WHEN TO VENTURE INTO CORPORATE VENTURE

A FRAMEWORK FOR THINKING ABOUT CORPORATE INVESTING

PREPARED BY
Will Dai T'19
Lindsey Wilcox T'19
CVC IN 2018

Corporate Venture Capital (CVC) reached all-time highs in 2018. CVCs participated in $53B of funding across nearly 3,000 deals, a 47% increase in total capital invested and a 32% increase in deals completed year over year. CVCs participated in 23% of all VC deals, led by tech industry stalwarts GV, Salesforce Ventures, Intel Capital, and Baidu Ventures. CVC deals have also gotten more expensive: the average VC-baked deal size in 2018 reached an all-time high of $21.8M. Deals that included a corporate arm were 20% more expensive, averaging $26.3M.

In this market context, as legacy industries scramble to maintain pace with new entrants and tech companies search for sound capital placements, it’s no surprise that 2018 saw a 35% jump in the number of global CVC players. New funds, including Coinbase Ventures, Maersk Growth, and Porsche Ventures, emerged in a frothy market with record-high price tags. However, the market failures in the early 2000s demonstrated that not every corporation is able and willing to fund a venture program.

Fundamentally, CVC leaders must clearly define their organization’s goals and set an appropriate structure to succeed.

Unlike traditional VC, which follows a consistent, returns-driven thesis and independent MD/investor organization, CVC diverges in response to varying investment objectives. This whitepaper will address the considerations for each of these decisions along with other critical components, including market differentiation, functional metrics, and time horizons.
The corporate venture arm must exist for a reason
Managers must first understand their sector and market position to set appropriate goals
Investment strategy must balance market maturity with risk tolerance

Internal alignment and structure are paramount
Different investment strategies require different talent
Talent and/or the corporation must flex as the venture arm matures
Metrics differ substantially from traditional VC

The CEO must build a culture of entrepreneurship and ensure that the corporation is educated about venture
Long-term focus can’t be held to corporate standards
Short-term down-cycles shouldn’t distract from 8-10 year innovation goals
INVESTMENT CATEGORIES

SURVIVAL
Companies in mature industries with low risk tolerance (due to strategic, financial, or other constraints) are finding themselves increasingly displaced by new challengers. Investment arms in legacy companies may emphasize survival – maintaining a core position while understanding how to keep up with upstarts.

MOONSHOT
Companies in mature industries with the ability to take substantial risk are looking to maintain relevance and earn an outsized winning position in the future.

EQUALIZER
Companies in emerging industries with low risk tolerance cannot afford to compromise their core position yet are still incentivized to maintain innovation pace with current and future competitors.

LEAP FROG
Companies in emerging industries with a high risk tolerance look for the ability to jump competitors for market share in the race to market maturity.
All venture objectives lie on a financial – strategic spectrum. Ensuring that the venture organization isn’t a consistent loss center is a necessary quotient to a venture arm, but the corporation often lacks the experience and talent to make investments for pure financial returns. To do so successfully, the venture arm must be willing to endure the long return horizons of VC, the opportunity cost of investing that capital elsewhere, and the availability of capital for this type of investment; it is questionable as to whether venture investing is in the best interest of the limited partners.

In most cases, strategic investments are the most appropriate for a corporate venture, whether they be outsourced research and development or broader ecosystem facilitation. Internally focused firms tend to require that the investment arm earn business unit sign-off for an investment above a certain monetary threshold. While this process is designed to ensure that investments directly serve to benefit the business, it does handicap an investor from taking a riskier position.

There is a trade-off between business buy-in and operational support and the potential for outsized innovation impact.

As venture arms mature, there is a common shift towards independence from the greater corporation. Based on investment objectives and structural processes, different venture arms lie on the spectrum between these factors to achieve strategic and structural alignment (see figure below).
INVESTMENT OBJECTIVES

SAFE BET

- When investors are required to get business unit sign off for an investment and the financials are attractive, it’s a safe bet. However, the involvement of multiple parties often slows the investment process and handicaps the investor from taking riskier (and potentially higher-return) positions.

COMPLEMENTOR

While not financially focused, this type of investment has a strategic impetus for a business unit. Again, the investment process is slow, but the investor has a broader range of potential deals.

RETURNER

This quadrant represents a “traditional” investor: deals are focused solely on returns.

INNOVATOR

Investment objectives in this quadrant allow the investor the most flexibility: they operate independently of the business and are not constrained by financial metrics. Rather, strategic development of the ecosystem is generally the focus.
TALENT AND INCENTIVE STRUCTURES MUST MATCH INVESTMENT STRATEGY

SAFE BETS & COMPLEMENTORS

- Top performing internal hires
- Tenure: supporting closer business unit partnerships
- Compensation: salary aligned with bonus structure

Talent retention and recruiting are essential for Safe Bet and Complementor investment objectives. Top performing internal hires from execution units may be the most effective; these employees are familiar with the product, business, and markets and will quickly understand and spot the most strategically positive investments. Additionally, their tenure at the company will better support the close partnership required with a business unit for investment sign-off. The investor must be innovative while still maintaining a close relationship with the existing business. Cultural competency for navigating the necessary internal discussions is critical. Unlike traditional investors, business unit focused investors are generally compensated with a salary typical in the business, depending on their seniority and skill.

RETURNERS & INNOVATORS

- More traditional investor: moves more quickly and takes riskier positions
- Not subject to business cycles and buy-in
- Compensation: traditional carry

Returner and Innovator strategies require a more traditional investor. This person works much more independently, allowing them to move more quickly and take riskier positions. While good investors may be found internally, investing in external talent may be the quickest and surest way to ensure success. Effective investing, especially at the early stage, requires a developed and curated network for sourcing and diligence. Internal talent tends not to bring this asset to the role, whereas an experienced and well-connected investor brings a personal brand and can immediately identify critical players in the ecosystem for access to the most promising deals. To recruit and retain the best investors, the company must be willing to shift to a more traditional carry structure.
Often, initial corporate venture investments are Safe Bets (1). With business unit support and a clear financial outlook, there is little risk at the outset. As the venture arm becomes more successful and focused, they tend to move right into the Complementor quadrant (2); business unit support demonstrates the clear signal of intended success and investors are given the freedom to look more broadly at the strategic ecosystem.

Ultimately, the most successful venture arms focus on Innovators (3). These firms provide their investors with flexibility and outcomes are focused on strategic goals. Few CVCs emphasize pure Returner investments. Depending on the firm’s market position, maturity, and strategic objectives, along with a number of internal factors, the firm may move quickly through this investment objective lifecycle or skip steps entirely.
As venture arms mature and grow, strategies may begin to diverge based on investor practice, industry trends, and previous successes. Often, companies solve for this disparate focus by splitting a single arm into multiple investing units, each with different objectives. If executed properly, this organizational shift allows for investor focus on core positions and metrics while providing the firm with optionality across deal size, strategy, and round. However, it can also lead to organizational chaos; resources may be allocated haphazardly and lines across units may blur. A corporation should support multiple units only in the case of clear, concise, and mutually exclusive investment strategies and market focuses.

If executed well, a multi-grouped investment strategy can provide network effects that traditional VCs can’t reproduce. Through its multiple, divergently-focused arms, Samsung can build its own ecosystem of growth and product demand (see chart below). Google Ventures’ 2015 split into GV, CapitalG, and Gradient Ventures is another example of focused stage and siloed investing at scale.

Ultimately, when considering the launch of a venture arm, a leader must consider the long-term goals of the arm and why it is the best route for achieving those goals. If goals are unclear or a more direct or cost-effective route is available, a venture arm will likely become a non-viable resource drain.
STORIES OF STRUCTURAL SUCCESS

When incentives and strategy are aligned properly, corporate venture firms are much more likely to find success.

Intel Capital: a venture talent builder

Intel Capital is one of CVC’s posterchildren for longevity and success through multiple cycles. Created in 1991, Intel Capital has invested $12.4B across 1,544 companies in 57 countries.[1] It was the most active CVC in 2015 and 2016 and second-most active (behind GV) in 2014 and 2017.[2] Its strategic focus is investments that stimulate demand for its core offerings, a sort of “complementarity.” Within this, each investment must receive business-unit support and sign-off.

In this case, talent is required to flex in order to maximize earnings and investment independence potential. While this structure limits its talent, its clear strategic partnership with the greater organization maintains stability and organizational cohesion.

As of yet, questions linger around this structure’s repeatability. Despite constant talent turnover, the firm is consistently successful and while it doesn’t disclose discreet financial results, 2018 was another fruitful year: four of its portfolio companies IPO’ed and 14 were acquired. The talent market is competitive and the company’s willingness to sacrifice its human assets to maintain operational cohesion is rare in the industry.

STRATEGY: maintain business connection, lose talent
Value drivers: SAP to Sapphire: investors want room

In 1996, SAP launched SAP Ventures as a wholly-owned entity of SAP SE. In 2011, SAP Ventures split from SAP and in 2014 it rebranded as Sapphire Ventures to reinforce its independence and venture prominence. Much like Intel, Sapphire is a cornerstone brand in CVC. The firm boasts $2.5B+ AUM with 20 IPOs, 30+ M&As, and a portfolio of over 50 high-growth technology companies. Since its spin-out, Sapphire has launched Sapphire Partners, an independent LP, and Sapphire Sport, a $115 fund focused solely on sports tech.

Sapphire is an example of the parent firm’s willingness to flex in order to support its talent. While SAP remains a key LP for Sapphire, the investment team has complete autonomy in its investments. Naturally, investments are focused in the technology sector, but no SAP business unit support is required for an investment. This model allows Sapphire to more quickly and nimbly invest and support its portfolio companies according to market need and investor expertise.

This structural evolution appears to be the most repeated in the market. As investors become more experienced, they desire an increasing amount of investment freedom and traditional venture compensation. Rather than lose the talent, companies are willing to spin out venture arms in order to maintain the strategic ecosystem benefits and financial returns. Ultimately, the ecosystem access that venture provides is too valuable and the risk of talent turnover is too great to be shut down, so independent arms are created to remove the incentive battle with the parent organization.

Similar companies operating with this model include Scale Venture Partners (formerly BA Venture Partners, the venture arm of Bank of America) and CVC Ventures (the venture arm of Citigroup). As of spring 2019, corporate giant GE is expected to spin out GE Ventures into a separate entity.

**STRATEGY:**
lose business control, retain talent and value
Xerox started XTV in 1988 with $30M to monetize the peripheral technology created in its research labs. It was modeled much like an independent firm: principals could act quickly on decisions, were allowed to invest up to $2M autonomously, and were measured on ROI. Between 1988 and 1996, XTV invested in over 12 companies and involved outside VCs to help scale its portfolio and reach a broader market.

XTV was a stunning financial success. It netted capital gains of $291M on the initial $30M investment, a remarkable IRR of 56%. However, Xerox scrapped XTV in 1996 in favor of Xerox New Enterprises, which shifted control internally; XNE removed investor independence, structured compensation in a traditional corporate manner, and did not permit outside investor participation.

Despite its success, XTV fell victim to internal misalignment. The VC compensation structure favored XTV’s executives, creating tension with corporate line managers. Many employees outside of XTV believed that the venture group succeed at the expense of other units – top technologies within PARC (Xerox’s famous Palo Alto Research Center) were “stolen” by XTV, rather than promoted for internal use. The company’s unwillingness to lay the initial foundation for success – by moving the venture group wholly in-house or providing the investors with complete flexibility – created an atmosphere of competition for internal resources, ultimately dooming XTV.

Strategy: neither side willing to flex, no path for shared success
AT&T Ventures was founded in 1991 as the CVC arm of AT&T. It was an independent venture firm capitalized by AT&T created to nurture and commercialize Bell Labs Technology (much like XTV’s purpose with PARC technologies). The firm was active in the mid-90’s and invested $350M across numerous telecommunications technologies. By 1999, the firm had returned $1.2B to AT&T. Much of the investing activity was led by Brad Burnham, the founder of Union Square Ventures, one of the top returning VCs in the world.

In 1997, AT&T provided Juniper Networks with $22M (of note, Juniper reached a near $10B valuation in May, 2019).[1] In an effort to test and deploy the routers, Burnham attempted to implement the Juniper technology through AT&T’s network. However, the then-President of AT&T Network Services, Frank Ianna, declined the proposal. As it stood, incumbent Cisco could afford to provide AT&T with a nearly 60% cash discount in network services. For Ianna, who was measured on EBITDA performance, the decision to remain with Cisco was simple. Juniper couldn’t afford to provide such cash discounts; instead, they offered warrants, which lacked immediate, measurable value for Ianna.

Line managers and executives rarely get credit for balance sheet appreciation (as Ianna would have had incentives been aligned for long-term corporate development). In this scenario, the misalignment of incentives clouded corporate judgement as to the potential for corporate synergy creation. Ultimately, a series of management changes in 1999 led to a restructuring of the venture arm and the corporation took over all investing activity. It chose to go long on the $1.2B before the internet bubble burst and was sold in 2015. AT&T now partners with a third party venture firm for all investing activity.

Strategy: firm unwilling to flex on incentives, destroyed value potential
Venture partners’ narrow scope yet carry-structured compensation creates tension within the organization.

Neither venture partners nor line managers are compensated for innovative investments and long-term synergy creation.
As with traditional VCs, the most objective measure of CVC success is financial return. In the fully autonomous model, performance and compensation are primarily based on return, providing attractive economics for investor talent. Because insights about what makes companies successful are eventually observable to the market, returns are good leading indicators of strategic relevance as well.

In addition to returns, corporate parents with other strategic goals for their CVC arms will want to establish and measure quantifiable KPIs against these goals explicitly to effectively track progress and appropriately incentivize fund managers.

At a session on Measuring Strategic Value at the 2018 Global Corporate Venturing & Innovation Summit (GCVI) in Monterey, a survey of the audience identified top 5 strategic priorities for CVC. Each of these goals can then be translated into measurable KPIs. David Horowitz, CEO of Touchdown VC, who led the session, pointed to several potential KPIs for each goal:

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<th>METRICS</th>
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<td>COMMERCIAL RELATIONSHIPS</td>
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<td>• Agreements signed</td>
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<td>• Successful pilots</td>
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<td>LAUNCHING BUSINESSES IN NEW</td>
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CONCLUSION

Long-term commitment and alignment of objectives is crucial for CVCs.

For a corporation, investing as one of many LPs in an independent VC fund may generate positive returns, but limits the corporation’s influence on investment decisions and insights. On the other side of the spectrum, establishing a purely in-house business unit may limit visibility and knowledge of sectors beyond the aperture of the corporate leadership. CVCs offer an alternative: the ability to customize investment decisions to fit financial and strategic goals and visibility beyond a company’s core business.

There is no single model for CVC success, but from the interviews and case studies presented, several themes emerge.

1. Because VC investments are inherently risky and returns, both financial and strategic, take time to materialize, the committed institutional capital needs to be patient. Funds with long time horizons and sustained buy-in from corporate leadership are better prepared to survive cycles.

2. A fund’s mandate and manager compensation determines its ability to attract and retain investor talent and entrepreneurs to its platform. Independence and a strong economic model based on financial returns and measurable KPIs will provide incentives and draw high-quality investors. At the same time, alignment of objectives and deep relationships with the corporate parent can differentiate a fund in its value proposition to startups and entrepreneurs.

3. Corporates need to establish explicit objectives for their VC programs and regularly review how the fund is tracking against these goals. Restructuring the fund, splitting it into specialized stages and verticals of investment, or spinning it out entirely may be necessary to meet objectives and maximize shareholder interests.