
HBR SPOTLIGHT

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Manage Customer-Centric Innovation—Systematically

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No matter how hard companies try, their approaches to innovation often don't grow the top line in the sustained, profitable way investors expect. For many companies, there's a huge difference between what's in their business plans and the market's expectations for growth (as reflected in firms' share prices, market capitalizations, and P/E ratios). This growth gap, as we call it, springs from the fact that companies are pouring money into their insular R&D labs instead of working to understand what the customer wants and then using that understanding to drive innovation. More often than not, the traditional approach thrills R&D teams, but not customers or investors. As a result, even companies that spend the most on R&D remain starved for both customer innovation and market-capitalization growth.

Having collectively worked with senior executives of hundreds of companies all over the world and in all kinds of industries—from heavy manufacturing to abstract research, from retailing to financial services—we have developed a process for making innovation

deliver results that meet or exceed market expectations. We call this process customer-centric innovation. CCI is not just about top-line growth; it's about sustained and profitable top-line growth, which in turn raises market capitalization.

At the heart of CCI is a rigorous customer R&D process that helps companies continually improve their understanding of who their customers are and what they need. Customer R&D focuses on developing better ways of communicating value propositions and delivering complete, satisfying experiences to real customers. Since so much of the learning about customers and the experimentation with different segmentations, value propositions, and delivery mechanisms involve those regularly dealing with customers, it is essential for front-line employees to be at the center of the CCI process. Simply put, customer R&D propels the innovation effort away from headquarters and the traditional R&D lab out to those closest to the customer.

Companies that use the disciplined cus-

customer R&D process we describe—such as Best Buy, Royal Bank of Canada, and Seven-Eleven Japan—accrue three linked strategic benefits. First, they gain knowledge that is often opaque to competitors, effectively allowing them to block disruptive threats. The more customer-centric you are, the longer it takes your competitors to figure out your game, and the more times you will probably win. Second, employees closest to the customer become intensely engaged through their central role in CCI; as a result, employee loyalty increases, turnover declines, and the customer goes away thrilled. Third, the process of deeply learning about and then addressing customers' needs leads to the kind of innovation that closes the growth gap.

CCI need not require a huge monetary investment; rather, it may simply require a redirection of funds from traditional product R&D into customer R&D. It also demands an investment of time and patience. Learning to do CCI well is not something that happens overnight. If your company wants a quick fix or an easy solution, it may play right into the hands of a hungrier and perhaps more patient competitor. Indeed, if your competitor is willing to work harder at CCI than you are, you will likely fail. CCI also demands sustained and focused effort and—perhaps hardest of all—a willingness to break through existing mindsets. (See the sidebar “How to Kill Innovation.”) But if you do the hard work, your new offerings will result in a virtuous cycle of learning, sustained profitability, and growth in your market cap.

Cementing Your Innovation Advantage

Companies cannot successfully innovate and grow unless they systematically invest in customer R&D. In doing so, they must take both an offensive and a defensive approach. The offensive strategy has three phases: Establish a deep relationship with core customers, then extend the number of customers beyond the core, and, finally, stretch into new customer realms. The defensive strategy focuses on continually scanning for potential competitive disruptions, as Clayton Christensen terms them.

Let's walk through the phases of our customer R&D process, using the example of Tumi, a leading global marketer of high-end

luggage and accessories. Tumi has practiced key elements of customer R&D since 1985 and is renowned for its deep understanding of its customers and its ability to deliver superior value propositions.

Phase 1: Establish and develop the core.

The first step in conducting customer R&D is to identify core customer segments and develop mutually beneficial value propositions that exceed the buyers' expectations. The value proposition represents the complete customer experience, including products, services, and any interaction with the company. Having identified this core, the customer R&D team then systematically identifies subsegments, sharpening the alignment between customers' desires and the company's offerings and generating additional profits. At the same time, the company needs to build the capabilities (the organizational infrastructure, customer insight, technology, communications, and field sales operations and logistics support) to create, communicate, and then deliver the new value propositions to the targeted segments.

In the mid-1980s, Tumi initially targeted the male frequent business air traveler (the so-called road warrior) and endeavored to deeply understand this segment's needs. The company focused on a series of encounters, which we call the consumer consumption chain, that road warriors had with the company. Tumi's goal was to discover which product attributes mattered and which didn't to this segment. (For more information on the consumption chain, see Ian C. MacMillan and Rita Gunther McGrath, “Discover Your Products' Hidden Potential,” HBR May–June 1996).

Customer R&D was regarded as so important at this stage that all activity was directed by the CEO, Laurence Franklin, and his top team at headquarters. All managers and executives at Tumi were expected to identify customer needs and contribute solutions, no matter how mundane. They began by exploring the road warrior's luggage requirements, how he evaluated alternatives, and how he made his selection and purchase of a Tumi product. By obtaining feedback directly from consumers and points-of-sale, the team then tracked the road warrior's use of the luggage, the frequency of complaints, returns and repairs, and the rate of product disposal.

Based on customer reactions to the total of

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fering, Franklin and his top managers assessed customer needs. Ease of packing and unpacking as well as mobility, it turned out, were far more important than durability, style, or size. Accordingly, Tumi sought to satisfy the road warrior by designing luggage with easy-open zippers, flap-down zipper pockets, and a host of other features that made packing and unpacking the bag as effortless as possible. The company also came up with inventive ways for the customer to easily transfer suits directly from the closet to the bag or put stacks of clothes on top of each other as if they were in drawers.

The customer R&D team then looked even more closely at this core customer group, sub-segmenting male road warriors according to the kinds of trips they took—whether one- or two-night trips or extended journeys to multiple locations. Tumi designed expandable bags that best fit each type of trip, equipping the roller luggage with high-grade wheels tested for durability and performance.

Phase 2: Extend. In this next phase, companies enlarge the business beyond the core segment in two ways.

Phase 2a: Extend capabilities. Customers use or experience products and services within a variety of distinct “life capsules.” For example,

road warriors’ lives aren’t just about traveling from plane to hotel to plane to home; these people have at-work capsules, at-home capsules, on-vacation capsules, and so on. Even within each capsule, a customer’s needs evolve—so a business traveler may have different needs as he or she gets older or moves up the corporate ladder. The goal is to extend product capabilities to address these different and changing needs.

In 1991, Tumi’s customer R&D team focused on extending the company’s capabilities into new products for its existing core segments. Many road warriors not only needed luggage for their clothes, but they also carried expensive and easily damaged laptop computers. Using this information, Tumi launched a highly successful line of office-use products, including a soft, expandable briefcase and portfolio case line that now constitutes more than 25% of the company’s business.

Phase 2b: Extend segments. Companies can extend the customer base by discovering potential “halo” customer segments, whose needs are similar to those of existing customers. Here, the goal is to understand the nuances and differences in their needs, modify the value proposition to target these groups, and then tailor products for them based on the existing capa-

How to Kill Innovation

Customer-centric innovation isn’t just a strategy—it’s a mind-set founded on the belief that a win for customers and employees is a win for the company. Unfortunately, most companies are unwilling to make the transformation from being product, geography, or function centric to becoming truly customer centric. Below are six mind-sets that block customer-centric innovation.

Spend without reward. Firms pour money into traditional product and technology R&D, but research shows that the market refuses to give them credit for this in the form of even average P/E multiples. Leaders make all kinds of excuses for this state of affairs—“We’re in a tough industry” or “All the Street cares about is short-term results”—but shareholders just aren’t buying it.

Make R&D an entitlement. Senior managers who negotiate R&D funding typically make their decisions on the basis of the prior

year’s budget or the company’s general cost concerns. At the same time, R&D staff view the funds as an entitlement rather than as a hard-nosed investment focused on exceeding the expectations of customers and investors. The result? Business as usual, and the same boring customer offerings.

Assume people in the field know nothing. Most firms treat R&D as a centralized function run by people with technical backgrounds. “God forbid,” a CEO might think, “we put people with real hands-on customer experience in charge of product development—they would never understand the complexities of reverse engineering.” This mind-set almost guarantees that products and services don’t connect with the customer.

Put Marketing, Finance, and R&D on different planets. These distinctly different functions are more or less autonomous. They rarely communicate, except to consider cut-

ting budgets when overall business performance lags. Such disunity ensures that no one pays attention to what the customer needs and wants from the company as a whole.

Detach Marketing from the customers. Marketing people can’t do much for customers beyond feeding them propaganda. When full-fare, first-class airline customers often lack a decent meal or even a pillow, the poor folks in Marketing can only report on customer rage.

Don’t rock the boat. Business leaders shy away from organizing their businesses around customers, arguing that doing so is “too complicated” or “too disruptive” for them. But given the lack of organic growth of the average business, shaking up the silo leaders wouldn’t be such a bad thing for customers, employees, and shareholders.

bilities of the firm. These halo segments serve to expand the firm's core business.

In 1999, Tumi extended its core customer segment to the rapidly growing halo segment of the female business air traveler, who had different needs for packing clothes, shoes, makeup, and accessories, as well as for carrying briefcases and purses. This segment also needed lighter-weight luggage. Once the customer R&D team had identified this group's specific needs, product R&D engineers reconfigured the luggage designs to accommodate those requirements. One offering was a small, wheeled carry-on bag with compartments for shoes and see-through pouches for toiletries and accessories. Another was a backpack briefcase that freed up a woman's hands while allowing her to safely carry a laptop computer and related paraphernalia. A third product was a hook for hanging a briefcase on wheeled luggage. The female road warrior segment now accounts for at least 20% of Tumi's business.

Phase 3: Stretch. Once a company has extended its business, it can begin to hunt for opportunities to stretch, again in two directions.

Phase 3a: Stretch capabilities. To fulfill the needs of existing segments or new subsegments, a company identifies new capabilities to be developed, as well as new offerings and delivery mechanisms. Tumi's customer R&D

team, for example, found that the subsegment of international road warriors carried a growing plethora of IT and telecommunications gadgets, connectors, chargers, and the like. Travelers in this subsegment needed their equipment to operate regardless of their location throughout the world. Tumi discovered that it could address these needs by delivering connectivity product options. Tumi managers researched other industries and scoured consumer electronics trade shows, finding technology partners to help design and package innovative connectivity products. This led to a number of offerings, including PDA portfolios and international connector kits that operated anywhere. The initiative added 2% to Tumi's sales in the first year.

Phase 3b: Stretch segments. In this phase, the company identifies completely new segments unrelated to the core, where it can deploy current capabilities. In 2000, Tumi began appealing to a new customer segment, young male travelers. These "relaxed but wired" customers had many of the same needs as road warriors, but they were more focused on style. They also carried their electronic entertainment—iPods, gaming computers, and portable CD players—in addition to their laptops. Realizing that its existing capabilities could be leveraged to pursue this new segment, Tumi

Do You Have a Growth Gap?

CEOs often feel harassed by sell-side and buy-side analysts' constant pressure to meet quarterly earnings targets. Rather than being bullied into an excessive focus on the very near term, CEOs need to worry about a far more fundamental problem: Do their companies have a growth gap?

Depending on your firm's past record and announcements about future plans, the capital market develops a set of expectations about your future performance and assigns a price to your stock. That price reflects two components: growth and nongrowth. The nongrowth component represents the continuation of all your current investments carried out into the future. The growth component reflects the market's expectations of your ability to build and sustain new profit streams at returns greater than your cost of capital.

For example, if you currently have a market-

average P/E ratio of 20, valuation models suggest that about 50% of your stock price springs from new investment opportunities. Based on a mix of past performance and competitive market opportunities, the capital markets have already credited your firm with the capability of continuing to find new investment opportunities, on which you are expected to earn very good returns for a number of years before competitors erode your advantage. But suppose that in reality your company has run out of growth investment opportunities. The difference between market expectations and your actual business plans is the growth gap. No matter how many bold announcements you make about your business plans, the market will over time realize you are not delivering on them and will discount your price. Your P/E ratio will spiral from 20 to 10—and it will happen quickly.

Surprisingly, few companies know how to address this issue. In our research on S&P 500 firms over a number of years, we've found that by far the majority of the companies that spend the most on traditional product and technology R&D (General Motors and IBM, for example) don't get rewarded with even market-average P/E multiples; investors appear to have little confidence that such traditional R&D spending will produce innovations likely to generate even average future profit growth. Additionally, companies with consistently above-average P/E multiples (Starbucks and Dell, for instance) tend to spend very little on traditional product and technology R&D and focus more on customer R&D. Clearly, most companies need to change the way they go about R&D. Focusing on the customer is the only way to close the growth gap.

rolled out a line of “wired but relaxed” day bags and luggage with edgier styling and aggressive colors. The T-Tech collection now accounts for 8% of sales.

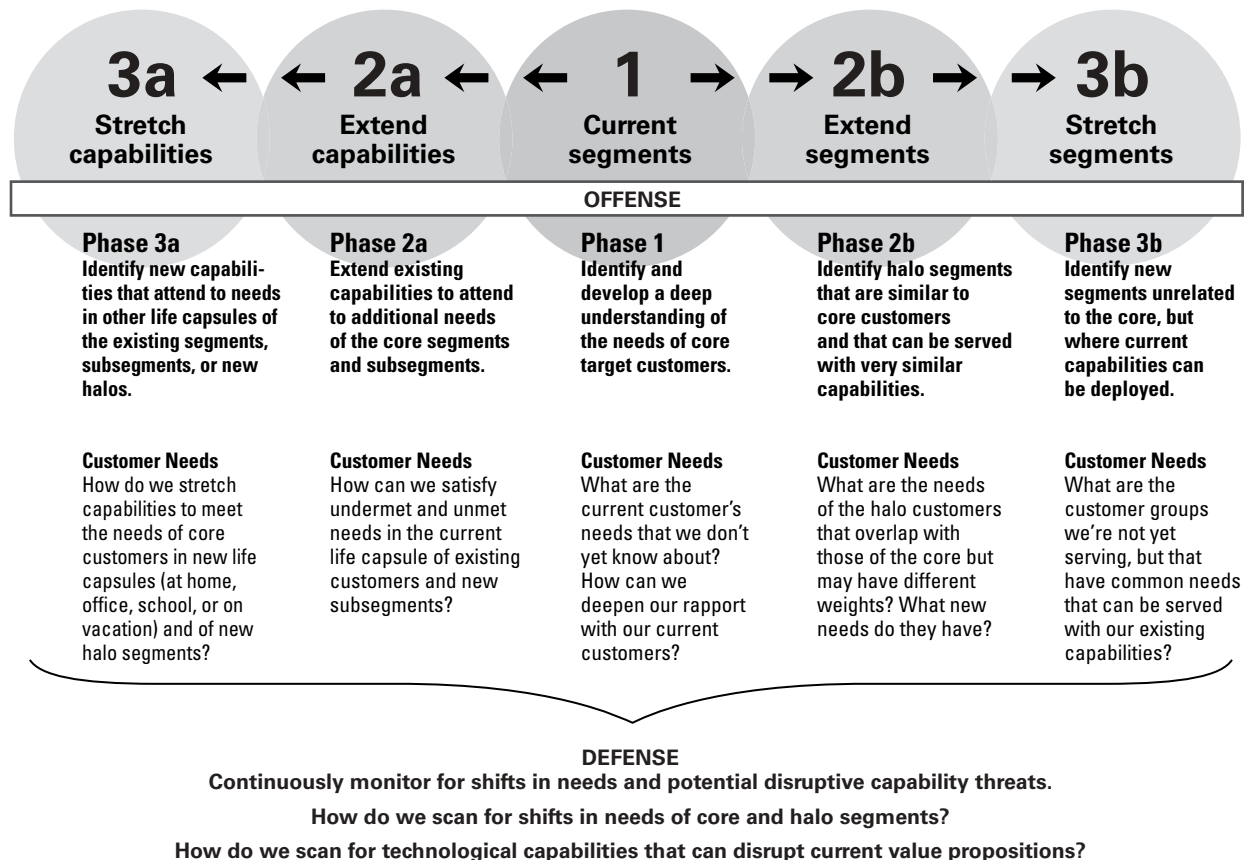
Maintain defensiveness. During all these phases, companies must pay close attention to disruption threats from competitors. Here, the customer R&D team aggressively scans for early indications of shifts in customers’ needs or growing dissatisfaction with the value propositions on the market, especially in underserved segments. Shifts in customers’ expectations can precipitate a need for new value propositions and capabilities. Customer R&D’s mission is to know more about the company’s existing customers than anyone else on the planet and to ensure that the company is strategically and operationally pre-

pared to preempt any competitor’s move. For example, when Netflix launched a mail-driven movie rental business, effectively eliminating the need for late-return fees, Blockbuster had to respond defensively by eliminating its own late fees. Knowing that customers disliked late fees, Blockbuster should have done away with them—thus improving its value proposition—before Netflix made its move.

In defensive mode, the company also scans for shifts in technology. A firm may not yet be able to meet certain customer needs because no technically viable solution exists, but such a disruptive alternative may be emerging. Investing in new technologies or partnering with other companies through licensing agreements, joint ventures, strategic alliances, or acquisitions can buy crucial time to respond to threats.

Customer R&D Strategy

A successful customer R&D strategy requires that companies play both offense and defense. The offensive strategy is to establish a deep relationship with core customers, then extend the number of customers beyond the core, and finally stretch into new customer realms. The defensive strategy focuses on continually scanning for potential competitive disruptions.



Tumi faces both kinds of threats. For example, a competitor could develop or acquire materials that are significantly more scuff-proof and wear-resistant than the ones Tumi currently uses. Such a technology breakthrough could have large implications for the female segment, since attractive, new-looking luggage is an important factor for women. The company is also aware that women require a broader selection of styles and colors than it has traditionally offered and that these continually change. Accordingly, Tumi developed its Signature line of colorful wheeled luggage with matching tote bags and purses.

To address disruptive threats, Tumi's customer R&D team works closely with technology R&D to monitor shifts and to identify and secure access to the capabilities that can keep threats at bay. For instance, Tumi continues to stay abreast of developments in super-strong fibers like artificial spider silk and tracks fashion trends among women who purchase haute couture luggage.

Tumi has been able to access many technologically sophisticated solutions without having to develop them in-house by sourcing from other companies. Its ballistic nylon fibers come from DuPont; its extendable handle tubes made of anodized aircraft aluminum come from Boeing; its wheels are made by inline-skating manufacturers like Rollerblade; its padding is made from neoprene used for scuba suits; and so on. These partnerships allow Tumi to rapidly evolve its products without spending enormously on product R&D. Based on what it learns, Tumi can also continually reinvent and patent new kinds of luggage without attempting to build something from scratch every year.

The Field Imperative

Like most companies beginning the customer R&D journey, Tumi orchestrated much of its initial innovation at headquarters with a handful of visionary leaders. In order to sustain innovation, however, it became necessary to push innovation to its retail stores and online channel. Today, Tumi regularly uses an online panel of several thousand customers to get quick responses on new R&D initiatives.

Our experience shows that the only way to sustain customer R&D is by putting customer-facing employees behind the wheel. The benefit is twofold: Companies exponentially expand

their knowledge of their patrons, and employees become engaged as they contribute their insight and energy. They want to “win with the customer” (which for us is precisely the definition of being customer centric), and they take intense pride in doing so.

The convenience retailer Seven-Eleven Japan has for years been a leader in this regard. In April 2004, at the Seven-Eleven store across from company headquarters in Tokyo, we observed one part-time worker who single-handedly developed a customer experience resulting in what may have been the best lunch sales day of the year. He was thoroughly educated on Seven-Eleven's systems and product offerings, fully knowledgeable of the customer segments in his store and their respective needs, and empowered to run his department. When the weather one day suddenly switched from cool to hot, he made an early-morning decision to change lunch offerings for the local construction workers who patronized the store. He hypothesized that the workers would be quite warm as they worked in the morning and would prefer to have cool noodles for their lunch. He estimated the number of cool noodle lunches that he could sell and the profit, including the loss for lunches not sold.

He placed his order over the satellite network with the distribution center and then arranged the products and displays to tout cold, refreshing food and drinks. Coordinating with the cashier to estimate the number of construction workers who had actually chosen his value proposition, he was delighted to find that, by the end of the lunch period, everything had sold out at a superb profit. By providing an integrated infrastructure and a culture dedicated to educating, empowering, and engaging those closest to the customer, Seven-Eleven Japan has for years been an exemplar of customer R&D—and one of the most successful convenience retailers in the world.

A Western example is Best Buy, which puts roughly 70,000 store employees in hands-on “customer learning environments”—its retail stores. As part of its customer R&D strategy, Best Buy set out to test proposed value propositions for a number of specific customer segments, measuring the incremental impact of each value proposition on customer profitability and satisfaction over time. Best Buy's initial lab consisted of four existing stores in the northeastern U.S. The lab team consisted of a district manager, a district support team, the

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store general managers, and the staff in each store.

Best Buy trained the employees in customer profitability management, segment identification, communication, and execution. For example, employees experimented with the product assortment, end-cap displays, and a variety of signage. The results in the Northeast labs were encouraging enough for Best Buy to expand the test to stores on the West Coast. Today, more than 200 of Best Buy's 750 U.S. outlets have been transformed into what the company calls its Customer Centricity stores. The company has reported that these transformed stores have generated year-over-year sales growth nearly double that of the balance of the chain.

The detailed knowledge of customers that companies accumulate through their field learning labs confers a significant advantage over competitors. This knowledge asset is very opaque and difficult for competitors to imitate, extending sometimes very substantially the years of superb financial returns.

Beyond Customer R&D

Customer centricity is not just a slogan. It's a prerequisite for sustainable profitable growth. But it's the rare organization that understands what it means to be customer centric, and true customer-centric innovation includes two additional efforts that both frame and go beyond the customer R&D endeavors we have described here.

One of the most important first steps a company should take, even before embarking on customer R&D, is to measure and manage customer profitability. Few companies have tried to discern which customers are profitable and which aren't by fully allocating all invested capital and expenses to individual customers. Even fewer do such analysis on a regular basis and make customer ROIC (return on invested capital) a central metric for business performance. But doing so helps firms get a solid idea of who their customers really are in the first place and where and why they make a profit or don't. Take the example of a specialties chemical company that, rather than assessing profits on a per-product basis, chose to look at profitability on a per-product *and* per-customer level. The company found, as have others in many industries, that the top 20% of customers (in terms of profitability) generated roughly

150% of the company's profits, while the bottom 20% generally lost at least 100%. The insights from this analysis helped the company segment its customers much more effectively and ensure that the value propositions they developed were mutually beneficial for the customer and the company.

Once the company has done its deep segmentation, capability-development, and value proposition work, the firm should institutionalize customer centricity. This is accomplished by making the customer segments the basic business units of the company; that is, organizing by customer segment rather than by product, geography, or function. Dell, Best Buy, Royal Bank of Canada, and a handful of other firms have set up customer segment units led by individuals who are responsible and accountable for the financial performance and customer satisfaction of those segments. These leaders develop strategies for their segments and allocate resources with the goal of growing "share of wallet" and achieving a high customer return on invested capital from customer R&D.

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By looking closely at customer profitability; segmenting customers according to their needs and desires; creating and delivering a superior customer experience; organizing around the customer; and putting customer-facing people in charge, firms achieve a holistic customer-centric innovation system that puts them ahead of the pack. We have found that CCI has the potential to boost profits not just in retail, but in virtually every business that has direct sales access to large numbers of customers—from financial services to hotels, from consumer goods to manufacturing firms. We have even seen it work when direct access is obscured by a distribution channel; firms like Procter & Gamble use customer R&D to create mutually beneficial value propositions for both their end-user consumers and their supermarket customers. (To read more about the details of creating a truly customer-centric company, see *Angel Customers and Demon Customers*, by Larry Selden and Geoffrey Colvin.)

Firms that practice CCI increase the number of new investments earning large return spreads in excess of capital costs for as long as possible. New customer investments, greater customer return spreads, and longer durations of the spreads all boost a company's value. CCI

The more customer-centric you are, the longer it takes your competitors to figure out your game.

By offering increasingly tempting value propositions, firms avoid the trap of having to compete on price.

allows firms to offer increasingly tempting value propositions, helping them to avoid the trap of having to compete on price. The superior returns allow the customer-centric innovator to continually reinvest in the customer knowledge base. The result: a truly virtuous learning cycle and a never-ending source of

competitive advantage.

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