

INTUIT FUTURE OF SMALL BUSINESS REPORT

RESEARCH BRIEF: DEFINING SMALL BUSINESS INNOVATION

Small businesses are an important and growing driver of U.S. economic growth.

They employ about half of the nation's 144 million private sector workers. They create 60 to 80 percent of new private sector jobs. They generate more than \$6 trillion in annual revenue and create more than half of the country's non-farm gross domestic product.

Despite their influence and importance, relatively little is known about the specifics of how most types of small businesses innovate. Academic and business literature discuss and study innovation, but the majority of this research focuses on large corporations or small, high-growth technology firms.

To better understand small business innovation, Intuit, Emergent Research and the Institute for the Future organized a research project to identify, analyze and forecast the significant trends and forces affecting small business innovation. Over the next year, we will release a series of research briefs and memos presenting our findings.

This research brief – Defining Small Business Innovation – is the first in the series. It defines a small business innovation framework describing the drivers, enablers, amplifiers and outcomes of small business innovation.

Future research briefs and reports will explore small business innovation topics in more depth and include an outlook on the innovation trends that will affect small business over the next decade.

This study is part of the broader Intuit Future of Small Business project. This research and related materials are available at www.intuit.com/futureofsmallbusiness.

“Innovation is the specific tool of entrepreneurs, the means by which they exploit change as an opportunity for a different business or a different service.”

Peter Drucker
“Innovation and Entrepreneurship”

Today's turbulent and rapidly changing world magnifies the increasing importance of small business innovation. Drucker's words, written in 1985, carry even greater weight today. The intensity of economic and technological change means few businesses can succeed without continually incorporating new methods. Innovation, once optional for most small businesses, is now mandatory.

In the next decade, small businesses will embrace innovation even more broadly than they do today. Passionate owners with deep market knowledge and an entrepreneurial spirit will adopt new methods and business processes to increase productivity, grow their business and save time. They will take advantage of a wide range of new technologies to improve their products and services. And their agility will let them create new business models to seize new opportunities, improve their competitive position and provide more value to their customers.

In the shorter term, innovation will help small businesses and the U.S. economy through the current recession. Small businesses react quickly to changing economic conditions and their owners have a can-do attitude, enduring and even creating opportunity out of adversity. Despite the tough times, the vast majority of small business owners remain upbeat about their long-term business prospects. Intuit's Small Business United survey, conducted in December 2008, found that nearly 9 out of 10 small business owners see opportunities for their business despite the stagnant economy.

The following sections of this research brief discuss why and how small businesses use innovation to increase productivity, create new products and services, better serve their customers and improve their businesses.

THE INTUIT FUTURE OF SMALL BUSINESS SERIES

MARCH 2009

©2009 Intuit Future of Small Business. All rights reserved.

intuit

SMALL BUSINESSES ARE NATURAL INNOVATORS

Todd Watson, owner of pool servicing company Algae Busters, created a new business model using innovative financing options to help commercial customers afford new technology that improved pool cleanliness.

Chuck Siegel, of Charles Chocolates, created new cooling trays that tripled production using existing manufacturing facilities. The idea enabled him to fill new orders for specialty chocolates from a major retailer.

Cristy Clarke, the creator of the popular game TableTopics, was thinking of interesting conversation starters on her way to a party. She turned this idea into a successful game company.

Ask any of these business owners to describe their innovation, and they might seem perplexed. More than likely, they would tell you they had an idea, saw a way to do it better, recognized an opportunity, found a way to meet their customers' needs, or creatively solved a problem.

But in fact, each is an innovator, introducing a new product, idea, method or approach.

Innovation is common across the entire small business sector, regardless of size, industry or geographic location. Driven by their passion for their business, concern for their customers and nonstop market pressures, many small business owners innovate on a continuous basis to survive and thrive.

But rather than calling it innovation, they simply describe what they do and the results they're looking for. Words such as "tweak," "adjust," "improve" and "change" roll off their tongue. They talk about experimenting, improvising and trying new ideas. They describe their approaches to solving customer problems and finding new ways to do things. And they discuss the methods and approaches they use to improve their businesses, deliver new products and services, increase profits and save time.

Small businesses are active and natural innovators. Just because they don't see themselves in that light doesn't diminish the fact that they are innovators, or the importance of small business innovation to the U.S. economy.

DRIVERS OF SMALL BUSINESS INNOVATION

The word “innovation” invokes a picture of resource-rich lab settings. Science parks, university research teams and large corporate research and development budgets come to mind.

The reality of small business innovation is quite different. For small businesses, the market is the lab. Small business owners, managers and employees are the innovation specialists. And resources are scarce. Despite the constraints, or perhaps because of them, small business innovation thrives.

The drivers of small business innovation fall into three broad categories:

- **Necessity:** Small businesses operate in competitive and changing markets. Pressures to meet payroll, reduce prices and costs, provide customer value and respond to customer complaints are continuous. Competition is always a threat and resources are limited. Small business success often hinges on making constant changes and improvements in the business.
- **Opportunity:** Entrepreneurs are opportunistic by nature and small businesses are constantly looking for new ways to make money, save time, improve their processes and create more customer value. Because they are close to their customers, and have owners and decision makers that are closely involved, small businesses are well positioned to see and pursue new opportunities.
- **Ingenuity:** In his book, “Reality Check,” entrepreneur and venture capitalist Guy Kawasaki says if you want to be innovative, build something you need or want to use. Many small businesses spring from the desire for something that doesn’t exist. When that need is shared by millions, these businesses could join the ranks of larger success stories. Gatorade was created to rehydrate football players. eBay began as a way to make money by selling garage clutter. Both met an individual need that had much broader implications.

Small businesses innovate both reactively and proactively. They innovate reactively in response to customer, market and competitive pressures. But they are also proactive innovators, scanning for and acting on new business opportunities. Interestingly, small businesses blend the two processes by reacting to a need but often creating something bigger and better – or altogether different – than what is needed to oil a squeaky wheel in the marketplace.

Responding to the market and pursuing new opportunities, small businesses often refine and tweak their businesses. With no large corporate fortress separating them from the marketplace – and no silos impeding their ability to hear and respond to the market – small businesses rely on an almost instinctive muscle memory approach toward innovation to survive and thrive. Their internal makeup lends to their success.

VOICES OF SMALL BUSINESS:

HipBubs was formed out of a basic need – we, as parents, were frustrated with the same old choices in kids’ clothes ... So we created a line of clothes that capture a child’s imagination through playful and hip images.

HipBubs

We saw an opportunity to offer a versatile product in a unique way and we took the plunge.

Bottle Your Brand

As long as I keep a practical ear open to my customers’ needs, I keep growing and growing.

The Secret Cellar

The idea for my small business dawned on me while riding on the back of my husband’s motorcycle through the hills of southern Illinois. Biker Bling was born.

Biker Bling

Focus on your passions.
Listen to your audience.
Make a difference.

BlankSpaces

Through listening, thinking
and responding – you can
find opportunities, even in a
slow economy.

Coffee News

Don't be afraid of failing – if
you never fail, then you have
never tried.

uTipu

The ability to adapt was the
key to our success.

Rolling Thunder Productions

Adversity is an opportunity
to strengthen your ideas and
creatively problem solve.

Sogno Productions

ENABLERS OF SMALL BUSINESS INNOVATION

Small businesses share a number of characteristics that enable their ability to innovate and provide competitive advantage relative to large corporations. They are also affected by innovation amplifiers, which are factors that augment the ability to innovate and the success of their innovation. Each is discussed below.

Innovation is in Small Business DNA

Because of their size, business agility and deep customer understanding, small businesses have several inherent innovation advantages over large corporations. They can more readily identify opportunities, quickly react to changing market and industry conditions, and nimbly compete with bigger competitors. Small business innovation enablers include:

Personal passion: Entrepreneurs often start small businesses based on their passion for a hobby or business, or to live out a dream. Often wearing many hats, from receptionist to CEO, their personal stake and enthusiasm for their ideas makes them willing to try new business approaches to make their business more successful.

Customer connection: Because of their close customer relationships and deep market understanding, small businesses can anticipate customer needs, identify new opportunities and fix problems quickly and efficiently. This deep and direct market involvement creates many more innovation opportunities.

Agility and adaptation: Unlike large corporations, small businesses can quickly and easily adapt their business practices, change course or even pursue entirely new direction. Because of this agility, innovation takes fewer resources and is easier to implement than for larger corporations.

Experimentation and improvisation: When pursuing new opportunities, many small business owners and managers aren't afraid to experiment and improvise, accepting failure as part of the path to success. They see the rewards and the risks associated with potential innovations. Rather than avoiding all risk, small businesses will try new solutions, address setbacks and move forward to attain future rewards.

Resource limitations: Small businesses are adept at doing more with less. And these resource constraints lend to their innovative mindset. With small staffs and often fewer dollars, small businesses are forced to focus on high-impact or low-cost innovation efforts, or both. Successful small businesses use their resources effectively.

Information sharing and collaboration: Small businesses traditionally rely on strong social networks – trade associations, the Rotary Club, chambers of commerce and extended friends and family – to share information and inspire innovative thinking. These networks provide feedback on ideas, input on solutions and assistance when resources are scarce.

These enablers combine to make innovation less risky for small businesses than large corporations. Because of their smaller scale, small businesses can experiment with and implement new approaches faster, easier and cheaper than large corporations. And unhindered by a decision-making bureaucracy and remote decision makers, small businesses can move much more quickly on innovation opportunities.

Small Business Innovation Amplifiers

Multiple factors affect small business innovation in positive and negative ways. Improvements in technology, an organization's culture, better information and access to capital can all increase, improve and amplify small business innovation efforts. These factors also make it easier for small businesses to enter more markets and industries, and to compete successfully with larger organizations.

Government regulation can both help and hinder small business innovation. In the U.S., the current trend toward increased government regulation and involvement in the economy requires officials to remain vigilant on improving, and not harming, small business innovation.

TECHNOLOGY INCREASES INNOVATION OPPORTUNITIES

Technology is leveling the small business playing field. Today's entrepreneurs are using technology that, just a few years ago, was the exclusive property of large enterprises. As technology becomes cheaper, more powerful and more accessible, the costs of starting and operating a business decrease, while the opportunities for small business innovation increase.

The growth of the Internet, broadband networks, social networking software and mobile computing are obvious examples of this trend (see the second installment of the Intuit Future of Small Business Report, *Technology Trends and Small Business*).

Technology also enhances small business innovation opportunities in manufacturing, logistics, customer service, finance and almost every other business activity. The tools and technology to do everything from creating products to supporting customers have become cheaper and easier to use (see the third installment of the Intuit Future of Small Business Report, *The New Artisan Economy*).

Don't ever be afraid to think outside the box. Unique problems are only solved by unique solutions, which require unique ways of thinking.

Prairie Wildlife Research

Follow your dreams... and make sure you have a good Web site!

Psychedelic Creations

We invested in the latest technology because the Internet is one of the most powerful ways to reach a vast and diverse constituency of underserved populations.

Mad To Live

It's also important to build a strong culture with your employees and clients. That way you will attract like-minded individuals.

Alchemy Hair Salon

Knowledge is a powerful business tool. Go after new opportunities to learn and expand on the knowledge you already have.

Bliss Plaza

Be guided by the things you love about your business; it's critical to your success. But be sure to build on that foundation with solid business skills and practices that will let you do what you love, and do it profitably, for as long as you'd like.

Fairy Godmother

BUSINESS CULTURE INFLUENCES INNOVATION

While many small business owners are natural innovators, there is a wide range in their interest and ability to innovate. Some are resistant to change and unwilling to try new ideas, approaches or methods. As with all organizations, leadership has an enormous effect on small business culture and their willingness to innovate.

Business leaders define culture, and leadership is about dealing with change. The way small business owners embrace and manage change determines their willingness, or lack of willingness, to innovate. Leaders can adjust the organization's goals, style, pace and behaviors to either increase the pace of innovation or to impede it.

Most highly innovative companies, large and small, have a culture that values risk taking, experimentation and a willingness to try new ideas. The leaders at successful, innovative small businesses understand, encourage and reward behavior that increases innovation.

Changing the culture of any organization is not easy, but it's possible to instill an innovative spirit in small businesses that have resisted it in the past. Their leaders need to embrace innovation opportunities and actively encourage open employee dialog and new ideas. Information sharing, open collaboration and innovation training can help, but in the end, the leaders' influence will have the most impact on a business's innovation effectiveness.

KNOWLEDGE IS POWER

The ability to innovate successfully also hinges on having the right information about customers and markets, and the methods and skills to act on that information.

Today's online world provides rich and broad sources of innovation information. Online small business communities and social media tools, such as blogs, wikis and Twitter, greatly expand peer networking opportunities and provide small businesses with a diverse pool of knowledge. It's easy to tap into best practices from a range of industries and geographies.

Online interaction makes it much easier to stay close to customers, and more effectively spot opportunities and problems. Going further, inexpensive online innovation education and training is available 24/7, accessible when and where it is needed.

In addition, more formal training on innovation methods, skills and approaches is becoming more broadly available and useful. Universities are adding innovation and entrepreneurship programs to their curricula, and the number of innovation seminars and training programs from government agencies and private firms has grown substantially over the last decade.

CAPITAL ENERGIZES SMALL BUSINESS INNOVATION

Small businesses often rely on credit – bank loans, home equity credit lines or credit cards, for example – to maintain cash flows, support inventory levels and pay employees during seasonal or slow revenue cycles. They also use credit to purchase buildings, equipment or other business expansion. Without access to credit, many small businesses cannot pursue new opportunities or invest in new ideas, methods or markets. Credit greases the skids of small business innovation.

Venture capital also plays a key role in small business innovation. Although less than 1 percent of all companies that are started each year in the U.S. are backed by venture capital, they tend to be fast growing and extremely innovative. They get funded because investors expect them to build large and successful businesses by creating innovative new products and services. Almost all the famous technology firms, such as Google, eBay and Intel, received venture capital in their infancy. And the trend continues: In 2008 alone, venture capital firms invested over \$28 billion in startups, according to the National Venture Capital Association.

Research and development spending by government agencies, universities and other research firms is an indirect source of capital for small business. State, local, university and private incubator programs also reduce small business capital requirements by providing low-cost and shared services and support. The ability to build upon outside research lowers small business capital costs and provides relatively inexpensive access to new ideas, methods, products and business opportunities.

THE REGULATORY ENVIRONMENT AFFECTS SMALL BUSINESS INNOVATION

Government regulatory policies can spur small business innovation. Innovation-friendly and transparent regulation can encourage new business formation. Tax policy can stimulate and reward research, development and commercialization of new technologies, products and methods. And government-supported innovation and business training can help small businesses be more effective innovators.

Conversely, complex rules, laws and regulations make compliance difficult and innovation risky. Regulations can hinder companies of any size, but reporting requirements are often much more burdensome for small businesses than large corporations. In the U.S., for example, firms with fewer than 20 employees face regulatory costs in excess of \$7,000 per year per employee, the Small Business Administration estimates. In other countries, the costs can be even higher.

With a sound business plan and a firm belief in yourself, there are always ways to find the money you need to keep your business running.

Marx Parts

Spend some quality time with an accountant to get familiar with all of the state and federal requirements of doing business before you start.

Second Chance

When dealing with a municipal official, always ask to have the answer in writing and always ask for a business card for your records. Don't forget to laugh!

Clayton Design Services

Business Model Innovation: A Special Case

Business model innovation refers to taking a new approach to a business. Targeting new customers, changing what is offered, or redefining how an offering is provided are all examples of business model innovation, which can be market-sustaining or market-changing. While this sounds simple, successful business model innovation requires identifying new, previously uncovered opportunities and changing how a firm operates.

Large corporations often struggle with business model innovation. Clayton Christiansen, in his book, "The Innovator's Dilemma," found that almost all disruptive business model innovation comes from new industry entrants, and not existing industry participants. Corporate bureaucracy, aversion to risk and entrenched ways of doing business makes it hard to identify and pursue business model innovation.

Small businesses, however, tend to be much more opportunistic about business model innovation. With few management layers and involved, market-savvy owners, bureaucracy rarely gets in the way. And because of their smaller size, business model experimentation and change is easier and less risky for small businesses.

We will discuss the use of business model innovation by small businesses in more detail in future research.

INNOVATION OUTCOMES

Entrepreneurs have the ability to innovate their way into new markets and new opportunities by rethinking their business and reworking how they approach the marketplace. By creatively applying their resources and skills to address a need, an opportunity, or a desire to make something better, small business owners bring about change. Their goal: to grow their business, improve their lifestyle or enhance their community.

Innovation can occur in all aspects of business. We see it in how they interact with customers, produce their goods, structure their organization, and manage their employees. These innovative solutions can be as broad as the major redesign of a production system, product or business model, or as focused as ongoing refinements that improve and strengthen relationships with customers and suppliers.

Both levels of innovation add value to a small business. They enable companies to provide higher quality, increased customer value or improved goods and services. Innovation also can increase profitability and allow small businesses to accomplish more with less effort, time and expense.

Innovation not only improves the business and potentially the lifestyles of those working there, but it can affect the structure of the marketplace as well. Our research revealed two types of market outcomes resulting from small business innovation: market-sustaining and market-changing. In addition to measuring the effect of innovation on the business itself, it is important to gauge the magnitude of change resulting in the marketplace overall.

Magnitude of Small Business Innovation

MARKET-SUSTAINING

Market-sustaining innovations are improvements to existing products or business processes. Also referred to as incremental or sustaining innovations, these are the ongoing refinements to products and processes that most businesses regularly churn out to improve productivity and financial performance, increase customer satisfaction and save time. Most market-sustaining innovations aim to add value without making significant product or business changes or requiring large investments.

Market-sustaining innovation is the most common form of innovation. In their book, "Making Innovation Work," authors Marc Epstein and Robert Shelton say it generally comprises more than 80 percent of a firm's innovation efforts. It is also important to the ongoing success of a firm. Many management methods and techniques (total quality control, Six Sigma, business process re-engineering and employee reviews) are designed to improve performance through incremental innovation.

Many entrepreneurs start small businesses because they see an opportunity to make money through a market-sustaining or incremental innovation. “I can do this better,” and not “I can create something totally new,” is their starting point. They are natural, continuous incremental innovators who are constantly re-evaluating, redesigning and refining all aspects of their businesses.

MARKET-CHANGING

Market-changing innovation, as its name implies, shifts the competitive landscape of an industry through some fundamental product, technology or business model change. Also referred to as radical or disruptive innovation, it rewrites industry rules and overturns widely accepted industry practices. Market-changing innovation is rare, but because it changes the industry landscape, it is very visible.

There are many famous examples of small businesses growing into large corporations through the use of disruptive innovation. Southwest Airlines, Dell Computers, Charles Schwab, Nucor Steel, Amazon and Google are all examples of small businesses that used disruptive, market-changing innovation to become industry leaders.

But small business use of market-changing innovation is not limited to breakthrough companies that become large corporations. Many market-changing small businesses disrupt on a smaller scale or local level, or choose to stay small. The owners of Algae Busters, for example, could grow their business substantially because of their market-changing use of technology. But they choose to stay small for lifestyle reasons.

We found many examples of small businesses changing the market on a local or small-scale basis. In particular, small businesses are increasingly applying technology in ways that create substantial competitive advantage and change the market for their goods and services.

Summary

Innovation will be mandatory for small businesses over the next decade as they survive and thrive by seizing new opportunities, improving their competitive position, and providing more value to their customers.

Small businesses are up to the challenge. They are natural and continuous innovators. Small business innovation takes the form of smaller incremental or market-sustaining changes as well as business model shifts and even market-changing innovation. These innovations result in improved products and services, better business processes, increased customer value and stronger financial results.

Most small business innovation focuses on the commercialization of new ideas, methods and processes and not patentable, scientific research. Because of this, the impact of small business innovation is often overlooked. But despite being silent innovators, small business success hinges on innovation and is an important driver of economic growth.

ABOUT THE AUTHORS

Steve King and Carolyn Ockels are partners at Emergent Research, senior fellows at the Society for New Communications Research and research affiliates at the Institute for the Future. They are co-authors of the Intuit Future of Small Business Report™ Series. Emergent Research is a research and consulting firm that identifies, analyzes and forecasts the trends and forces impacting small businesses and their role in the global economy.

ACKNOWLEDGMENTS

We acknowledge and thank the many small business owners, entrepreneurs, and small business and innovation experts who shared their insights with us.

We thank the hundreds of small business owners who shared their stories as part of Intuit's Small Business United (www.smallbusinessunited.com) campaign. This collection of user submitted stories provided a broad set of small business innovation examples. The side quotes in the report are taken from these stories.

We especially thank the following people, who not only shared their insights, but also took time out of their busy schedule to participate in an expert workshop on small business innovation:

Anita Campbell
Publisher and CEO
Small Business Trends
www.smallbiztrends.com

Todd Watson
Owner
Algae Busters
www.algaebusters.com

Andrew Waldeck
Partner
Innosight Consulting
www.innosight.com

Robin Joy
Marketing Director
Intuit
www.intuit.com

Cesar Castro
Research Director
Institute for the Future
www.iftf.org

Breck Yunits
Entrepreneur
www.breckyunits.com