CHAPTER ONE

HOW AND WHY INNOVATION AT PROCTER & GAMBLE CHANGED ITS GAME

My* job at Procter & Gamble is focused on integrating innovation into *everything* we do.

Every business has some central organizing principle that people use as the basis for making decisions, meeting challenges, and creating opportunities. For P&G, it is innovation.

Innovation must be the central driving force for any business that wants to grow and succeed in both the short and long terms. We live in a time when the rate of change is such that today's unique product or service becomes tomorrow's commodity. Winning—playing the game better than your competitors and changing the game when necessary—requires finding a new way to sustain organic revenue and profit growth and consistently improve margins.

This means seeing innovation not as something left to the R&D department, but as the central foundation in the way you run your business, driving key decisions, be they choice of goals, strategy, organization structure, resource allocation, commitment to budgets, or development of leadership.

All too often, managers decide on a business strategy—what markets to pursue and what products to make—then turn to innovation

* This chapter is in the voice of coauthor A. G. Lafley.

to support it. *This is the wrong way around.* Innovation needs to be put at the center of the business in order to choose the right goals and business strategy and make how-to-win choices. It is central to the job of every leader—business unit managers, functional leaders, and the CEO. The CEO, in fact, must also be the CIO—the chief innovation officer.

While we will both hone our definition of innovation and fully develop the practical tools for becoming an innovation-centered business, let's simply say that innovation is the foundation for controlling your destiny. It was for P&G (in my experience) the real "game-changer"—the real source of sustainable competitive advantage and the most reliable engine of sustainable growth. Innovation is the answer. That's what I learned in the weeks and years after I received an unexpected phone call.

ARE YOU READY?

It came on June 6, 2000, a few minutes before a business meeting in California. On the line was John Pepper, former chairman and CEO of P&G.

John got right to the point: "Are you prepared to accept the CEO job at P&G?" I was stunned. Just the afternoon before, I had been speaking with chairman and CEO Durk Jager about our plans for the final month of the fiscal year.

"What's happened to Durk?" I asked.

"He resigned."

"Why? What happened?"

"I don't have time to go into that now. I just need to know whether you're prepared to do the CEO job for P&G."

"Of course I am."

"Then get on a plane as soon as you can and come directly to my office when you arrive back in Cincinnati."

"OK."

I turned to my colleagues and told them something had come up. I had to leave. On the plane, I considered this sudden and totally surprising turn of events.

I tried to put first things first: What would I need to do in the next twenty-four, forty-eight, seventy-two hours? And what would I need to do in the first week, first month?

No question. P&G was struggling. We'd issued a big earnings profit warning in March, and the business was still coming in below expectations. While one of my areas of responsibility, North America, was delivering, my other business, Global Beauty Care, was not going to make its numbers. Other businesses were in even worse shape.

Stepping back, I reflected on P&G's recent history. We'd moved to a new global-business-unit-led strategy. We'd totally changed the organization structure—moving from local country to global category profit centers. We were adjusting to more global competition, a faster-changing industry landscape, and the challenges of the Internet and the so-called new economy. Most of our managers were in new roles. I'd worked in P&G's beauty business for exactly eleven months. In the midst of all this, we'd raised the company's goals to unprecedented levels—7 percent to 8 percent growth in net sales and 13 percent to 14 percent earnings growth.

Stretch, innovation, and speed were the orders of the day. Stretch for higher goals. Innovate in all we do. Go fast. Take more risk. All of these are good things in and of themselves. In hindsight, though, we were trying to change too much too fast. Many of our businesses were in no shape to stretch. Too many new products, businesses, and organization initiatives were being pushed into the market before they were ready. Execution suffered, as we too often fired before aiming. We had to come to grips with reality, to see things as they were, not as we wanted them to be.

Job one was to determine the state of P&G's business. At 6 a.m. on June 7, I began digging into the numbers—business by business, region by region, customer by customer. Unfortunately, we were in worse shape than I suspected. We were twenty-three days from year-end and there was no way we were going to make the month, the April–June quarter, or the 1999–2000 fiscal year. After briefing the board on Thursday, June 8, we issued another profit warning. P&G's stock opened more than $3.00 lower on the morning I was announced as CEO. By the end of the week, P&G's stock price was down more than $7.00 from Monday's close. It was not exactly an early confidence booster for me. (All told, our stock had dropped more than 50 percent over six months since January, a loss of more than $50 billion in market capitalization.)

I knew it would take another three to six months to know whether the business bottomed out. In the meantime, I had to retain the people at P&G who would be critical for future success. I talked one-on-one with each leader, as clearly and directly as I could about my expectations. We needed to come to a clear and common understanding of the business challenges and opportunities, and to get the fundamentals back in place quickly to get P&G growing consistently again. I shared with the leaders what was expected of them and what we needed to do together. I encouraged them to compete like hell externally but to collaborate like family internally. Just about everyone signed on to this vision.

What follows in the rest of this chapter is a disciplined crystallization of what was accomplished and how we did it. *While I had the fundamentals, cultivated over a long period of time, in my mind, the reality is their sequencing and actual execution evolved by "muddling through."* While I now have more clarity, I certainly did not have all the answers when I started.

WHAT WE HAD TO DO

Proud P&Gers, we were embarrassed by recent results. We wanted to turn this ship around. To do so, we focused on a few simple but powerful things.

We put the consumer at the center of everything we do. Three billion times a day, P&G brands touch the lives of people around the world. In our company, the consumer—not the CEO—is boss. Regardless of the original source of innovation—an idea, a technology, a social trend—the consumer must be at the center of the innovation process from beginning to end. In ways large and small, P&G was not living up to the "consumer-is-boss" standard; that is why we were losing market share in core categories like disposable diapers and toothpaste. Now we spend much more time with consumers, in stores and in their homes and in consumer-testing centers of all kind—to watch them use our products, to listen to them, and to learn from them what they want from us.

Our goal at P&G is to delight our consumers at two "moments of truth": first, when they buy a product, and second, when they use it. To achieve that, we live with our consumers and see the world and opportunities for new-product initiatives through their eyes. We do this because we win when more consumers purchase and use our brands—and do so repeatedly. We win when consumers use our brands more loyally. We win when consumers trade up to higher-priced, higher-margin brands. Consumers are now at the center of every key decision we make in a routine and disciplined, not episodic way.

We opened up. Long known for a preference to do everything in-house, we began to seek out innovation from any and all sources, inside and outside the company. Innovation is all about connections, so we get everyone we can involved: P&Gers past and present; consumers and customers; suppliers; a wide range of "connect-and-develop" partners; even competitors. The more connections, the more ideas; the more ideas, the more solutions. And because what gets measured gets managed, I established a goal that half of new product and technology innovations come from outside P&G. We are already beyond that figure, compared to 15 percent in 2000.

We made sustainable organic growth the priority. Innovation enables expansion into new categories, allows us to reframe businesses considered mature and transform them into platforms for profitable growth, and creates bridges into adjacent segments. So we changed our emphasis to organic growth, which is less risky than acquired growth and more highly valued by investors. In the second half of the 1990s, top-line growth had slowed, and some of P&G's most venerable brands were weakening—a vulnerability that competitors were quick to attack. I felt P&G could do—had to do—better. That, of course, is easier said than done. P&G is now an $80+ billion company; increasing revenues 5 percent a year means adding the equivalent of a brand like Tide or a market like China—year in, year out—against world-class competitors like

Colgate-Palmolive, Henkel, Johnson & Johnson, Kao, Kimberly-Clark, Unilever, and L'Oréal, as well as retailer private labels and popular low-cost local brands in developing markets like Brazil, China, and India.

Innovation now drives virtually all of P&G's per annum organic sales growth. We now only count on 1 percent of our 5 percent to 7 percent sales growth to come from acquisition activity; the balance must be innovation-driven organic growth. From fiscal 2001 through 2007, even against a background of rising energy and commodity costs, we have improved operating margins by more than 4 percentage points (i.e., 400 basis points). Profits have more than tripled to $10+ billion while free cash flow has totaled $50 billion over the same period. Innovation-driven value creation and incremental sales growth from innovation have nearly doubled since 2001. That has helped us average 12 percent earnings per share growth and increase our market cap by $100 billion, making us one of the ten most valuable companies in the United States. Since fiscal 2000 through November 2007, P&G's share price has increased nearly threefold, reaching a record high on December 12, 2007.

We organized around innovation to drive sustained organic growth. To get organic growth, we needed to innovate. We had to become a more consistent operator, and a much more consistent and reliable innovator. I consciously set out to restore innovation to the heart of P&G. My goal was and is to create an organization of sustainable innovation, which, in turn, drives sustainable organic growth through:

- Thinking about innovation as a strategy—a capability we wanted to build and to strengthen and to turn eventually into sustainable competitive advantage

- Regular business strategy and brand equity reviews that focus on innovation as the competitive advantage and game-changer

- Regular innovation reviews for every global business unit that focus on growth goals, innovation strategies, plans, and major initiatives

• The careful selection and use of the right metrics, recognition, and rewards to encourage innovation

• The process of evaluating, developing, and promoting outstanding business leaders who are also outstanding innovation leaders

• The allocation of resources—financial and human—to drive the successful commercialization of outstanding innovation

By running a disciplined development, qualification, and commercialization process, we have proved we can manage a large portfolio of innovations in various stages of development. Innovation is now P&G's lifeblood and is at the core of our business model. Every day, more P&Gers are involved in innovation. Consumers expect P&G brands to improve their lives with new innovations. Retail customers count on P&G innovation to grow their business and create value. P&G investors and shareowners look to innovation as an indicator of overall future financial performance.

We began thinking about innovation in new ways. We started from the premise that it is possible to run an innovation program in much the same way we run a factory. There are inputs; these go through a series of transformative processes, creating outputs. It is possible to measure the yield of each process, including the quality, the end product, and the financial and market results. The necessary dynamics to talk about innovation this way—opening the innovation process, focusing more on the consumer, and building teamwork and processes—cannot be done in isolation. To work at all, they have to work together and be integrated into the main decision making of the business.

Second, we broadened the way we thought about innovation to include not just products, technologies, and services, but also business models, supply chains, and conceptual and cost innovations. We also saw innovation not just as disruptive—the proverbial home run—but also incremental, the less glamorous but highly lucrative and profitable "singles and doubles."

And, third, while everyone knows that innovation is risky, we have learned how to pinpoint the sources of those risks and have developed the tools and know-how for managing them. We've made learning from failure a regular practice to improve our ability to manage risk.

HOW WE DID IT . . . FIRST THINGS FIRST

That is what we did. What you want to know is how we did it.

The first step was to improve our execution so we could then focus more resources on innovation. In June 2000, it was crystal clear that we were not executing very well—and in the fast-moving consumer goods industry, execution is often decisive. As a result, we were not delivering on business and financial commitments to our shareholders, customers, suppliers, and employees. The obvious question was "Why?" The answer: We were trying to do too much, too fast, and nothing was being done well. P&G needed clarity and focus. What were the critical choices to make? What would be the key priorities? What was the right *balance?*

Our first choice was growing the core—categories like fabric care, feminine care, and hair care. We had been harvesting or milking these businesses to invest in new brands and products, and/or in new geographic expansion. We would obviously like to do both to maximize short-, medium-, and long-term growth, but we had swung the pendulum too far. We had to get these core businesses and leading brands growing more consistently and more profitably as soon as possible.

In doing so, we placed a laser-sharp focus on current consumers, who at least occasionally bought and used our brands and products, and current retailers, wholesalers, and distributors we worked with. We also needed to improve the discipline with which we managed the operating fundamentals of P&G businesses. For example, in June 2000, we were able to ship only about 97 percent of the cases ordered by customers. That meant we were leaving up to 3 percent in potential sales "on the table." Every Monday morning, my leadership team was asked to report on missed cases and what actions were taken to fill orders. We continued the practice until missed cases were in much better control. Today, missed cases run less than 0.4 percent, and they are no longer a major cause of lost sales and profits.

Pricing was another area of focus. On too many brands and product lines, in too many countries, P&G prices were too high. We needed to find the pricing "sweet spot" that represented a better value for consumers, gave retailers a fair profit, and would drive P&G to improved market share, net sales, and margin performance. This was incredibly important because P&G's business model is driven by well-differentiated brands and superior-performing products that can command modest price premiums and more loyal-consumer purchase and usage. We worked the issue hard and took about two points per year out of net pricing between 2000 and 2002 to ensure better consumer value for P&G brands.

While missed cases and winning the consumer value equation were important areas to work on, we knew that innovation would be the key to winning over the medium and long term. Why? Fundamentally, P&G had been built on a strategy of differentiation—of differentiated, branded consumer household and personal-care products. Brands are promises of something different and better in terms of performance, quality, and value. Brands are guarantees of consistent quality, performance, and value.

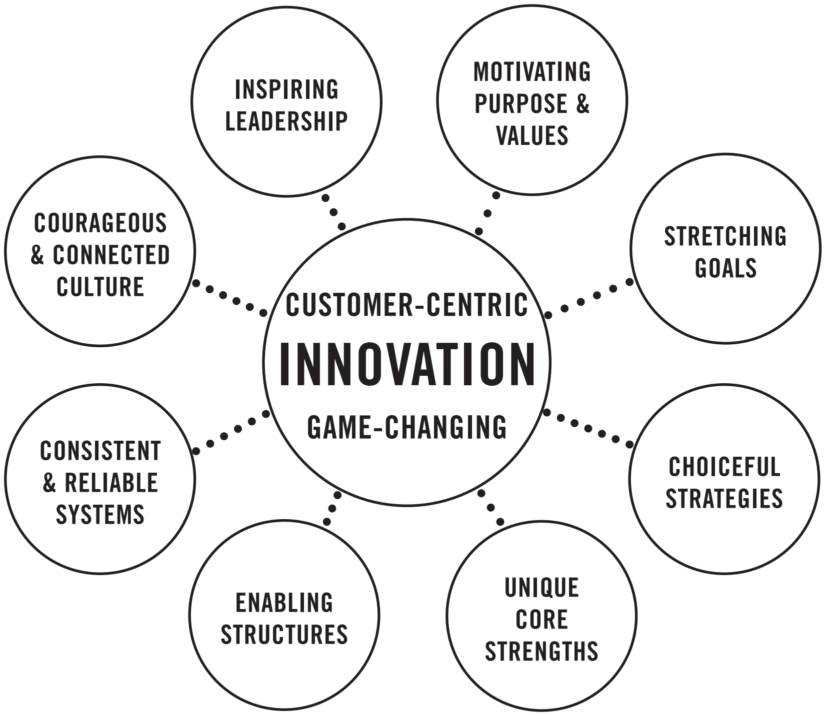
But the critical questions were, *how* could we put innovation at the center of everything we do? *How* could we turn innovation into more consistent, more decisive, and more sustainable competitive advantage? And, *how* could we manage the risks associated with our all-in and full-on commitment to innovation? Could we identify and take advantage of the opportunities innovation might offer us? With this in mind, we looked at what we believed would be the key enablers or drivers of an innovation strategy; the drivers that would create an innovation-led operation and build an innovation culture; the drivers that would result in game-changing innovation that would touch more consumers and improve more lives.

INNOVATION IS AN INTEGRATED MANAGEMENT PROCESS

For innovation to have a payoff—for it to generate sustainable organic sales and profit growth—it must be integrated into how you run your business: its overall purpose, goals and strategies, structure and systems, leadership and culture. As illustrated in the diagram on the next page, there are in fact eight elements of any business that ultimately must be organized and led to drive innovation. These eight drivers work together; that is, they are integrated with one another and with the everyday operation of the business. It's important to keep in mind that this is a model, not a lockstep process that must be rigidly followed. It is intended as a guide for breaking down into manageable pieces the seemingly overwhelming challenge of making an organization more innovative. Adapting it as conditions change and idiosyncratic challenges arise is crucial to its usefulness. While we describe the model in a linear, sequential way in order to make it understandable, the reality is that the model doesn't have to be implemented in any particular sequence. You can begin to integrate innovation into your organization through any of these drivers and through more than one at a time. Being adaptable, commonsensical, practical, and "muddling through" to see what works best for your company given the situation at the time are important to making the model work and for innovation to take root.

The overarching or guiding principle for game-changing innovation that delivers sustained organic growth and profits, no matter whether your business is consumer products, services, or business-to-business industrial products, is placing the consumer or customer at the center of this framework. While many say they are "customer-centric," few actually put the customer as boss in the center of the innovation process. The goals of sustaining organic growth and differentiation from the competition are best fulfilled when all eight drivers are fully working together.

1. Motivating purpose and values Companies centered on innovation are inspiring places to work, and the people who work there are



turned on by a higher purpose. Having a sense of purpose larger than delivering numbers that keep Wall Street happy gives meaning to one's work and unifies an organization.

P&G is purpose-led and values-driven. Billions of people around the world are striving to improve their lives through accessible and affordable products and services. Our purpose is to improve their everyday lives in small but meaningful ways with brands and products that continually deliver superior performance, quality, and value better than the best competition.

Our values—integrity, trust, leadership, ownership, and a passion for serving and winning with consumers—translate purpose into action and show up in everyday behaviors, beginning with how we treat the consumer and each other.

Our purpose and values are not unique, but they *are* powerful because our employees have been embracing and practicing them for generations. The key is translating them so they are relevant to winning in today's marketplace. For example, a generation or two ago, we mainly focused on serving middle-income mothers in the United States, Canada, and Western Europe. Today, we aspire to serve a much broader array of people of different income levels and lifestyles in both developed and developing countries around the world.

Our purpose inspires us. Our values unite us. Emphasizing them was the first critical step in the transformation of P&G as a company with the consumer as the boss and innovation at its center. The linkage of purpose and values with innovation energized management and inspired P&G employees in ninety countries around the world. Purpose-driven innovation, everyday-life–improving innovation, was a higher calling—a cause everyone could embrace, a very real opportunity to make small but meaningful improvements in the human condition.

2. Stretching goals Goals influence every other critical choice. Identifying a few critical goals creates clarity in focusing on strategies that win and align everyone's energy.

In creating game-changing innovation, therefore, it is important to get the growth goals right—goals that are stretching but achievable, yet cannot be reached without a sustained process of innovation, driven by leaders who see it as *the* way to change the game.

The problem in 2000 was that we had committed to stretching goals that we had less than a fifty-fifty chance of delivering. One of the first things we did was to reset our three external growth goals so that they were still stretching but achievable, for example, 4 percent to 6 percent sales growth in categories typically growing 2 percent to 3 percent a year. These goals would elicit bolder, more innovative business unit strategies and more ambitious operating plans.

3. Choiceful strategies Once goals are set, you have to figure out how to achieve them. Strategies are the few critical choices required by clear goals—choices that result in winning *with* consumers and customers and *against* competition. Putting innovation at the center of our thinking enabled us to see strategic choices in a different light. Businesses and brands previously considered "mature" could then be looked upon as growth opportunities. Innovation thus energized our leaders to grow our four core businesses (fabric care, hair care, baby care, and feminine care) and ten leading brands that each generated a billion dollars or more in sales. Innovation also enabled us to make decisions about where *not* to play. For example, we decided to exit most food and beverage businesses. While profitable and earning cost of capital, they neither had the potential for growth through innovation nor for long-term competitive advantage. Resources, then, were freed up and deployed toward faster-growing, higher-margin, more asset-efficient beauty, health, and personal-care businesses. Innovation also opened up an entirely new opportunity to capture more than a billion new lower-income consumers, particularly in the fastest-growing developing markets.

4. Unique core strengths Once we made our choices about *where to play*, we then focused on *how to win* by building on, enhancing, and deploying our unique core strengths. Core strengths enable you to play successfully in your industry and are consistent with what your company does or could do best. They create and sustain competitive advantage; they can be integrated in different ways to meet new and unforseen needs. P&G's core strengths include a deep understanding of consumers and placing them at the center of all decision making; creating and building brands that endure; the ability to create value with customers and suppliers; and effectively leveraging global learning and scale into competitive advantage.

We invested serious money, resources, time, and management intensity to make our core strengths stronger. For example, we've reinvented our highly valued market research organization and focused it on deep consumer understanding. Our research has moved away from traditional focus group research and invested heavily, to the tune of a billion dollars (double the industry average), in consumer and shopping research, with particular focus on *immersive* research.

We're spending far more time in context with consumers—living with them in their homes, shopping with them in stores, and being part of their *lives*. These real-world connections lead to richer consumer insights, faster speed to market, and lower risk. It alters the mind-set of P&G leaders and changes their decision making. Total immersion gives real meaning to the power of "consumer is boss" in practice.

The effect has been not only to improve our performance in each unique core strength, but also to create real competitive advantage from their combination. When we put it all together through our deep local knowledge and close retail partnerships, we see and create more innovation opportunities. We use P&G's leading global brands as platforms for innovation. And we commercialize innovation more consistently—all of which leads to more *sustainable* growth and to *superior* shareholder returns.

5. Enabling structures The execution of a chosen strategy and the deployment of unique core strengths require the design of an organization structure that supports innovation at the center of the business. While there is *no* one best way to structure an innovation-centered company, it is clear that the sun is setting on the internally focused, vertically integrated organization. We are in the era of the open corporation. The behavior and psychology of managers has to be in tune with this phenomenon; they need to be comfortable designing structures and processes that bring in and commercialize outside ideas. At P&G, we call it "Connect and Develop." It is the structure and process that brings in more than 50 percent of our innovations and produces billions of dollars in revenue. Structure—which *could* be a liability, particularly in a large, global, diversified company—instead becomes a powerful, sustainable source of competitive advantage.

6. Consistent and reliable systems Innovation is creative but not chaotic. It is a systemic way of moving from concept to commercialization. The process of innovation has well-defined success criteria, milestones, and measures. It is integrated with the mainstream of managerial decision making, particularly the choices of where to play, specific time-based goals, and key performance indicators. Innovation is also linked with budgetary revenue growth and cost targets, resource allocation and reallocation, people development and promotions, and performance appraisals and rewards.

7. Courageous and connected culture A culture is what people do day in and day out without being told. In an innovation-centered company, managers and employees have no fear of innovation since they have developed the know-how to manage its attendant risk; innovation builds their mental muscles, leading them to new core competencies. They know that the culture of innovation will continue to help the organization be agile and not only adapt to change, but also cause change. A forward-looking culture of innovation continuously transforms a company at the speed of external change.

At P&G, there is a broader, stronger, more-consistent innovation culture today than at any time in our history. It is not perfect, nor where we ultimately want it to be. But we're getting there. P&G leaders, management, and employees are more connected to consumers whose lives they are committed to improving, more connected to customers and suppliers—who are important innovation partners, and more connected to each other as we move from a "not-invented-here" culture to an open-learning culture that "applies and reapplies with pride." They are more courageous and more curious and open to any and all new ideas. They are willing to take more risks because they understand that failure is how we learn.

8. Inspiring leadership No organization can work without leadership. In the integrated process of innovation, it is the leaders who link all the drivers of innovation together, energize people, and inspire them to new heights. Leaders are instigators. They continually look over the horizon to gauge the changing landscape in their industry. They set the goals that are stretching but achievable and require innovation. They know innovation is a team sport and exercise both their IQ and EQ, enabling them to work with diverse people whose creativity needs to be converted into practical results. Innovation leaders are passionate about knowing the consumer, personally immersing themselves into finding insights about consumer needs. Over time, they learn and develop confidence about how to deal with the risk and failure inherent in innovation. They become confident in the art of balancing possibilities and practicalities. They are intellectually honest about diagnosing the causes of both failure and success. Above all, they know innovation is a highly integrated process that is systemic and replicable and produces results.

A WORK IN PROGRESS

Once our purpose was reaffirmed, clarified, and focused, I could turn to those drivers of game-changing innovation where I believed I could make the biggest impact as CEO. While all eight are important innovation drivers, and each can be addressed in a different sequence, I chose to focus on those I "owned" as CEO and where I could make the biggest impact—goals and strategies, and leadership and culture. What you choose to focus on will vary with your specific responsibilities, your current business situation, and which innovation drivers are either working or need improvement.

I think you'll find, as I have, that you can evaluate any program against these innovation drivers and see where the problems and opportunities are. They are both a description of what we want to achieve and a diagnostic tool.

The most important part of the system is the one in the middle: the consumer. Everything begins and ends with the consumer. We have figured out how to keep the consumer at the center of all our decisions, actions, and behaviors. As a result, we don't go far wrong.

In fact, P&G is getting it right more often. Now we can say that P&G's strategy and structures empower innovation. Our systems enable innovation. Our culture is more an innovation culture. The numbers tell the story. Sales growth and net present value of the total innovation portfolio have more than doubled. Shareholders who stuck with us have been rewarded. R&D productivity is up 85 percent, even though R&D dollars are modestly up versus 2000. Capital spending, which was 8 percent of sales in 2000, is only 4 percent now—and we have not foregone investment in a single unit of capacity to support a growing business or a single innovation initiative to sustain growth.

We have created new products that serve our consumers in new ways, such as Swiffer, Crest Whitestrips, and Tide Coldwater detergent and its international counterpart, Ariel Cool Clean. Consumers tell us they are delighted. Pick a measure, any measure, and P&G is a healthier, more-prosperous, and more-dynamic company today than it was at the turn of the millennium.

The Game-Changer is about what I have learned over the course of a lifetime in business, but particularly since I became CEO of P&G, one of the world's most admired companies. Through many trials and too many errors, I have learned that innovation is an integrated process and that innovation is a game-changing and winning strategy that can transform the everyday work and behaviors of managers and employees. We have not perfected the process of innovation—not by a long shot. But I have no doubt that the right building blocks are in place because we have thought innovation through, step by step.