



# Organizing for Innovation in the Middle Market

## Creating Ideas and Capturing Value

A REPORT FROM THE NATIONAL CENTER FOR THE MIDDLE MARKET AND  
CHERRY BEKAERT LLP WITH DR. MICHAEL LEIBLEIN OF THE OHIO STATE UNIVERSITY  
CENTER FOR INNOVATION AND ENTREPRENEURSHIP



NATIONAL CENTER FOR  
THE MIDDLE MARKET

In Collaboration With



**THInc.**  
*Guiding Innovation*

Technology, Health & Industrial companies



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# About This Report

## THE U.S. MIDDLE MARKET

The U.S. middle market comprises nearly 200,000 companies that employ 44.5 million people and generate more than \$10 trillion in combined revenue annually. The middle market is defined by companies with annual revenues between \$10 million and \$1 billion. In addition to their geographic and industry diversity, these companies are both publicly and privately held and include family-owned businesses and sole proprietorships. While the middle market represents approximately 3% of all U.S. companies, it accounts for a third of U.S. private-sector GDP and jobs. The U.S. middle market is the segment that drives U.S. growth and competitiveness.

## INNOVATION PRACTICES IN THE MIDDLE MARKET

The most successful middle market companies—those growing at least four times the rate of GDP growth—are 40% more likely to describe themselves as innovative than less dynamic businesses of their size, according to Blueprint for Growth by the National Center for the Middle Market (NCMM). Exploring how middle market companies approach innovation, including their methods, processes, and sources of ideation, and what drives the most successful innovation initiatives gives important insight into the ongoing vitality of this critical segment of our economy and helps build a body of knowledge for executives seeking to enhance company performance.

## HOW THE SURVEY WAS CONDUCTED

The survey was conducted among 400 middle market leaders and senior managers who share in responsibility for innovation at their companies. Additional responses from 50 leaders in each of three innovation-intensive industries—health and life sciences, industrial, and technology—augmented the findings. The purpose of the survey was to identify how more and less innovative middle market companies differ. The online survey was self-administered from June 10, 2015 through June 30, 2015. Several terms were defined for respondents (see glossary of terms on page 19). This report was jointly designed and prepared by the National Center for the Middle Market and Cherry Bekaert LLP. It was based on a survey originally developed by Dr. Michael Leiblein, Associate Professor at the Fisher College of Business and Academic Director of the Center for Innovation and Entrepreneurship at The Ohio State University, who provided guidance throughout the research and development of this study.

## THE NATIONAL CENTER FOR THE MIDDLE MARKET

Founded in 2011 in partnership with GE Capital, and located at The Ohio State University Fisher College of Business, the National Center for the Middle Market is the leading source of knowledge, leadership, and innovative research on the U.S. middle market economy. The Center provides critical data, analysis, insights, and perspectives to help accelerate growth, increase competitiveness, and create jobs for companies, policymakers, and other key stakeholders in this sector. The Center's website, which offers a range of tools and resources for middle market companies, can be visited at [www.middlemarketcenter.org](http://www.middlemarketcenter.org).

## CHERRY BEKAERT LLP

As a nationally recognized, growth-oriented CPA firm, Cherry Bekaert LLP provides guidance and support that helps its clients move forward to reach their organizational goals. The Firm's THInc practice is focused on middle market innovation and its impact on clients in the Technology, Health & Life Sciences and Industrial sectors. This team has seasoned professionals with advisory, tax and accounting expertise in the areas of Accounting & Advisory; Tax Optimization; Innovation Strategy & Consulting; Innovation Credits; Business Economics Consulting; and State & Local Tax (SALT) Advisory. For more information please visit [www.cbh.com/THInc](http://www.cbh.com/THInc).

## THE CENTER FOR INNOVATION AND ENTREPRENEURSHIP

The Ohio State University Center for Innovation and Entrepreneurship supports academic research, education and community engagement in innovation and entrepreneurship. The Center strives to advance both the science and practice of innovation and entrepreneurship so as to stimulate economic growth and development through new company formation, technology commercialization, new product and service creation and improved competitive performance of entrepreneurial and innovation based ventures. To learn more visit [fisher.osu.edu/centers/innovation-and-entrepreneurship](http://fisher.osu.edu/centers/innovation-and-entrepreneurship).

## IMPORTANT TERMS

For a glossary of important terms used throughout this report, see page 19.

# Executive Summary

Innovation—or the introduction of new ideas, products, services, processes, and practices—drives revenue growth for industries and individual companies alike. In the middle market specifically, companies that rate themselves very good at innovation are significantly more likely than less innovative firms to experience rapid revenue growth of 10% or more per year. Middle market firms appear to be quite adept at innovation, with more than half of implemented innovation projects succeeding by the standards of company executives.

In the middle market as a whole, innovation initiatives tend to skew in a conservative direction, focusing on familiar markets and employing familiar knowledge rather than venturing out into unmapped “blue oceans.” Contrary to conventional wisdom, these close-to-home innovation initiatives appear to result in similar profitability and value capture for middle market firms as more risky initiatives.

That said, the most adept middle market innovators, which are also likely to be the fastest-growing companies, maintain innovation portfolios that include more adventurous projects. They are more likely to aim at unfamiliar markets or employ new knowledge. These companies also are more likely to possess a well-developed set of capabilities and practices—e.g. formal processes, tools to track and measure innovation, attention from senior leadership—in order to better manage the risks they take.

Time and again, research has shown that innovative companies outperform firms that are less confident in their innovation capabilities. Past work by both academics and practitioners has demonstrated a clear link between innovation and sustained profitability in a wide range of industries, including technology-intensive industries, service firms, and manufacturing firms.<sup>1,2,3,4</sup> Previous studies by the National Center for the Middle Market have confirmed that fast-growing middle market companies place more emphasis on innovation than their slower-growing counterparts.<sup>5,6</sup> The Center’s new innovation survey bears out these findings, revealing that 43% of middle market companies that rate their firms as very innovative experience revenue growth of 10% or more. Just 32% of less innovative firms experience the same high growth rates.

The connection between innovation and growth is even more pronounced in innovation-intensive industries. In the health, technology, and industrial sectors, only about a quarter of less innovative firms experience revenue growth rates above 10%.

Regardless of industry, middle market firms that engage in the innovation process execute their innovation projects quite effectively. Middle market executives indicate that 57% of innovative ideas they generated last year made it to market, a success rate consistent with studies of innovation by companies of all sizes.<sup>7</sup> Of the ideas implemented over the past five years, 54% were successful. (There is, it should be noted, an oft-cited figure that 80% of new products fail. That number is mercurial—it scoots away when probed—and appears to depend on how a study’s authors have defined success.<sup>8</sup>) On average, middle market firms earned a 27% profit on their most recent innovation, based on an initial investment of \$1.5 million.

These solid success rates may be partially attributed to the tendency of middle market firms to manage innovation risk carefully. Companies in the middle market are highly likely to generate innovative ideas using their own internal resources. They also invest in what they know: Of the total middle market innovation investment, 42% is devoted to projects aimed at existing markets and deploying existing knowledge. Just 15% is directed toward projects focusing on new markets and requiring new knowledge.

Why do middle market companies choose to innovate close to home? One reason may be that, because of their size, they have fewer innovation projects across which to spread investment dollars as compared to larger companies. At the same time, because of their relative stability—the median age of a middle market company is 31—they may be less willing to “bet the farm” than start-ups.

Whatever the reasons, such close-in initiatives are—unsurprisingly—more likely to be executed effectively and considered successful than projects that employ new knowledge and target new markets. What is unexpected is that these less daring ventures appear to result in similar value. While one might expect riskier projects to come with a bigger payoff, middle market companies realize similar profits from projects in the existing space as they do from their more exploratory endeavors.

<sup>1</sup>Innovation and profitability Geroski, P. A., Machin, S. and Van Reenen, J. (1993) *The profitability of innovating firms*, RAND Journal of Economics, 24, 198–211. <sup>2</sup>Innovation and Sustained profitability Roberts, PW, 1999. *Product innovation, product-market competition and persistent profitability in the US pharmaceutical industry*, Strategic Management Journal, 20: 655–670. <sup>3</sup>See also: Knott, AM. 2003. *Persistent heterogeneity and sustainable innovation*, Strategic Management Journal, 24(8): 687–705. <sup>4</sup>Madsen, TL and MJ Leiblein. Forthcoming. *What factors affect the persistence of an innovation advantage?* Journal of Management Studies. <sup>5</sup>National Center for the Middle Market. *Pathways to Growth: Game-Changing Performance Strategies for Middle Market Companies*. The Ohio State University and GE Capital Corporation. 2013. National Center for the Middle Market. <sup>6</sup>Blueprint for Growth: Middle Market Growth Champions Reveal a Framework for Success. The Ohio State University and GE Capital Corporation. 2012. <sup>7</sup>Markham, SK. 2013. *The impact of front-end innovation activities on product performance*. Journal of Product Innovation, 30(S1): 77–92. <sup>8</sup>Castellion, George. *Perspective: New Product Failure Rates: Influence of Argumentum ad Populum and Self-Interest*. <http://newproductsuccess.org/white-papers/new-product-failure-rates-2013-jpim-30-pp-976-979/>

However, this picture changes when we consider the best middle market innovators. These companies invest significantly more on developing new knowledge and exploring new markets. In this group, those investments outperform investments in safer, close-to-home projects. In these firms, upper management plays a greater role in

all phases of the innovation process from idea generation through implementation. Additionally, these companies have constructed a more robust innovation infrastructure, including more formalized processes and greater use of innovation tools. These firms are also likely to be the fastest growing middle market companies.

## Key Takeaways for Executives



### PROFITABLE INNOVATION IDEAS EXIST CLOSE TO HOME

Generally speaking, middle market firms are most likely to invest in innovation projects in the existing knowledge/existing market space, and they do so quite successfully. Contrary to conventional wisdom, which suggests that riskier projects are typically more profitable, for the overall middle market, close-to-home initiatives generate about the same amount of profit as many of the projects that delve into newer territory, perhaps because they are carefully selected and pre-vetted for success. What's more, projects in the "known" space account for almost half (48%) of both revenues and profits. Clearly, it can pay to stick with customers and subject matter you know. With plenty of green grass right under foot, firms may want to exercise caution when considering innovating far beyond their comfort zone or level of sophistication.



### LOOK BEYOND THE R&D TEAM, BUT WITHIN YOUR FOUR WALLS

It's not always necessary to hire outside contractors or consultants or to tap into crowdsourcing to generate your next big idea. In fact, middle market executives predominantly conduct innovation using internal R&D or business unit teams. However, the most effective innovators tend to consult broadly beyond the innovation function and engage the entire company, and they enjoy more success than those firms that limit innovation to the closest-in team. Seasoned innovators focus on cross-departmental interaction and look to teams elsewhere within their own companies. The highest performing firms also make sure to engage senior leaders including those who are closest to the customer (Chief Marketing Officer) and those who know the technology best (Chief Technology Officer and Chief Information Officer).



### FORMAL PROCESSES HELP PROPEL SUCCESSFUL INNOVATION

More than half of middle market firms have formal processes in place for generating, selecting, and implementing innovative ideas, with the implementation phase of innovation being the most likely phase to be formalized. The innovation process tends to be most formalized in larger middle companies (with revenues between \$100 million and \$1 billion) and in companies that rate themselves most effective at innovation. Firms with the highest revenue growth rates are also likely to have more robust innovation infrastructures in place. While formal processes can feel a bit antithetical to entrepreneurship in the minds of many middle market leaders, such processes need not be bureaucratic to work. Simply putting a little structure and definition around a company's innovation approach can lead to more and better ideas (e.g. by involving marketing) and higher innovation project success rates (e.g. by enlisting the expertise of the Chief Financial Officer).



### A GREATER APPETITE FOR RISK SHOULD GO HAND IN HAND WITH MORE CAPABILITIES FOR MANAGING IT

Some industries—healthcare and technology in particular—tend to invest more in projects for new markets or using new science. Further, companies that rate themselves best at innovation, which are also likely to be the fastest growing middle market firms, invest more overall. And they direct a larger portion of their innovation resources toward new territory. They also generate more profit from these initiatives than their peers. The firms and industries that do venture into the "blue ocean" appear to benefit from taking a higher level of risk. However, they also are the most likely to have processes and strategies in place for managing the risk, including more senior management involvement, more consultation outside the firm, and more formal processes. They benefit from innovation largely because of superior capabilities.

# Innovation Sources: Middle Market Innovation Is Largely Homegrown

Internal innovation is by far the most common method of conducting innovation within middle market firms. Nearly three-quarters (72%) of middle market leaders rely on their own teams—either dedicated R&D teams or teams within a specific business unit or function—for innovation projects. When leaders seek fresh perspectives, 34% seek input from other business units or functional teams elsewhere in their companies. About a quarter of middle market companies contract with outside providers such as agencies and consultants, and only 7% rely on crowdsourcing or other “open innovation” techniques.

While internal teams are preferred across all middle market revenue segments and industries, the largest middle market companies (with revenues between \$100 million and \$1 billion) and firms that consider themselves highly capable at innovation are significantly more likely to leverage outside sources of ideas, including crowdsourcing. Companies in innovative-intensive industries where scientific progress is rapid, like technology and health and life sciences, are also more likely to engage the crowd and seek diverse opinions. Proponents of crowdsourcing say that because great ideas can come from anywhere, talking to many and diverse outside sources ensures opportunities are not missed, an especially valuable benefit in fast-changing fields.

The 26% of middle market firms that work with consultants on innovation projects say they benefit from tapping into expertise they do not have in-house. These firms are somewhat more likely than their counterparts to rate themselves as being good at innovation. A number of academic studies clarify the specific instances where the value of working with outside providers is likely to be the greatest.<sup>9, 10, 11</sup> These studies generally suggest it is useful to work with outside providers when knowledge is broadly dispersed and/or innovation problems are highly complex.

*“The key is asking the right questions and observing client needs. We encourage experiential learning about the marketplace, and we host chief experience officer roundtables once a month. We distinguish between transformative and incremental innovation and are focused on helping our client deliver effortless digital experiences.”*

**-TECHNOLOGY PROVIDER**

<sup>9</sup>Felin, T. and T. Zenger (2014). Open or closed innovation? Problem solving and governance choice. *Research Policy*, 43(5): 914-925. <sup>10</sup>Knott, AM. Outsourced R&D and GDP growth. Available at SSRN: <http://ssrn.com/abstract=2575977>. <sup>11</sup>Bertrand, O. and MJ Mol. 2013. The antecedents and innovation effects of domestic and offshore R&D outsourcing: the contingent impact of cognitive distance and absorptive capacity. *Strategic Management Journal*, 34: 751-760.

## How Innovation Is Conducted

### METHODS FOR CONDUCTING INNOVATION BY COMPANY SIZE

	TOTAL	\$10M-<\$50M	\$50M-<\$100M	\$100M-<\$1B
Using your own team	72%	73%	73%	73%
Working with a team elsewhere in your company	34%	28%	30%	39%
Contracting with outside providers	26%	24%	24%	28%
Using crowdsourcing	7%	4%	6%	13%
Some other way	2%	1%	1%	3%
I do not conduct innovation projects	2%	4%	-	2%

### METHODS FOR CONDUCTING INNOVATION BY INDUSTRY

	TOTAL	HEALTH & LIFE SCIENCE	INDUSTRIAL	TECHNOLOGY
Using your own team	72%	71%	69%	77%
Working with a team elsewhere in your company	34%	42%	44%	46%
Contracting with outside providers	26%	32%	23%	21%
Using crowdsourcing	7%	16%	4%	19%
Some other way	2%	-	2%	2%
I do not conduct innovation projects	2%	1%	4%	-

# Value Creation: Internal Teams and Formal Processes Drive Idea Generation

On average, middle market firms generate more than one innovative idea per month, or 13.7 per year. While internal innovation teams are the most common source of new ideas, customer or user feedback is also critical, especially in innovation-centric industries like health and life sciences, technology, and industrial. C-level executives also play a role in the idea generation process across middle market industries.

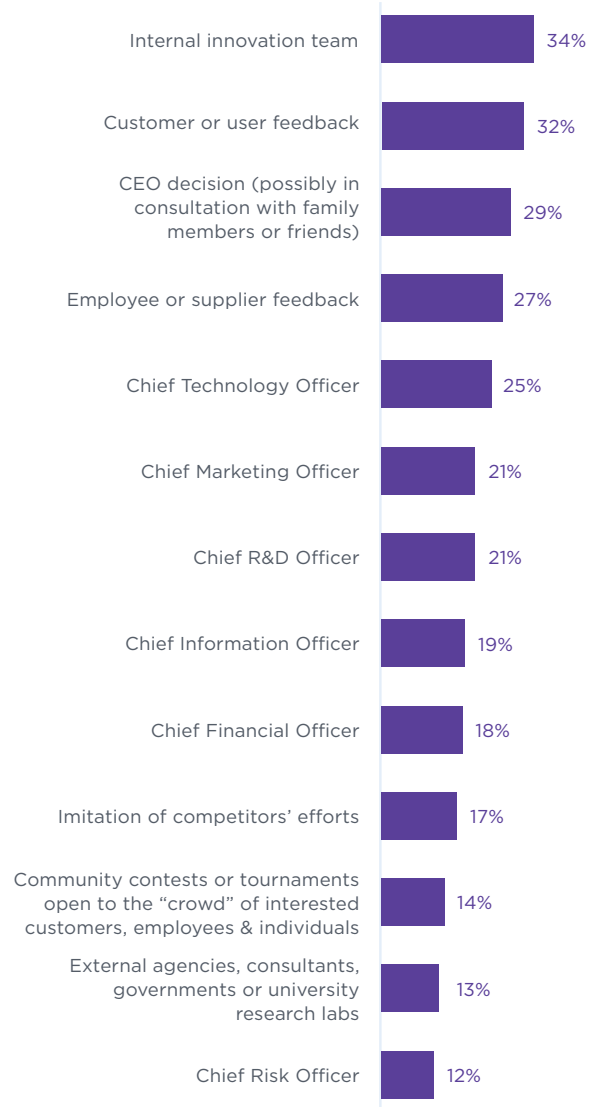
Overall, over half of middle market companies (51%) employ a formal process for generating ideas. Formal processes are most common in the fastest growing middle market firms, the largest middle market firms, and in health and life sciences and technology firms. In health and life sciences companies, the high presence of formal processes is likely due to the need to obtain regulatory approval for new drugs and medical devices.

Idea generation processes can range from programs that incentivize employees for coming up with new ideas, to brainstorming sessions, social network data mining, or conducting focus groups or traditional market research. Some companies also implement processes for staying on top of the evolution of technology, such as periodic meetings or technology road mapping, or for involving the C-suite more directly in idea generation activities.

While there are limits to the use of formal tools to manage the idea generation phase of innovation, given changes in markets and technologies, those middle market firms that do implement formal idea generation processes generate more ideas and experience a higher innovation project success rate.<sup>12</sup> Specifically, firms that believe they are more successful at innovation are more likely to involve the C-suite in the idea generation process, especially the Chief Research and Development Officer (CRDO), Chief Information Officer (CIO), Chief Technology Officer (CTO), and Chief Marketing Officer (CMO).

Additionally, about a third of middle market executives believe processes such as incentives, formal brainstorming tools, and the “crowd” of interested customer, employees, and other individuals, are influential motivators in the idea generation process.

## WHO PARTICIPATES IN GENERATING IDEAS?



<sup>12</sup>Felin, T, S. Kauffman, R Koppl, and G. Longo. 2014. Economic opportunity and evolution: Beyond landscapes and bounded rationality. *Strategic Entrepreneurship Journal*.

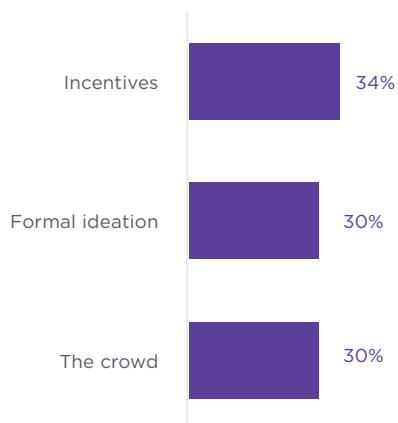


## Idea Generation Tools and Processes

### PERCENTAGE OF FIRMS THAT UTILIZE FORMAL IDEA GENERATION PROCESSES

	TOTAL	\$10M-<\$50M	\$50M-<\$100M	\$100M-<\$1B
By company size	51%	47%	51%	55%
	TOTAL	HEALTH & LIFE SCIENCE	INDUSTRIAL	TECHNOLOGY
By industry	51%	72%	48%	58%

### TOOLS USED FOR GENERATING IDEAS



*"Innovation is vital to our company's success as we have created a new category in the healthcare market. Project management from concept to execution is the key to success."*

**-PIONEER IN STEM CELL SCIENCE**

*"Our innovation team knows the product best, so we're quicker to generate ideas."*

**-FINANCIAL TECHNOLOGY LEADER**

# Decision Rights: Middle Market Executives Are Most Effective at Selecting Innovations to Fund

Middle market companies implement more than half (57%) of the innovation ideas they generate. Most often, the Chief Executive Officer (CEO) is the most influential factor in deciding which innovation ideas to fund. Customer or user feedback is the second most influential factor; the opinion of the Chief Financial Officer (CFO) also carries great weight in the decision-making process.

In firms with the most rapid revenue growth, the CEO, CMO, CIO, and CTO are somewhat more involved in selecting ideas with which to move forward than they are in the middle market as a whole.

About four in 10 middle market executives believe their senior managers are highly effective at making innovation investment decisions, and 35% have confidence in their internal team's ability to choose the most promising projects. Executives are less confident about entrusting innovation investment decisions to the crowd or to external agencies or consultants.

Nearly six in 10 firms (59%) use formal processes to select which ideas to fund, with those firms that consider themselves very good at innovation being more likely to have formal processes in place. Companies in highly innovative industries are most likely to rely on formal processes for decision making, with nearly three-quarters of health and life science firms and 68% of technology firms using such processes.

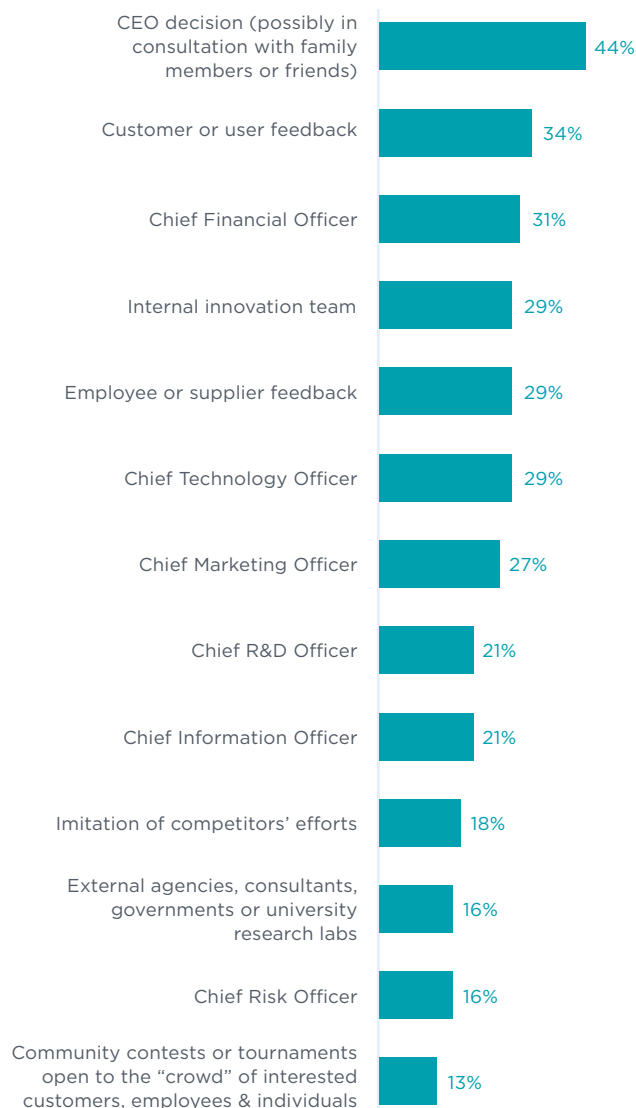
Formal processes can include formal decision or voting right procedures or policies, the use of administrative controls, or the use of decision-making tools such as innovation portfolios, real options logic, or stage gate processes.

Nearly a third of middle market companies use innovation portfolios while only about two in 10 make use of real options logic or stage gate processes. The majority (51%) of middle market companies do not use formal decision-making tools at all. Moreover, the effectiveness of such tools is questionable, with 50% or fewer users rating the tools as highly effective.

However, it is important to note that companies in innovative industries are more likely to use the tools. Almost three-quarters of health and life science firms and 60% of technology companies use at least one type of formal decision-making tool. Additionally, middle market

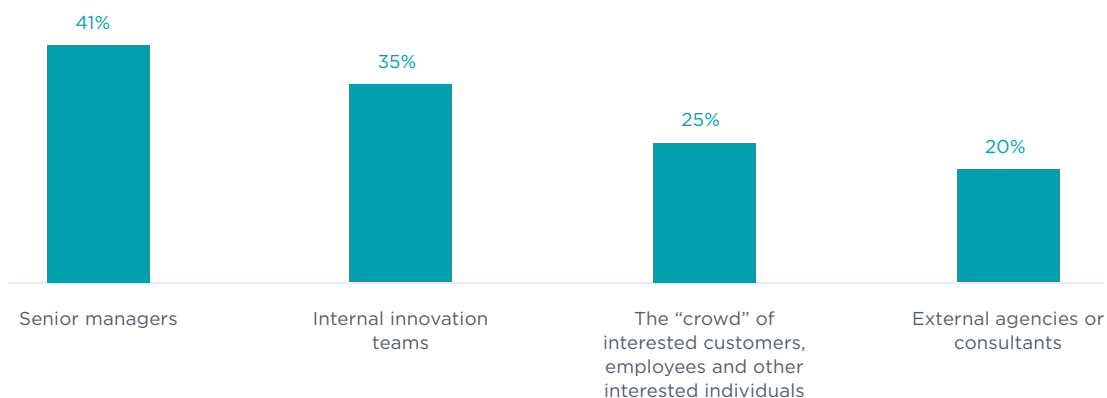
companies with the highest rates of revenue growth are significantly more likely than their peers to rate innovation portfolios effective for idea generation. (It is worth noting that many life sciences companies must seek regulatory approval—for example, for new drugs or medical devices—a requirement that may make formal processes a necessity.)

## WHO INFLUENCES WHICH IDEAS TO FUND?

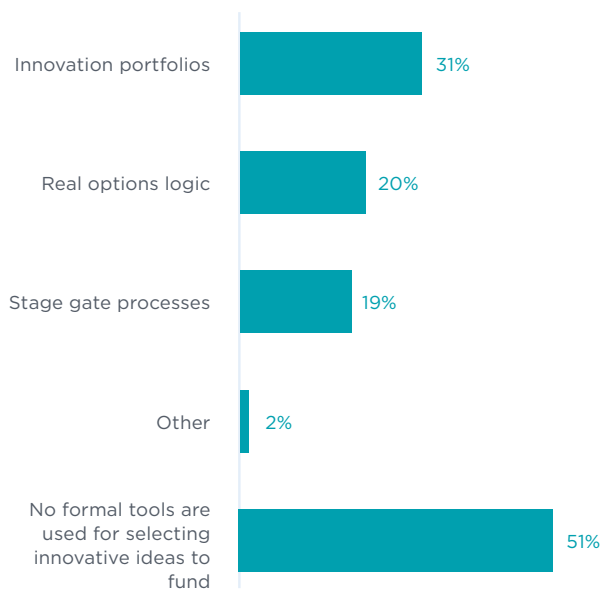


## Idea Selection Tools and Processes

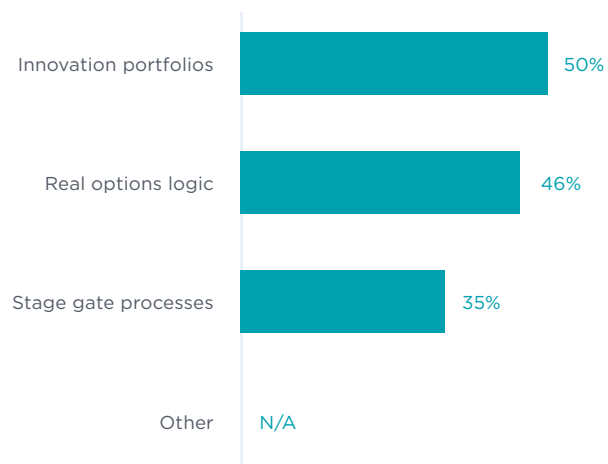
### WHO IS MOST EFFECTIVE AT SELECTING WHICH IDEAS TO FUND?



### TOOLS USED FOR SELECTING IDEAS



### EFFECTIVENESS OF TOOLS



## Idea Selection Tools and Processes

### PERCENTAGE OF FIRMS THAT UTILIZE FORMAL IDEA SELECTION PROCESSES

	TOTAL	INDUSTRY		
		HEALTH & LIFE SCIENCE	INDUSTRIAL	TECHNOLOGY
Formal idea selection process	59%	74%	58%	68%

### IDEA SELECTION TOOLS USED

	TOTAL	INDUSTRY		
		HEALTH & LIFE SCIENCE	INDUSTRIAL	TECHNOLOGY
Innovation portfolios	31%	43%	32%	42%
Real options logic	20%	30%	17%	33%
Stage gate processes	19%	34%	27%	26%
Other	2%	1%	2%	2%
No formal tools are used	51%	26%	45%	40%

*"We are restructuring to foster innovation toward business and financial needs. We recently formed an engineering team to focus on cost savings, new products, etc."*

**-LEADING PROVIDER OF SPECIALIZED SECURITY, IDENTIFICATION, TRACEABILITY, AND UTILITY PRODUCTS**

# Idea Implementation: Development and Commercialization Are Most Often Formal Processes

In the middle market, the implementation phase of innovation is the most likely part of the process to be formalized. More than six in 10 (63%) companies have a formal process in place for putting innovations into practice, which may include administrative controls such as monitoring, evaluations, and checklists.

No matter the process, internal innovation teams, CEO involvement, and customer or end user feedback are the most critical components in implementation. Among middle market firms with the highest rates of revenue growth, the CEO, CMO, and CTO are more involved in implementing ideas.

*“We have a number of ways we implement innovative ideas. These include a process leader for new product innovation, service fulfillment process for launches, and an annual hackathon to test systems and processes.”*

**-LEADER IN INSTITUTIONAL INVESTOR  
DATA AND ANALYTICS**

## WHO PARTICIPATES IN IMPLEMENTING IDEAS?

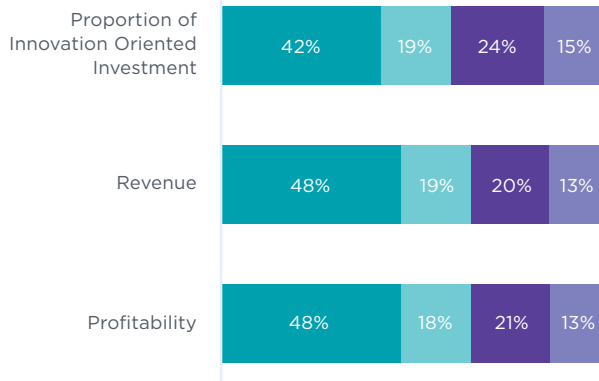


# The Innovation Portfolio: The Middle Market Takes a Value-Capture, Profit-Oriented Approach to Innovation

At the level of the individual company portfolio, middle market firms are most likely to invest in innovation projects that employ knowledge they already work with and are aimed at markets they already serve. On average, they allocate 42% of their investment dollars to these safer, close-to-home initiatives. In balance with their investment, companies generate about half (48%) of their total revenue and profitability from innovative products and services in the existing space.

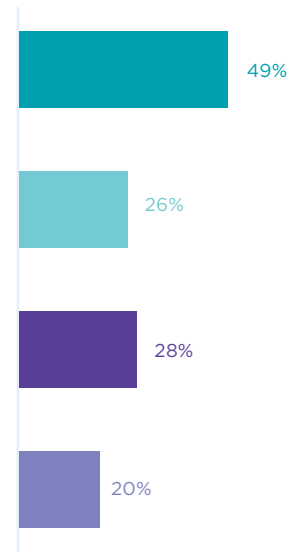
Not surprisingly, these safer and more conservative projects are easier to execute and more likely to be considered successful by most middle market executives. Executives believe that nearly half (49%) of existing knowledge/existing market innovations succeed, while only a quarter of projects that venture into new markets and/or new knowledge areas are deemed a success.

**AVERAGE INVESTMENT & PROFITABILITY**



- Existing Knowledge/ Existing Markets
- New Knowledge/ Existing Markets
- Existing Knowledge/ New Markets
- New Knowledge/ New Markets

**SUCCESS RATE OF INNOVATION PROJECTS IN 2014**



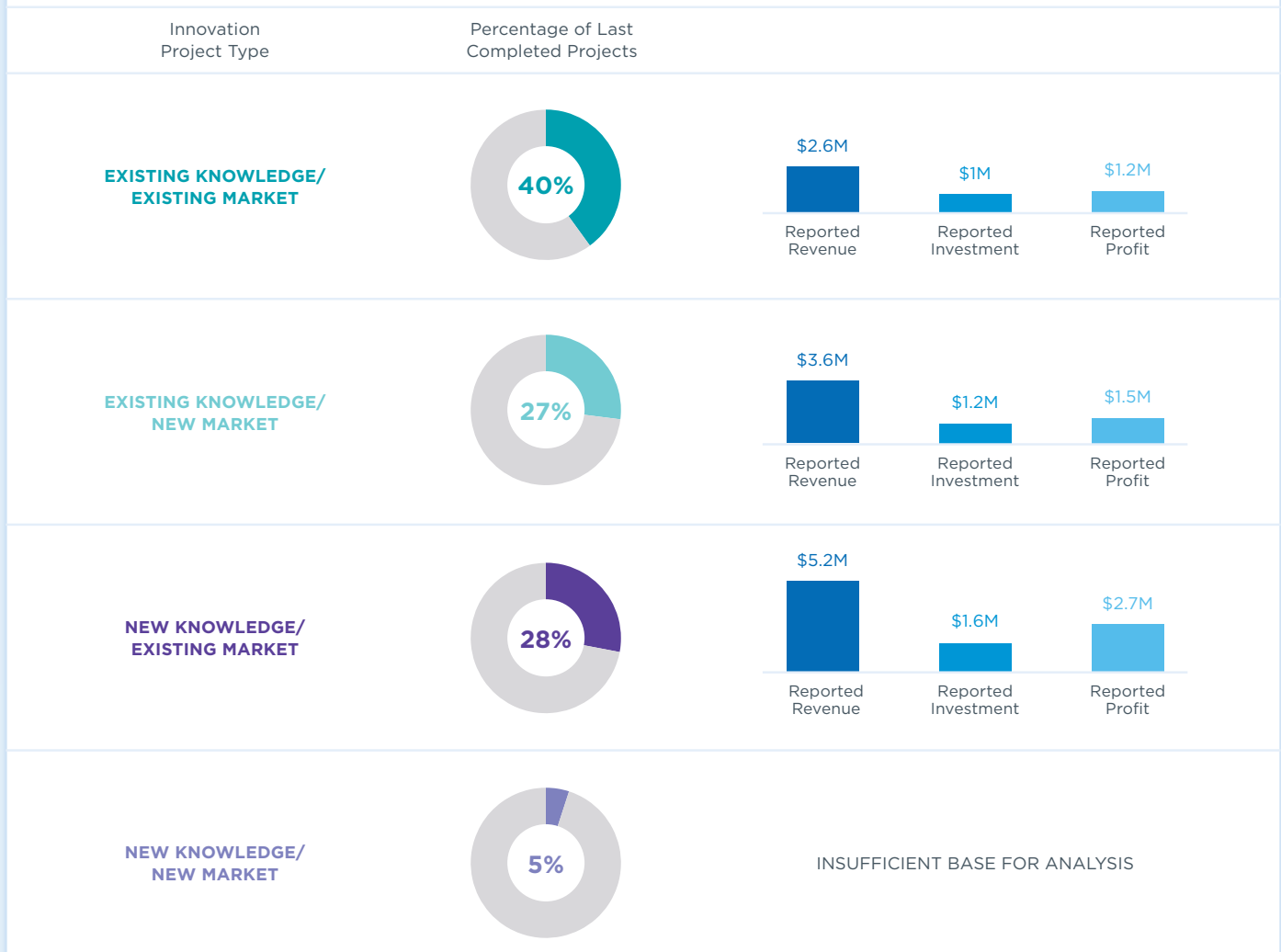
- Existing Knowledge/ Existing Markets
- New Knowledge/ Existing Markets
- Existing Knowledge/ New Markets
- New Knowledge/ New Markets

The portfolio level analysis conceals the performance consequences associated with investments in specific types of innovation projects. Innovation projects that explore new markets or (especially) develop new knowledge generate substantially more revenue, on average, than projects that apply existing knowledge to existing markets. The middle market companies in our sample whose last project conservatively applied existing knowledge to existing markets invested an average of \$1.0 million per project and generated revenue growth of \$2.6 million and profit of \$1.2 million. The middle market companies whose last project more speculatively attempted to apply new knowledge to existing markets invested on average \$1.6 million and generated \$5.2 million in revenue and profit of \$2.7 million. While there is greater dispersion in returns for these breakthrough-oriented projects, the ability to enter new markets or (more importantly) develop new knowledge that competitors cannot quickly imitate offers higher revenue growth and profitability.

So, what does all this mean for middle market firms? While middle market managers may wish to capture the greater revenue growth and profitability associated with entry into new markets or through the development of valuable new knowledge, they typically are unable to invest in a sufficient number of projects to mitigate the risk of explorative investments through simple portfolio diversification. Consequently, most middle market firms tend to invest in conservative project portfolios.

When looking at the middle market as a whole, the safer, better known innovation territory appears to be about as profitable as some of the further out initiatives, specifically those that target new markets. This may be because middle market firms that wish to avoid, or at least minimize risk, tend to watch carefully, invest cautiously, pick their shots, and succeed. In many cases, their prudence pays off.

### SUMMARY P&L OF LAST COMPLETED INNOVATION PROJECT



Note: Unreported expenses for things such as overhead are not accounted for in the difference between reported revenue and reported profit.

# Innovation Success: The Most Successful Innovators Bet More Boldly While Managing Risk Closely

Middle market firms that rank themselves most successful at innovation—and that are likely to be some of the fastest growing middle market firms—are much more likely than other middle market companies to venture into new domains and capture value when they do.

These companies not only invest more heavily in innovation efforts like R&D and ideation, they are also nearly twice as likely to direct that investment in the new knowledge/new market space as their counterparts. However, they are correspondingly less likely to invest in existing knowledge/existing market projects.

These more effective innovators report a significantly smaller percentage of their revenues and profits from close-in innovations as compared to their less innovative peers. At the same time, they see greater revenues and profits from their riskier endeavors—close to double as much as their colleagues (16% compared to 8% for revenues and 16% compared to 9% for profits).

Overall, these risk-taking companies enjoy considerably higher gains from innovation, perhaps because they combine greater risk-taking with more sophisticated risk management and careful alignment of innovation efforts with overall company strategy.

Specifically, the most effective innovators are much more likely than their peers to have formal processes in place for selecting, generating, and implementing ideas. They are also much more likely to involve senior managers in all phases of the innovation process, from ideation to development, approval, and execution. The best innovators include the CRDO, CMO, CIO, and CTO in innovation projects. These leaders are often closest to the end users and/or the technologies, bringing invaluable perspective to the table. Presumably, they are also tuned into the company's overall strategic direction and mission and can help ensure the company stays the course in terms of innovation initiatives.

Finally, open innovation plays an important role in the success of talented innovators, particularly in the implementation of ideas. In general, talented innovators include more outside sources in all areas of the innovation process. They are more inclined to talk to their suppliers and their customers and to contract with outside consultants.

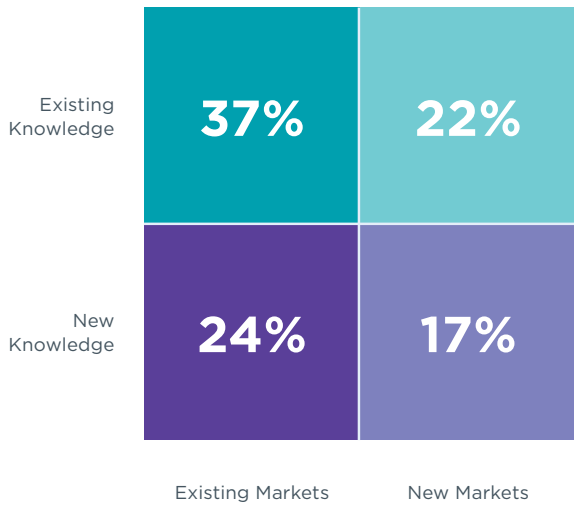
## INCLUSION OF OUTSIDE SOURCES IN THE INNOVATION PROCESS

		LESS EFFECTIVE INNOVATORS	TOP INNOVATORS
Supplier	Generate	3.9	4.9
	Select	3.4	4.8
	Implement	3.3	4.7
Consumer	Generate	4.0	5.0
	Select	3.7	4.9
	Implement	3.2	4.8
Consultants	Generate	3.0	3.8
	Select	3.0	3.9
	Implement	2.9	3.9
Crowdsourcing, Open Innovation	Generate	2.1	3.5
	Select	2.3	3.6
	Implement	2.0	3.5

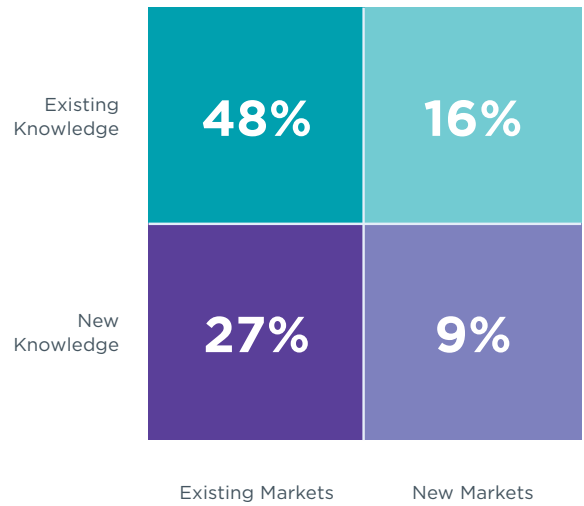
Note: Responses are based on a 1 - 5 scale



### ALLOCATION OF INNOVATION INVESTMENT FOR TOP INNOVATORS



### ALLOCATION OF INNOVATION INVESTMENT FOR LESS EFFECTIVE INNOVATORS



### PERCENTAGE OF INVESTMENT, REVENUE AND PROFIT BY TYPE OF PROJECT AND INNOVATOR

	EXISTING KNOWLEDGE/ EXISTING MARKETS		EXISTING KNOWLEDGE/ NEW MARKETS		NEW KNOWLEDGE/ EXISTING MARKETS		NEW KNOWLEDGE/ NEW MARKETS	
	TOP INNOVATORS	LESS EFFECTIVE INNOVATORS	TOP INNOVATORS	LESS EFFECTIVE INNOVATORS	TOP INNOVATORS	LESS EFFECTIVE INNOVATORS	TOP INNOVATORS	LESS EFFECTIVE INNOVATORS
Investment	37%	48%	22%	16%	24%	27%	17%	9%
Revenue	45%	54%	20%	16%	20%	22%	16%	8%
Profit	44%	55%	19%	16%	22%	20%	16%	9%

# Conclusion

## Whether You Play It Safe or Take Calculated Risks, Middle Market Innovation Leads to Success

The introduction of new ideas, products, services, processes, and practices is a critical driver of revenue growth and success among middle market firms. And middle market companies tend to be good and frequent innovators, regularly generating and implementing ideas and enjoying a respectable success rate and a healthy return on investment.

Interestingly, when it comes to how the middle market organizes for innovation and which practices are most effective, two distinct paths to innovation success appear to exist.

On one hand, many middle market firms choose a conservative approach to innovation. They pursue ideas that are close to home, leveraging existing knowledge and targeting known markets. They keep innovation in house, concentrating efforts among internal teams and senior leaders. For these firms, exercising caution and staying within their comfort zones doesn't cost them. On the contrary, these firms enjoy high project success rates and capture greater value by pursuing carefully chosen and more familiar territory.

Yet, while conservative innovation is both successful and profitable for many middle market businesses, the most capable innovators in the segment are finding success by venturing a little further from home. Middle market companies that do invest more heavily in new knowledge and

new markets are the most likely to rate themselves as highly effective innovators, and they are also most likely to enjoy rapid revenue growth. Like their peers, they rely heavily on internal teams and senior management support, but they are more apt to go beyond their four walls and seek outside assistance in all phases of innovation. They also tend to have more formal processes in place to better manage the risks they take.

These firms that judge themselves superior in terms of innovative management capabilities and/or are able to devote substantial top management time to the innovation process leverage their comparative advantages. They attempt to channel their presumed superior innovation management skills into investments in riskier and more lucrative projects. They benefit from innovation—largely because of superior capability.

The best innovation approach for your firm, then, likely comes down to your assessment of your firm's skills, risk appetite, and capabilities. If you're more inclined to gravitate toward a sure bet, never fear—you can innovate quite profitably by focusing on who and what you know. But if you have an appetite for a more adventurous portfolio and—potentially—more rewards, it is worthwhile to put in the effort to create more structure around your innovation approach. Either way, the research shows that you likely have teams of people and leaders already in place that can lead your firm to its next successful innovation and may pave the way to the growth and profitability you seek.

### HOW TOP INNOVATORS COMPARE TO THE OVERALL MIDDLE MARKET

	TOP INNOVATORS	OVERALL MIDDLE MARKET
Innovation Portfolio	More likely to invest in and profit from new/new innovation projects	Most likely to invest in and profit from known/known innovation projects
Open Innovation	More likely to include outside sources — including consultants and the “crowd”	Innovation is primarily accomplished in house
Formal Processes	Much more likely to have formal processes in place for generating, selecting, and implementing ideas	More than half have formal processes in place for generating, selecting, and implementing ideas
Senior Management Involvement	C-suite involvement is significantly greater and more likely to include the CFO, CMO, CIO, CTO, and CRDO	C-suite involvement is important and common

## Important Terms

### **INNOVATION**

The introduction of new ideas, products, services, and/or practices and processes that are intended to generate either economic or social value. Innovation activities include, but are not limited to, R&D. Innovations may be 'new to company,' or 'new to world.' (Note: we do not include purely aesthetic modification of products or services, such as color or style.)

### **NEW-TO-COMPANY INNOVATION**

A new product, service, or process introduced by a company. This product, service, or process may have already existed in other companies in the industry.

### **NEW-TO-WORLD INNOVATION**

A new product, service, or process that has been introduced by a company. This product, service, or process has never existed in any other company in the industry.

### **OPEN INNOVATION**

A paradigm that promotes the use of external ideas, knowledge, and paths to market along with internal sources in order to accelerate and advance the innovation process.

### **CROWDSOURCING**

The practices of soliciting ideas from a large and loosely defined group of external people, such as an online community.

### **INNOVATION PORTFOLIO**

A decision-making process that selects innovative ideas from multiple proposals and allocates resources to a selection of ideas with the purpose of maximizing the returns on the portfolio as a whole.

### **REAL OPTIONS LOGIC**

A method of evaluating investment opportunities, such as innovation projects, that applies to these decisions the same techniques used for putting a value on financial options.

### **STAGE GATE PROCESS**

A model for product innovation that breaks down the complex process into smaller stages (e.g, pre-development, development, and commercialization) and identifies key go and no-go decision points along the development path.



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