How Do You Capture Value From an Innovation

By Matthias A. Tietz and Simon C. Parker

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Creating a good product does not ensure success in the marketplace, though it is a necessary first step. The next steps, whose goal is to capture maximum value from the new product, are crucial. This article will help practitioners successfully structure these “next steps.”

It isn’t well known, but the fact is that Xerox did a great job developing the first office computer. The mouse and the cute little icons were exactly what the consumer wanted. But not long after the launch, engineers at Xerox were walking down the hallways, complaining about how their ideas had been “stolen.” Apple had introduced the Macintosh and capitalized on Xerox’s innovation. Xerox learned the hard way that value creation and value capture are two different things.

To help practitioners avoid repeating Xerox’s experience, this article will describes strategies designed to capture value for an innovator. The two guiding questions will be: (1) Is the innovation appropriable or will you have to share the profits with many others? And (2) What is the innovator’s relation to the owners of complementary assets, i.e. those assets needed to fully realize value the innovation (e.g. the sales network, if you have a great new product)

Is your innovation appropriable?

Suppose you are an innovator and you want to appropriate the value of the intellectual property (IP) it embodies. To what extent this is possible depends in part on how the legal system defends and enforces IP rights. In some cultures, innovations are seen less as a private good than a social one. This can be a problem because if rival firms can copy your innovation without any legal barriers, they will.
Coca Cola and Pepsi had a diet version of their products on the market within a few weeks of RC Cola’s introduction of the first diet beverage.

Even if legal protection exists, you will have precious little time to capture value if competitors can invent around your patent. For example, Bowmar launched the first pocket calculator, but it could not survive the competitive pressures from HP and Texas Instruments. Both rivals circumvented Bowmar’s patents legally, culminating in the eventual sale of Bowmar and its exit from the industry. Unless your IP can be tightly protected like a chemical formula in the pharma industry, you are easy prey for imitators – much like Xerox, which lost all of its initial advantage to Apple.

**How to position yourself against the owners of complementary assets**

To capture value, you want to be in a good bargaining position with regard to the owners of the complementary assets needed to leverage the innovation. You need to have market power over critical resources required to make your innovation cash-generative. Supplier relationships, production capacity, sales networks, maintenance facilities and advertising teams are all examples of such resources. You will certainly find more along the value chain.

Take McDonald’s for instance. In the beginning, it negotiated excellent supplier relationships, and quite often, even exclusivity. It never grew the potatoes for its fries, but it quickly used its market power to demand an exclusive, specialized product, i.e. its fries are all cut to the same precise thickness. Additionally, McDonald’s always designed advertising and promotion activities at the corporate level. It aggregated the advertising demand of many thousands of franchisees and thus ensured a good bargaining position with media companies and advertising agencies. Thus, McDonald’s has good fries and a strong brand, while not depending on any owner of specialized, complementary assets, such as the marketing agencies or the potato farmers.

To take another example, an automobile company’s maintenance facilities are a complementary asset. Selling a product without having a working maintenance network in place can make you overly reliant on a partner that does. This is why Mazda was extremely careful with the introduction of its rotary...
engine, which required specialized maintenance facilities in its dealerships. The roll out was much slower than it anticipated, but Mazda was able to keep control and avoid the so-called “hold-up” problem.

By answering the two questions above, you can locate your innovation within the following graph:

![Innovation value-capture matrix](image)

**Figure 1: Innovation value-capture matrix**

**Quadrant 1: Potential Winner (Contract)**

In this quadrant, you are the only party to hold the intellectual property rights, but you have low market power against the owners of complementary assets. Imitation is less a problem in such a scenario than the possibility that your partner can use its bargaining power to capture value. To deal with this, you need to design an enforceable contract to maximize your profits from the innovation. Since your new invention creates the demand for the complementary assets (and not the other way around) you have a fair chance of negotiating for a substantial share of the profits.

In the pharma industry, this strategy is known as “internalizing R&D.” A new pharmaceutical start-up develops a promising drug, but cannot extract its full potential value by itself. It needs the complementary resources of a larger partner. In most cases, it is possible to draw up contracts, which

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1. Core idea adapted from Teece, 1986
enable cooperation between the new start-up and a pharma giant. The result is often a more or less friendly takeover that rewards the innovators handsomely.

**Quadrant 2: Winner**

This is the most rare of all scenarios, but it promises the highest value-capture potential. The firm that enjoys the combination of a secure technological advantage without relying on another firm’s assets is in the ideal position. A well-known example of this occurred in the artificial sweetener industry. After the discovery of aspartame, the calorie-free sugar replacement “Nutrasweet” was born. G.D. Searle & Company quickly filed patents to protect its chemical formula. But it did not stop there. FDA approval came next and today it still remains a barrier to entry for anybody who tries to “invent around” Searle’s protected molecular formula. Searle’s production process could hardly be simpler. Yet, it never renewed the contracts with its initial suppliers, in order to avoid leaking trade secrets. Thus, Searle has been very successful in putting “Nutrasweet” and “Equal” on most American coffee tables – and profiting directly as a result.

**Quadrant 3: Loser**

This is the least favorable situation to be in. If you can neither exploit the ownership of your IP, nor secure the assets you need to market your innovation, you might consider delaying or abandoning a launch. Time spent securing your IP rights is time well spent. Another useful strategy is to build up a strong position with regard to the assets you need, in a way that does not alert suppliers or competitors. Building up sales and service teams before your product is launched might be much cheaper in the long run than relying on partners that can later turn against you. Sadly, many innovations still fall into this quadrant. If yours does and it has been already launched, a contract that limits your exposure and liabilities might be the best way to still make some money from the idea.

**Quadrant 4: Potential Winner (Integration)**

This position describes a low degree of IP protection, which is compensated for by having some market power over complementary assets. If you want to play to your strengths here, integration is your

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2 See M.G. Jacobides, T. Knudsen and M. Augier (2006), Benefiting from innovation: Value creation, value appropriation and the role of industry architectures, Research Policy, 35 (8), 1200-1221.
best option. Depending on the depth of your pockets, acquisition and partnerships can help you ensure that you will control the most critical assets when you launch the product. Even though competitors will copy it, they may have a hard time copying all of the complementary assets you have put in place.

This case tends to apply to corporate giants rather than to small innovators. A good example is Procter and Gamble. It sells its regular anti-dandruff shampoo "Head & Shoulders®" with a huge premium. Although the product itself can be easily copied, P&G’s distribution channels, production capacity and above all, advertising such well-known brand names such as “Head and Shoulders®” are complementary assets that very few competitors can match. That is why we are willing to pay four dollars for 200 ml of soap.

This article explored four different ways that value can be captured from an innovation. A key message to emerge from our discussion is that, before an innovative product is launched, an innovator should carefully consider the ownership of the IP and the complementary assets. If Xerox had known this when it introduced the first office computer, it could probably have captured much more of the value of its innovation. Who knows, perhaps we might be using Xerox computers instead of Macs today.