers want to see, ahead of the competition.

Low-performing businesses are focused on their rivals and on their own internal operations, and are therefore exposed to larger risks – macroeconomic and regulatory, for example – that they can only infer, but do not observe directly.

THE CASE FOR INNOVATION

Innovation, driven by commercial leadership, requires the repurposing of already familiar resources in new ways.

For a business, innovation is evolution, and, like evolution, its pace is determined by the pressure to change set against the potential for change. In the past, scale and heritage guaranteed resilience; but today the most sought-after trait is the ability to adapt and innovate.

The pressure to change can have myriad sources. Among our respondents, 93% believe that the disruptive impact of regulation means that a key contributor to staying competitively relevant is a successful innovation strategy. The other major blindside risks highlighted on p.12 each also contribute to evolutionary pressure.

If each generation of business leadership represents a new evolutionary cycle, then businesses should be aware of the differences between these cycles, as they will correlate with levels of innovation.

"Innovation is required. It is a must, a basic ingredient for corporate success," says Dr Young.

Defining innovation is crucial. It is not the same as invention in the sense of a scientific breakthrough, but rather the repurposing of familiar tools to support a new way of acting. The authors of the seminal book *The Alchemy of Growth* outlined the three-horizons model for identifying how systems change. In this model, the dominant system at present is the first horizon, reflecting incumbent and stable systems. The second horizon represents ongoing innovation and the potential futures it creates, with many possible outcomes. These include the absorption of innovation into existing models by changing the first horizon, and the creation of new innovative models of working.

The third horizon is seen as a "successor" to incumbent business, offering new ways of working that arise from activity within the second horizon, which functions as a bridge between the first and the third.

In 1981, Michael Bloomberg spent his severance from Salomon Brothers building a new business, Innovative Market Systems (IMS). Although his business did not invent technology, it innovated using available technologies that activated the potential for change, and thereby created a new way of supplying the data that capital market traders needed. Rival Merrill Lynch invested in the business, now named Bloomberg LP, which was founded with the aim of improving the customer's ability to perform.

Throughout the history of industry, businesses that have developed new ways of working have succeeded in changing their industries, often outpacing incumbents with greater resources, as Apple did with respect to Sony in the process of digitalising the retail music business.

In such cases, innovation can materialise as a result of the technological capacity to deliver new service models and the commercial imperative to make things easier for the customer.

While it serves the interests of customers, innovation can also be disruptive to the wider

"To truly innovate, a business must invest in the people and culture necessary to build innovation into the core of its operations"

93%

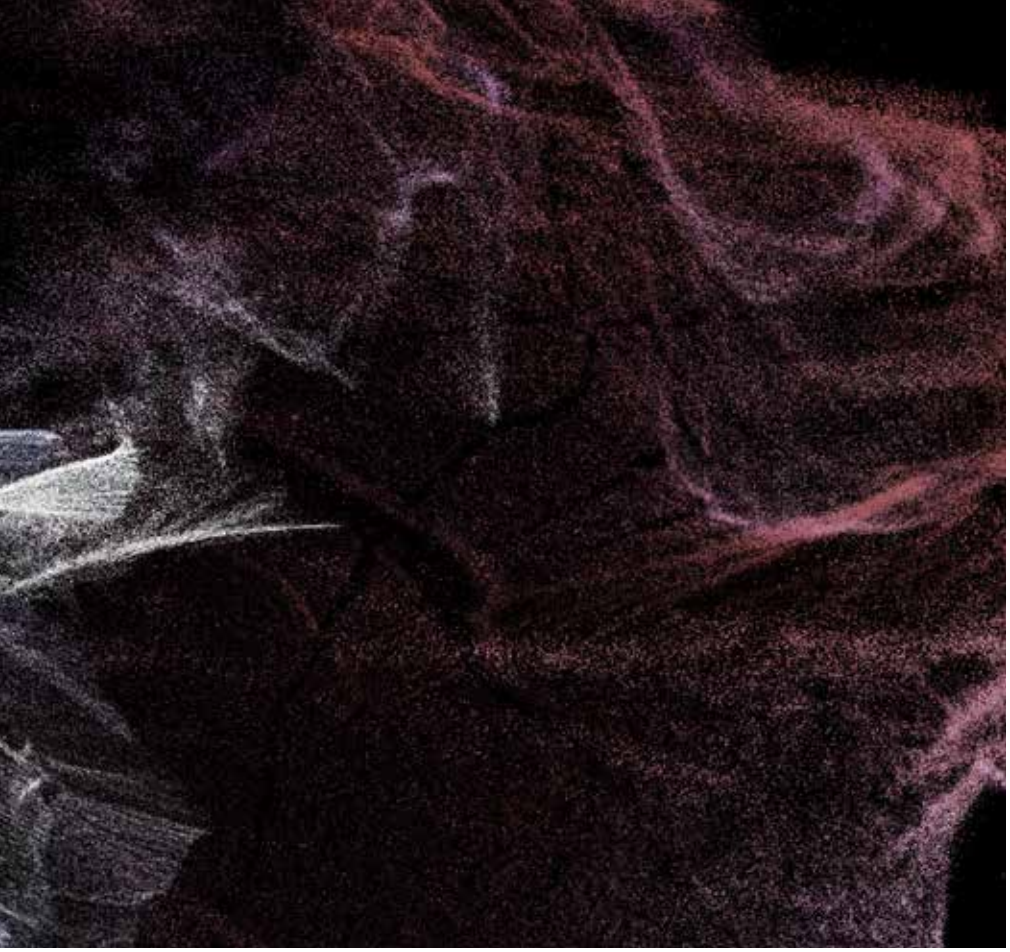
believe that the **disruptive impact of regulation** makes a successful innovation strategy key to staying competitively relevant

50:50

split on **new market entrants making a successful innovation strategy key** to staying competitively relevant

68%

of businesses have increased **prioritisation of innovation** on the boardroom agenda



environment, including competitors and regulators, and the flows of information and value that surround them. When innovation is disruptive, it can appear to share characteristics with "instability", which regulators typically seek to avoid by imposing rules.

Innovation can therefore trigger evolutionary pressures by itself. Examples of this include the legal cases brought against "gig economy" businesses such as Deliveroo and Uber, which saw challenges to the legal definition of freelance employment as it relates to workers' rights.

Equally, self-driving electric cars are transforming a model that had been stable throughout the 20th century. While there have been several reported deaths from accidents involving self-driving cars, proportionately many more have resulted from accidents caused by human error. As a result, lawmakers need to consider a balance between actual safety and perceived safety based on the growing body of statistical evidence.

Both cases represent a key challenge for industry today; new technology and evolutionary pressures have increased the pace of change substantially over the past two decades. As Burbidge says, "All of these things are happening so quickly that the traditional business models and norms that existed for many years just cannot be taken as read any more."

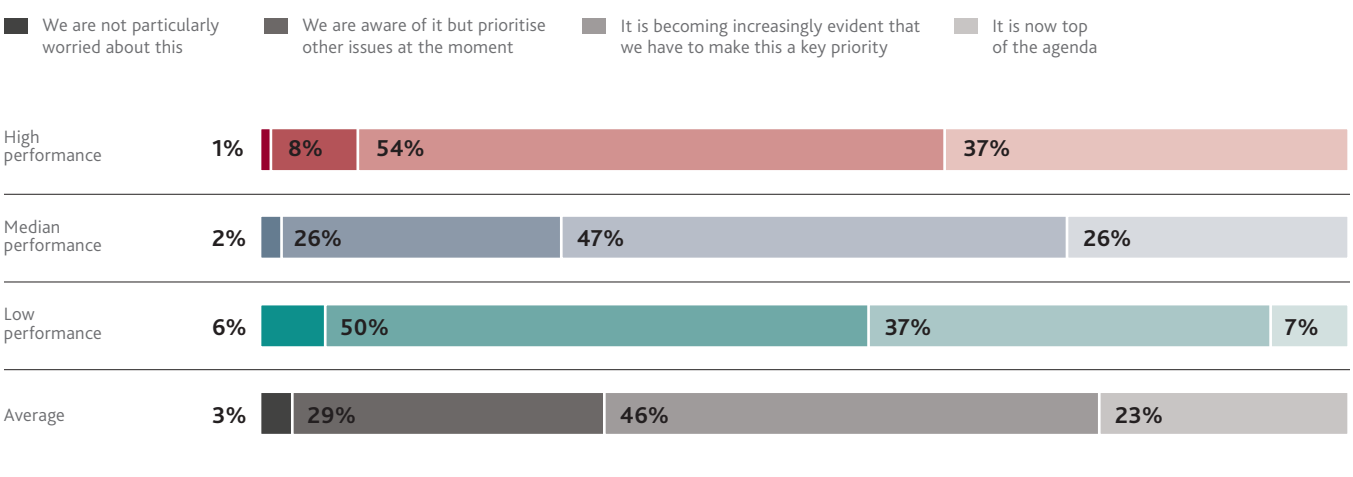
Among respondents to the research, 81% found that the speed of technological change means that a successful innovation strategy is critical to staying competitively relevant. A real risk for businesses that do not innovate is that they will be left behind by the competition, or that the changing environment will render them obsolete.

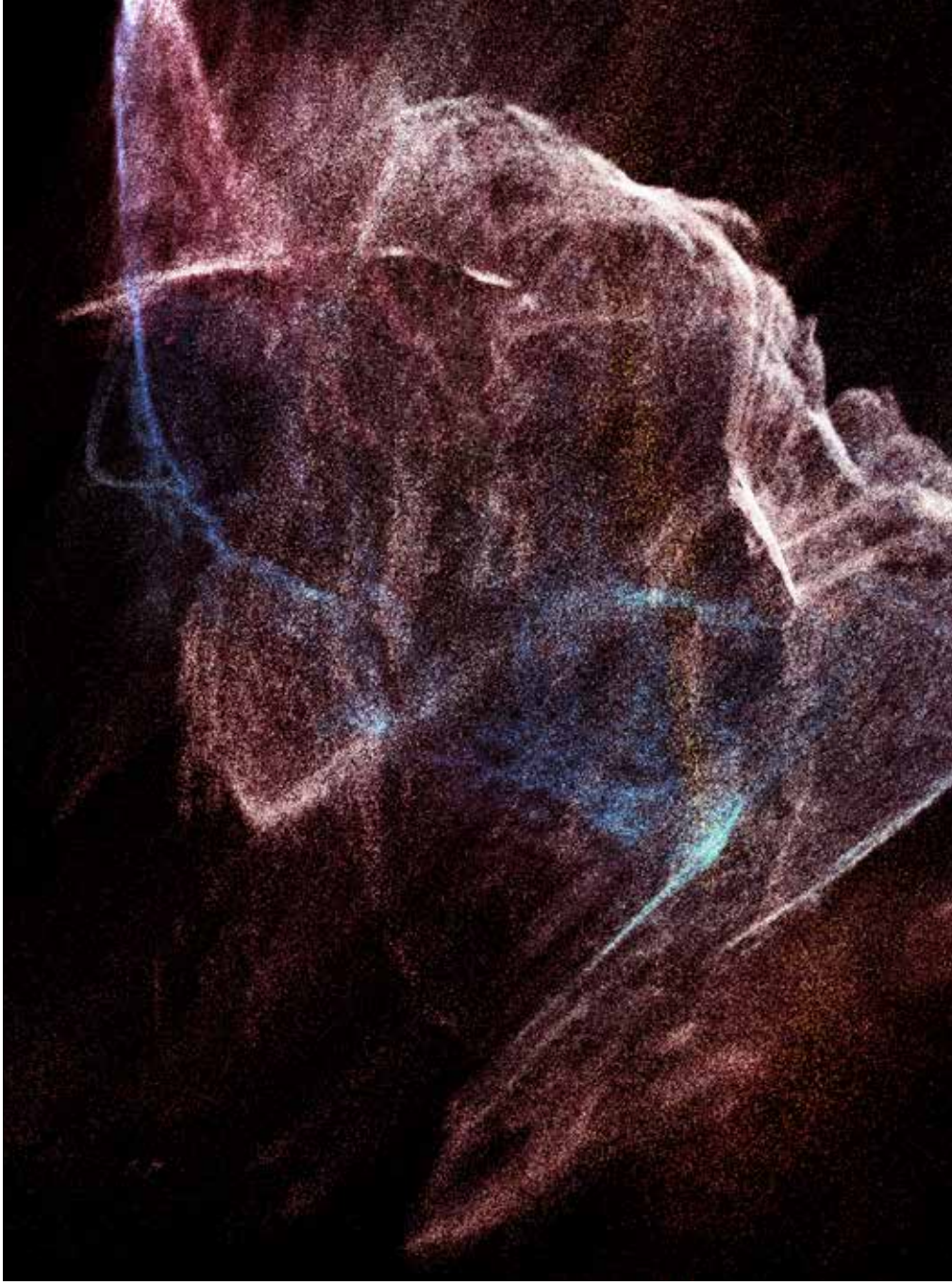
"If you look at the retail businesses and traditional high street businesses, they are being crucified by e-retailers," says Burbidge. "That's having an impact not just on the retailers themselves, but also the businesses owning properties in the high street. They are in for a long-term play and have to assess what they are going to use these premises for in the future."

However, the respondents were split 50:50 over the extent to which new market entrants were driving innovation. One can see that incumbent businesses are able to take their operations and deliver an enormous change if they can become innovative. Businesses have done this in the past by reinventing their business, as Apple did, branching out of computer hardware and proprietary software to

BOARDROOM PRIORITISATION OF INNOVATION BY PERFORMANCE LEVEL

% of respondents





deliver platform-independent software, an online music marketplace and a dominant smartphone brand.

Investing in innovation can deliver a much stronger upside than making capital investments. Analysis has found that businesses that invested in R&D in advanced economies over the past 50 years have been well rewarded in terms of commercial success. One study found that the rates of return from R&D were "positive in many countries, and usually higher than those to ordinary capital", reaching 75% in some cases, while the social returns were "almost always estimated to be substantially greater than the private returns".

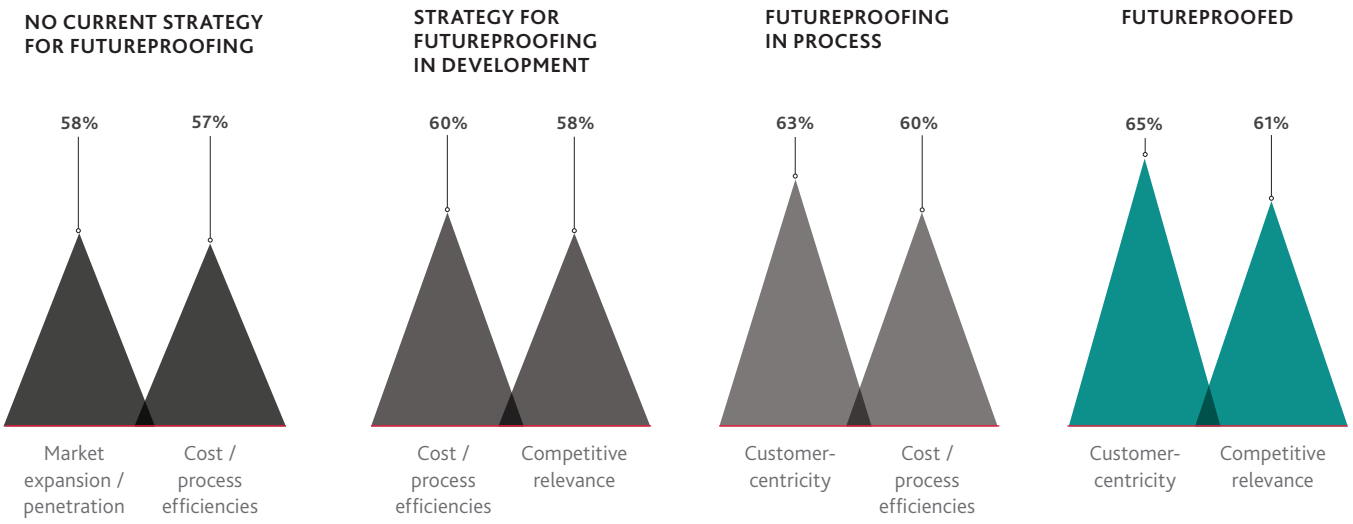
Investment must be more than financial. To truly innovate, a business must invest in the people and culture necessary to build innovation into the core of its operations. That will allow it to develop with a clear

"Innovation is required. It is a must, a basic ingredient for corporate success"

DR ANGUS YOUNG

TOP TWO GREATEST POSITIVE IMPACTS OF INNOVATION

By level of futureproofing
% of respondents



strategic direction, and therefore move effectively towards a shared goal.

The drivers for a particular business are likely to be determined by what type of business it is. Among both high- and medium-performing businesses, customer-centricity is perceived as one of the greatest benefits of innovation, while efficiency and competitive relevance are shared as the most positive impacts by businesses at all performance levels.

Projects can be instigated that combine these elements, though there is also a risk that projects will move in different directions or at different speeds.

Nevertheless, we can deduce some positive outcomes from the results themselves. One in five futureproofed businesses prioritise innovation, compared to one in ten businesses that have no current strategy for futureproofing – a strong correlation.

Among high-performing businesses, innovation has been pushed up the priority chain to board level, so that 37% see it as a top priority, far more than among medium-performing (26%) and low-performing (7%) businesses. Over half of low-performing businesses prioritise other dynamics at present.

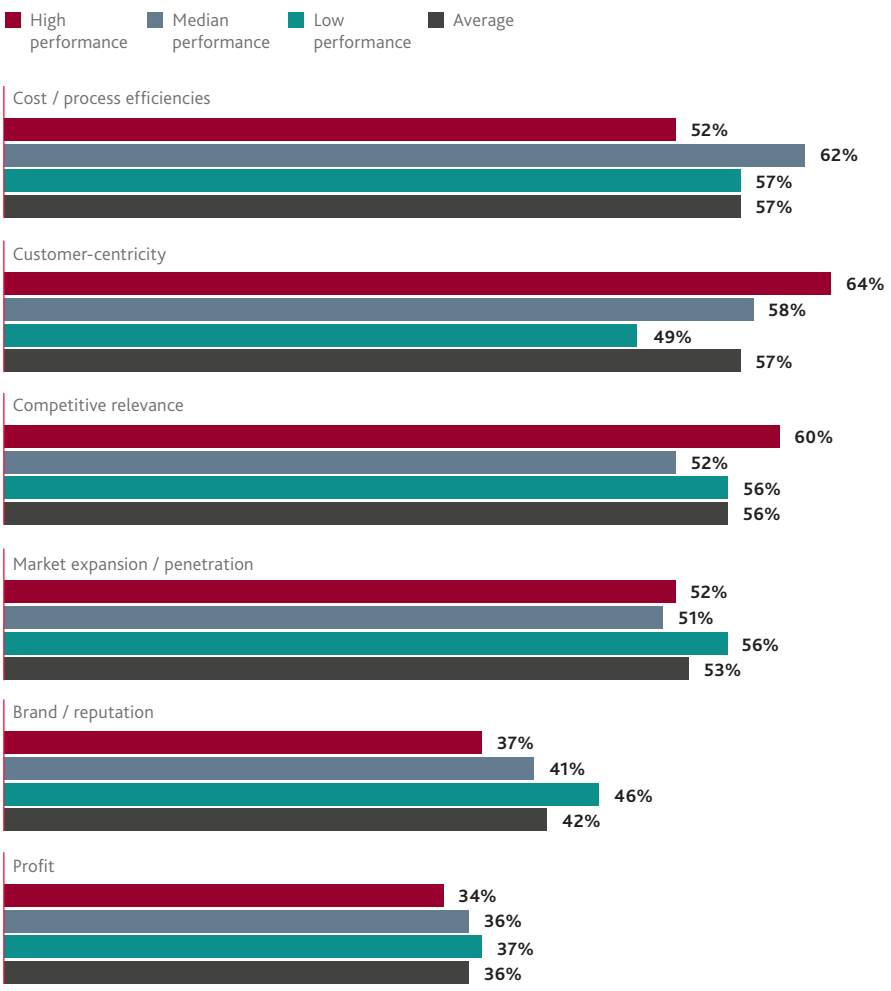
Senior management buy-in is fundamental in creating momentum to innovate, but other elements are needed to control the direction in which the business travels. There is no consensus among market participants as to the key drivers for innovation; 67% feel that changing customer behaviour renders a successful innovation strategy critical to remaining relevant, but a third of respondents dismiss its impact.

In short, a business must have a top-down strategy that guides innovation internally. It must be conscious of the external factors that are driving it to change, and the possible mechanisms – technological or otherwise – that will facilitate innovation. It must also ensure that its purpose and strategy is disseminated across the organisation, in order to keep the whole business moving in a single direction and at a constant speed, thus avoiding internal disruption.

The risks of failing to innovate are high; such a failure can demote a business into the second tier, or even render it redundant. But innovation needs to be carefully managed and controlled, not simply unleashed and left to itself.

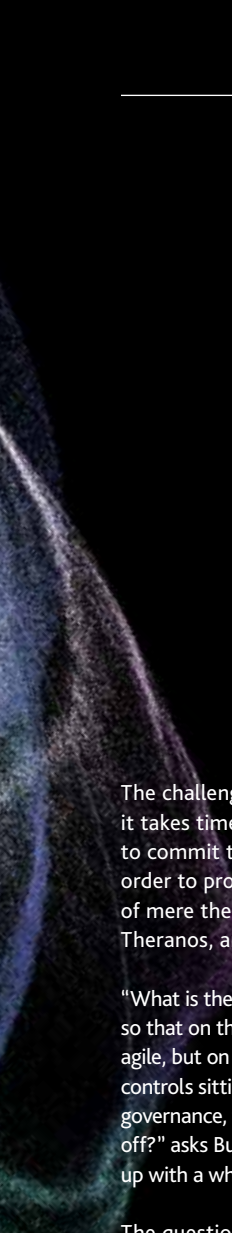
POSITIVE IMPACT OF INNOVATION BY PERFORMANCE LEVEL

% of respondents



THE INNOVATION-OPERATION DICHOTOMY

Is it innovation or operational effectiveness that is more important in ensuring business success?



The challenge in testing new ideas is that it takes time, and that requires a business to commit to a model for a fixed period in order to prove the idea. This is not a matter of mere theory. For every Google there is a Theranos, and that creates real risk.

"What is the best way of managing a business so that on the one hand it's innovative, it's agile, but on the other hand it has sufficient controls sitting around it in terms of governance, that doesn't frighten investors off?" asks Burbidge. "The market is yet to come up with a wholly satisfactory answer to that."

The question is: How much resource should a business commit to innovation as against existing business practices when investors need to see the sorts of returns that stem from operational success? Among respondents to the research, half saw a balance between operational effectiveness and innovation as central to their business's success. Among businesses that thought one was more important than the other, the majority identified operational effectiveness as the higher priority.

This dichotomy partly reflects the maturity of a business. In many industries, smaller start-ups are able to provide the "creative" element to establishing functional business models. In the pharmaceutical industry, there are many smaller businesses whose innovations are taken up and industrialised by the pharma giants. In finance, smaller "fintech" start-ups are developing everything from the bitcoin transaction infrastructure to online-only banking models that build loyalty through social media activity. Meanwhile, the incumbent banks support these enterprises with innovation labs through funding and guidance.

This polarisation of industry can be necessary where viable disruptive activity must avoid being crushed by the competitive weight of larger businesses, and where those businesses are to identify future opportunities for growth without risking instability.

A potential challenge to this model in the future is that the pace of change may mean that innovation risk affects the viability of the governance/investment cycle.

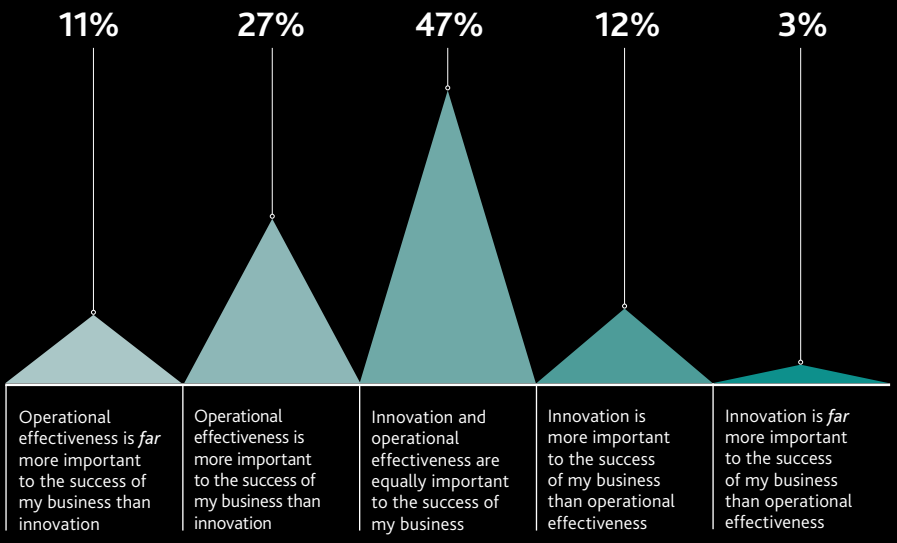
"Historically, a new idea and a new product could grow a business to a certain size, and it would float on the stock market," notes Burbidge. "That business would have 75 years of life in it. These days, instead of 50 or 75 years, you might be putting money into a business that might have a five- or seven- or eight-year lifecycle. If it doesn't make money in that period, you are throwing your money down the drain."

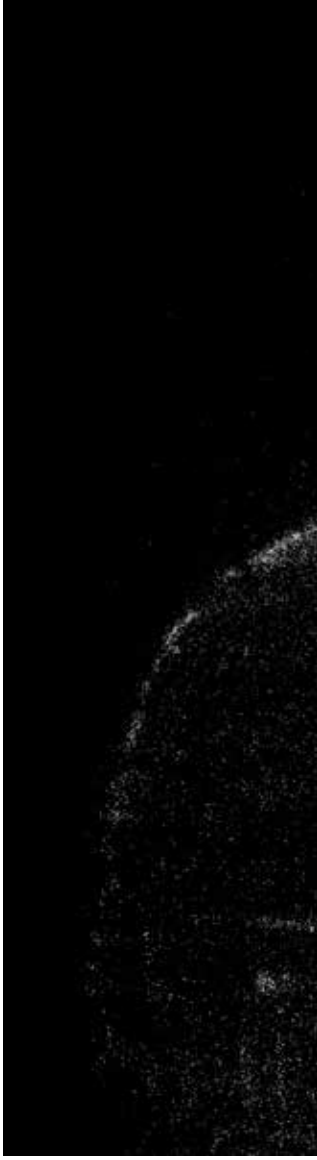
Consequently, senior management need to develop a mechanism in which money can be invested in some of these businesses in such a way that an investor can see a return over a much shorter timescale, so that they consider an investment worthwhile, retain their capital, and thus resolve the dichotomy. Without that, not only will funding be lost, but industry will suffer as the pipeline of innovation dries up, weakening agility in turn.

"Innovation invariably involves risk," says Haley at Nesta. "Even when an innovation is ultimately successful, there are often measurable short-term decreases in performance as the business first adapts to the new way of doing things."

THE INNOVATION-OPERATION DICHOTOMY

% of respondents





TO BE INNOVATIVE AND AGILE

The balance between energetic innovation and consistent delivery requires strong, strategic leadership.

Resilience is the characteristic that businesses strive for, and achieving it demands a careful balance of different capabilities, without any one becoming too dominant.

"Resilience depends on many things, including the ability to adapt and innovate," says Haley. "In many areas of life, efficiency and resilience are opposed; that is to say, squeezing redundant systems and unused capacity may improve efficiency, but often reduces one's capacity to cope with unexpected shocks."

There is clear statistical alignment between commercial success and innovation in our research, which is a call to action for businesses that are struggling to innovate. Yet there are many risks when engaging in the process that can make it challenging for businesses either to innovate or to commercialise their innovations.

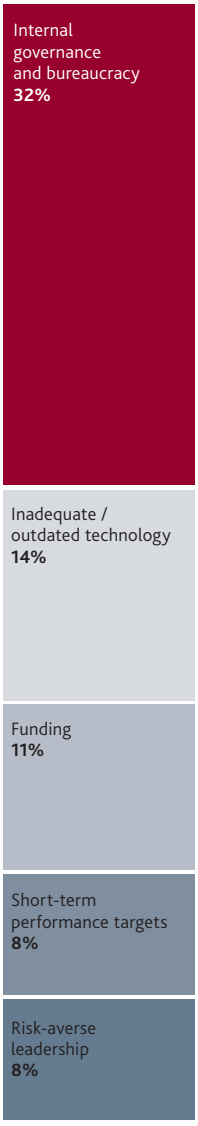
The application of different project-management models, such as Agile and the "fail-fast" methodology, is more common in newer businesses, and these can help them to change in a more responsive way than older Waterfall methodologies.

That said, there are risks in employing some of these models, although they have found success in context. Scaling up models such as Agile can be difficult, as they require a level of feedback and communication during the project that is optimal when developers, testers and business users are not disproportionately different in number, or separated by time zones and geography.

Whether one is assessing a business in terms of its potential for change (innovation) or its capacity to realise change (agility), respondents note that the two dynamics are closely intertwined. The main barriers to both are perceived to be very close to each other; 32% of respondents cite internal governance and bureaucracy as the most significant barrier in both cases.

TOP BARRIERS TO SUCCESSFUL INNOVATION

% of respondents

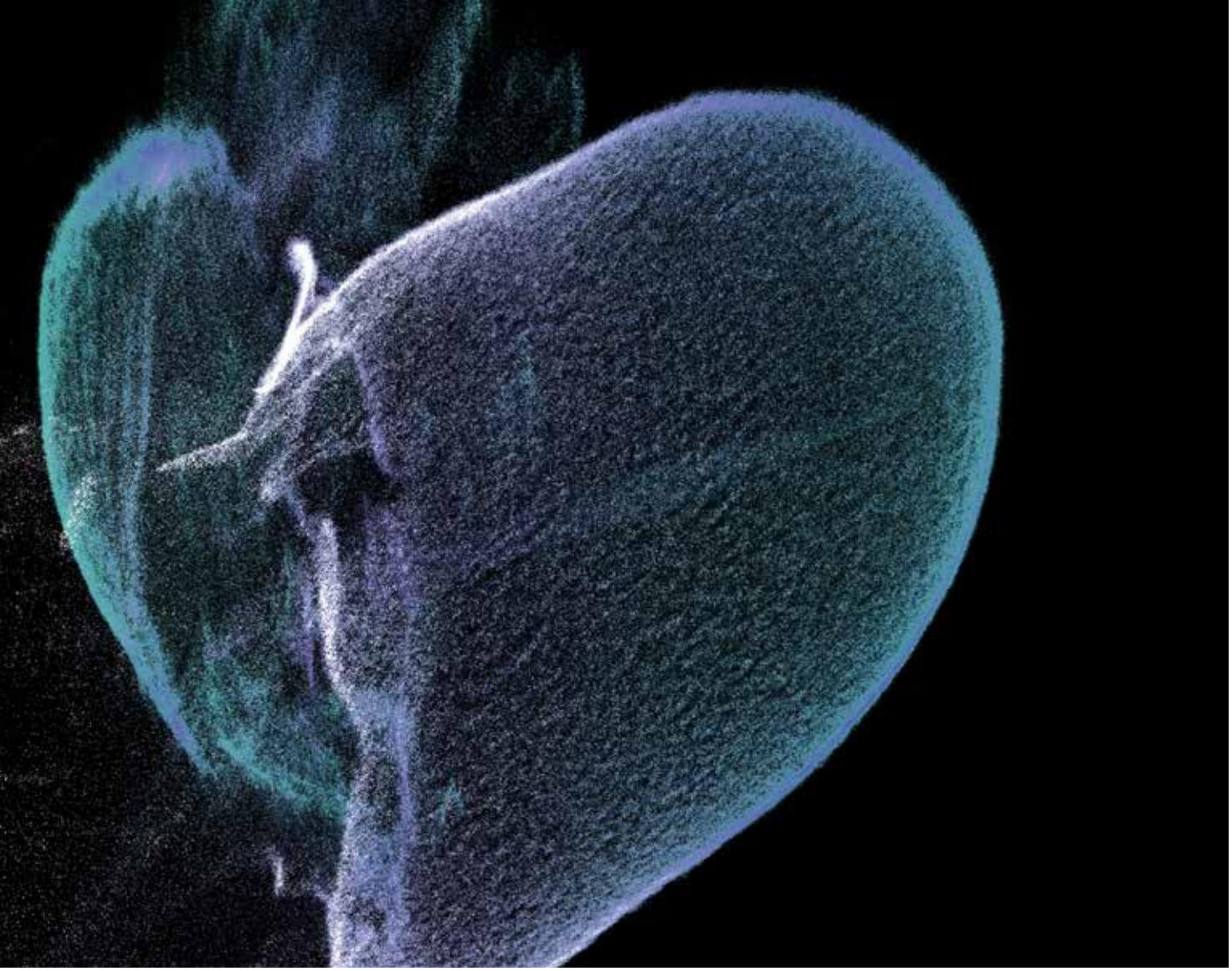


The size of a business can play a role here, as well; the checks and balances that allow management to control a large business effectively, and impose strong governance to create transparency in relation to executive behaviour, creates risks in the context of agility. They can constitute bureaucratic impediments to innovation and reactivity. As a result, partnerships are often used to try to blend more innovative, agile businesses with larger, less nimble peers.

"Increasing numbers of large corporates are choosing to work with start-ups in the hope that these younger businesses will bring new thinking, help solve problems, and rejuvenate staid corporate culture; however, such collaborations bring their own set of challenges and are difficult to get right," says Haley. "Other businesses are concentrating more on encouraging entrepreneurial attitudes among their staff."

The risk of supporting inadequate or outdated technology is seen as the second-highest barrier to both innovation and agility, cited by 14% of respondents. Inevitably, innovation requires a technological underpinning, and change requires a flexible infrastructure and use of application programming interfaces to support connectivity between systems.

> *"Squeezing redundant systems and unused capacity may improve efficiency, but often reduces one's capacity to cope with unexpected shocks"*
>
> CHRIS HALEY



It is not only heavy-duty legacy technology that inhibits transformation. New technologies are being introduced to industry, from 3D printing to distributed ledgers that alter IT infrastructure requirements, in order to support different ways of working. New, on-demand provisioning of computing power and cloud storage requires businesses to maintain an open approach to working with third parties. These can represent a challenge even for businesses with new technology if they are still built around older operating models.

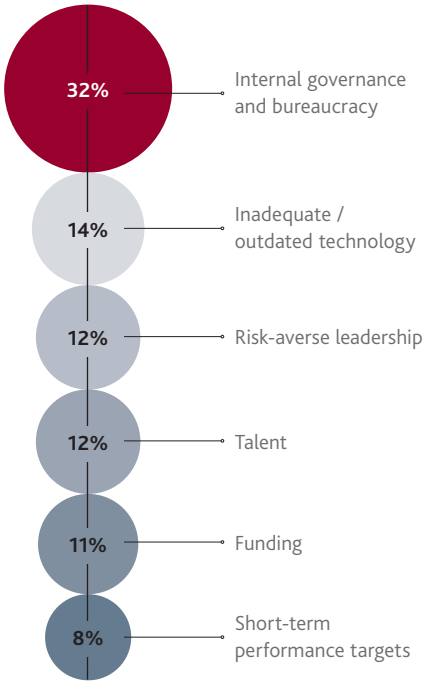
Based on our data, considering the top three choices of the main barriers to innovation, "funding" is the biggest problem. An absence of funding can indicate that management is not providing buy-in and support for new projects, which can point to wider problems.

Having the right culture and encouragement from senior management is imperative for developing a business that achieves both innovation and agility, with 77% of respondents citing it as the most important element in innovation. It is not just that the right management culture supports creativity within a business – there is the risk that attracting talent from outside will be more difficult if a business is not seen to be at the leading edge of innovation, as many businesses found when they sought to build digital capabilities in competition with the likes of Facebook, Google and Amazon. That point was given added weight by the common citation of "risk-averse leadership" as being among the barriers to both innovation and agility.

The corrective to a staid and risk-averse leadership team is the demand for new blood, even from within a business, in order to facilitate the emergence of new ideas. The ability to locate and train the right people, combined with a capacity and capability for innovation, was seen as the second most-important element (51%).

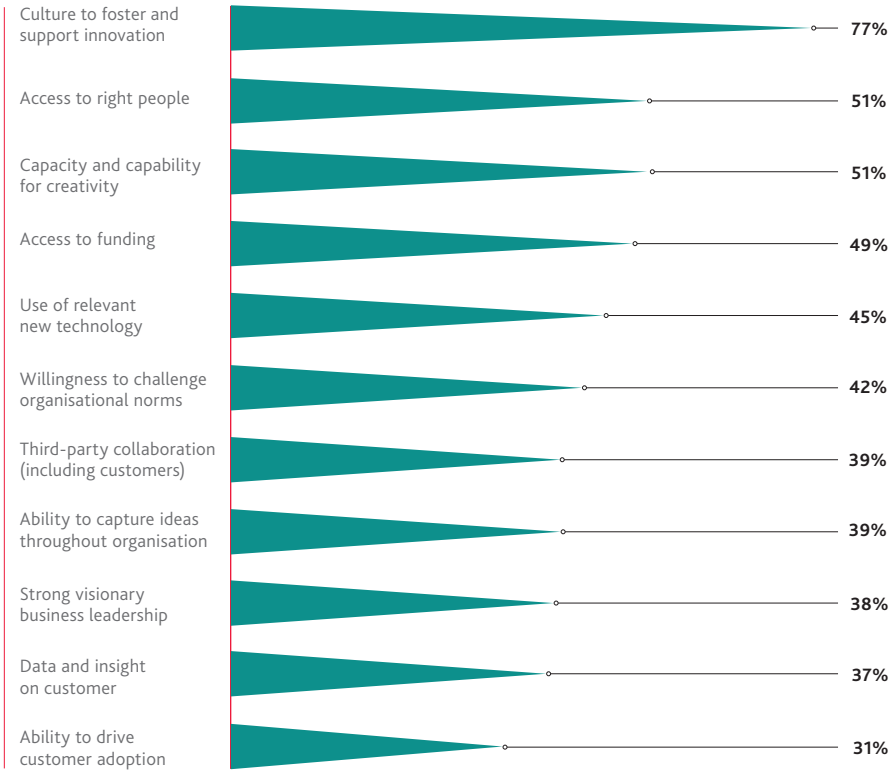
"To an extent it's a culture thing," says Burbidge. "A business that is agile and constantly moving probably attracts the sort of person who responds well to that, and enjoys the challenge of something different every day. An agile business will be able to change [in order] to be at the cutting edge. But the issue you can potentially have is that after you have shaken the tree, you have moved things around, and then actually there isn't any further you can go."

BARRIERS TO AGILITY



MOST IMPORTANT INGREDIENTS FOR INNOVATION

% of respondents



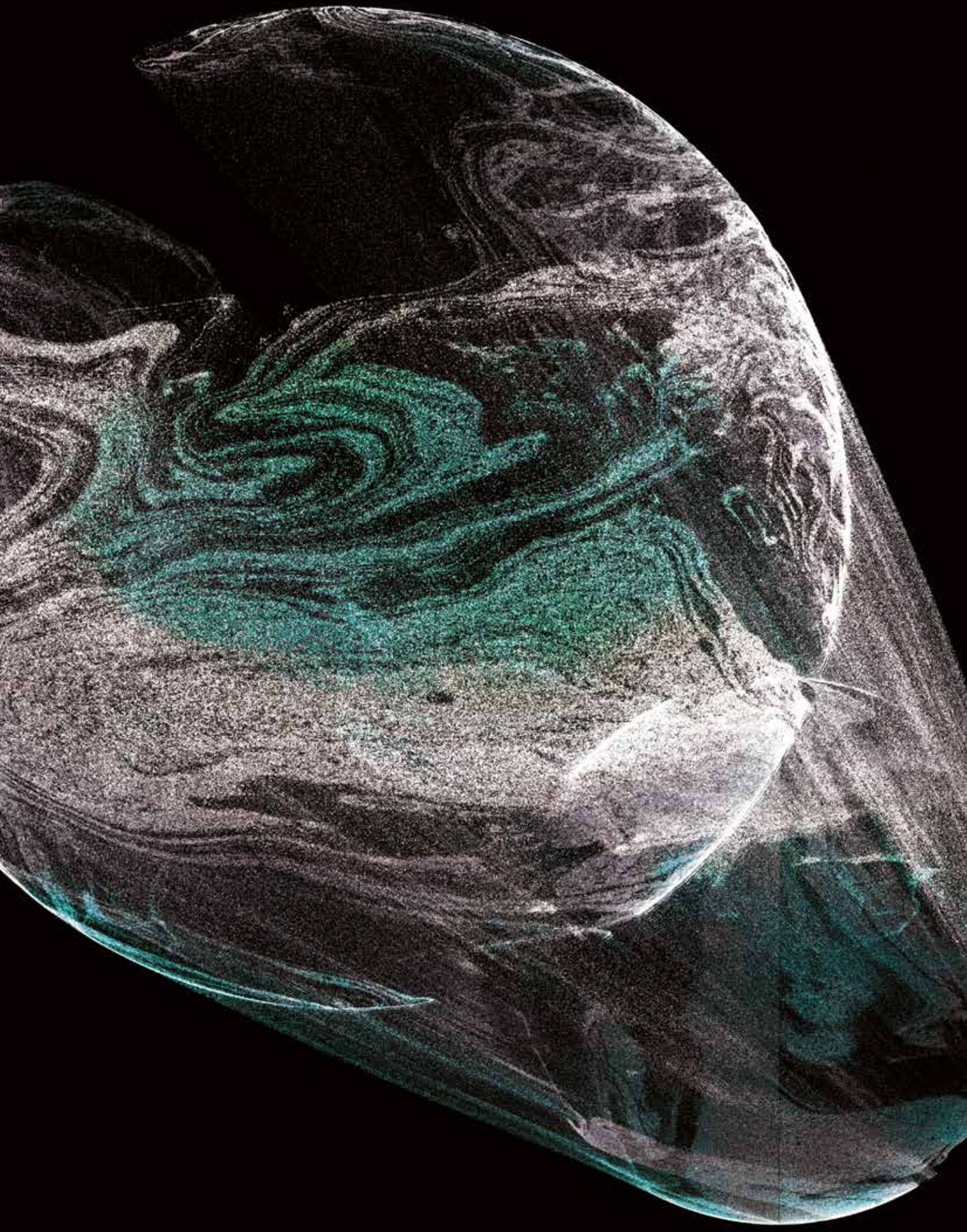
Nevertheless, greater agility is perceived to facilitate a more successful innovation strategy by 94% of respondents, enabling them to create and market products more competitively. Having both thus confers a significant advantage. The leadership of a business must therefore ensure it is providing the funding and cultural support for creativity, and that the technological underpinnings are in place that work with the demands of the customer base and wider environment.

As Dr Young notes, "The culture must not just be top-down; although it starts from the top it has to run through the organisation, with various rewards to acknowledge and encourage innovation via the HR policy and employment environment, in order to nurture innovation rather than complacency."

It is also crucial that innovation and agility are understood in context, and not placed on a pedestal to the detriment of all other activity. A business must support the growth it generates, and not constantly seek change without the necessary commercial model. Balance is required between these elements.

"You might have a successful business that has come up with some paradigm-shifting changes to the market that they are in, but then the market or the consumers in that market don't necessarily want to go any further and the business is still trying to push the market into different places," notes Burbidge. "By doing that, they can topple off the tightrope because they are pushing the market into places that [aren't] appropriate. That can happen if you have an imbalance of people who are restless and want to move the business in different directions."

Strong leadership can support a manageable level of innovation within a business, maintaining a consistent, enterprise-wide programme that ensures the whole business moves together as one – keeping ahead of the opposition without risking tripping over its own feet.



A CULTURE FOR SUCCESS

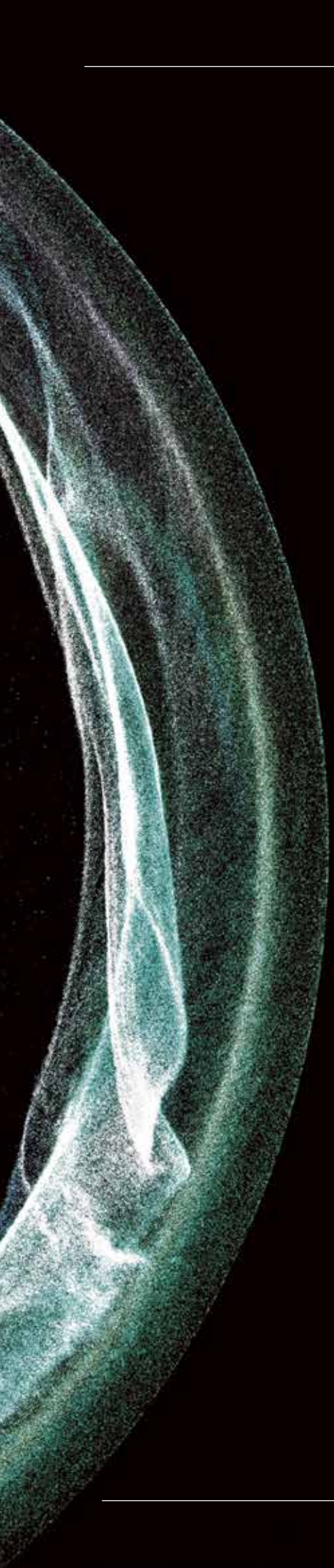
Innovative management must be combined with sound structures of governance.

Leadership can rule by command, but it only earns commitment if it leads by example. The culture of a business is determined by the attitude and actions of senior management. It is further strengthened by the processes and structures they put in place to support it.

"Complacency has no place in a successful business," says Dr Young. "Business policies need to reflect zero tolerance for anyone that cannot step up to meet new challenges. This does not mean those who fail to live up to expectations [should] be punished or discriminated against. The right attitude and policies [are] to provide every opportunity for employees to demonstrate a 'can do' attitude and receive proper training to nurture growth and development in each person."

The research undertaken for this survey demonstrates the importance of innovation and agility for businesses that are rated as "high-performing". It also outlines the advantages of building both within a business, and the perceived barriers to doing so.

There are a number of paradoxes that need to be challenged in order for businesses rated as medium- to low-performance to up their game. Investors typically want a sound governance structure that provides



them with a balanced way of managing and controlling a business. The processes that enable such a structure to exist are a consequence of historic malpractice, and the consequent development of best practices.

Even today, questions are rightly raised around businesses seen as highly innovative but less open to the norms of corporate governance. The recent fining of senior staff at medical testing innovator Theranos has been an example of this. Volatility in tech stocks can be seen whenever innovative models face legal challenges.

On the other hand, some of the more innovative businesses remain privately held; they have been set up and run by a visionary or inventor who had a brilliant idea and threw everything into it. However, for every one or two successful businesses in that bracket, there are hundreds of failures.

Where businesses can combine leadership with innovation and agility, they can begin to focus on the macro risks: regulatory, macroeconomic and geopolitical concerns. They lead their "shoal", and they can see what will be the best path forwards for them. Failure to combine leadership with agility and innovation leaves laggard businesses to follow their rivals, and to rely upon the protection afforded by the size of their industry. That is not a futureproof strategy – it is a passive strategy.

#1

ingredient for successful innovation: **the right culture**

BUSINESSES NEED TO ADOPT THE ATTRIBUTES OF THEIR MOST INNOVATIVE COMPETITORS, AND CONSIDER THESE TAKEAWAYS:

» Has your leadership got an appetite for innovation?

» Does the wider business understand and support the approach to innovation that senior management is taking?

» Will the business be able to realise the potential of its innovations? Does it have the necessary agility?

» Are the resources – in terms of financial and human capital – in place to operationalise the business's innovations?

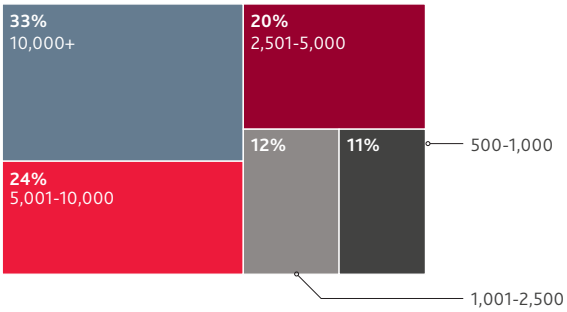
» If all of this can be managed, how can the new model of the business be realised without disruption, taking into account the likely impact on the wider market?

Nokia went from the global leader in mobile phones, over a decade ago, to a business that is struggling to retain relevance, while its rivals – including Samsung, Huawei and Xiaomi – continue to innovate. The lesson is not only that the ability to innovate and be agile is key to achieving and maintaining success, but that risks must continually be confronted and overcome in order to maintain a business's position as an innovator.

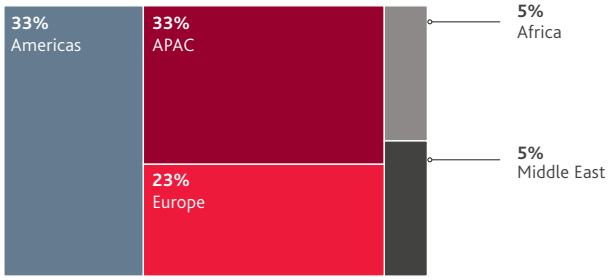
Achieving this is not a matter of appearances. It requires all-encompassing changes that must be reflected in every aspect of the business. As T.S. Eliot said, "Only those who will risk going too far can possibly find out how far it is possible to go."

DEMOGRAPHICS & METHODOLOGY

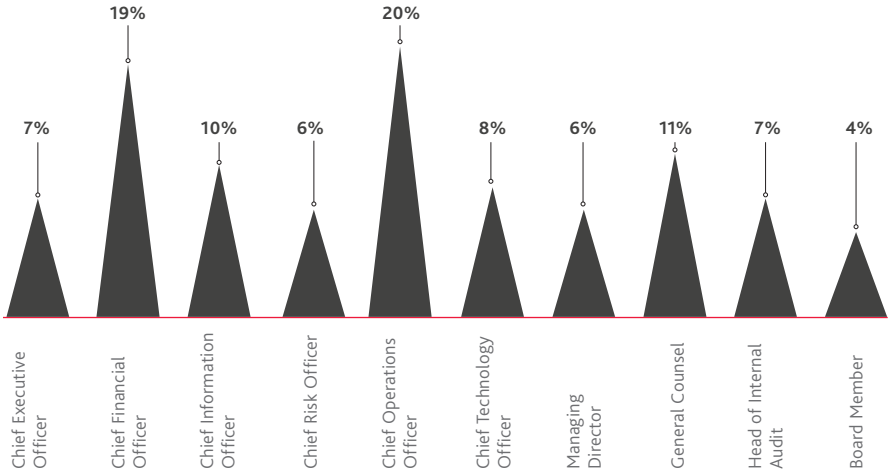
Q1 HOW LARGE IS YOUR ORGANISATION (STAFF)?



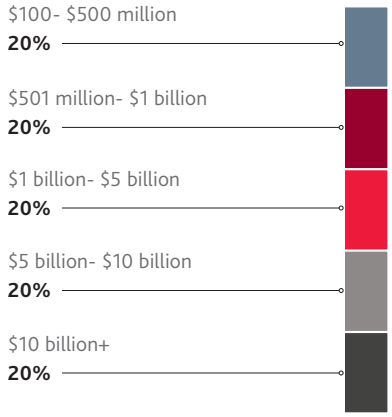
Q2 PLEASE STATE WHERE YOU ARE BASED



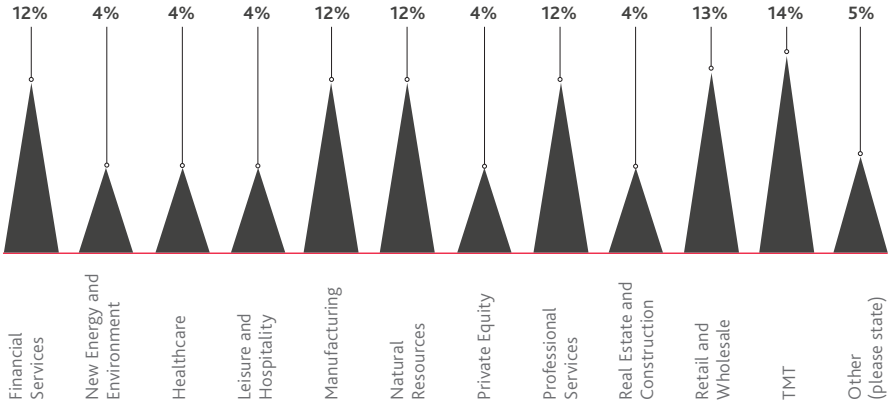
Q3 WHAT IS YOUR JOB ROLE?



Q4 WHAT IS YOUR ANNUAL TURNOVER?



Q5 WHAT IS YOUR ORGANISATION'S PRIMARY INDUSTRY SECTOR?



Q6 PERFORMANCE LEVEL WITHIN MARKETPLACE