EXCERPT FROM: VALUE INNOVATON PORTFOLIO MANAGEMENT: ACHIEVING DOUBLE-DIGIT GROWTH THROUGH CUSTOMER VALUE

INTRODUCTION

Managing the Product Portfolio for Customer Value: Transforming the Business Drivers for New Product Development

Every executive who has sat through presentations by eager product managers touting hockey-stick growth curves for proposed products knows that financial projections alone may not provide a meaningful assessment of a product's potential market success. Yet, given no viable alternatives, most will either shoot from the hip or resign themselves to simply going by the numbers, using metrics such as projected market share and growth, net present value, and cost/benefit analysis -- even when such economic measures involve an uncomfortable amount of guesswork.

There is a better and simpler way. The key to choosing products that contribute to sustainable profitability lies in changing the business focus of portfolio management from *financial metrics* to *customer value*. Paradoxically, by putting aside financial data and giving more weight to customer value data when making product portfolio decisions, companies can in fact improve financial performance by identifying products with the potential to delight customers. Customer value, defined as the customer's perception of how well a solution meets their needs, is the only proven course to drive profit: The greater the value of the solution to the customer, the more likely the customer will buy it -- and pay a premium price for it. And, unlike many financial projections (and contrary to the beliefs of many executives), customer value *is* based on something real, which you *can* accurately measure to yield trustworthy results.

REDEFINING YOUR PORTFOLIO ALONG THE VALUE DIMENSION

Just as an individual's dogged pursuit of happiness for its own sake may in fact engender misery, a myopic quest for profit may not actually yield long-term profitability. So how can companies transform their approach to portfolio management from being profit-obsessed to customer value-driven?

The first step is to examine how the company defines portfolio management and how well -- or poorly -- its product portfolio meshes with its business strategy. In our work with scores of companies, we have encountered many that divorce portfolio management from business strategy. They consider only how much of the R&D budget they will allocate to each project to maximize the calculated value of the total portfolio. While R&D resources do have dollar values and efficient resource allocation is a valid concern, in our experience this view leads to over-reliance on financial metrics and a narrow focus on individual products and their revenues and costs. By contrast, those companies approach portfolio management holistically, considering how their allocation of resources maps to strategy -- and include in those decisions all functions in the company, from sales and distribution to support and manufacturing -- make sounder product portfolio decisions and create products that better match customer needs.

We have observed another serious problem. Portfolio management, product realization, and business strategy can become disconnected from each other when decisions about which products to build are divorced from the company's vision and mission. Several factors contribute to this disengagement:

* There's **process**: Product development often is managed using the phase/gate review process, a methodology concerned with schedule and resource management. Phase/gate reviews can be isolated from the portfolio and unsuited to the dynamic nature of products and markets.
* There's turf: Companies believe: Product development is an R&D thing. R&D is not part of business strategy, which is a business thing. Product management is for lower levels of management. Departmental functions (often referred to as silos) in the organization take ownership of -- or set up barriers to -- successful product development efforts.
* There's **personality**: Business managers think, *We're on the business side and product development is too technical*. R&D looks at marketing and thinks, *What do they know? Marketing is an art, not a science*. The overarching problem is that, for many companies, portfolio management is not aligned with new product development. Further, while many companies create cross-functional teams at the operational level, senior level teams often *don't* operate cross-functionally.

When deciding which projects to fund in the portfolio, executives must consider not only cost, but also the customer value delivered by the project in relationship to the company's strategic goals. As Figure 0.1 shows, the intersection of high customer value, high strategic value (aligned with the strategy of the business unit or enterprise), and optimal investment intensity (the level and profile of resources invested in a new product or venture) is the *sweet spot* for new portfolio projects.

Figure 0.1: Identifying the sweet spot for new portfolio projects at the intersection of high customer value, high strategic value, and optimal investment intensity

Optimal investment intensity depends on the specific product and the company's market. Sometimes a company needs to make a high level of investment -- and do it quickly -- to enter and dominate a new market or a new technology. If the new market or technology offers high customer value, high investment intensity is justifiable and desirable. Sometimes low investment intensity is right because creating an incremental product may be the right thing to do. For example, Apple's iPod Nano was a new product requiring a major investment in R&D and manufacturing tooling while its predecessor, the 4GB iPod Mini, was an incremental release that improved on its forerunner with more memory and a longer lasting battery. Both met customer requirements -- and therefore generated large revenues -- with different levels of investment. A healthy portfolio is comprised of a balance of products that span the range from new-to-the-world to incremental. Where a company finds its sweet spot depends on what it needs to do to solve the customer's problem using its core competencies or partnering with others.

The representation of various portfolio factors in three dimensions, with customer value assuming a place alongside strategic value and investment intensity, drives home the point that monetary investment should not be the sole barometer of new product development. "We can calculate all kinds of stuff out to ten decimal places, 100 if you want," says Don DeLauder, director of product innovation and advanced development at Medrad, Inc. "But it’s all gibberish. The degree of uncertainty in the inputs to those calculations is so high that it’s almost nonsensical to make the calculations." Instead, DeLauder says, "You have to use a balance of judgment and some estimates driven by market research."

Finally, one of the biggest problems in the area of product portfolio management is poor or nonexistent guidance of the portfolio by senior management. Senior management too often ignores portfolio management altogether or ties it to an *internal* metric -- profit -- rather than an *external* one like customer value. This is a tempting trap, because profit seems easy to measure, while customer value seems far less tangible and much harder to quantify. However, you *can* in fact measure customer value and use it to guide portfolio decisions. This book is about why you should and about the mindset, decisions, and business practices required to successfully align your portfolio along customer value dimensions.

GETTING TO VALUE: A NEW DEFINITION OF PORTFOLIO MANAGEMENT

Twenty-first-century portfolio management requires an integration of competencies, hierarchies, strategies, and tactics. It's an enormous management challenge, and one that companies can't afford to ignore. This book argues that mastering integrated, customer-centric portfolio management is the most important accomplishment any senior executive team can strive for -- one that will pay off for years to come in better products, higher profits, and happier customers. We advance the idea that portfolio management will build greater competitive advantage and generate larger economic value if it is tied to customer value. This does not discount other approaches such as financial analysis, but adds a vital and more significant parameter.

The ideas advocated in this book comprise what we call *Value Innovation Portfolio™ (VIP) management*, which we believe is the key to building and sustaining a winning position in the marketplace. Why did we choose this title and name?

* **Value** -- because we believe the fundamental driver for decision making on where to go should be the value created for the customer
* **Innovation** -- because innovation is the ultimate output of your development activities, i.e., the new value you want to introduce to the marketplace
* **Portfolio** -- because it is through the full basket of products, services, and related product lifecycle, support, and delivery projects that you effectively create that value
* **Management** -- because none of this will happen without thoughtful, active senior management guidance and direction through a systematic and structured framework

This approach uses techniques that uncover customer value so corporate managers can base portfolio decisions on factual, objective data about what customers will value. Far more encompassing than the traditional portfolio management goals of allocating resources and choosing among proposed product ideas, the VIP approach to portfolio management leads to a product portfolio that:

* Delights customers by delivering total solutions to customer problems
* Aligns new products with the strategic goals of the company
* Optimizes investment intensity to ensure the right amount of investment at the right time and in the right places depending on a product's role in the portfolio

The prevailing focus of portfolio management must expand to encompass more than just development resource allocation. Resource allocation -- figuring out what R&D should do over the next year, how much money it needs, and how many people it requires -- may have been a worthy overarching focus in a simpler business environment. But today, products are complex, competition is tough and multifaceted, differentiation is the mantra of success, and long cycle times cripple even the best products. The question becomes how to create economic value in the face of these challenges. The answer is to take a broader view of resource allocation, to make sure that senior management views portfolio management as a strategic, not tactical tool, *and* to tie portfolio management explicitly to customer value.

The creation and success of FedEx Corporation exemplifies this. FedEx provides the same services as the US Postal Service, but with greater speed, reliability, traceability, and accountability. It saves time, which its customers value and are willing to pay a premium to get. It also assures that shipments arrive when specified, offering security in addition to speed. Creating services that reduce time and increase delivery reliability, traceability, or accountability has driven product development at FedEx. Developments such as wireless communications with portable computers, Internet tracking, bar coding, and radio frequency identification all offer opportunities to solve real customer problems, and therefore the potential to increase the value of FedEx services to the customer.

In the VIP approach, portfolio management never stands alone. Strategic planning, information gathering, and capability assessment precede it. Project management, implementation, and risk mitigation follow it. The effectiveness of the VIP approach depends on the results of the new product development process and project management.

Figure 0.2: This representation of the corporate environment as a planetary gear shows customer value as the central driver

Figure 0.2 shows a view of a corporate environment that embraces a VIP management approach. The center gear -- customer value -- provides the system's input, driving the motion of the other gears. This illustrates the interconnectedness of the portfolio management process with other key aspects of the business, its essential place among other strategic executive concerns, and the primacy of customer value as a driver for the other concerns. All other activities, whether internal processes such as sales metrics or externally focused ones such as competitive strategy, must mesh with the mission, vision, strategy, customer value and management of the enterprise. If one area is not functioning well or is not aligned, it slips out of synch with adjacent areas and throws the corporate environment out of balance.

Executives must recognize customer value's rightful place at the nexus of the gear system, since a successful VIP approach to portfolio management is a strategic, integrated process that goes beyond R&D to connect with a company's core business strategy. As we describe in upcoming chapters, some executives operate this way intuitively, describing their work as comparable to juggling many balls without letting any fall to the floor. Rarely, however, do they explicitly acknowledge portfolio management as a primary executive concern.

"Historically, because finance is the language of business, before you make a decision as a general manager to do something it's mandatory that you have the financials," says Steve Sichak, president of BD Diagnostics - Preanalytical Systems, a medical device company. However, he goes on to point out that "there's a foundational element to portfolio management, which is a deep understanding of your customer and deep understanding of their requirements, and their future direction, and future requirements. If you have that, then it becomes much easier to prioritize and amongst projects, and by extension, your resources. If you don't have that, you end up blindly responding to IRR, NPV, the financial projections, but…if you don't understand customer needs, you run the risk of making flawed projections and flawed decisions."