



BLEND INTERNAL AND EXTERNAL INNOVATION FOR SUCCESS

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Companies must be wary of letting outsourcing that was helpful under COVID conditions become the permanent rule.

Digital disruption today is unprecedented. Amid these turbulent times, executives have, increasingly, relied on external innovation to acquire digital capabilities quickly and navigate a plethora of novel technology.

However, striking deals with technology partners or experimenting with startups rarely sets incumbents apart from the pack. Outsourced innovation cannot substitute for internal capability. The two approaches must work in tandem if companies are to future-proof themselves.

Most digital transformations fail because they do not bring about wholesale change to business models, which are being upended by technologies – from artificial intelligence to virtual reality – that require complex and rare skills. A deeper re-invention is required to create value through product, process and business model innovation.

This is a tall – and expensive – task. Many organizations said they simply did not have the internal capabilities they need to pull off digital transformations.

This is why so many of them are sourcing innovation from other organizations — universities, consultants, think-tanks and startups — in a desperate dash for digital technology and expertise. The approach is faster than starting from scratch, and it helps corporations to discover previously unknown competitive threats from new market entrants.

Consider the case of McDonald's. It has relied on technology to reshape the fast-food experience. Last year, it bought Apprente, a startup building voice technology that enables ordering in multiple languages.

McDonald's plans to apply the technology to its mobile ordering system and automated kiosks in restaurants — innovations that it similarly sourced externally. It has already trailed Apprente's software in voice-activated drive-thrus and with robot fryers.

The result was faster, simpler and more accurate order-taking. So critical was the technology to McDonald's long-term advantage, that Apprente's team became the founding members of McD Tech Labs, McDonald's innovation hub in Silicon Valley.

External projects as drivers of diversity of thought

The diversity of thought that accompanies external projects is fertile ground for creativity.

China's iFlytek, which provides voice recognition software, has leveraged cutting-edge academic research to create new technologies. It established several innovation laboratories with leading Chinese universities where professors and executives cross-fertilised ideas for fresh products and services.

This helped iFlytek, established in 1999, to become the global leader in voice-recognition technology, providing services to the education and music industries among many more.

Another benefit to an open approach is that it enables companies to de-risk innovation. They can experiment with high-potential technologies outside the organization, refining them until they are ready to be fully incorporated into the business.

What's more, open innovation guards against one of the biggest risks in internal innovation: incrementalism, which curtails more radical innovation that could revamp a business and leave it vulnerable to disruption from external players.

But open and internal innovation approaches are not mutually exclusive. The sweet spot is where both methods meet, and companies must strike the right balance.

Internal innovation is key because it helps companies to differentiate themselves from the competition. Many leading technology companies work with incumbents so as to spread the cost of research and development, attract venture capital and grow.

Google's self-driving car business, Waymo, works with a range of car giants in the hope of offering consumers autonomous vehicles quickly, but the deal means no single partner will have an edge over the others.

This is the key problem with becoming dependent on external innovation: you merely establish parity between rivals. Our survey results bear this out: 60% of external innovation projects yielded a sustained competitive advantage compared with 87% for internally developed ventures.

In-house development also helps to keep trade secrets and protect intellectual property. This is much harder to do when working with an industry partner, which also makes you dependent on them in the supply chain and gives them bargaining power to take a larger share of your profits.

Internal projects can also be tested using real consumer data, in the same way that Facebook is constantly tinkering with its algorithms and designs. This can iron out kinks earlier on, speeding up the innovation process.

And because in-house innovators are familiar with their business, it's often easier for them to generate new ideas that are more relevant to the company and can be scaled faster.

What's more, internal projects raise an organization's capability to change and evolve its culture, meaning the business can be more responsive to digital disruption in the future.

One case in point is Monsanto, the American agrochemicals and agriculture company that was bought by Germany's Bayer in 2018. Before the sale, Monsanto worked out that data science would be critical to its future and would give the company an edge, in the sense that Monsanto could manage inventory better and help farmers decide which crops to plant, how much fertilizer and water to use.

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It turned to Amazon Web Services and Google Cloud for data analytics infrastructure, and to other vendors for artificial intelligence and cyber security capabilities. It also acquired startups that provide relevant data, and built a data science lab. In addition, the company reskilled employees and let them run external partnerships to ensure transfer of capabilities.

This all highlights how the most successful companies will be the ones who blend in-house and outside innovation, which are complementary. But what is the right balance between both approaches?

How to blend in-house and outside innovation

The first step is identifying your company's critical competencies, both now and in the future, and determining whether they help to differentiate the business from its rivals. It's also key to work out which external organizations will provide the missing link.

Then, create an innovation architecture, including a process for managing relationships with external partners. Helpful in this would be an innovation lab, which can help you access world-class talent and bridge the gap between external and internal innovation. This requires agility, clear governance and processes.

The third step is creating a transfer process to embed external capabilities in your organization, whether through hiring, reskilling or acquisition of startups.

An external partner will help to access and develop capabilities quickly, and this is important to innovation. But tapping knowledge about your customers, processes and cultures is even more so, and internal innovators can do that.

Read more about Prof. Bonnet's research into future of innovation published in the latest edition of MIT Sloan Management Review [here](#).