privately speaking

Insights on private company growth

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Issue #2

Tackling innovation on a tight budget

KPMG

cutting through complexity

IN THIS ISSUE

The *Privately Speaking* series investigates the growth appetites and growth plans of private companies, based on quantitative survey data, interviews with private CEOs, and perspectives of KPMG's private markets specialists. This issue examines the important role of innovation on the CEO's agenda and the strategies leaders of growth stage and midsize companies should consider when driving innovation in an environment of constrained budgets and competing priorities.

STAYING **RELEVANT** THROUGH INNOVATION

Amid new and changing competitors and consumers, 69% of private company CEOs are concerned about the future relevancy of their products and services and are therefore focused on improving them through innovation, according to the KPMG Private Markets Group's survey of 226 U.S.-based private company executives.

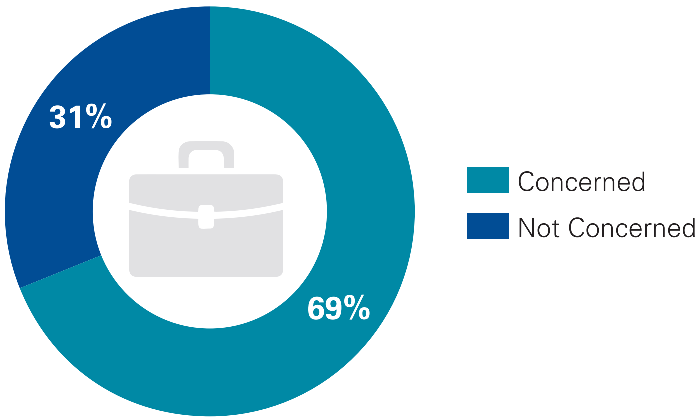
Our survey shows that developing new products and services, and improving existing products and services, are both playing a significant role in directing innovation in private companies.

"Product [and service] innovation is directly related to top line growth. If you want to grow organically, you have to innovate," says Eric Redifer, managing director in KPMG's Strategy & Operations practice.

But in today's environment, innovating alone is not enough. As open source design tools, internet-based collaboration software, 3-D printing technology, and other new tools and techniques make innovation processes faster and cheaper and significantly shorten product life cycles, organizations may also need to increase the speed at which they innovate.

"Companies have always driven revenue and market share by bringing new products and services to market at a high speed relative to competitors," says Redifer. "But today, if you don't take advantage of product innovation quickly and get products into the market first, you will lose in the marketplace."

How concerned are you that the products/services you sell today will be as relevant three years from now?



What plays the most significant role in driving or directing innovation for your company?

The top 5 responses given:

1. Improving existing products or services
2. Improving year-over-year growth and profitability
3. Delivering new products or services
4. Leveraging technology to facilitate internal collaboration
5. Leveraging technology for external purposes to improve the customer experience

INNOVATING COST-EFFICIENTLY

Our survey results show that budget constraints are hindering the innovative efforts of many growing companies. Research and development (R&D) to foster innovation is a low priority for capital allocation, and 45% of private company CEOs say budget constraints are the greatest barrier to innovation.

"Private companies often have fewer resources and therefore must be careful about making mistakes they will not have the ability to recover from. At the same time, they must be more entrepreneurial because they tend to be smaller and closer to their customers. It's a real balancing act," says Redifer.

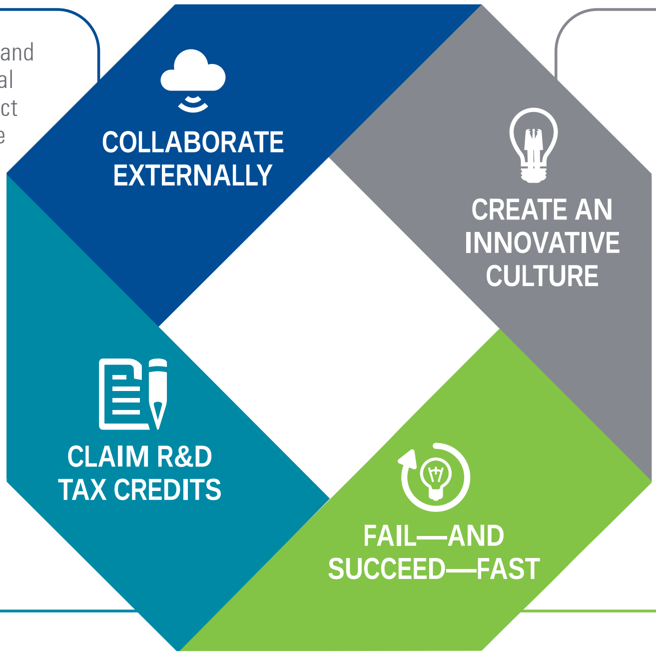
As they balance the bottom line with a nose for growth, increasing innovation budgets may not be an option for many private companies. So the question is: How can they do more with less?

45% OF PRIVATE COMPANY CEOs PARTICIPATING IN THE SURVEY SAY BUDGET CONSTRAINTS ARE THE GREATEST BARRIER TO INNOVATION

FOUR STRATEGIES TO ENHANCE INNOVATION

Developing and implementing an innovation strategy is never easy, clear-cut, or risk free, especially when confronted with resource constraints. To do more with less, and help increase the odds of success, private companies should:

Embrace open innovation models and use digital advances such as social media and crowdsourcing to collect fresh ideas and feedback. Remove barriers to the customer-facing organization so innovation is more closely targeted to real-time consumer desires.



Lead innovation by example, but also relinquish control to key innovative talent—bold thinkers with a deep understanding of target customers. Introduce new policies—like public recognition for creativity—to surface good ideas from employees.

Collect the necessary documentation and make the necessary calculations to claim R&D tax credits, helping to offset the cost of innovation projects.

Pursue a few innovation projects simultaneously, rather than going all in on one single idea. Take prototypes and pilots to customers to pinpoint losing innovations quickly, and then reallocate resources to winning ones.

COLLABORATE EXTERNALLY

Private companies will be better able to spot trends, capture ideas, and predict future needs if they tap into the data and knowledge of the external world.

"External collaboration really turns the tables on innovation and allows small and midsize businesses to keep up with larger companies," says Redifer. "While large companies are generally more protective of their intellectual property, entrepreneurial companies don't have the same barriers or resistance and actually *need* to collaborate outside."

In this age of digital connectivity, sources of information and ideas from all over the world can share valuable insights that inform innovation activities, without much or any expense. Consider open innovation models, internet-based collaboration and research tools, and ways to connect with consumers.

- **Embrace open innovation.** Open innovation models help private companies innovate cost-effectively by incorporating external ideas, feedback, and support throughout the internal R&D process, and encouraging companies to share ideas externally to identify new ways to innovate with others. This open collaboration accelerates innovation by bringing in widely distributed knowledge that may not be available from internal engineers, designers, and developers. Collaboration can take the form of joint ventures, licensing arrangements, or informal networks of customers, inventors, business partners, and universities. P&G has built a billion-dollar business with its Febreze brand through many open innovation initiatives, such as licensing Febreze brand name and technology to Bissell for inclusion in a line of successful vacuum bags and filters.[1] CEOs looking to accelerate innovation should assess if their R&D is adequately exploiting external knowledge by investigating what external sources teams are tapping into for feedback and how innovations are being shared externally with potential partners.
- **Harness the power of social media.** Tapping into social media and online communities is an inexpensive way to develop the customer insights necessary to bring relevant products and services to market. With social monitoring tools, marketers can "listen" to real-time customer conversations and feed findings to product managers, who can find inspiration for new features or new products. Companies should also consider crowdsourcing, the act of inviting communities to share ideas and feedback, as an incredibly powerful and low-cost channel for product innovation. Online clothing startup Lolly Wolly Doodle crowdsources customer feedback from their Facebook page. If a style is a hit on Facebook, they produce more, but not until initial orders come in. This method for product innovation helped Lolly Wolly nearly double its revenues every year since 2009 and attract investment of $20 million.[2]

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[1] Trademark Licensing
Source: P&G, Connect & Develop, Open Innovation Stories (January 1, 2013)

[2] The Startup That Conquered Facebook Sales
Source: *Inc.* magazine, Tom Foster (June 2014 issue)

- **Leverage ideas from your stakeholders.** Crowdsourcing, innovation challenges, and cocreation models allow companies to connect directly with customers, innovators, and employees to develop new ideas. Madison Electric Products created an online portal to collect product ideas from end users—electricians—and saw new product sales increase by 37% in less than two years.[3] This cocreation model is a win-win. The community provides a wealth of new ideas and Madison provides the vehicle to bring their ideas to market. One key challenge for CEOs looking to source new innovations from the crowd is determining how they will incentivize and motivate the target community to participate. Managing the volume of ideas that come in can also be a daunting task. Idea management software platforms like KPMG's Innovation Factory (www.kpmg-innovationfactory.com) and the accompanying Idea Challenge program allow organizations to harness the collective brainpower of the internal or external target crowd.

"For small to midsize companies, initiatives like this are a great way to get feedback and ideas relatively inexpensively and move an idea forward with few resources," says Redifer.

CEOs of midsized companies should recognize that outside ideas and paths to market can be just as viable and valuable as inside ideas and paths to market. To optimize innovation, they should seek out low-cost, high-reward external collaboration models that align to their business model and risk appetite.

Fueling innovation with an Idea Challenge: Four steps to consider

KPMG's Innovation Factory helps organizations harness innovation from key audiences through Idea Challenge programs. In the development phase of any idea challenge, it is important to take these four steps:

1. Frame the challenge and create a structured campaign in the form of an open discussion forum with a defined purpose
2. Align the challenge to strategic business objectives or programs
3. Establish a process for moderating the program to ensure the right quality and volume
4. Design the program to include a structured and transparent idea selection process and allocate resources to develop the best ideas

A structured approach coupled with Idea Management software like KPMG's P.I.T. (Power Ideas Together) platform can help turn stakeholder ideas into actionable innovations. Learn more at www.kpmg-innovationfactory.com.

[3] B2B Crowdsourcing: Product development effort boosts sales 17% and new product sales 37%
Source: MarketingSherpa (February 15, 2012)

CREATE AN INNOVATIVE CULTURE

Internal factors like people, processes, and tools are vital to successful innovation. Even when ideas are plentiful, effective execution can be very difficult without the right environment. For growth stage companies with limited resources and budgets, creating a culture that fosters and encourages innovation is paramount to success.

To lower the risk of innovation failure, the CEO should be personally involved in leading innovation. It should be the leader of the company that communicates the innovation vision, ensures the right innovation teams are in place, and engages regularly with the organization to align both mind-set and behavior. Our recent survey of private company CEOs found that the CEO or executive team drives innovation in almost 60% of companies. As evident by the survey, most private companies get this part right.

While the CEO should always drive innovation from the top, it is equally important for leaders to recognize their limits, hire the right kind of people to create continual innovation in the company, and relinquish some control, giving others the opportunity and authority to drive innovation.

"Many midsized private companies are led by a lone entrepreneurial mind who grew the company from scratch based mainly on that person's innovative capability," says Redifer. "But there is a limit to any one person's ability to innovate."

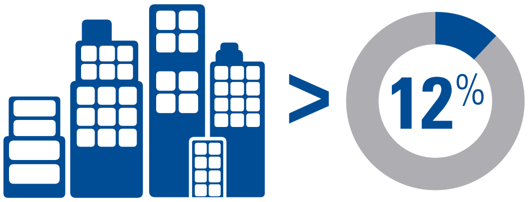
Here are three characteristics of an innovative culture:

1. **Bold talent that understands the customer.** CEOs should seek talent who have the ability to see things from their customers' perspectives—to get in their heads, find out what they want, and create innovations that meet their demands. Another characteristic to look for is boldness—people willing to aggressively pursue calculated risks based on their profound understanding of customers and markets.

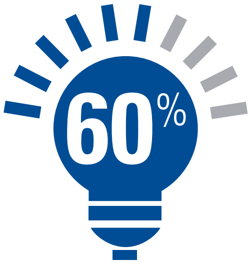
2. **Processes that promote innovation.** While a fully developed, formal, company-wide process for innovation does not guarantee success, it undoubtedly increases its likelihood. Each innovation project can benefit from a structured approach that includes decision points and feedback at each phase of the project. These milestones provide an opportunity to validate project hypotheses and solicit stakeholder feedback on an ongoing basis. Business leaders can respond by allocating resources more appropriately—adding resources to course-correct struggling but promising projects, or eliminating resources from losing projects early in their development. Our survey of private company CEOs found most midsize companies (88%) lack a formal process for innovation. Sometimes these companies luck into success, but more often than not, they find themselves launching innovations with limited market appeal that require costly, time consuming redesign efforts. An inclusive and structured approach to innovation can help growing companies save time, money, and resources.

3. **Tools to collect ideas from within.** Private companies should also tap into ideas from organization-wide employees. Use enterprise-wide platforms to enable everyone in the organization to share ideas—the modern version of the suggestion box. To encourage participation, offer rewards to employees for exhibiting above-and-beyond creativity. These rewards do not have to be monetary; employees are also motivated by personal praise, public recognition, or celebrations of victories. Finally, when good ideas surface, private companies could create focused working groups to develop and take them to market rapidly.

Corporate culture plays a significant role in innovation. It is either the bottleneck that stifles innovation or the fire that sparks it. CEOs should continually assess, manage and refresh the company's culture—and the operations that support it—to ensure it has in place the building blocks to innovate and keep innovating.



FEWER THAN **12**% OF PRIVATE COMPANIES HAVE IMPLEMENTED A FULLY DEVELOPED, FORMAL, COMPANY-WIDE PROCESS FOR INNOVATION.



THE CEO OR EXECUTIVE TEAM DRIVES INNOVATION IN ALMOST 60% OF PRIVATE COMPANIES.

CREATE AN INNOVATIVE CULTURE CONTINUED

KPMG Case Study

Catalyzing growth with a culture for innovation

Client challenge

Facing increasing pressure to maximize margins and grow the customer base, cultural and process issues were inhibiting innovation and growth at a global customer loyalty management company.

Approach

KPMG conducted a thorough innovation diagnostic, including market research and stakeholder interviews, to identify three key innovation gaps: a noninnovative culture, insufficient commercialization processes, and a lack of support for new ideas. Armed with a clearer understanding of the challenges preventing the company from being more innovative, KPMG helped the company develop and launch a novel innovation architecture, comprised of:

Governance – a clear set of accountabilities for managing and championing the program

An "Inspiration Network" – a team of external and internal experts to contribute and inspire new internal ideas

Incentives and Measurement – a set of rewards to measure and incent participation in the innovation program

Innovation Coaches – an annual cohort of internal experts to coach innovation champions and promote quality business plans

The "Innovation Sandbox" – an online portal that facilitates the sharing and refinement of ideas

Results

The new innovation architecture, strategy, and capabilities enable innovation from all levels of the organization. The company is now able to deliver novel and profitable internal improvement initiatives and market offerings.

CEO perspective

CEO perspective

Innovation in practice: Bright future for solar innovator

Our interview with Tom Leyden, CEO of Solar Grid Storage, a mid-market solar energy storage company, demonstrates how a collaborative, idea-driven culture can help a private company innovate at speed.

For a startup less than three years old, Solar Grid Storage views rapid innovation as its primary growth engine. Leyden said the company expects to continue on its current trajectory of "explosive growth" over the next three years, as its potential customers are educated about perceived risks, and product acceptance goes up and costs go down.

Of course, the company is innovating on the technical side. It has developed an integrated power electronics and energy storage system neatly packaged in a 10-foot by 20-foot shipping container that allows solar systems to operate disconnected from the energy grid. This storage innovation is completely new to the rapidly growing solar industry.

But it is also pioneering new financial mechanisms, such as a "solar storage services agreement," that makes solar energy storage projects more affordable. In this financing option, Solar Grid Storage sells its equipment to third-party investors, who then sell the lower-cost energy and storage services to residential and business consumers—that can now not only have lower cost electricity year-round, but also the benefit of emergency power when the grid goes down.

"With most energy projects, there's a large capital expense up front. Fossil fuel generators have been able to finance their systems over the life of the system—traditionally 30 years or more. For a long time the financial community could not get comfortable with doing the same for solar energy," said Leyden. "However, over the last several years the industry introduced new financial products that will finance the capital cost over 20 years, and that really accelerated growth in solar. We're now deploying the same model to storage."

Solar Grid Storage has tried four to five different go-to-market approaches, and how it structures its offer has changed over time. Leyden attributes the company's agility to its small size and emphasis on innovation.

"We're a small team with virtually no hierarchy. There's a lot of cross-pollination of ideas, and communication within the company is very efficient. All ideas are on the table and we're able to move very quickly," he said.

As the company grows, Leyden said it is very important to evolve the culture to remain innovative. These adjustments are also essential for Solar Grid Storage to position itself to merge or be acquired by larger companies with greater capital and resources, so it can pursue even more lofty innovative goals in the future.

"It's natural to get more bureaucratic as you get bigger in order to maintain control and be productive, but we hope to be able to maintain an entrepreneur culture even as we get bigger," he said. "As we grow, we're likely to start creating more intensive focus on specific key channels, like retail or the public sector, so we can go into sales opportunities with higher degrees of expertise and understanding of that sector."

FAIL—AND SUCCEED—FAST

Private companies should carefully manage their product development initiatives, and the resources applied to those initiatives, to derive the greatest possible value. Doing too much at once in the engineering and development space can limit the impact of all innovation efforts and quickly deplete the precious budget dollars that growing businesses have to allocate to these important projects.

Consider these tips for driving greater return on innovation:

- **Act fast:** Figure out which development programs are the losers and kill those quickly. Reallocate those resources back to the winning programs.
- **Hedge bets:** Do not bet all of your innovation dollars on one or two "perfect" ideas. The risk: getting so much investment, ownership, and insular thinking that it becomes very difficult to let the project die when it is not creating results. Fund five or ten ideas in the pipeline at the same time and staff them all appropriately.
- **Critically assess efforts:** One of the most important considerations in determining which portfolio and innovation initiatives have the most potential is whether they are aligned with key business objectives. After all, innovation by itself is not strategic. It is only strategic if it enables the realization of corporate goals. Private companies need to focus limited resources on the greatest growth opportunities. Projects that are not aligned only get in the way.
- **Consider the long term:** Can the costs associated with developing the innovation justify themselves in the long run? If the innovation comes with an astronomical price tag, it may take many years of operating in the black to pay off—if it ever does. Even if they could come up with the financing to support the development of the innovation, most midsize organizations likely cannot afford to take that risk.
- **Measure sales:** Assess if the innovation is saleable. Do you have the interest of customers? If you cannot get a customer interested in it fairly quickly, it is not likely to succeed.
- **Prototype products:** Rather than create and wait for customers to come, private companies should create prototypes of product innovations or pilots of service innovations and take them out directly to the market. If it is difficult to find participants to try the innovation, or if initial feedback is negative, it is not likely to sell and investment dollars should be reassigned.

Under constant pressure of immediate deadlines, urgent crises, and today's commitments, it is easy to leave prioritizing innovation to another day. But approaching innovation management in a controlled and thoughtful manner may be one of the most important investments you can make for your company's future.

CLAIM R&D TAX CREDITS

Private companies in almost any industry can benefit from federal and state tax credits for R&D projects, which can help offset the cost of innovation activities and reserve cash to fund future innovation activities.

Francois Chadwick, partner in KPMG's Federal Tax practice, says most mature private companies that are profitable, and therefore taxable, are probably taking the R&D tax credit already. However, entrepreneurial ventures and growth stage companies that are moving from losses to potential profits should be considering what steps they need to take to qualify for these credits. This can also be a strong benefit for private companies with goals to go public or hoping to be acquired. It is important companies fully understand the requirements for these credits so that their claims can be defended upon audit and they are properly identifying all potential credits for which they may be eligible.

Meeting the requirements

To claim the credit, privately backed companies must generally qualify R&D activities against a four-part test in the tax code. At a high level, qualifying research must satisfy the following;

- Technological in nature (e.g., relies on principles of engineering, physical or biological sciences, or computer science)
- Undertaken to eliminate uncertainty as to capability, method, or appropriate design
- Undertaken for a permitted purpose (i.e., new or improved function, performance, reliability, or quality)
- Substantially all of which consists of elements of a process of experimentation (e.g., modeling, simulation, prototyping, or even good old-fashioned systematic trial and error)

For example, to satisfy the requirement "consists of a process of experimentation," a software business could show evidence of its beta testing process, minutes from programming meetings, or status reports from programmers to executives. After identifying qualified R&D activities, the business must then quantify expenses related to those projects.

"The taxpayer needs to supply the IRS with extensive documentation to start using the credit and to keep the credit if they're audited," Chadwick says. "They generally need to find documentation that was created during the time of the project that truly shows the project passes all parts of the test." However, credible oral testimony can also be used to support a research credit claim.

In addition, certain internal-use software (generally defined as software that is not being held for commercial sale, lease, or license to third parties and software that is not designed to provide computer services to customers) can also qualify for the credit if it meets three additional tests:

- It is innovative
- It involves significant economic risk because of technical reasons
- The software is not commercially available without modifications that would be innovative and involve significant economic risk

Start your planning now

Attempting to compile this information years after the R&D activities took place can be a daunting task. It is beneficial to collect all potentially relevant documentation on an ongoing basis, even if the credit cannot be used immediately. Implementing tools and software like KPMG's LINK R&D Exchange can help organizations streamline this process by providing a centralized system for managing the ongoing collection of information related to R&D activities.

Private companies may also be able to claim the R&D tax credit for prior years in which they were not profitable. For a growth stage company, that could be back to the date of incorporation. The benefit is that even if the company is unable to use the credits now, the federal credits do not expire for 20 years and some state credits never expire.

Even taxable companies can seize the opportunity to claim the credit if they have not yet taken it through an amended tax return.

"Lots of growth companies don't want to figure out R&D credit and make it audit defensible if they aren't going to use it anytime soon," says Chadwick. "But if they are burning through their losses and are going to produce tax soon, they should certainly consider it."

IN CONCLUSION

As private companies grow, their assets are often pulled in many directions. In some cases, innovation gets a lesser cut than it did during the organization's early-stage, entrepreneurial beginnings.

But resource constraints do not need to slow or stall innovation. Midsize companies can enhance innovation on a tight budget by:

- **Embracing external collaboration** – consider how to incorporate open innovation models in your business and use technology to crowdsource feedback from your communities.
- **Fostering a culture of innovation** – lead by example, but relinquish control to your bold thinkers and create processes that encourage innovation.
- **Prioritizing initiatives that create value for the customer** – hedge your bets with multiple innovation projects and act fast to determine if each project has market fit and customer interest.
- **Considering tax credits to offset the cost of innovation projects** – take the time to understand potential tax credits and begin collecting the proper documentation now.

Contributors

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	**Francois Chadwick** is a partner in KPMG's Federal Tax practice and national Tax leader for the Venture Capital practice. He has more than 20 years of experience in corporate tax, focusing on corporate taxation for U.S.-based multinational companies.
	**Debbie Heard** is a managing director in KPMG's Accounting Methods and Credit Services and San Francisco leader for the Private Markets Group. She has more than 15 years of experience assisting growth stage through FORTUNE 500 companies with research credit claims across many industries.
	**Tom Leyden** is CEO of Solar Grid Storage, a leading energy storage company. One of the early solar pioneers, Leyden has helped launch some of the most successful solar companies in the world, as well as held leadership positions at several solar industry associations.

About the Privately Speaking series

Entrepreneurs and business leaders of fast-growing, private enterprises are driven by passion. Translating that passion into marketplace success can be a challenge. The *Privately Speaking* series examines the strategic choices that private company business leaders are faced with on their journey towards achieving profitable and sustainable growth. Join us as we explore these topics and share our perspectives on how to best position your company for long-term success. Download the latest piece in the series at www.kpmg.com/us/privatelyspeaking.

About KPMG's Private Markets Group

KPMG's Private Markets Group (PMG) has the knowledge and insight to help private companies address complex marketplace challenges and drive growth in today's global economy. Focused on serving privately held entities, including private-equity- and venture-capital-backed companies, our global network of professionals offers integrated audit, tax, and advisory services tailored to meet the needs of private enterprises. By providing industry perspectives and proactive guidance, our PMG teams help private companies achieve their strategic objectives throughout each stage of the business life cycle. Learn more at www.kpmg.com/us/privatemarketsgroup.

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