

Creativity Pays. Here's How Much

So you're one of the 25 Most Innovative Companies in the world, but what about the bottom line? Does innovation really deliver? You bet. More than half of the Top 25 with histories as public companies scored big, with better profit margins and higher stock prices over the past decade.

How big? The innovators achieved median profit margin growth of 3.4% a year since 1995, compared with 0.4% for the median Standard & Poor's (MHP) Global 1200 company. That's a huge achievement, thanks in large part to innovation. And the group's median annual stock return of 14.3% was a full three points better than the S&P 1200 median over the decade, according to a study done for *BusinessWeek* (MHP) by The Boston Consulting Group using data from Standard & Poor's Compustat.

"Innovation is allowing companies to grow faster [and] have a richer product mix," says James P. Andrew, who heads BCG's innovation practice. Many companies could use the encouragement to push for it: Some 48% of businesses surveyed by BCG said they were dissatisfied with their returns on investment from innovation.

Target (TGT), Starbucks (SBUX), Procter & Gamble (PG), and Microsoft (MSFT) especially stand out for raising their profit margins and being rewarded by the stock market. Target Stores Inc.'s operating margin (earnings before interest and taxes as a percentage of revenues) doubled over the 10-year period, reflecting the discount retailer's skill in positioning itself as a hip alternative to Wal-Mart (WMT) Stores Inc. with designer brands such as Isaac Mizrahi apparel and Michael Graves housewares. Target's stock performance was half again better than Wal-Mart's, another top innovator.

Starbucks Corp. presses for new ways to sell more than caffeine from its coffee shops. Its operating margin is up to 11.1%, from 9.1% in 2002, a level that had been fairly steady for the previous seven years. Starbucks shares delivered total returns of some 28% a year, nearly three times the S&P 1200's median of 11.1%. Procter & Gamble Co. shifted its product portfolio to higher-margin beauty and health-care businesses. Its operating margins are up to 19.3%, from 12.5%.

Microsoft Corp.'s profit margins rose to nearly 41.8%, from 34.3% in 1995. Its critics would attribute the gain to Microsoft's monopoly-like power. But the company does direct substantial R&D toward enhancing software. The effort makes its upgrades more compelling and helps protect its fat margins. One example: ClearType, which produces higher resolution of text in Windows XP.

Of course, innovation does not always deliver products and profits in a steady stream. Consider Apple Computer Corp. Even in its darkest money-losing days of the mid-1990s, it was the innovation leader in the computer industry. But only after co-founder and CEO Steven P. Jobs returned in 1997 and focused Apple's scattered efforts on key products did the company begin to prosper. In fact, Apple lost money three times in the past decade, including in fiscal 2001, which ended the month before Jobs unveiled the first iPod. Last year, Apple posted operating margins of 11.8%, nearly double the 6% of 1995.

Sony (SNE) Corp. shows a different picture. Its fall in the innovation rankings in '06 may reflect eroding margins. Sony's operating margins have steadily declined from 7.7% in 1998 to 1.6% in 2005. And its stock has limped along, returning just 5.1% annually over 10 years.

Sometimes the fruits of innovation are hidden by other factors. At Samsung Electronics Ltd., operating margins tend to oscillate between 21% and 7% with the ups and downs of the

semiconductor cycle. Samsung's latest reported margins, 14.3%, are two-thirds of 1995's. Yet the company has made innovation key in its drive to cut development time and improve value for customers. That's one reason Samsung still makes good money even when industry growth slows. Samsung Electronics' shares have returned an annualized 22.7% for the last 10 years, according to BCG.

IBM ([IBM](#)), too, has continued to be a strong innovator over the last decade even as its operating margins have remained essentially flat. The company produces more patents than any other company in the world, coming up with new chip designs, semiconductor manufacturing processes, and computer design. IBM has aggressively used innovation to stabilize its margins in the face of price-cutting competitors, such as Dell ([DELL](#)) Inc.

Even when the benefits of innovation clearly reach the bottom line, it may take a while for gains to benefit stockholders. 3M Co. ([MMM](#)) and Toyota Motor ([TM](#)) Corp., for example, have delivered perhaps the most consistent improvements in operating margins, yet their stocks have been mediocre. Maybe it's time for the stock market to reward their innovation.