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Debunking Myths in Corporate Venture Capital: What Works, What Does not, and How to Make It Happen

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On paper, large multinational corporations and startups seem like a perfect pairing. Multinationals can open doors for startups, provide them with necessary capital, and deliver tremendous resources in the form of knowledge sharing, distribution channels to seemingly endless rolodexes. The list goes on. And startups can help large and mature corporations stay lean by giving them access to innovation that takes place at the peripheries of their core products or services that may eventually upend the core business itself by being an external source of valuable R&D (research and development). These benefits, which seem so hard to pass up on in theory, are largely why so many corporations currently open up corporate venture capital (CVC) arms or groups and offer insight into why many promising startups willingly accept capital from these strategic investors. In this paper, the authors take a look at the facts to see if these CVC groups measure up to this ideal (and if not, what they should do about it).

Keywords: corporate strategy, corporate venture capital (CVC), entrepreneurship, startups, venture capital

Corporate venture capital (CVC) historically gets a ton of flak from their more traditional venturing counterparts. From Fred Wilson's saying that he will "never, ever, ever, ever" invest alongside a CVC again in an interview with Pando to the proliferation of zombie CVCs over the last four years, the average corporate is not known for its ability to engage with startups (Mott, 2013). Fred Wilson has later gone on to clarify his comments by saying that there are a select few of corporates that add value like the Google's of the world, but it is no secret that CVC is not particularly well regarded in the startup world (Wilson, 2013).

On paper, large multinational corporations and startups seem like a perfect pairing, a match made in heaven so to say (McCahery & Vermeulen, 2010). Corporates can open doors for startups, provide them with necessary capital, and deliver tremendous resources in the form of knowledge sharing, distribution channels to seemingly endless rolodexes. The list goes on. And startups can help corporates stay lean by giving them access to innovation that takes place at the peripheries of their core products or services that may eventually upend the core business itself by being an external source of valuable R&D (research and development) (Hoffman, 2015).

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These benefits, which seem so hard to pass up on in theory, are largely why so many corporates open up CVC arms or groups during economic upswings and offers insight into why many promising startups willingly accept capital from these strategic investors as opposed to those that are purely financially driven (CB Insights, 2013; CB Insights, 2014; Chemmanur, Loutskina, & Tian, 2014; McHugh, 2013). But let us take a look at the facts to see whether these CVC groups measure up to this ideal (and if not, what they should do about it).

Some Quick Facts About CVC

In order to get a better insight into the facts and to examine patterns in CVC, the authors closely monitored the latest in CVC via the monthly *Global Corporate Venturing Magazine*[1]. The facts are that of the 419 corporate venturing divisions that were initiated from the second half of 2010 to the first of half 2014, 202 were already (or were still) inactive by the end of 2014 (see Figure 1) (Lerner, 2013), or what people in the industry prefer to call: "zombies"[2]. For such a surefire homerun in theory, that is a lot of CVC units letting things fall by the wayside. Statistics like these partially explain and contribute to why CVCs are not so highly regarded and the number of quality CVCs are few and far between. Though interests between corporates and startups can align in a variety of ways on paper, differences in expectations, aims, and ways of operating in practice can largely get in the way of either party actually benefiting from a corporate-startup relationship (Tagare, 2011).

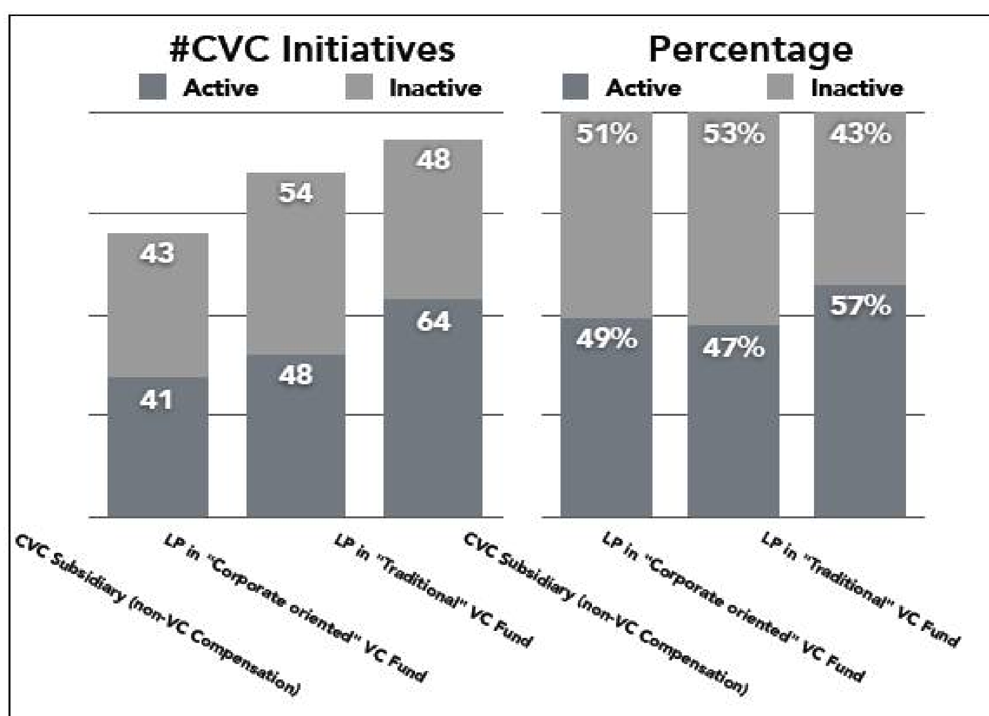

Figure 1. CVC initiatives in 2010 (2H)-2014 (1H) (and still active on December 31, 2014).

With that said, however, there are notable exceptions of corporates that have made it work like Google and Intel, which lead CVC league tables (Rahal, 2014). There is no shocker there. In this paper, the authors will go into why these companies have made things work, but there is no denying that it requires the right mix of

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[1] Retrieved from http://www.globalcorporateventuring.com.

[2] The failure rate has increased during the last two years. This can partly be explained that more and more corpo-rates are inclined to set up a corporate venture capital unit (which can be interpreted as herd behavior).

leadership, human capital, and experience to make this happen, something that the wide majority of global companies unfortunately do not have access to in-house (Simoudis, 2015a). But rest assured there is hope for the rest of the companies out there looking to tap into the startup world. We put together a checklist of what corporate venturing units should aspire for while setting up a CVC unit for the first time or re-structuring a venturing group that just is not getting the job done. As is the case with traditional venture capital, CVC requires its leaders to be pulling the right strings and pushing the right buttons because investing in startups for the sake of investing absolutely does not cut it (*The Economist*, 2014).

The authors' respective experiences having worked inside a Fortune 500 company is not all that groundbreaking in their humble opinion when it comes to CVC, but they find that too many corporates are repeatedly making avoidable mistakes when it comes to shaping their engagements with startups. The authors' hope is to share what they know within the world of CVC from their own experience within the space in hopes of seeing corporates better engage with startups and to ultimately further develop startup ecosystems worldwide for the betterment of entrepreneurship holistically.

Why CVC

In principle, it is well-documented why corporates and startups have a mutual interest in one another and all the potential synergies of a relationship so we do not need to go into this ad nauseam, but let us cover the basics (Grill, 2014; King, 2013). As was the case with the advent of the steam engine that served as a major catalyst for change during the industrial revolution that forever impacted humanity's understanding of industry, startups are in many ways driving the technological revolution that we are currently witnessing. The internet of things, big data, the blockchain, and cyber security are examples of some of the many tidal waves of change that is happening where every sector and industry is being affected one way or another. Or in today's words is disrupted (Vermeulen, 2015).

Larger companies have a major incentive to willingly embrace such change and integrate new technologies into their offerings or else they will seriously risk falling into obscurity and irrelevancy (Quittner, 2014). Whereas internal R&D of large corporates typically focus on furthering and enhancing current lines of business to increase margins or improve sales volume (Jaruzelski, Staack, & Goehle, 2014), many large companies are engaging with startups as a form of external R&D that is more focused on penetrating growth markets as well as the peripheries of their core businesses to have a glimpse into the many potential "next big things" that already are or may become relevant in the near future (Fugere, 2014; Bielesch, Brigl, Khanna, Roos, & Schmieg, 2012).

From a startup's point of view, engaging with a corporate investor can be alluring on many fronts. Aside from fulfilling a startup's need for financial capital, large companies have tremendous resources that can be of profound benefit to any company that is relatively just starting out. Big companies have established distribution lines, strategic partners, deep domain intelligence, not to mention an experienced sales force and a global presence. If a startup could access even a sliver of some of these resources, it could make all the difference.

Why Does CVC Fail

In practice, most corporates are pretty terrible at venturing (Chesbrough, 2002). As already indicated, nearly half of all CVC units set up over the past four years are idle and have not made a successful investment by way of strategic or financial return, let alone closed a single deal. Reasons for this lack of success are

plentiful ranging from a lack of internal know-how to minimal interest in actually engaging as a legitimate partner to startups (Lerner, 2012). However, what the authors find as the most common source of failure is some sort of mismatch between corporates and startups in how they operate, set their expectations, and ultimately how they define the aims of a partnership.

The reality often is that mature companies and startups are inherently different creatures. Too many corporates unreasonably expect that the rules of the game for a company that has been around for a half century are the same for one that has been around for less than five years. The diligent and comprehensive way of working at a large company can be crippling for a new venture (Patel, 2015; Raynor, 2012). That goes for making decisions to taking actions. Whereas Fortune 500 companies operate in relatively stable markets that are somewhat predictable, startups predominantly operate in a market that is yet to be defined and is far from certain (Zhuo, 2014; Pollack, 2013). The standard market research and deep dives that strategists like to conduct at corporations around the world are largely useless in the context of the startup world and is even counterproductive as speed, which is such a critical component to the viability of a startup, can be compromised (Blank, 2015). As a worse case scenario, by the time the boardroom of major Company X would have wrapped its head around an emerging market, the market could already have been changed considerably.

Along the same line of reasoning, mature companies measure progress and success in highly different ways than how startups measure development. Expecting the same level of accuracy for projections at a large company for a startup is unreasonable. It is the job of a good corporate venture capitalist to reasonably discount any projections that a startup provides based on their own independent sound rationale, not to unconstructively berate founders for not meeting lofty projections provided during a due diligence process on a competitive landscape that is yet to be defined. As with properly adjusting the standard way of working inside a larger company when working with a startup, expectations need to be re-calibrated as well to align with what works in the startup world.

A misalignment in goals is just the cherry on top (Rosenbloom, 2014). For the corporate, its goals are simple: advance its interests. For the startup, goals are rather straightforward as well: deliver on its own objectives. Notice that neither has a primary emphasis of improving another's interests so long as it does not advances its own (Pozin, 2014). When an investor has its own strategic interests from a business point of view beyond a financial return, conflicts can arise and they typically do. For example, a corporate may have an incentive to suppress the valuation of a next round of financing so as to lower an eventual price tag that it would have to shell out for any potential acquisition. This does not happen so often, but it is certainly also not an outcome only left to fiction. Another case of misalignment, which happens far more often is that a CVC investor may demand that a startup it has invested in refuse dealing with or creating partnerships with its competitor to the direct detriment of the startup (Partnered News, 2014). Imagine a management team being hindered from engaging with a competitor of one of its investors where such an engagement may be a huge coup that unlocks its potential. These are the types of shady dealings that get corporates into trouble in the world of entrepreneurship.

Venture capital firms that are not tied to any particular corporate interest on the other hand typically have less potential points of conflict with their entrepreneurs. There are certainly times when entrepreneurs and pure financial investors can disagree, *à la* the timing of a liquidity event, but more often than not, when a founder wins, the investors win (Suster, 2015). Things get more contentious between a pure financial investor and a startup when things go awry, but that is an outcome that is not specific to venture capital and entrepreneurship.

Just think sports and how winning cures all illnesses whereas losing typically leads to the airing of dirty laundry within the locker room, which eventually leaks to the public. We are more concerned with the positive outcomes here and traditional VCs (venture capitalists) naturally have less points of potential conflict with startups, at least the quality VCs out there do (Park & Vermeulen, 2015).

You may ask: Why are corporates the ones having to adjust their way of working, expectations, or goals? The answer is rather simple. The best startups do not have a shortage of eager investors looking to participate in the latest round of financing. It is the job of the CVC to make a case and to prove to the founders why they should take them on as an investor. Or even if you are looking to put together a syndicate, it will be awfully tough to pull a quality group of value adding investors together if you have built up a bit of a bad reputation for not catering to what is acceptable in venturing.

How to Set-Up Your CVC Unit for Success

There are many mechanisms for which corporates can use to engage with the global startup community and there are many subtle nuances amongst them, but engagement in a meaningful capacity by and large typically boils down into two options: direct investments in a startup thereby becoming a shareholder as a CVC subsidiary or contributions in a VC fund as a limited partner (Volans Ventures Ltd., 2014).

Setting Up Your Own Corporate Venturing Unit

The most active approach would entail setting up a CVC subsidiary. If this is the elected set-up, a decision needs to be made as to whether the corporate venture capitalists will be compensated like a traditional venture capitalist with a combination of management fees and carried interest (a share of the profit of the fund) or if they will only have a fixed corporate salary (Timothy Hay, 2013; Lewis, 2014). This decision along with where and to whom the CVC subsidiary reports into (e.g., the Chief Executive Officer or the Chief Financial Officer) has profound impacts on the likelihood of success (Simoudis, 2015b).

For instance, empirical research shows that not awarding CVC subsidiary managers with incentive mechanisms attuned to what venture capitalists receive usually leads to risk averse behavior to the detriment of the CVC arm (Dushnitsky & Shapira, 2010). This can rear its head in the form of managers preferring to invest in later-stage financing rounds where premiums paid are high and where it is conceivable that much of the value has been captured by earlier investors. The benefit of course is that the probability that the startup and the market has reached proof of concept increases, at the cost, however, of catching wind of the latest groundbreaking innovations (too) late.

Compensation schemes go a long way in maintaining critical talent in-house, a reality that cannot be discounted in a people driven ecosystem like entrepreneurship. We know of many instances where successful CVC managers left their respective companies to set up their own shop as lucrative venture capital funds. It will come as no surprise that the drain of valuable expertise and skills from the corporate has a devastating impact on the sustainability, continuity, and profitability of the CVC initiative. Connections, relationships, and reputations matter. Reinventing a CVC unit from the ground up is usually a daunting task that so rarely works out after a changing of the guard. Since the venture capital industry is highly networked and based on deep interpersonal relationships, only well-established CVC units are generally able to identify the right investment opportunities. Egos aside, properly compensating your investment professionals in your CVC unit like their industry counterparts can and will go a long way in making your subsidiary a success.

Next up on the list of ingredients for successful CVCs is governance and along the same vein, leadership. A lot of what separates the good from the bad CVCs is a matter of mindset and culture. This is not to say that this in and of itself is sufficient to open up a great CVC, but it is certainly a necessary starting point to build a foundation and a brand of great corporate venturing upon. It is very tough to get this right without the right type of leadership. Either the ultimate decision makers in a company need to already possess a sound understanding of how entrepreneurship functions or they need to exhibit a willingness to learn with an open mind to change. If you are looking for discussion points on how to get your company and its leaders to be more suited to working with startups, the authors suggest carefully reviewing the section on "Why Does Corporate Venture Capital Fail?" once more.

Companies like Google and Intel and their respective CVC units have no problem with this. Startup life is in their DNA having been ones themselves in the not too distant past. Larry Page and Brian Krzanich do not need a briefing on the many potential areas of conflict between big companies and young ones. Their CVC arms are light years ahead partially for this very reason. You can add the likes of Qualcomm, SAP, and Cisco to the list. They understand tech and they surely understand how to engage with the startups of tomorrow. The authors' experience tells them that the closer the CVC unit sits to the board of your company in the organizational structure, the better. For corporate venturing to be firing on all cylinders, there certainly needs to be buy-in at the top.

Now let us talk about strategy. As alluded to on the compensation discussion, the authors believe CVC managers should be compensated like VCs. They also believe CVC units should chase financial returns as opposed to having a sole focus on strategic returns (Vančura, 2014). Generally, however, CVC units are set up for strategic reasons and their managers are paid fixed salaries. Aside from the difficulties of maintaining top-level talent in-house when following a pure strategic approach, there are simply more potential points of conflict among you, the corporate investor, and the entrepreneur (as mentioned previously).

From a pure operational standpoint, adequately defining what constitutes strategic returns presents its own set of challenges for companies and their CVC managers as well. How will they go about measuring or quantifying strategic returns? Some CVC groups have designed and introduced special metrics to measure and demonstrate strategic success. These metrics vary from deal tracking dashboards and scorecards tailored to each individual investment to looking at the number of successful interactions between startup companies and the corporation (Chesbrough, 2002; Corporate Strategy Board, 2000).

This is not to say that strategic interests do not matter. We fully recognize and understand that in the wake of the financial crisis, corporates have stepped up their involvement and investments in innovative technology companies to seek out competitively advantageous technology, not to earn an extra buck. However, as emphasized throughout this paper, large companies and startups are inherently different creatures.

Whilst providing a broad range of strategic benefits to startups from industry partnerships, distribution opportunities and product development insights are all well-intentioned, pursuing a financial return needs to play a role in a CVC's strategy even if only to signal to the ecosystem that you are a real partner to startups and that you will not throw a founder under the bus for your sole corporate strategic benefit. The less your CVC arm acts like a traditional corporate parent in that sense, the better. The exception being those relatively young listed (usually venture capital-backed) companies, such as Google, Cisco, Qualcomm, Salesforce and Gree that understand what entrepreneurship is all about (and it is no coincidence that many of these companies pursue financial returns as well) (Mawson, 2015).

For those adamant on keeping strategic returns front and center, the authors are also of the belief that financial and strategic returns are not necessarily inconsistent and mutually exclusive with one another. Akimichi Degawa, Senior Director of Intel Capital in Japan, ventured so far as to say during a CVC event in Tokyo in January 2015 that strategic returns and financial returns go hand in hand (Corbin, 2015). He argued that pursuing financial returns like traditional VCs is a powerful way to attract more deal-flow and identify new innovations, new markets, and new investment opportunities. What the authors find is that a successful CVC (in terms of financial returns) will provide a bigger window to the market, which will make it a better "market intelligence" tool.

Lastly, managing other departments, units, or divisions within large companies like R&D and business development groups are an important consideration when setting up a CVC unit. The "This is not invented here syndrome" (a mindset in which externally developed product and services are labeled inferior to the internally developed ones) is alive and kicking, often seriously hampering the ability of the CVC arm to deliver on its promises. It is good to keep an eye out on this from day one so that it can be put to rest when necessary before it gets out of hand.

Collaborative CVC Models

If for whatever reason running an autonomous CVC arm is not for your company, corporates can always elect to follow a more collaborative model involving other limited partners.

For one, setting up an external venture capital unit with one or more separate limited partners is an option that many have followed to success (see Figure 2). Many former CVC subsidiary units have even been spun-off and are in essence following this approach, evolving more and more into a separate venture capital firm with its own name and investment agenda (see Figure 3). A corporate, as one of the few LPs (limited partners), can still exert influence on the types of stage, sector, or technology that the VC fund would invest in as a legacy or anchor investor. It should come as no surprise that spun-off CVC arrangements tend to make more risky seed-stage investments (see Figure 3).

There are some clear advantages to this approach. First, the mission and scope of a separately managed "corporate venture capital unit" can be made clearer, making it easier to assess results objectively. Second, it is easier to establish effective governance and compensation systems within a separately managed fund. Third, separately managed funds are more effective in managing minority interests in portfolio companies because they are less impacted by cumbersome accounting and antitrust rules and regulations of a parent (Romans, 2013). Fourth, establishing a separately managed fund helps ensure continuity because the CVC initiative is less driven by the whim of prevailing executive management. Fifth, and perhaps most importantly, becoming a limited partner in a fund mitigates startups' fear that accepting investments from a direct CVC restricts their exit opportunities and brings about the risk of "negative signaling" should the CVC unit decide not to support the investment in the future.

Alternatively, a corporate that is relatively new in the CVC game can learn by investing directly in a traditional VC fund or a fund of funds (depending on the risk appetite) thereby allowing the company to indirectly invest in startups. The upside is that the level of commitment relative to the other more active models is rather limited, a definitive advantage while building up valuable internal knowhow and developing internal capabilities. The downside is that you are one of the many institutional investors serving as limited partners to the fund. Despite this, it is worth mentioning, however, that certain VCs can cater to the specific interests of

their corporate limited partners much like a formerly spun-off subsidiary would do. For example, anything from special sidecars to co-invest or making investments in a space of strategic interest would be in the realm of possibility.

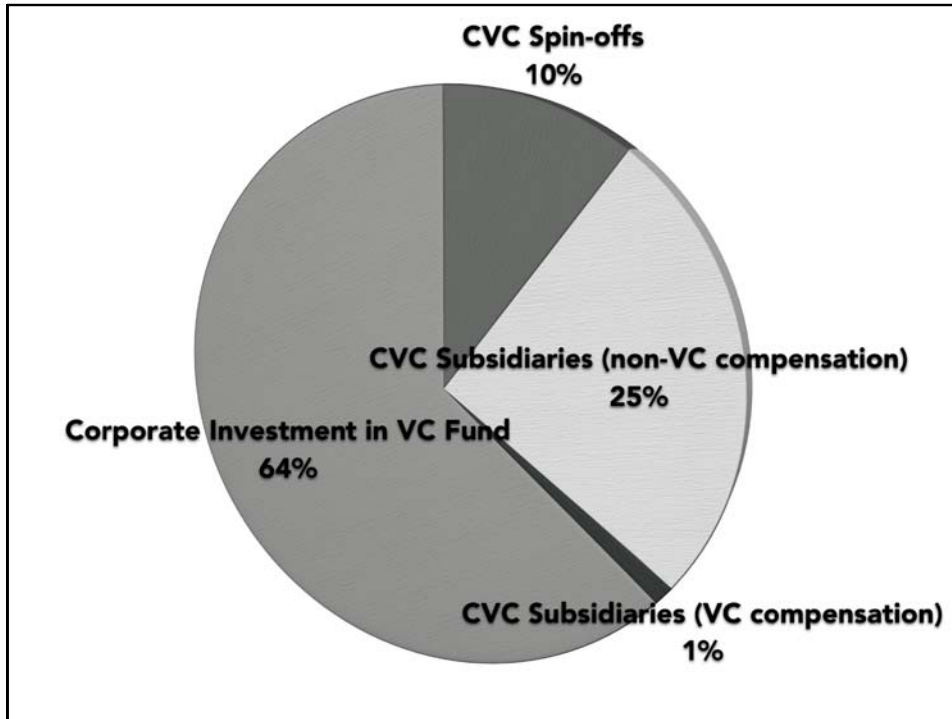

Figure 2. CVC initiatives 2010 (2H)-2014 (1H).

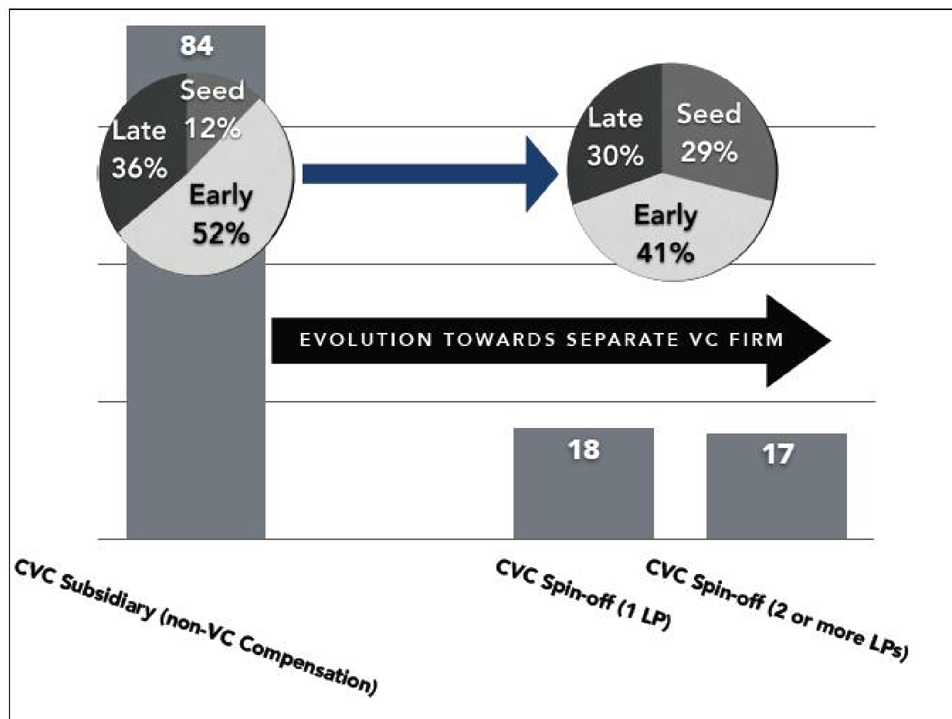

Figure 3. The evolution of CVC arrangements—2010(2H)-2014(1H).

As reflected in Figure 4, we see that the collaborative approach of investing in traditional venture capital funds as a limited partner has become the dominant CVC model. Rest assured that there is a home for a corporation's deep pockets in venture capital as corporate contributions has its advantages from a venture capitalist's vantage points as well. Take for instance, corporations can actively contribute to the reputation of a venture capital fund. In fact, it is often argued in the industry that corporate investors optimally facilitate the development of fruitful and lasting collaborations, signaling a quality fund in which other investors like family offices have ample incentives to commit to the funds' strategy and investment decisions.

Corporate investors can do much more to contribute to VCs beyond their capital contributions and reputation as well. Corporations often contribute knowledge, investment opportunities, and deal flow (via participation in a corporation's spinouts or spinoffs). Moreover, at the request of venture capital fund managers, corporations can and sometimes indeed participate in the due diligence processes of potential investment targets, offering technical and marketing advice to portfolio companies and assisting them in the development of new technologies. There is always the possibility that the large company will be the eventual home for startups at the time of exit as well via a trade sale of a portfolio company that proves to be strategically interesting.

All of this is not to say that collaborative CVC models are a guaranteed success. This sample shows that a large number of the collaborative initiatives can be viewed as "zombies" (being inactive on December 31, 2014), but this is less of a knock on collaborative models but more to do with corporate venturing in its entirety (see Figure 5). All in all, this is not such a surprising reality given how the market is flooded with less than stellar (C)VC funds. So how can corporations identify the funds that are attuned to their interest? The authors' experience with making corporate anchor investments in traditional venture capital funds tells them that it all starts with selecting the right partner. Certainly, the opacity of the venture capital industry makes this selection a troublesome, but not an entirely impossible exercise.

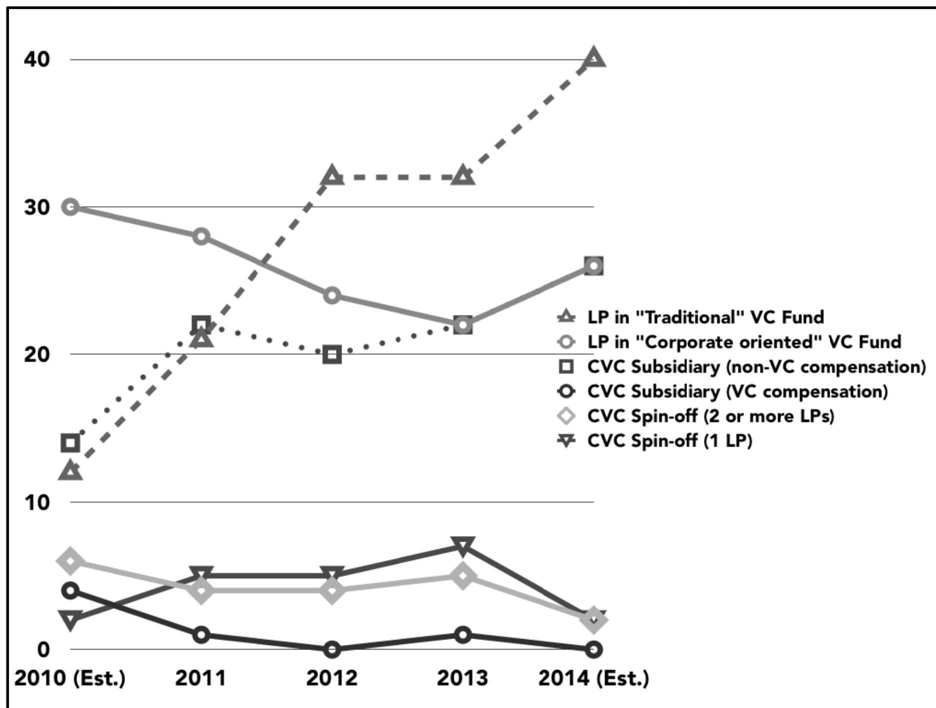

Figure 4. CVC models announced in the period 2010 (2H)-2014 (1H).

Let us walk you through a replicable process that has worked for large companies to much success.

It is important for companies that want to enter the CVC game to tap their network for recommendations before inviting VC firms to participate in a beauty contest of sorts where prospective VC general partners are given the opportunity to pitch why you should invest in their fund(s). The proliferation of global databases on the market such as Dow Jones VentureSource, CB Insights, PitchBook, and PWC MoneyTree contribute to improving the selection process for investors a great deal. However, whether it is the lack of data, the even greater scarcity of quality data, or rampant levels of selective disclosure employed by firms, the ability to compile information at a sufficient volume to be representative continues to be an arduous task. Supplementing the corporate rolodex by attending international venture capital and CVC events, such as the yearly Global Corporate Venturing event in London, can prove to be invaluable in coming up with a shortlist of potential VC funds to invest in and in the partner selection process.

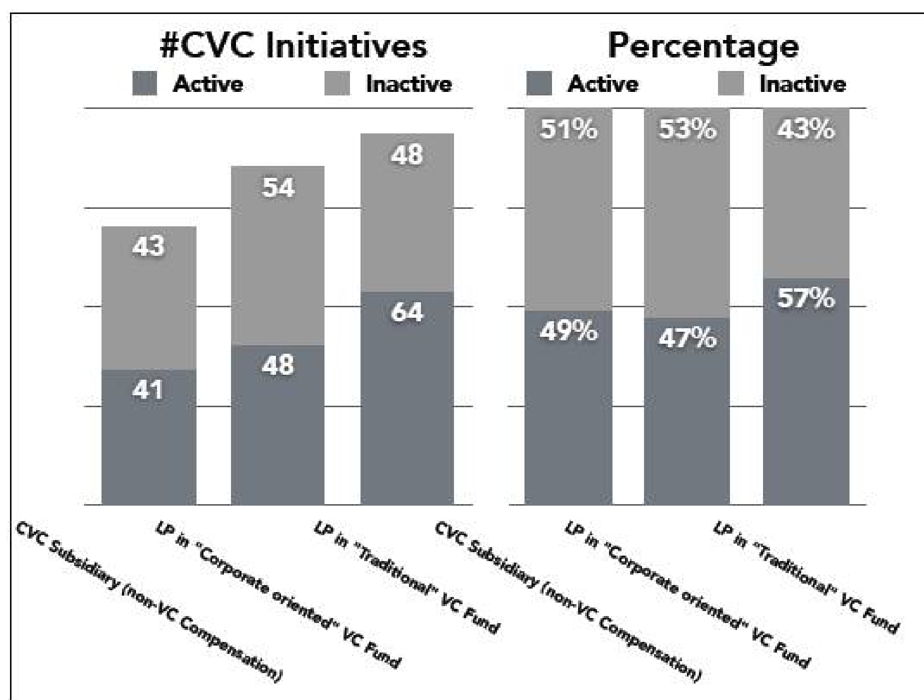

Figure 5. “Failure Rate” CVC initiatives 2010(2H)-2014(1H) (and inactive on December 31, 2014).

Once a target fund has been selected, negotiating the venture capital fund agreement is the next crucial step toward developing a mutually beneficial engagement. In contrast to the “traditional” venture capital fund agreement, which mainly sets out conditions for investing, capital contributions, and compensation and distribution requirements, an agreement with a corporate anchor investor must govern three distinct relationships: (1) the relationship between the venture capitalist and the corporation as a “strategic” investor; (2) the relationship between the venture capitalist and other strategic and/or financial investors; and (3) the relationship between the strategic and financial investors in the venture capital fund.

As it turns out, the traditional financial investors and other limited partners will often bargain for more restrictions and covenants relating to the management of the fund, conflict of interests, and restrictions on the type of investments the fund can make when the venture capitalist raises funds from a strategic anchor investor. Be weary of that, the restrictive nature of covenants, which must make sure that all investors are treated equally,

will come as a “natural” reaction to the uncertainty, information asymmetry and agency costs resulting from the strategic investor’s participation. Still, the use of restrictive covenants can entail inefficiencies and the erosion of value from the partnership, as they restrict venture capitalists’ ability to benefit from the knowledge, resources, and investment capabilities of the strategic corporate investor.

This should not stop you from working with the venture capitalist to obtain more favorable terms than other investors with respect to management fees, deal flow, portfolio selection and monitoring, investment decisions, and co-investment rights. Note that it is even in fact common practice that corporations to do so in conjunction with a venture capitalist, explore whether this would be a possibility with the VC of your choosing. These favorable terms, which deviate from the underlying limited partnership agreement, are set out in side letters or side agreements. The reputation of both the venture capitalist and the corporation, as a strategic investor, will ultimately affect the other investors’ willingness to accept the side letters for one of their co-investors in the fund.

If there is a serious standstill with the other institutional investors or family offices that have difficulties in accepting the more favorable deal terms for the strategic corporate investor, venture capitalists and corporations are generally left with three options (Dittmer, McCahery, & Vermeulen, 2014). The first of which is for the corporation to take a position as the sole investor/limited partner in the venture capital fund. If that is not to the company’s liking, finding a reputable and established investor that is able to restore the balance of interests among the investors is certainly a possible alternative. The third avenue is that the venture capitalist can set up a partnership with two or more other corporate investors that are willing to join forces in an investment fund which targets high-potential growth companies and/or other innovative projects.

When the terms of the partnership agreement are concluded and the investors have committed their capital, the process does not end there. Corporate engagement plays a pivotal role in the success of any collaborative fund. In order to ensure commitment and involvement, corporations can often consider allowing staff members (either through relocation to the fund or through secondment arrangements) to liaise between the fund and the corporation’s strategy and research and development departments. Clear rules on conflicts of interest are of course a key element in structuring the liaison’s position. It will not be surprising that these rules are preferably addressed during the negotiation process and included in the limited partnership agreement or side letter.

Key Takeaways in a Nutshell

Whether it is the fact that CVC engagement in the startup ecosystem is highly fickle, the abundance of zombie funds, or the predatory acts that large companies sometimes undertake, big companies are not particularly well regarded in the startup ecosystem when it comes to being a legitimate, real partner to entrepreneurs. In this regard, it is any corporation’s challenge to prove otherwise if they are serious about building a positive reputation in the industry. Whether you decide to set-up your very own CVC subsidiary unit or pursue the variety of collaborative models, understand that multinationals and startups are inherently different creatures with different ways of operating and with differing sets of expectations and aims. Recognizing this very dichotomy and understanding the pitfalls of acting like a traditional corporate in the startup world will already go a long way in allowing you to begin to follow the many pieces of advice the authors have covered in this paper.

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