Global Corporate Venturing

December 2012
Price: $750

Quest for maturity

A Global Corporate Venturing supplement

Sponsored by

Contents

Global Corporate Venturing

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Second generation opens the doors to success

Welcome to this second supplement in a series by Global Corporate Venturing looking at how the industry tackles the challenges of managing units over time.

The first supplement, Corporate Venturing 101, published 12 months ago, focused on how companies thinking of setting up a unit or having just done so answered questions about why do it, how it can be organised and managed and, finally, how to invest.

This second supplement looks at the groups that have survived and thrived through the first few years and are now grappling with the next set of challenges as they mature between four and nine years of age.

As with the first supplement, Corporate Venturing 201 is split into three parts looking at the team, dealmaking and fund structures that can be increasingly relevant.

The more than 200 corporate venturing programme and fund launches since 2010, as tracked by Global Corporate Venturing, has in some ways overshadowed the achievements of more mature peers that have belied the industry's reputation for short-lived units.

Global Corporate Venturing through its "most influential" rankings of each sector each year has identified more than 100 groups with more than a decade's experience and a similar number with between four and nine years' track record. This is only a slice of the firms with this level of experience as the origins of a number of corporate venturing units have not been disclosed or have been affected by repeated reorganisations and renewals.

US trade body the National Venture Capital Association has said ahead of its webinar on "Spanning the valley of death: lessons on longevity from corporate VCs", more than 20 groups within its membership have been in existence for over 10 years, and more than five have been in existence for over 15 years.

The trade body says for its webinar: "In some corporations, the CVC [corporate venture capital] effort has flourished, with allocations raised and teams increased over their tenure.

"Much has changed with respect to economic drivers of corporate success but regardless of these external pressures, CVC requires patience and persistence to deliver success."

James Mawson, editor

Corporate venturers also need to find governance and goals that fit the culture and business of the parent organisations.

As Elinor Ostrom, the first woman to win the Nobel prize for economics in 2009, found when studying communities on their governance of common-pool resources, such as forests and fisheries, there is no "one right" way to do things.

She talked about the "panacea problem" – belief that there was a "best way" of doing things – instead of looking at the detail of what is actually involved in the job at hand and crafting specific solutions to the problems and needs of the time and place.

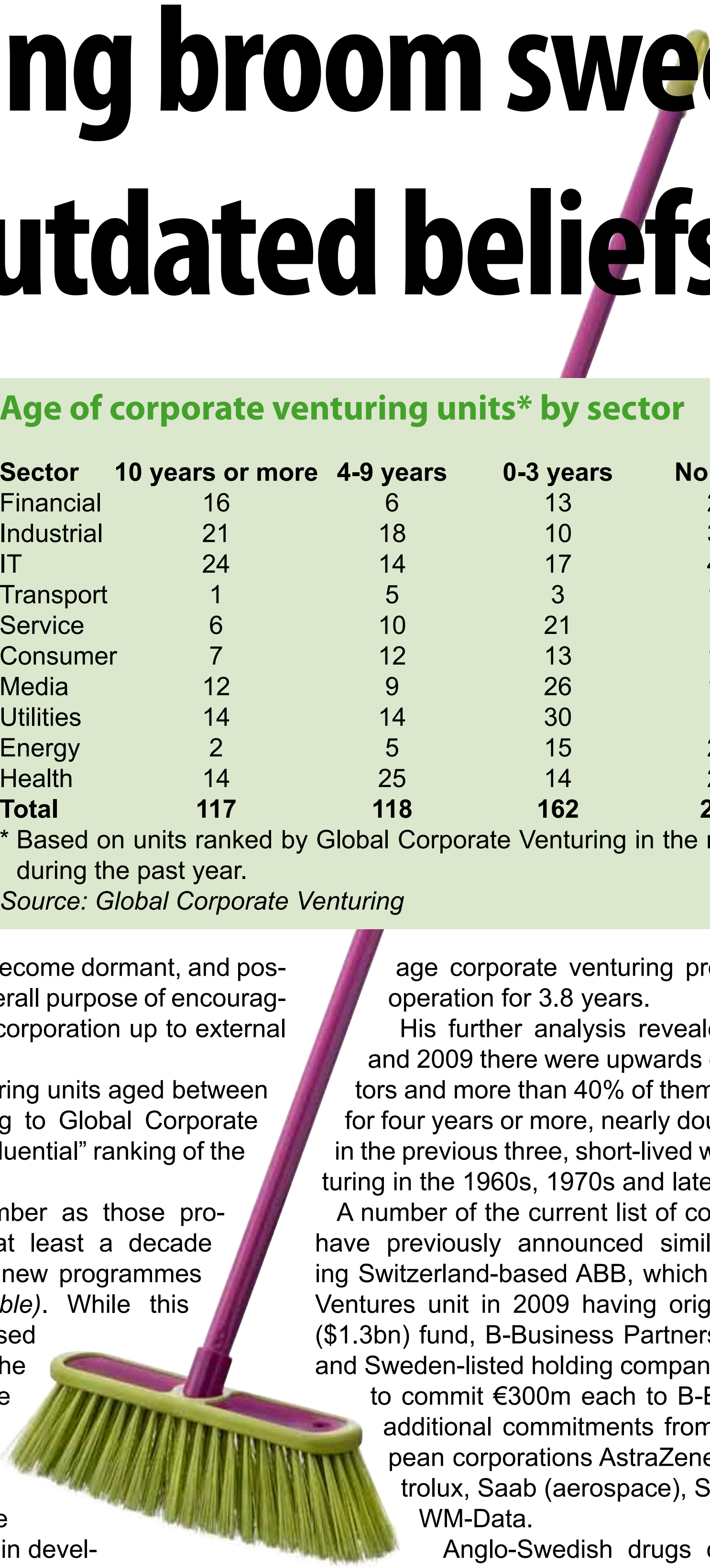
While in this supplement's articles and analyses contain many answers provided by experts passing on their years of wisdom, in a field as nuanced and sophisticated as corporate venturing this supplement is less a do-it-yourself manual than an introduction to a subject to set out some of the main questions and challenges that either lie ahead for nascent groups or are already being tackled by the leaders.

We are keen to learn from practitioners and cover the responses this current generation of thought-leaders are developing

As ever, we are keen to learn from practitioners and cover the details and responses this current generation of thought-leaders are developing, so let us know your thoughts.

And, also as ever, our thanks go to sponsors Relevant Equity Works, SVB Financial Group and DLA Piper, and industry figures who made this supplement possible. They have opened the next door to a successful corporate venturing programme.

Venturing broom sweeps away outdated beliefs



Philosopher Trigger was once asked on television show Only Fools and Horses how he had maintained the same broom for 20 years.

He said: "This old broom's had 17 new heads and 14 new handles in its time … There's the picture [it is the same broom]. What more proof do you need?"

It is a question a number of corporate venturing executives and their parent firms have perhaps asked themselves over the past 40 years as leaders and strategies change and programmes are opened with fanfare, only more quietly to be become dormant, and possibly then restarted, while the overall purpose of encouraging innovation and opening the corporation up to external ideas remains the same.

Age of corporate venturing units* by sector

Sector	10 years or more	4-9 years	0-3 years	No date	Total units
Financial	16	6	13	26	61
Industrial	21	18	10	37	86
IT	24	14	17	46	101
Transport	1	5	3	18	27
Service	6	10	21	4	41
Consumer	7	12	13	18	50
Media	12	9	26	15	62
Utilities	14	14	30	7	65
Energy	2	5	15	23	45
Health	14	25	14	22	75
Total	**117**	**118**	**162**	**216**	**613**

* Based on units ranked by Global Corporate Venturing in the most influential tables during the past year.
Source: Global Corporate Venturing

There are 118 corporate venturing units aged between three and nine years, according to Global Corporate Venturing data using its "most influential" ranking of the 10 sectors covered each year.

This is nearly the same number as those programmes that have survived at least a decade but about a third less than the new programmes launched since 2010 *(see table)*. While this data excludes new funds raised by established groups and the broader database of corporate venturing units that fail to make the monthly rankings, it does indicate the large number of nascent programmes and the challenges groups seem to face in developing a substantially long-term track record.

There is, however, a trend for greater longevity. Gary Dushnitsky, a professor at London Business School, in his chapter, Corporate Venture Capital in the 21st Century, in The Oxford Handbook of Entrepreneurship, said the average corporate venturing programme has been in operation for 3.8 years.

His further analysis revealed that between 2000 and 2009 there were upwards of 350 corporate investors and more than 40% of them had been in operation for four years or more, nearly double the length of those in the previous three, short-lived waves of corporate venturing in the 1960s, 1970s and late 1990s.

A number of the current list of corporate venturing units have previously announced similar operations, including Switzerland-based ABB, which started its Technology Ventures unit in 2009 having originally planned a €1bn ($1.3bn) fund, B-Business Partners, in March 2000. ABB and Sweden-listed holding company Investor had planned to commit €300m each to B-Business Partners with additional commitments from bank SEB and European corporations AstraZeneca, Atlas Copco, Electrolux, Saab (aerospace), Sandvik, StoraEnso and WM-Data.

Anglo-Swedish drugs company AstraZeneca later developed its in-house venturing programme after acquiring US-based biotech MedImmune in 2007, while other of the B-Business partners have merged or developed their programmes separately.

And a list of 27 corporate venturing fund and programme launches from a year before B-Business Partners', in 1999, shows a similar pattern in the mix of companies that were subsequently merged or stopped venturing *(see table, right)*. Relatively few of the funds announced in 1999, such as chip maker Intel and database provider Oracle, maintained a relatively consistent minority-equity investment programme, albeit with often some shifts between financial and strategic goals.

Heidi Mason, partner at consultancy Bell Mason Group, describing some corporations' fifth or sixth attempts at developing a programme, said: "Consistent with most big companies' innovation history, many corporate venturing and innovation units have had multiple cycles [of enthusiasm and hibernation] and management and leadership rotations. Mounting external market, economic and time pressures have often forced corporate innovation programme (re-)development."

More recently, while the number of corporate venturing programme launches have outnumbered the closures, a number of groups have changed their approach or shuttered the operations, including dugs group Biogen Idec preferring alliances with entrepreneurs or other pharma groups against taking equity stakes in start-ups, publisher Playboy changing its Digital Ventures unit, Draper Lab closing Navigator Technology Ventures, film equipment maker Kodak selling its assets following bankruptcy, industrial group Danfoss turning towards internal as against external venturing and logistics group TNT shuttering Logispring *(see box at the end of this feature)*.

Corporate venturing funds formed in 1999

Corporation	**Size ($m)**
Electronic Data Systems	$1,500
Andersen Consulting	$1,000
Time Warner	$500
Intel	$450*
Hikari Tsushin	$332
News Corp.	$300
ValueVision International	$300
Comcast	$250
PECO Energy	$225
Inktomi	$200
Sun Microsystems	$200
TransCosmos	$150
Cambridge Technology Partners	$100
Duchossois Enterprise Group	$100
E*Trade Group	$100
Global Crossing	$100
Oracle	$100
Readers Digest Association	$100
Rare Medium Group	$87
Lycos	$72
InfoSpace.com	$30
Seagate Technology	$25
Broadvision	$10
Cognex	$10
Freedom Communications	$10
Venture Catalyst.com	$10
Fujisawa Pharmaceutical	$5
Total	**$6,259**

Source: press reports

Finding why firms maintain consistent venturing programmes is challenging given the wide mix of types by geography and sector. Academics, however, have started using "behavioural finance" to try to formulate explanations. In a paper, Aspirations, Innovation and Corporate Venture Capital (CVC): A Behavioral Perspective, published in December 2011, Insead business school professors Vibha Gaba and Shantanu Bhattacharya found from units operating in 71 IT firms from 1992 to 2003 that a firm "is more likely to adopt and less likely to terminate a CVC unit [as a way of externalising research and development (R&D)] when its innovation performance is closest to its aspiration levels".

Effectively, this means corporate venturing survives in a Goldilocks zone, in which innovation at the parent company is neither too hot, that is far above – leading to complacency – nor too cold, that is far below – causing cannibalisation of resources from venturing – the level of innovation performance the company is looking for.

The Insead professors' work followed research into organisational cultural factors behind the relatively high failure rates of corporate venturing programmes under energy utility parents. This was a primary factor in the launch of energy utilities' venturing funds between 1999 and 2001, and the subsequent closure of three-quarters of them within about five years, according to an academic paper, Why Corporate Venture Capital Funds Fail – Evidence from the European Energy Industry, by Tarja Teppo, co-founder of Cleantech Invest in Finland, and Rolf Wüstenhagen, Good Energies professor for management of renewable energies at the University of St Gallen in Switzerland.

According to their analysis, the main factors related to parent firm organisational culture are parent firm view on innovation and industry development, and its organisational mindset.

Two issues were identified regarding innovation and industry development in the energy sector. First, many electric utilities did not perceive innovation as an important competitive advantage, which in turn made the life of a corporate venturing fund difficult as it tried to identify innovative new business models or technologies promoted by start-up firms.

Second, even in cases where the parent firm realised scouting for innovative business approaches was important, the company saw no urgency to act.

The lack of urgency was because parent companies were used to reacting to external regulatory pressures, not to business threats imposed by new external ventures.

The parent firm's organisational mindset or worldview may differ strongly from that of the corporate venturing fund, which therefore needs "adequate autonomy to establish its own management processes", according to the academics.

The differences were often shown in utilities' preference to work with relatively larger, mature third parties. The effect of the organisational culture is also affected by risk-taking practices in the parent firm's decision-making process, such as conducting effective due diligence on prospective technology and involving non-venture experts in decision-making, and its skills in managing and measuring the corporate venturing fund's success.

As one corporate venturer told the academics: "The problem [with venturing] is that if you are really innovative you get in trouble with the traditional organisation … And if [the ventures] are gaining market share, the headquarters or the operating unit is losing market share. And losing market share in the traditional sector or an operating unit is valued more than chances in the new growth area."

This quote sums up the challenges for many corporate venturing units. As professors Susan Hill and Julian Birkinshaw said in their London Business School academic paper, Strategy – Organisation Configurations in Corporate Venturing Units: Impact on Performance and Survival, for survival, the type is critical. "Those [that survive are] geared towards exploitation of parent firm assets" to the benefit of internal and external portfolio companies for financial return rather than trying to gain strategic benefit from exploring how venturing can set up whole new business divisions.

Birkinshaw, in a subsequent paper – Know the Limits of Corporate Venturing – with Andrew Campbell from Ashridge Business School, added: "Almost all units set up to create new opportunities for a company fail to develop any significant new businesses, but that is not to say that the techniques are useless – they can be harnessed for other purposes: harvesting spare corporate resources for cash, ecosystem development, innovation in an existing function, and participating directly in venture capital for financial returns."

But this Ashridge paper, published in 2004, came at the nadir of sentiment for corporate venturing. Surviving and more nascent units have built on the academic research and developed teams often with a mix of business leaders, who understand the parent corporations' strategies and can gain the political support and business division buy-in to the ventures, as well as experienced venture capitalists from independent or other corporate venturing firms who can handle the dealmaking and understand the relationships to be formed in an investment syndicate.

Rather than viewing the corporate venturing unit as a silo, these groups have been exploring how the innovation tool fits within the wider strategy kit and can execute on that potential.

This month, US-listed industrial conglomerate General Electric set up a software corporate venturing fund and hired experienced investor Mike Dolbec as managing director. He said: "This software initiative is a big deal inside GE and, similar to its strategy in health and energy, GE is creating a vibrant business development, open innovation and acquisitions strategy. It is exhilarating to be working with people who are sophisticated about software and start-ups and to be on a team that is aware of the hard work and investment that is required to execute that strategy, not just set up the goals and turn away."

It is this relentless focus and application by talented people under a leadership that understand the challenges and support required that offers the potential fully to utilise ▶

the opportunities created by corporate venturing.

As with Trigger using his broom to sweep the streets, the goal in corporate venturing has fundamentally remained the same: find talented people who can meet and work with the best entrepreneurs, as they are the ones most likely to give the financial returns to maintain a programme as well as offer – through the medium of the corporate venturer power brokers – the creative insights into how the world can change and develop for the parent business to respond to and also help to shape.

The waves of corporate manoeuvring can swamp long-term investment strategies

Netherlands-based delivery company TNT's decision to wind up its corporate venturing operation ahead of the demerger of its postal and express delivery divisions has shown up the difficulties of maintaining a team taking stakes in nascent companies for the longer term.

In 2009, TNT "seized control of Logispring's first fund and moved to dissolve Logispring II", according to Ad Eundem Partners' website. Ad Eundem – Latin for "the same again" – said it was the partnership for the team that built the Logispring brand, founded Logispring, built the portfolios of the funds commonly known as Logispring I and Logispring II, and managed these funds and their portfolio companies from July 2001 to 2009.

However, Ad Eundem is understood to have been unable to raise a subsequent fund and its team has split, including Robert Mullins, a former partner at Logispring, joining Confidx, a Finland-based maker of radio frequency identification tags, in May 2010 as its chief financial officer. Ad Eundem declined to comment as its staff were "bound not to disclose any information re[garding] the Logispring funds or their (former) portfolio companies". TNT failed to respond to calls and emails.

TNT was the largest investor in the Switzerland and New York-based Logispring general partnership's (GP – another term for a venture capital firm) €103m ($135m) first fund raised in 2001. Another so-called limited partner (LP – investor) in the fund was consultancy firm Booz Allen Hamilton, which was unavailable for comment.

TNT, which said in its 2006 annual report that it had made €20m in additional capital contributions to Logispring, also committed again to the 2006-vintage Logispring II fund. A court filing from the second fund's jurisdiction in the Cayman Islands showed TNT had committed 78.57% of the second fund, which had made six investments by the time it was wound up. The other LPs in Logispring II included Trinet Logistics Investment Company, a special purpose vehicle of Japan-based bank Mitsui, with 15.71%; and, despite what is assumed to be a court spelling error, Hasso Plattner, the co-founder and supervisory board chairman of Germany-based enterprise software company SAP, through US-based wealth manager Loewenthal Capital's 4.71% holding. Both Trinet and Plattner were unavailable for comment.

The court filing said TNT served notice on the Logispring firm on April 22, 2009, to dissolve Logispring II with support from Trinet in order to pass the 80% threshold needed to wind up the fund.

A source involved in the wind-up said the LPs "sold the venture portfolio piecemeal at the worst time. The problem is corporations do not understand the type of commitment and consistency of strategy needed for this industry [venture capital]".

TNT's last annual report said it had taken a €10m impairment charge on Logispring, which was the company's "most significant" investment in a group of associate assets worth €62m as at December 31, 2009. Global Corporate Venturing research has revealed at least 19 companies backed by Logispring.

In May, TNT's shareholders will vote on the demerger of the group's express and mail operations, following the launch of its 2015 strategy plan at the end of 2009. TNT had been formed in 1996 through the merger of the Dutch national postal service with Australia-based logistics and express delivery company TNT.

This profile was first published in Global Corporate Venturing in January 2011.

SVB Financial Group

The world is banking on innovation. And so are we.

Every day SVB Financial Group (SVB) clients push the boundaries of what was previously thought possible. Their innovations make our lives more efficient, connect people across geographies, make our environment cleaner and safer, eradicate disease and improve the quality of life. Their vision for the world will create a better future. We're banking on it.

People skills

Managing a team's development as a corporate venturing unit matures often requires changes in the skills of the people in the unit and management of international expansion through the use of a mix of local partners and expatriates from headquarters.

After the initial excitement of having a corporate venturing programme set up and the initial deals completed *(described in the CV101 supplement)*, a number of teams are expanded so the personnel have the skills to help the portfolio companies by connecting them with business units or with specialist functions, such as marketing, design and product development and testing.

US-listed search engine provider Google's corporate venturing unit was set up in 2009 with a financial returns objective as a consequence of the company having developed a scattered and incoherent basket of about 50 minority equity investments in companies around the world and across multiple sectors.

Google Ventures has in three years invested in more than 100 companies and tripled its annual budget since launch in 2009 to $300m. In its re-evaluation of the venture industry, Google divided its venturing team of 53 into a number of different streams, including investment, hands-on support of portfolio companies, administrative and entrepreneurial outreach and incubation.

Along with an investment team of 15, there are 24 in hands-on support functions, such as recruitment for portfolio companies, design, engineering, marketing, statistics and communication.

Other corporate venturing groups have also divided their teams into incubation and investment professionals with separated back-office functions and those helping portfolio companies leverage their connections to the parent business.

Financial services provider Citigroup's Citi Ventures has a three-strong innovation team under Susan Andrews "focused on building the tools and capabilities that will allow our teams to scale ingenuity across Citi and drive new growth for the company".

Citi Ventures has also been expanding internationally from the US to source deals. While its partners work across Palo Alto, Chicago, New York and Boston in the US, its overseas managers are in Singapore and Shanghai, China.

But international expansion is not a one-way process. Google retrenched back to the US when it set up its venturing unit in 2009, while Siemens Venture Capital (SVC), venturing unit of the Germany-based industrial conglomerate, has offices in the US, Germany and China, although offices in Israel and India have been closed over the past four years. Ralf Schnell, chief executive of SVC, said in a profile this month that he would consider opening other new offices if there was a business case. "We are regionally agnostic – we are more concerned with the technology and the industry space," he said.

A common way of trying to expand into new regions has been to hire local managers, albeit with challenges in managing long-distance relationships. John Suh, director of Hyundai Ventures, said his biggest issue of the past year since the corporate venturing unit was set up in the US was "learning how to co-work between the corporate venturing business group at headquarters [in Korea] and my office [in California]."

Alternatively, corporate venturing units have invested in local venture capital firms. The Capvent Asia Consumption Co-investment Fund (CACC) is a $150m fund co-run by consumer conglomerate Unilever and Switzerland-based fund of funds Capvent, while last month Royal DSM, a Netherlands-based advanced materials company, joined peer BASF by committing to the fourth clean-tech China fund managed by Tsing Capital.

In May, Germany-based chemicals group BASF's corporate venturing unit invested $5m in Tsing's China Environment Fund.

But unless there is a tight relationship between venture capital firm and corporate limited partner as investor in the fund then it can be a diffuse way of gaining market understanding and experience.

If it takes about a decade for a corporate venturer to gain experience about investing then often the full team and head need a similar period to become fully proficient, at which point the managers are often challenged for their succession plans and the provision of career paths for their team – these are subjects for our third supplement in the series, CV 301, looking at firms with more than 10 years' operation.

Which way do you vote?

Motion: This House believes that in the field of corporate venturing, strategic objectives are becoming more highly prioritised, with a concomitant reduction in the relative importance of financial returns.

For the motion: Growth and innovation are two critical challenges faced by all corporations. Corporate venturing is a powerful tool that can stimulate and support access to external technology-driven innovation. The growing number of appointments of chief innovation officers with full responsibility for corporate venturing activities within the corporation is evidence of where current priorities lie. DSM is one such example. Other corporate venturing programmes, such as that of Dow Chemical, have evolved from being financial return-driven to being primarily focused on creating strategic opportunities for the corporation. Many independent venture capital (VC) funds have shifted away from early-stage deals, considered to be higher risk, in favour of later-stage investments. Corporates have stepped in to help fill the shortfall, with start-ups accounting for 64% of all corporate venturing deals over the period 2007-11, as opposed to 50% of all VC fund deals over the same period, according to trade body the European Private Equity and Venture Capital Association. This is not a reflection of corporations becoming voracious financial risk takers – it is recognition of the importance of securing early access to technologies and companies of potential strategic value to the corporation

Against the motion: The level of corporate venturing activity has waxed and waned over the past 40 years or more. In the current strong wave, more than 200 new programmes have been announced in the past two years, bringing the global total to around 750. A further 9,000 companies are considering launching corporate venturing units, according to figures from Boston Consulting Group. The longevity of corporate venturing groups is increasing and average assets under management are expanding. Corporations can no longer support burgeoning corporate venturing capital budgets in the absence of acceptable financial returns. Strategic value created may be important, but how it is measured, by whom, and when, is interpreted differently in each and every corporation. A significant number of corporate venturing units report to the company's chief financial officer, including new operations recently announced. The discipline imposed by financial return targets must shape the corporate venturing operation, including deal selection, portfolio management and exit strategy. In the absence of tangible performance results in the form of financial returns, the current surge in corporate venturing activity will not be sustained.

So, would you cast your vote for or against the motion?

The reality, of course, is that this oft-debated and complex subject requires considerably more time and space than is available for this brief article. The balance between strategic goals and financial return is the single most important question to be addressed by any fledgling corporate venturing operation. Over the years, many battle-hardened venturing veterans have debated this issue in small rooms at great length. There is no right or wrong industry answer, but there is most certainly a right answer for your particular company. Why?

The strategic-financial balance will underpin the key goals, objectives and performance measurements for the corporate venturing operation. It shapes how the unit staffing is balanced between internal appointments and external hires. It will dictate where to focus the hunt for dealflow, which external organisations to interact with and how and when to syndicate investments. It will determine the desired internal relationships with research and development, business units, new business development, and mergers and acquisitions (M&A). Exit strategy for a key strategic holding is likely to differ significantly from that of an investment seeking primarily financial return.

Some corporate venturing leaders have stated that, for them, strategic and financial goals bear equal weight.

- Their corporate venturing activity is expected to stimulate strategic external interactions that will ultimately generate new operational cashflow for the parent's existing or new business units.
- However, the corporation does not want to see investment capital disappear into a black hole, and thus an agreed financial return on capital deployed is required.

The desire to balance the two goals equally appears pragmatic. In reality, there is a trade-off. Attempts to balance the sometimes conflicting priorities of strategic ▶

and financial considerations have led to corporate venturing units falling short on both counts. Here are some situations in which the level of strategic importance of the portfolio company, or lack thereof, may materially affect your actions.

- The corporate venturing team of company A includes an external hire with extensive experience in investing in battery technologies. He has found an investment opportunity that has the potential for a high-multiple exit within five years (this is hypothetical – I am aware that some may struggle with this returns assumption) with a proven management team and strong syndicate partners. Company A has technical competence in battery technologies and a certain level of resource could be made available to support any interaction with the investee company. There is some interest in future battery technologies within the company but this is not high on the priority list. Do you invest?
- Company B is in discussions with an early-stage company in China which has been unable to secure new funding. Its existing investors are reluctant to provide additional capital. The Chinese company has a novel concept for carbon sequestration but needs \$10m and two years to get to a key validation point. Several more years and considerably more funding would be required to reach commercialisation. This concept fits well with an early-stage internal research project which has a high priority rating within company B. Do you invest?
- Company C invested in a software developer three years ago at a post-money valuation of \$10m. The adoption of a new product from the software company, due to be released next year, could provide company C with a significant competitive advantage. The board of the software company is about to initiate a search for a trade sale acquirer. Inviting the two main competitors of company C into a competitive bidding process is expected to produce a best bid of around \$50m. The M&A group of company C values the software company today at no more than \$40m. Company C cannot block a trade sale to a third party but has some limited rights to the software that might have an adverse impact on the valuation. What action do you recommend?
- Company D is conducting due diligence on a start-up medical diagnostics company. The target company is developing a test which, if approved, would fill a strategic gap in the product range offered by company D. There is considerable technical and approval risk involved, significant capital required and the management team would need to be strengthened. The corporate venturing team at company D is competent, enthusiastic but relatively inexperienced in making and managing this type of investment. The relevant business unit at company D wants to work in stealth mode with the diagnostics company and does not want other VC funds or strategic investors involved. An early acquisition, on achievement of certain milestones, would be the target. The corporate venturing head would prefer to syndicate the deal, bringing in experienced VC investors with resources to fund the company through to commercialisation and a high-multiple exit. What investment strategy do you adopt?

The answers to the four questions above may be very different from one corporate venturing unit to another. The correct answer is always the one that aligns best with the investment strategy that has been approved by your internal paymaster. Get this wrong, as many have in the past, and it may be your last investment. The corporate venturing landscape is littered with the corpses of failed and discontinued corporate programmes. However, in the past three years there have been far more entries in the births column than in its deaths counterpart. From a personal perspective, having interacted with a great many corporate venturing units over the past 15 years, there is indeed a subtle but tangible increase in the importance of strategic value-added compared with financial returns generated. Some corporate venturing leaders would capture this as follows.

I have an annual capital investment budget of, say, \$50m – less than one-tenth of 1% of my corporation's annual revenues. Which of the following two results are more likely to make the greater impact on the corporation?

- An outstanding internal rate of return (a measure of investment performance) of 15% on capital deployed.
- Access to enabling technologies, through strategic investments, that help drive future revenue growth for business units within the corporation.

Both would be nice to have, but a corporate venturing unit must have clearly defined goals which prioritise, when necessary, between financial and strategic options. The beauty of corporate venturing is that whatever rule or guideline you might identify, there are always exceptions.

If you have had the vision, skill and tenacity to build a corporate venturing operation of the magnitude of that of Intel, investment returns can have a very material impact on overall company results – even though the prime driver may remain strategic.

Companies such as IBM, Microsoft and GE have run successful programmes with a strategic focus that circumvent the financial-versus-strategic issue. Under such initiatives, the corporations offer help and support to young companies of interest but do not make traditional cash investments in the start-ups. This is an attractive model as it obviates the need for a capital investment budget. The viability of such programmes is underpinned by the brand equity and global presence of the corporations involved.

Unilever took a novel approach when it launched its corporate venturing activity in 2001. It set up three distinct funds, one purely strategic, one purely financial and the third somewhere in between.

Will the perceived shift in favour of strategic objectives help extend the life expectancy of the current crop of corporate venturing units? See Global Corporate Venturing in about four years' time. ■

Building a venturing unit

According to Global Corporate Venturing, there are now more than 750 active corporate venturing and innovation (CV&I) programmes, with an estimated $75bn to $150bn in assets under management.

CV&I programmes are now viewed as a vital addition to traditional corporate innovation sources – research and development (R&D), mergers and acquisitions (M&A), strategic alliances, licensing and joint ventures. And companies are taking a keen interest in best practices for establishing new CV&I programmes, or fine-tuning strategies and operations of existing groups.

We explored this trend in recent Bell Mason Group research and found a great deal of optimism for the promise of corporate innovation groups, tempered, of course, by concerns about internal and external barriers to success.

Patty Burke
partner,
Bell Mason Group

CV&I models

Today, a CV&I portfolio frequently includes several venturing models, such as corporate venture capital, incubation, commercial piloting, venturing centre of excellence and innovation partnering, chartered to address different but complementary objectives. As CV&I has become more mainstream, we are seeing a trend for companies to consolidate and leverage their innovation initiatives in an integrated innovation portfolio, often overseen by a chief innovation officer (CIO).

Whether part of an integrated innovation function or a standalone unit, corporate venturing groups make direct external investments. They may invest off balance sheet, as a limited liability company or through limited partnerships (as investors) with external venture capital funds (VCs), with a few beginning to look farther afield to growth private equity or innovation M&A. Mature corporate venturing units have established investment strategies and parameters, and are measured on achievement of both financial and strategic objectives.

The four phases of development

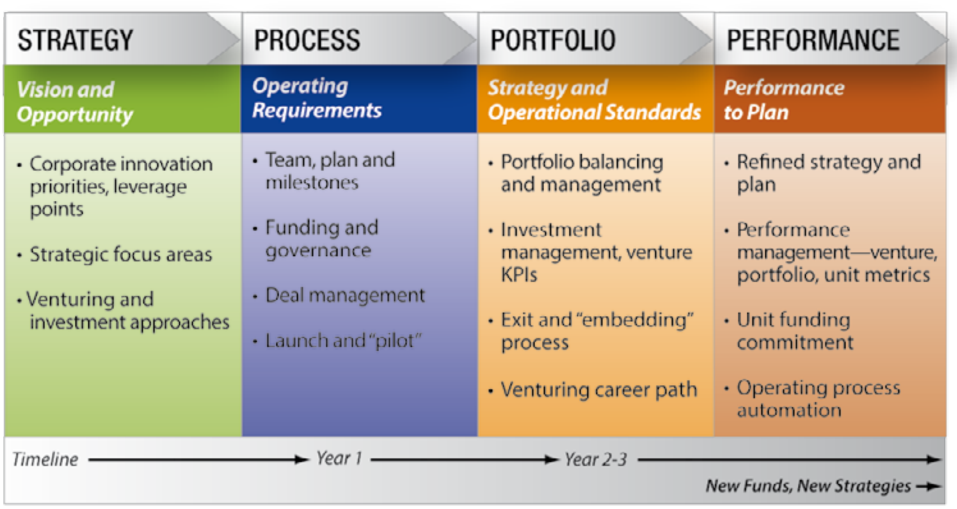
At Bell Mason Group we have analysed hundreds of CV&I programmes – both successful and unsuccessful – and have used that data to develop a four-phase framework for CV&I unit development that can be customised for innovation models – incubation or corporate venturing for example – by industry or for unique corporate requirements.

The four-phase model illustrated below shows sample high-level elements by phase – the full framework includes multiple levels of execution guidelines and tools within each phase.

Phase 1 – strategy: vision and opportunity (year 1): Most corporate venturing groups start with ad hoc activities, such as direct investments in just a few strategic companies, or with a fund of funds that has a complementary market or technology focus. Fund-of-funds investments can provide an easier way to learn about the market, build relationships, and introduce the company into the venturing ecosystem.

Investment strategy is a key deliverable of phase 1, including a charter that states explicitly the corporate venturing group's focus, objectives, and investment models. The corporate venturing team's job is to match current and projected corporate priorities ▶

Bell Mason 4 Phase Model for CV&I Development



to new markets and innovation growth areas that address the corporate vision.

The corporate venturing group's board and sponsors must also buy into the charter, alignment with corporate objectives and potential success metrics. Identifying and partnering business unit (BU) or functional executive champions to explore corporate gaps and potential focus areas ensures that objectives are aligned.

Venturing groups often choose to work with a limited number of BUs, functions and regions to start, usually choosing units that may be challenged by innovative competitors or have opportunities to leverage hot new technologies, regions or market trends. Once a successful corporate venturing-BU or functional relationship model is established, it can be duplicated and adapted for other groups.

Phase 2 – process: operating requirements (years 1 or 2): With strategy set and direction clear, the next phase is to establish the operating requirements for the corporate venturing group's annual plan, with an outline of key milestones for years 2-3. This is a trigger phase that sets up the foundation required for the successful development of the unit over time.

BMG has defined 10 operating requirements for phase 2. Among the most important are governance, deal management and marketing the fund through systematic outreach to targeted industry and VC partners as well as internal stakeholders..

Governance policies are always challenging for corporate venturing units, but efficient and predictable operating processes are critical to ensuring the unit can compete for the best deals and earn the respect of potential VC partners and target entrepreneurs. Ideally an investment board should include a limited number of senior venturing and domain experts and must be entrepreneurial and empowered – not just a collection of executives representing major corporate functions. Good investment boards have the time, industry knowledge and passion to help shape and tune the investment strategy.

Reporting structures vary by unit charter, with pros and cons for each option. For example, corporate groups – innovation, strategy, finance and corporate development – may be less constrained by quarterly profit-and-loss pressures but less connected to the BUs and resources they have to offer. A BU may bring great market expertise and ecosystem relationships but may also be burdened with established business operating processes that are not venture-friendly, particularly venture marketing and product development, along with short-term performance pressures.

New product and service categories may be unfamiliar territory for existing BUs, and adapting to new revenue sources, ecosystems, channels and partners can be a challenge. And because BUs are incentivised to bring in revenue fast, they may also move too quickly to attack larger, highly-visible markets, sometimes skipping the important validation and iteration steps that a new concept requires, and risking reputation damage as a result.

Deal management, with explicit processes within each phase of the pipeline, is one of the best ways to accelerate the often lengthy investment approval process. Well-defined investment criteria, and a phased due-diligence process that brings in corporate resources and reviewers at appropriate points, can accelerate the process and make it more competitive with traditional VCs. Using investment criteria as a prequalification tool is critical – many corporate venturing teams waste valuable time responding to and vetting internally generated ideas and referrals, especially pet projects from executives and board members. A clear investment strategy and process empowers the corporate venturing group to reject these time-sink projects.

Marketing and communicating a clear investment strategy sends a message to both internal stakeholders and the external innovation ecosystem – VC partners, academic institutions and market influencers – and helps to ensure a prequalified dealflow and strategic fit. This ecosystem also serves as the group's eyes and ears in identifying early-stage innovations and competitive and trend information, complementing its internal champions and scouts from R&D, sales and product groups, worldwide.

Phase 3 – strategy and operational standards (years 2-3): With operational plans in place and a critical mass of investments, phase 3 is the time to test and refine the portfolio strategy and standardise operating processes.

Portfolio balance is assessed at year two or three to determine whether the original investment strategy is still relevant and the portfolio is meeting the objectives of the group's investment strategy. This assessment should evaluate the mix of ventures in terms of focus areas, venture types, stages, regions and distribution across the innovation spectrum, with the goal of identifying misalignments and determining causes and implications. How has corporate strategy evolved? Have market and competitive dynamics changed? Should focus areas be changed or expanded?

In addition to portfolio analysis, a candid assessment of the group's management, operations and processes should also be done. The Bell Mason corporate venturing assessment is often used to evaluate progress at each phase. One of the goals of a phase 3 assessment is to define data and information needed to make investment strategy changes and for fine-tuning unit staffing and operations in phase 4.

Investment management systems should also be in place to track and manage milestones, risk and metrics – both strategic and financial – as ventures move towards exit – spin-in to a BU, spin-out, initial public offering (IPO) or trade sale. Development milestones are tracked across multiple areas – from product to marketing to management team composition – addressing key performance indicators by venture stage. The Bell Mason framework for venture development is one way to track portfolio company progress, providing input for management "dashboards" that give an investment board a summary view of corporate venturing investments in relation to one another, to incubated investments and to other corporate innovation initiatives.

Phase 4 – performance to plan (year 3): Building a corporate venturing unit is like building a start-up – a continuous process of action, analysis and iteration. Phase 4, in year 3, is the time to step back and take a critical look at performance to plan. Issues and market dynamics identified in phase 3 feed into an update of the investment strategy, plan and funding needs. Operational processes – both internal and external – are evaluated to ensure the group is functioning like a well-oiled machine.

Performance management is a key element of this phase. All corporate venturing units monitor financial metrics, but in reality, returns are rarely material to the company's overall performance, and are not likely to be achieved in less than five years. Setting, monitoring and achieving strategic milestones provides management with near-term ways to measure the success of the corporate venturing group, and to help refine its objectives and strategies. For example, the ability to pre-empt competitors or be first to market in a high-growth category are strategic metrics that can be identified and tracked prior to any significant financial results.

Establishing a system for tracking and reporting strategic objectives makes it possible to assess the portfolio's financial and strategic value, analyse the various elements against the original strategy model and portfolio mix, and determine appropriate changes.

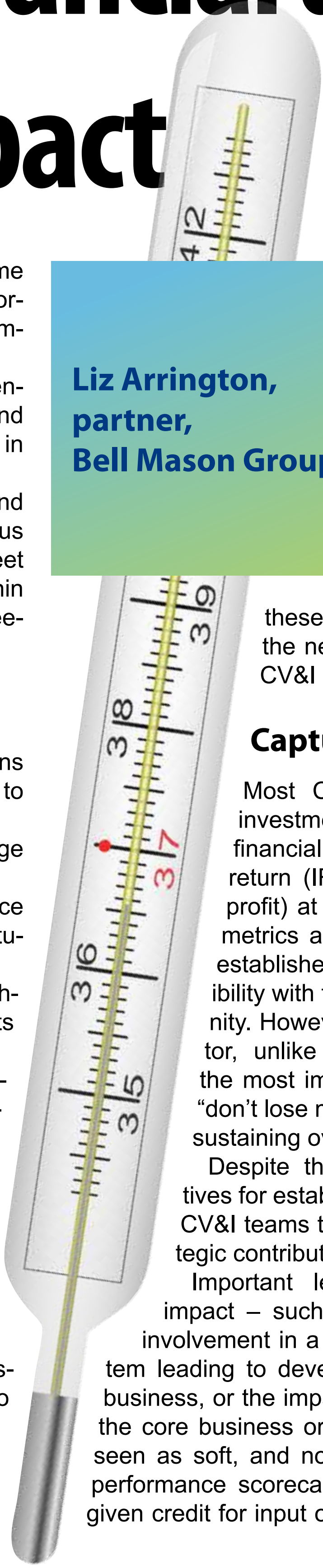
Standard dashboard views that illustrate metrics at the venture, portfolio and corporate levels can then be provided to the investment board and executive team as it assesses the value of its overall CV&I initiatives, and aggregates the performance of different innovation models across the company.

Corporate venturing: a growth engine

In today's dynamic, technology-driven environment, innovation is a critical topic for every corporate board, with high visibility and even higher expectations. Corporate venturing has the potential to deliver real results that can transform the trajectory of even the most traditional corporations – the opportunities are certainly there.

Innovation groups that set clear objectives and develop sound processes and metrics can build a solid foundation to leverage these opportunities. The result will be innovation strategies and teams that can survive and thrive through management and market cycles, bringing innovative products and services to market, and fuelling an important engine for corporate growth.

Assessing financial and strategic impact



Liz Arrington, partner, Bell Mason Group

In all its forms, post-2008 corporate venturing has become main stage, a foundational element of virtually every corporate innovation strategy for long-term growth and competitive advantage.

Corporations are uniquely equipped to leverage the benefits of venturing, with the ability to use powerful brands and global reach to accelerate markets, and with experience in setting standards and establishing market platforms.

However, the past 50 years of corporate venturing and innovation (CV&I) history has been marked by numerous programme starts and stops as CV&I units failed to meet sometimes changing business value expectations within a corporate patience cycle that typically parallels a three-year executive sponsor tenure.

Longevity mandates performance

The single largest barrier to CV&I unit longevity remains the ability to demonstrate strategic impact that leads to long-term financial growth and competitive advantage.

Corporations establish CV&I initiatives for a wide range of strategic reasons. For example:

Chevron Technology Ventures: help Chevron embrace emerging technologies to create new commercial opportunities, reduce costs and improve performance.

Merck Global Health Innovation: grow emerging healthcare solutions into meaningful businesses, adjacent to its pharma core.

Intel Capital: advance Intel's strategic objectives in computing and communications – new global business ecosystems, chip customers.

Steamboat Ventures (Disney): build long-lasting [ecosystem] partnerships and provide portfolio companies with direct access to a wealth of resources and business development opportunities.

Unilever Corporate Ventures (India): support expansion capabilities into emerging markets and address consumption-driven business opportunities.

BP Alternative Energy Ventures: scale tomorrow's disruptive clean energy and carbon innovations to bring to global markets

While baseline financial goals for investments and investment portfolios are table stakes, the ability incrementally to achieve and communicate progress on these strategic objectives that "move the needle" keeps corporations in the CV&I game.

Capturing full value

Most CV&I units track their venture investment performance primarily in financial terms, such as internal rate of return (IRR – a measure of investment profit) at exit, or free cashflow. Financial metrics are easy to track, familiar to the established business, and provide credibility with the venture capital (VC) community. However, for a strategic (CV&I) investor, unlike an institutional investor (VC), the most important financial metric is often "don't lose money", and ideally become self-sustaining over time.

Despite the fact that the primary objectives for establishing these units are strategic, CV&I teams typically struggle to capture strategic contributions adequately.

Important leading indicators of strategic impact – such as kickstarting the company's involvement in a game-changing market ecosystem leading to development of a billion-dollar new business, or the impact of a promising innovation on the core business or brand – have historically been seen as soft, and not part of the business-as-usual performance scorecard. And units are almost never given credit for input on decisions not to participate ▶

in hot but short-lived new markets – even though the research and knowledge that the CV&I units contribute may save the corporation millions of dollars.

Strategic value tends to be measured and communicated only anecdotally, with strategic benefit cited to justify and defend investment performance during market downturns, and the performance of an investment is seldom tracked after it exits the CV&I unit portfolio or is embedded in the core business, so there is no longer-term view of that investment's true value to the company.

To remain sustainable and relevant CV&I programmes must demonstrate both financial and strategic results that:

- Align corporate parent business urgencies, charters and lead-time-to-return criteria with CV&I unit portfolio strategy.
- Demonstrate value to all key stakeholders.
- Capture financial and strategic value incrementally, within the three-year corporate patience cycle.
- Ultimately move the needle for the corporation: creating a new business unit, attracting a significant new customer base or pioneering a competitive new business model

Key steps in assessing strategic impact

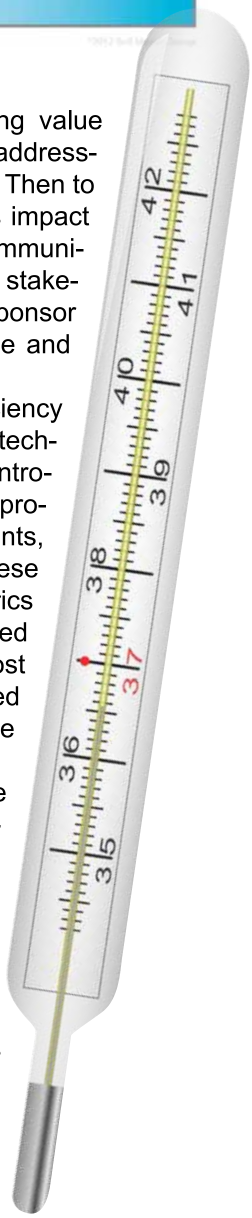
For definition and measurement Bell Mason Group uses a structured approach to help CV&I units establish strategic metrics.

The first step is to identify the key stakeholders and define their priority objectives in respect of the CV&I unit. Within each corporation there will be a combination of corporate, business and functional representatives, with a range of innovation charters, and a mix of nearer-in versus longer-term value return targets. Other important stakeholders include the portfolio companies, VCs and leading ecosystem partners.

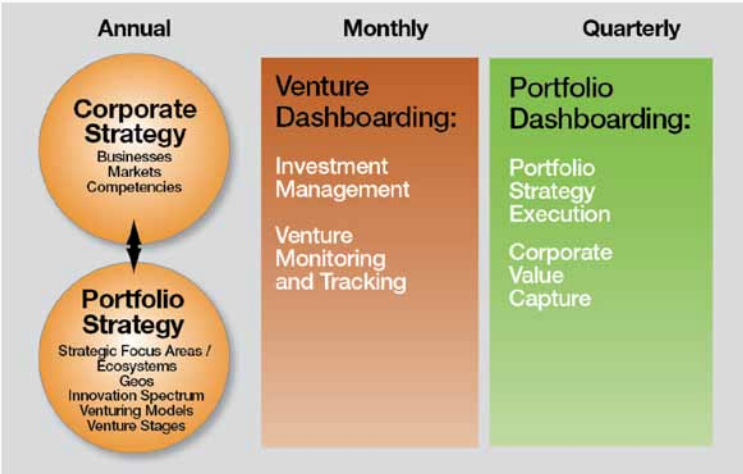
The next step is to determine leading value indicators that suggest progress toward addressing these stakeholder priority objectives. Then to translate these indicators into "business impact metrics" that can be quantified and communicated in terms that are relevant to key stakeholders – corporation, business unit sponsor or partner – and generally relate to time and money.

For example, in an operational efficiency play, the leading value indicator might be technology transfers, where ventures are introduced to the core business through pilot programmes, joint development agreements, enterprise roll-outs or acquisitions. In these cases the relevant business impact metrics would be associated with value chain cost savings or reduced process cycle times.

Getting to the right set of leading value indicators and business impact metrics is not simple. Bell Mason has found it to be an iterative process for every CV&I unit, with continual testing ▶



BMG Portfolio and Performance Management Approach



to determine which metrics are most relevant, optimal for executive consumption, and can be standardised for consistent tracking across the portfolio.

Tracking and reporting

Making strategic value tracking and reporting an integral component of both the individual venture investment cycle and the portfolio management process is critical to effective operational use of strategic metrics.

The starting point is to identify potential leading value indicators and business impact metrics when evaluating new deals, and then lay the groundwork for the collection of supporting data once the investment is made. There should be just enough data collected to support the strategic case, without becoming burdensome to the portfolio company, the CV&I unit or the corporation.

A streamlined, dashboard-based approach – such as the Bell Mason Group Portfolio and Performance Management Framework – can provide a consistent view while setting expectations for elements that management can continually monitor.

- An annual planning process, via investment and portfolio strategy and plan – a means to ensure alignment with corporate strategic priorities, balance the portfolio, refine unit objectives and set execution milestones.
- A monthly venture status tracking and monitoring process, via venture dashboards – used to keep investment managers and venture leaders engaged in assessing financial and operational progress, flagging risks and issues and highlighting incremental insights and added value.
- A quarterly portfolio review, via a portfolio dashboard – an opportunity to assess aggregate portfolio performance and to highlight leading progress indicators to show that the CV&I unit is on track. This is particularly important for the increasing number of companies with an integrated innovation structure that includes corporate venture capital, incubation, innovation partnering and commercial piloting.

The performance of these different venturing models may be viewed separately, or aggregated as elements of an innovation portfolio.

The CV&I unit also needs to be able to demonstrate that the sum value being created is greater than its individual parts. That could include reflecting the value created when the corporation is leading the development of a new market ecosystem, or combining multiple investments or partnerships to enable a new business vision or platform. One real-world example is Citi Ventures, which is using investments – ViVOtech, Billing Revolution – and innovation partnerships – MasterCard, Google, Nokia – to accelerate the establishment of mobile payment ecosystems.

Even after an investment has exited the portfolio, it is important to establish mechanisms that ensure strategic value is not lost with the transition, and that the CV&I unit is acknowledged for successful venture contributions. And, finally, it is just as critical to ensure that lessons and cost avoidance strategies from failed investments are captured.

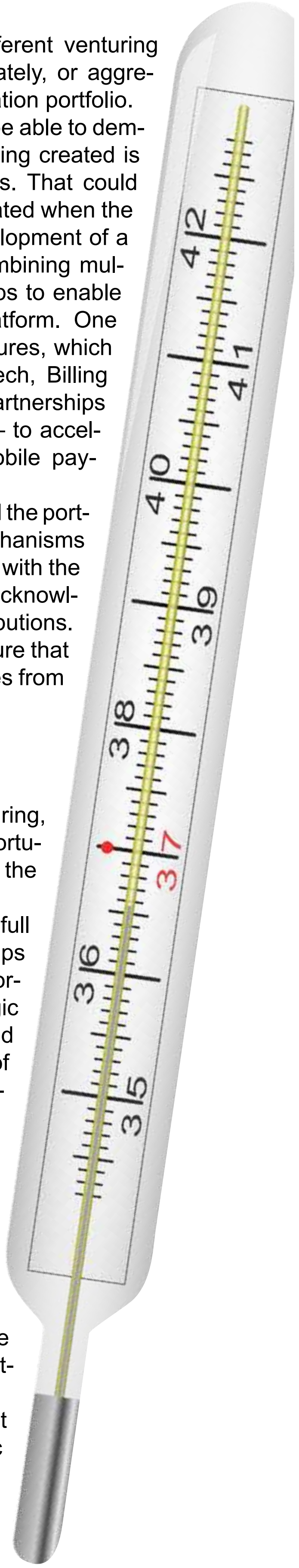
Demonstrating value

In this golden age of corporate venturing, successful CV&I units have an opportunity to create value that goes beyond the financial performance of many VCs.

However, to demonstrate that full value to the corporation, CV&I groups must annually clarify and revisit corporate and other stakeholder strategic priorities to be able meaningfully and incrementally to show evidence of both strategic and financial performance as the unit develops.

This requires stitching the concept of strategic value into the operational fabric of the CV&I unit, from individual deal sourcing, to investment management, to an aggregate strategic view of the portfolio's integrated CV&I performance – internal incubation; piloting, corporate venture capital and innovation partnering; joint venturing).

The leaders will be CV&I units that can make hard-to-capture strategic value concrete, and that understand how to communicate progress along a roadmap that demonstrates real business impact.



Satisfying needs in a new investment environment

This is an edited extract from the 2012 Global Corporate Venturing Symposium panel on syndicate partnering, chaired by Erik Sebusch, partner at CMEA Capital

Erik Sebusch: I was with UPS and their corporate venture capital group investing in private equity and venture capital [VC]. Now I have moved to a venture capital firm. My primary objective is to manage strategic relationships resulting from large investments from large corporations, and they have evolved over the years to $1.3bn in assets under management in seven funds. We now have a lot of institutional investors which make up a family office of high-net-worth individuals, state pension plans as well as a lot of corporates. I try to make sure I foster those relationships.

Here are a few different viewpoints, some new syndicate members who will be the future of venture capital deals.

Cédriane de Boucaud, partner, Disruptive Capital Finance, pictured right: We invest in disruptive technologies and also disruptive situations which might be distressed businesses, M&A [mergers and acquisitions] or buy-and-build. We have done a lot with corporate partners, which is great. Our portfolio now is primarily early-stage technologies and we are looking to do buy-and-build in the early-stage VC companies within one sector. We have a pledge fund now of about $200m that will be invested in buy-and-build for young companies.

Peter Cowley, investment director, Martlet, pictured below right: A bit about my background – engineering, computing, worked for a corporate for a couple of years in London in the 1970s, five years in Bavaria and then came back to the UK. I have been entrepreneurial for about 30 years. About 10 or 12 years ago I was involved in property development and charity governance, then about seven years ago in angel investing, mentoring.

The reason I am here is because I set up and run Martlet, a corporate angel, which is a rather unusual model compared with the rest of this room. I will tell you more about it later, but it is an operating arm a $1bn sales turnover engineering company based in Cambridge. I am both an active angel investor and run the Martlet corporate angel.

Matthew Mead, investment director, Nesta Investments: Nesta is an innovation agency based in the UK. You may be familiar with other models, like Sitra in Finland for example. Nesta was created about 15 years ago as a UK public body but very recently became an independent foundation. Nesta does a combination of different things – policy and research work, grant programmes and investment. In both the grant programmes and the investment work, clearly links with corporates and alignment with corporate agendas are very important.

My personal background is in venture capital, since 1995. I was at 3i for 15 years in the UK and did some stuff in the US as well. My responsibilities at Nesta fall into three areas. The first is managing a £25m [$40m] venture portfolio of assets based primarily in the UK. The second is a sort of chief financial officer role with oversight of the £340m trust that supports our activities and its investment. The third is the creation of an impact fund – investing to achieve outcomes, not necessarily to maximise return.

Tony Stanco, executive director, NCET2: I am the executive director of the National Council of Entrepreneurial Tech Transfer in Washington, DC. I am a securities attorney. I worked for about six years at [US regulator] the Securities Exchange Commission. I joined George Washington University after that. I worked for software government policy and since then at the National Council of Entrepreneurial Tech Transfer, which started at GW and spun out.

We are an organisation of about 200 and we search universities in the US. We are about seven years old. There is a huge push on the government side now to commercialise the $40bn of research dollars it spends at the universities and we help transition that research into start-ups.

We do basically three things. One is a database of university start-ups. These are US start-ups that started at university. Some are around the world but the majority are in the US. We have about 1,500 on this list now and we are aiming for the 6,000 that have come out of the universities over the past 20 years.

The other thing we do is education, both formal and informal. On the informal side we do a lot of webinars to help universities create start-ups, help the faculty and students understand the entrepreneurship of venture capital, and we do a Global Corporate Venturing webinar series.

The third thing we do is a conference – the first thing we started – and that is what I am going to talk to you about last. We do this with the NSF (National Science Foundation) and the NIH (National Institute of Health), which are the major funders of university research.

Sebusch: So we have the university, then we have the foundation, then we have your angel and corporate investor and the pure VC. We will get a little bit of a perspective. I know that is not the full inventory of syndicate members we are going to see in the future, but at least this is a small subset of it and you are going to get an idea of what they are going to be looking for and what their needs and wants are.

I would love to hear from a venture capital perspective, being a pure venture capitalist on this board, what is it you are looking for in your syndicate partners as well as what you want out of the corporate venture capital syndicate partners.

De Boucaud: We have two corporate partners in our portfolio – Coca-Cola Enterprises and the venture arm of the chemical company DSM. Both have worked out beautifully, but the key thing has been expertise. DSM has helped us scale up our technology with a drug delivery company. That was very helpful to make sure we went from a technology that was working in a lab to using their chemical expertise in manufacturing to make sure we could scale up and demonstrate to the blue-chip world that that works.

With Coca-Cola manufacturing standards, operations and distribution were very important. We have to have and are looking for that expertise. In addition we have to have an alignment. Alignment is not always easy between a corporate and a VC. We are looking for a return, but they are looking for strategic advantages and better margins for their own business. We have managed to structure it such that we are all benefitting from the bottom line and that is the common language we have. That is essentially what we are looking for in co-investors.

It has gone well. I would like to see more partnership in our portfolio with other corporate venturers. I find that difficult a lot of corporate venturers, as far as I have seen, have not been very risk-taking. While I am very much a risk-taker, I would like to see a little bit more from the corporate world, just to think a bit bigger alongside it.

As we are specialised in clean-tech, we have seen a lot of young companies grow to a stage where they are generating revenues, but they really struggle to get sufficient size, sufficient funds, sufficient management, and I don't say the number of management, but quality management. To attract quality management, the larger you are the better your balance sheet is. We are looking to consolidate ▶

some of these companies you have all seen popping out. There are lots of people in energy efficiency and waste treatment and so on. We are trying to consolidate that market. I hope that the corporate community will see that is exciting, that is very scalable and interesting for them in that we will see synergies with the corporate community.

Sebusch: Tony, from a university perspective what should a syndicate group expect out of the university? What are the pros and cons of working with them? Why are they even in venture capital to begin with?

Stanco: The universities are in two parts in the venture industry. One is in creating the start-ups. They have been doing that since about 2000 in a very directed way. Obviously Stanford and MIT have been doing it for a lot longer, but the rest, the whole 200-plus research universities have been trying to create start-ups since 2000. That is an interesting thing to do – tech transfer through a start-up – because if you have had trouble working with universities it is because the incentives don't allow it. Once the technology gets into a start-up then you don't have that problem anymore. The start-up is usually a smaller research group that really wants to partner, really wants to take technology forward, really wants to work with the global corporate community.

The [US] government invests $40bn in research. A typical example is a company out of University of California which had some research dollars from the NSF, and did some work on imaging technologies, such as ultrasound imaging. They had a grant from another government programme to commercialise the research. They got some angel money and then sold to Siemens for about $25m. That is a prototypical example of what the university community is trying to do on the start-up side.

Just this last year or two universities have tried to create accelerator funds based on the Y Combinator and the TechStart model. There is only a few million dollars at a university, sometimes more, sometimes less, and they put $50,000 in just to get the team moving, get them out looking for customers of the lead start-up model, and they want a partner. The global corporate community could be a great example of a partner there. They want expertise, they want money, but they also want the connections and the ability to network.

Sebusch: You have put together a consortium of universities. How many are there and what did it take to get them to join up? What motivates them the most to join together and what are some of the difficulties experienced by those you have talked to that have not joined?

Stanco: There are a lot of universities in the US, unlike some other countries. There are thousands if you include the community colleges. There are only about 200 research universities that get 95% of the $40bn available and all of those are part of our organisation. What motivates them? In the 180s9 they were given the property rights to the research they do under federal expenditure, but they have to commercialise that. They tried to do that through licensing. That did not really work that well, and then when you had examples like Google and Netscape where people were making a lot of money on the start-up paradigm, people thought "perhaps we should try that". That is what they have done since about 2000 and that is going pretty well. About 600 university start-ups are created every year on that government funding.

It is a wave. There were early adopters, some later adopters, but basically over the past 10 years – we have been around for seven – every university is now on board on start-ups because of the economic situation. They are pressured by governors and by the government to commercialise. There are active programmes.

Sebusch: Matthew, what should syndicate members expect out of a foundation? What could you offer them? Tell us a little bit about what it is you are structuring and putting together.

Mead: There are several very large foundations you will all be familiar with – the Gates Foundation, Rockefeller, Wellcome in the UK, Omidyar, Gatsby, the Sainsbury Foundation – and they are investing a lot of money. The first thing to get clear is where in the foundation that money is coming from. Are they investing purely for return to fund the activities they focus on, or for outcomes as part of their activity? You have to establish that first because they will think very differently, and we think very differently about how to invest our assets to produce the income to fund ourselves. We all think quite differently.

Most direct investment is done for outcomes, not purely for return. Most foundations are very clear about what outcomes they are targeting.

Nesta has a number of outcomes in our charitable objectives, but our fund focuses on education, the ageing population and something what we call "sustainable communities". We work with corporate partners in lots of different ways across those themes because it is not just an investment perspective.

Quite often that conversation starts with a programme, a grant programme or a focus programme in a certain area. One of the themes within education is about how people learn in UK schools. If you watch people's behaviour out of school with digital technologies, they learn in a very different way. How can you bring those two learning activities together in a comprehensive way? We are talking with corporates about that programme.

It is a long answer to your question, but it is a combination of being clear about the source of the money from within the foundation and then about the outcomes that foundation is seeking.

Most foundations see a lot of value in partnering ▶

Erik Sebusch speaks at his panel discussion with, from left, Tony Stanco, Matthew Mead, Peter Cowley and Cédriane de Boucaud

corporates that can bring something very different to that syndicate.

Sebusch: Peter, angel investing – some are saying it could be a bubble. One of our managing directors came into work and said: "It is official – we are in an angel bubble because my dentist said to me 'I have made my first venture capital investment of $25,000 with a group of dentists'." What would you expect from an angel investor, or what should investors expect from an angel investor in the syndicate? How will they act? What is their motivation? Do you think it is a bubble and do you compare the UK to the EU?

Cowley: The bubble bit is quite interesting, particularly with crowdsourcing and things like Crowdcube coming online. I will come back to that in a moment.

Some of you in this room will be angels, I am sure. Some of you will have done some sort of investments in family and friends, possibly even as fools, as the abbreviation FFF suggests. There is a lot of information in the media about angel investing, with some television programmes about it as well. It does not really fit in with corporate venturing at the early stage, because usually the sort of investments I get involved with – and I did about 12 or 13 last year – is a much earlier stage, where the pre-money is perhaps a few hundred thousand, perhaps up to $2m. A corporate venture probably would not dream of looking at that level. The angels are looking for a bit of excitement. They are not just looking for a punt – some are, but most are not – they are looking to somehow get involved and add value.

A few angel investors bumped into the UK Enterprise Investment Scheme [tax relief] limit of £500,000 last year, but not many compared with California, where £500,000 is probably entry level for a super-angel for one investment. We are putting together rounds of a few hundred thousand, typically £300,000 or £400,000 first round. We will follow on perhaps once or twice with a pre-money of £1m to £2m.

There are a couple of examples of the connection with corporate ventures. So far in my angel history, which goes back about three or four years, I have never seen anything where a corporate venture comes in early. They come in later on. We have one deal in my portfolio which is quite well known in Cambridge called Néal – Gaelic for cloud – which is at an £8 million round. [VC firm] DFJ went in, and IQ Capital and a group of angels put in £1m plus. That is on about a £10m to £12m valuation. Very unusual.

Generally angels go in, possibly with seed funds, and we are finding the corporate venture is getting later.

There is a good example, which I did not invest in unfortunately. Two years ago Oval Medical in Cambridge benefitted from a small angel round of about £300,000. Then they put in another £500,000. The initial valuation was about £1m two years ago. The corporate venture comes in at a £10m valuation. This is somebody in the drug field, of course, not the pharmaceutical company, but further down the chain. In terms of the connections, you need the angel to do the early stuff and take some of the risk out, then you can take over. We need you to feed into the system strategic investments in the same way as we see them.

Sebusch: We at CMEA Capital agree with a lot of that. ▶

From a corporate venture capital perspective in energy materials – one side of our business – we believe corporate venture capitalists should come in early and we are bringing them in early. In the US we think that is vitally important because of the technical nature of the sector, the need for pilot testing and so on.

On the life sciences side, from a formulaic and a chemical compound perspective we are bringing corporate venture groups in early, not to invest, but to give mindshare and say: “What is it you guys are looking for in the future?” On the IT side, I see much more of the later entry . There are some coming in earlier, but we don’t necessarily need them as much in the IT side.

On venture capital, everybody has seen the Kauffman report [Ewing Marion Kauffman Foundation report on venture capital: We Have Met the Enemy … And He is Us] claiming it is a philanthropic endeavour. I am curious, Matthew, how do you manage the good aspect of your investment and the financial returns? Is it purely philanthropic?

Mead: This is grey ground. Clearly a number of investors who invest for outcomes are doing it for philanthropic purposes. However, there are also a number of funded funds springing up in the UK and across the rest of the world that are interested in this blend of achieving outcomes and making a financial return.

The financial return will never be the sort a venture fund might promise. Typically they are looking for IRRs [internal rates of return – a measure of investment performance] in the 5% to 6% area. The message we have from talking to investors is: “We really like some of the outcome areas you are targeting. We like the way you are trying to develop the proofs of those outcomes being incremental,” and we have to invest in organisations that also want to deliver outcomes and not just shareholder return. That combination can be a challenging discussion with different organisations, depending on whether they are not-for-profit or for-profit.

At a minimum, for a social enterprise to have real impact it has to be sustainable, therefore return does have to come into the equation. It is just a combination of the weighting. We are very clear that when we invest, it is to deliver outcomes, not to maximise return.

Sebusch: Peter, as a corporate angel, should you do that? Is Martlet a good model? Should people copy it?

Cowley: You will have to ask me in about three years’ time whether it is a good model or not, as it is only a year old. Let’s just talk about what it is. Basically the concept was Marshall of Cambridge – a billion-turnover, 4,500-person company, 100 and so years old. It is an engineering service business, so there are about three-quarters of a billion in cars, about a quarter a billion or so in aerospace and some other bits and pieces.

It runs the airport in Cambridge and it has a land vehicle division. It is a family company still run by the executive chair, who is 80 years old, and the new chief executive is his son, who is 50-odd. It is run like a family company, although there is a governance body of great and good from the industry to give some level of independence. They invested in [UK biotech company] Abcam. One of the early investors claims to have made a 750-times return so far. Marshall went in early as well.

[For Martlet, Marshall’s investment vehicle], access to technology and new ideas is very important, but they don’t have to be synergistic. One of the rules when we set it up was that synergy might drag management time away from the operating companies. Another one was brand recognition, this business of Marshall not being known. It liked to be spread out, but there is the Marshall name. I don’t know what the long-term aim is there, but just to spread it out.

Another factor is innovation support, infrastructure support in the local area. The investments we have done have covered south-east England and East Anglia mainly, but they are spreading out. We have one in Loughborough [Leicestershire], and we have been over in Northern Ireland a couple of times. In the end, down the bottom of the list, is some sort of IRR calculation. These are public figures of course, because it is a large company and the rate of return on the asset base is very small. In that respect my target if I have to meet this IRR is not too bad.

About £500,000 has gone out – 11 deals in the last year. They tend to be stuff that is engineering based or web software based, no biotech, but some med-tech. The idea behind it is something that will seem pretty alien to the corporate venturers here because there is a level of altruism and other things that are strategic, but you cannot calculate to finances.

Sebusch: Cédriane, you have a pledge fund. Could you talk to that and the family offices that co-invest with you? How do they interact in a syndicate? Are they valuable, do they get out there and roll their sleeves up?

De Boucaud: A pledge fund is effectively funds that corporates, family offices of pension funds will commit to us, but we invest on a deal-by-deal basis and the structure for us is we get a carry [a share of investment profit] and an investment management fee based on what we invest in that one deal. It is not a pooled fund. Why do we do that? One, I don’t want to wait 10 years to have my carry, and two, a lot of these investors have been really frustrated in the past few years paying 2% management fees and 20% carry. In a recession you have a lot of investors who are very nervous about investing. They have paid a lot of money to investment managers that have simply not put that money to work. They just don’t like that anymore and they would like to see a lot more transparency in management fees. That is a bit of a response to that.

The other reason people want to invest directly is in the pension world. Because of Solvency II, if you have ▶

direct investments in companies, your capital ratio requirement is lowered, so that means you have less liquid cash on your balance sheet. That is important to them.

The other reason we are doing this is because I am a venture capitalist. Everybody knows that in the US the chances of success of a VC-backed company is a lot higher because there is a hell of a lot more capital people are willing to put in. You don't really have that in the UK. It is starting to get a bit better, but it is still way behind the US.

One of the problems is that if you have a VC firm, you will have fund one and then you have fund two. It is rare that you can reinvest in the fund one businesses because there are all sorts of conflicts of interest. What we are trying to do now is to take the companies we have had in our first fund and just put a hell of a lot of money into those winners. The only way we can do that in terms of governance and so on is by having a pledge fund. That has worked for us.

It is very difficult having the families on the boards. I also had some experience, good and bad, with angel investors, where some companies get so many angel investors that they are very difficult to manage unless they have one or two representatives.

When you go into a business that has angel investors or family offices with different incentives, you have to find a way from day one to make sure everyone is aligned. We tell our family offices that we will represent them because they have to trust us. They can, of course, get involved. They can tell us "I would vote like this, I would vote like that", but at the end of the day we have the ultimate say because we have to represent a large group of investors. They all know that from day one – they know exactly what our objectives are with these investments.


The 2012 Global Corporate Venturing Symposium ran alongside a gala dinner and awards evening

In my experience – I have been doing this for about 12 years – it is very important for us to have control. Democracy works sometimes, but if you have voters voting in too many directions you don't have a good result. You need someone to take the reins and represent all these people.

Sebusch: In cases where family office individuals took a board seat, what was the reason for them doing that? How did they act and play in the syndicate?

De Boucaud: We probably would not have allowed it. We have one case, but that is where they were putting 60% of the funds in. That has worked out well for us, because we are aligned, we know exactly what we are trying to do. Everybody wants to come out the other end with the same strategy within the waste sector, as an example. It has worked out quite well.

Sebusch: Can each of you tell me where you get most of your dealflow from?

De Boucaud: It basically comes from our investors, because they are out looking at the market as well. It comes from the management team of a particular company. I am looking for buy-and-build opportunities. If my management team knows their business well, they will be able to tell me who their competitors are and who is up and down the supply chain. I really count on them to identify potential M&A.

Cowley: We have contacts primarily, belonging to five separate angel groups. There is some cold calling, but that does not work for anyone in this industry. If it is a warm introduction it is much better. I probably have to screen 50 or 60 investments a month and invest in one. That bit of the job is pretty tedious to tell you the truth.

Mead: The impact investment market in the UK is a pretty nascent market. The equity market is about £60m to £70m. It is a very small, growing market. There are probably only a handful of equity investors in the impact investment world in the UK. Dealflow is not a problem. Increasingly there are more and more organisations and start-ups that are looking to get this blend between positive outcomes in areas like education and making a shareholder return. We have not done any publicity around our fund and we have a pretty deep pipeline already.

Sebusch: Tony, obviously yours come from universities, but how do you filter through those? Is every company or every idea that comes out of a university showcased?

Stanco: We start with the $50bn a year from the federal government that goes into research at the universities. Those are filtered down to certain ones that have potential. You get patents and then from there they are filtered down to the 600 university start-ups that get done every year. That is part of the screening.

Universities also have entrepreneurial networks – Facebook, for example, came out of just the students – that are not necessarily research intensive and owned by the university, but that is another branch to this dealflow sometimes if the university wants to bring it in.

Our filter, which is just recent, is building on this phenomenon of universities creating accelerator funds of a few million dollars. This year we are creating for the first time a showcase at a conference to filter start-ups that are nominated out of the portfolio companies of these accelerator funds at universities and then from there we are going to do an online virtual showcase by angels, VCs, corporate VCs and grant programme managers to get the 15 that will showcase at the conference. That is our pipeline.

Our conference is going to get it out to the angels, VCs and corporations and we are at the end of the funnel where the research transforms into a very specific, accelerator-type start-up that joins the venture community.

Mead: This accelerator phenomenon is quite interesting because it is spreading across different vertical domains. The TechStarts and Y Combinators were quite broad originally and there are examples like Springboard in the UK that are adopting that model, but what we are seeing, because we do a lot of work with accelerators here in the UK, is that they are increasingly focusing on specific areas.

There is one on high-value manufacturing from Qi3, based in Cambridge. There is one looking at the whole set of patents around Oxford. We are setting one around education. There is one on sustainability. They are being used increasingly to generate pipelines of opportunity for different people. It is really interesting to watch how it develops.

James Mawson, editor, Global Corporate Venturing: [Asset manager] Adveq says more than 50% of successful venture exits have a non-traditional VC as part of the syndicate. Does the panel think future syndicates will do better if they are more diverse, although that brings more challenges, so will that create more hassles for entrepreneurs and be more of a distraction for them?

Mead: Mixed syndicates are really interesting and they work really well when things are going well. In my previous career in 3i I had several investments which had a combination of angels, corporate investors and VCs. When they progressed well it was easy. When they hit roadblocks – and some of them had university in as well – the different alignment of interest is very hard to keep.

When things are going well and everyone is on the same timeline, it is easy. There is real value when it is working like that, because different connections, different values can come in. When you hit bumps it can get quite difficult to manage.

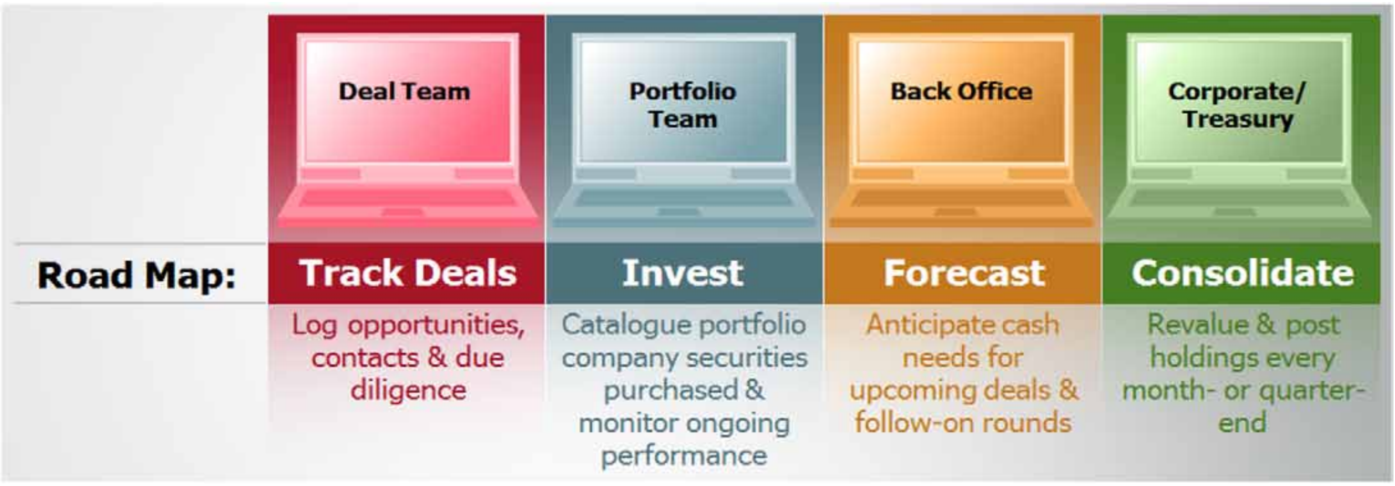
De Boucaud: The bumps are timing and how much each investor has available. Inevitably people have larger and smaller funds and if you continue funding the business, one will get diluted and then people get a little bit anxious.

Mead: The specific deal I was thinking of hit some bumps in 2000 and 2001, like lots of things did. The corporate that had invested wanted to take the technology in-house and made a global offer. The university wanted to take all the researchers back to the university. The VCs were scrabbling around trying to find whatever they could find. Those interests are really difficult to bring together.

Sebusch: Syndicates will get even trickier now that you have sovereign wealth funds and public pension plans getting involved. Besides angels there are super-angels, there are micro-VCs, multi-family offices with individuals managing their direct investments. It is going to continue to complicate the syndicate and you will have multiple agency risks when a deal goes bad. It will be tougher to manage.

I am a big supporter of corporate venture capital. I believe when you have a corporate venture capitalist in it helps your probability of success if they have done their diligence and said: "This is the best technology in the basket of technologies I have looked at."

Roadmap to deal and portfolio management, forecasting and consolidation




Ray Haarstick
chief executive
Relevant

The Challenge

● How can you implement infrastructure that will enable your firm to scale up your pace of investing, maximize the productivity of your team, and find the right deals for your parent company?

● How can you achieve all of this and still accurately forecast incoming cash needs and consolidate the cost and value of existing holdings for corporate? In other words, how do you scale up without leaving your back office personnel behind?

● As you outline your requirements and search for the right solution, you must also keep your IT department happy so you aren't creating technical headaches for their support teams.

Tracking Incoming Investment Opportunities and Related Due Diligence

● You've let the world know that your CVC team is ready to invest. As opportunities start rolling in, your team must log these "Deal Companies" into a central database where everyone has access.

● As you learn more about each firm, such as their contacts, documents and emails, details on their market size, shareholders and financials, etc., your team must proactively enter all of this data into the database so you can assemble a Deal Company Profile or dossier on the investment opportunity.

● All of your active deals will move through the various phases of due diligence and should be viewable in a ▶

Deal Pipeline screen or report.

- Since team members often play different roles, each person should have control over what information displays on their respective role-specific screens (e.g., the users' records, fields they are responsible for and their favorite reports).
- Ideally, your staff should have access to the Deal database via their office or home Windows- or Mac-based computers, and from their Apple iPads while on the road.
- Having seamless integration with Microsoft Outlook is also essential, so all related contacts, events, emails and tasks can be easily shared with your database.
- Having quick access to data and reports is critical. Thus, it's preferable to have an app on the desktop or device that stores all of the local screens and report templates. This optimizes communications with the internal- or cloud-based database server and is in stark contrast to browser-based apps that are commonly known for their slow access and very limited screens. A well designed app should display the most important details about a deal including contacts, third party reps, and which team members are analyzing this deal.

Cataloguing Portfolio Company Investments and Anticipating Cash Needs

- As you make investments, your team will need to track your holdings in "Portfolio Companies" in your central database. Ideally, your solution would have the ability to promote a deal company to a portfolio company so your team wouldn't need to reenter key information into another screen.
- Once your portfolio companies are set up, you will need to catalogue the securities you purchased (e.g., preferred shares, bridge loans, etc.), their cost basis, and how they fit within the existing shareholder table. For example, if you purchased 50% of the Preferred C shares, what percentage of the firm do you own when factoring in shares issued during the founders, A and B rounds.
- Tracking portfolio company contacts becomes even more critical at this point because you must have a lifeline into your portfolio companies. The same applies for tracking all documents and emails passed between your firms.
- Monitoring planned and actual financials gives you a window into the ongoing health of your portfolio companies. You can facilitate data collection by exchanging a monitoring spreadsheet between your firms. This data should have key performance indicators (KPIs) such as month- or quarter-end revenue, net income, head count, and burn rate.
- Finally, you must track ongoing commitments to future rounds so you can clearly and accurately forecast upcoming cash needs to your Corporate Parent.

Revaluing and Consolidating Holdings for Corporate/Treasury

- Each month- or quarter-end, you must determine the market value of your portfolio companies' holdings and forward a report to corporate with the consolidated cost and value of the firm's holdings. Corporate must have this report to comply with Investment Company regulations.

Deploying Apps within Your Existing IT Infrastructure

- Any technical solution or app you decide upon should be fully compatible with your firm's existing IT infrastructure.
- That means your app should run natively on any recent version of Windows (XP, 7, 8) or Mac OS. This will ensure your team is using the latest apps/solutions available, and put IT at ease that your team isn't creating support headaches for them. Management will also be pleased they've approved the purchase of a solution with longevity and the most modern architecture.
- Be careful of slower, browser-based apps that only run on the latest version of a browser. For example, if you're on Safari or a release prior to Microsoft IE9, you might not be able to use their solution.

In summary, it pays to outfit your team with the right "tools of the trade", so they can efficiently track incoming deals, monitor your portfolio, forecast cash needs and efficiently consolidate your holdings for corporate. Your team members will be happier and more productive, and management will be able to better monitor the success of your CVC program.

In a three-part article on investment and incubation, Jacqueline LeSage Krause investigates the merits of a combined corporate venturing and innovation group, how to deal with barriers to its success, and piloting revolutionary initiatives

Venturing and innovation go better hand in hand

1 A singular strategy

Corporate venture capital invests externally through taking minority stakes in third parties whereas corporate incubation operates internally. If you are accountable for the realisation of strategic value from your investments, but are not in control, this three-part series is for you.

I discuss combining investment and incubation in a single corporate venturing and innovation group, drawing on my experience leading innovation and corporate venture capital at The Hartford, and going beyond. While this model may not be suited to all corporates, it is increasingly part of the opportunity set discussed as a corporate venturing group is formed or reformed in subsequent years.

Strategic value: you already own it

Congratulations – you just closed a perfect strategic investment. You are backing a big data start-up that aims to revolutionise a core business process in your industry. Your strategic edge is accessing the technology first, influencing its development and incorporating it into your product before any of your competitors. If your company succeeds, you not only get a first-mover advantage, you also become the case study that drives more customers to the start-up, thereby increasing your investment's financial value.

Jacqueline LeSage Krause, most recently head of innovation and corporate venture capital at US-based financial services company The Hartford

It all sounds good. But with the deal done, who at your company owns the strategic follow-through of getting the start-up's technology adopted internally? Who figures out the right business model for offering the start-up's solution within your product? If it is you – by design or default –then you should consider how external investing and internal incubation could align under a single corporate venturing and innovation group.

While corporate venture capital invests externally in start-up companies, incubation internally develops strategic opportunities from initial concept through significant iteration to the point of launch, kill or spin-out. These two groups can help each other succeed.

An incubation team has protected resources and processes designed to overcome an established company's ▶

natural inertia against the new and unproven. These are the people who can facilitate, and if necessary execute, your company's side of a pilot project. They can also do much of the business planning in conjunction with, but not greatly burdening, key stakeholders. In return, the corporate venturing team's network and marketplace visibility can help access potential incubation partners, including those not related to the investment portfolio.

Why investing and incubation go together

Internal and external innovation fit well together because they have much in common.

- **Shared goal of strategic options for growth:** A single group can be accountable to the chief executive (CEO) and leadership team, acting as an internal advocate for innovation and overseeing a portfolio of innovation activities addressing the same strategic themes at different stages of development across multiple time horizons.
- **Shared internal innovation obstacles to overcome:** A single group can create a common context, governance and process to tackle three of the main reasons big corporations cannot innovate – difficulty with uncertainty, focus on today instead of tomorrow in the pursuit of quarterly earnings and fear of action that could risk the brand.
- **Shared external ecosystem:** To be effective, corporate venturing and internal incubation both tap the same network of start-up and mature companies, investors, institutions and service providers. Coordinating efforts provides clarity and a single consistent touch point for the ecosystem.

Bringing these two activities together into a corporate venturing and innovation group under one leader can be very powerful when the rest of the company has agreed that this decision-maker has the freedom to get things done in an unconventional matter. Not only do the investing and incubation teams work better together but they go faster.

Key elements of the group

The corporate venturing and innovation group combines elements of a corporate venture team and an internal incubation team into a single organisational entity.

- It is led by a head of corporate venturing and innovation or a chief innovation officer.
- It reports to the CEO, chief operating officer or perhaps a head of strategy, but not one of the other shared services such as finance, information technology or marketing.
- It has an enterprise-wide mandate.
- It takes a portfolio approach to both investment and incubation.
- It has its own protected people and project funds and is not a shared service.
- It partners point people in the businesses and functions, offloading much of what otherwise would be the point people's extra work in a new initiative. This partnering without burdening goes a long way to achieving buy-in.
- It oversees all minority equity holdings, whether investing off the balance sheet, through a separate dedicated fund or as an investor – limited partner (LP) – in independent venture capital funds.

Depending on the company's industry and growth strategy, the corporate venturing and innovation group can stick with investing and incubation or expand to include other familiar external and internal innovation activities, such as strategic alliances, spin-outs, new product development, research and development, emerging business units or innovation-oriented mergers and acquisitions.

In addition, if a corporate venturing and innovation group is successful at developing new opportunities under uncertainty, the core business will want more. For example, the group may be asked to provide culture-oriented services such as coaching project teams in the incubation process or acting as an internal venture capitalist to select and fund innovation projects within the core business.

While these activities may please the company leadership, they can end up having a greater impact on employee engagement than execution towards strategic options.

Single entity, separate teams

If they are in the same group, the incubation and investing teams should remain distinct. This reflects the significantly different skillsets required. For example, the incubation team may be a mix of people brought in from the outside who have experience creating something out of nothing, and people from inside with deep internal networks and knowledge of how to get things done.

In contrast, the corporate venturing team will be people with broad external networks and deal experience. The two teams will collaborate on common strategic goals and share their internal and external networks, albeit with appropriate firewalls around confidential information possessed by the corporate venture capital team.

Common innovation portfolio management

The corporate venturing and innovation group takes a portfolio approach to both investing and incubation, maintaining an external investment portfolio and an internal incubation portfolio. In both cases, there is not a single bet or a best bet, but a number of ideas in development, many of which will fail along the way before becoming strategic options. Thus, innovation portfolio management is critical to the success of the corporate venturing and innovation group. This is the umbrella framework used to set strategic themes, evaluate the health and status of innovation activities and assess strategic value. Managing the portfolio ensures the activities of the group are diversified across strategic themes, time horizons, types of innovation and stages of development. The framework is used in con- ▶

versations with the company's senior leadership to discuss performance of the group and make key decisions.

Conclusion

Let us reconsider the big-data investment cited at the beginning of this article, first without a corporate venturing and innovation group.

The good news is, there is an enthusiastic business unit champion – you would be nowhere without her. However, the number of moving parts that influence the realisation of strategic value is still huge, such as if the champion takes on a new leadership role. Her designated point person for working with the start-up is assigned to a major six-month corporate initiative and the latter's direct report has just been tasked with identifying how to cut another $50m from this year's budget. As the business unit shifts priorities to deal with the declining budget, the budget slack used to fund the unplanned pilot with the start-up disappears. "We really want this, but maybe next year…"

In contrast, a dedicated innovation team with its own resources – people and money – and under the same portfolio management and decision-making umbrella as the corporate venturing team can still proceed. Congratulations, indeed.

2 Key decisions for success

Corporate venture capital invests externally through taking minority stakes in third parties whereas corporate incubation operates internally. If you are accountable for the realisation of strategic value from your investments, but are not in control, this three-part series is for you.

I discuss combining investment and incubation in a single corporate venturing and innovation group, drawing on my experience leading innovation and corporate venture capital at The Hartford, and going beyond. While this model may not be suited to all corporates, it is increasingly part of the opportunity set discussed as a corporate venturing group is formed or reformed in subsequent years.

In the first article, we made the case for combining corporate venturing and incubation into a single group, which we called the corporate venturing and innovation group. In this second article we highlight five key structural decisions when bringing the group together in order to address the main barriers to innovation. Next month, we look at developing commercial opportunities under uncertainty in the incubator.

Innovation barriers

As companies become successful and grow, they often unintentionally develop a culture that reinforces the existing core business and protects it – and its people – from change. The results are barriers to innovation that appear consistently across industries.

- Difficulty with uncertainty – management systems and valued leadership skills are all about forcing certainty as soon as possible. They do not enable execution under uncertainty.
- Focus on today instead of tomorrow – corporate strategy often ends at a three-year horizon. In the competition for resources, today almost always wins out over tomorrow, especially in the face of quarterly earnings-per-share goals. Opportunity cost is not considered because it cannot be measured.
- Fear of action – with established businesses and brands, the risk of doing something is perceived as greater than the risk of doing nothing. In a start-up that analysis is flipped on its head.

The first two points, difficulty with uncertainty and focus on today, are intertwined by the corporate desire for decision-making based on facts, numbers, what can be measured. The uncertain cannot be measured. At best, we can derive a range. In a recent New York Times interview, Carl Bass, chief executive of software provider Autodesk expressed his concerns about this issue. He said: "This is my current fascination – it is this whole idea about keeping companies entrepreneurial and innovative and cutting-edge.

"The thing I worry about a lot is how companies measure themselves … We measure ourselves around revenue and profits and financial metrics that perform long after a spark is gone … I have been spending a lot more time trying to quantify or figure out if what we are doing is right, or whether what we are really doing is just celebrating the result of things that happened a while ago. I think it is real easy as a leader to confuse what the results are today with the actions that happened a while ago … because then you just start coasting."

These innovation barriers can be present whether the company is small or large, as long as there is an existing successful business. At the 2010 Wired Disruptive conference, Mark Pincus, the founder and chief executive of US-listed online games company Zynga, told a surprising story about a programme called Bold Beats that he set up to give the Zynga product teams permission to take risks within an existing successful game franchise. He said: "The more successful a game gets, the more conservative the team gets."

However, the situation is exacerbated in companies that are large, mature and have significant internal competition for scarce resources among multiple established businesses – companies like many of ours as Global Corporate Venturing readers.

Setting up the group to counter barriers

When structuring a corporate venturing and innovation group, the primary goal is to tackle these barriers. As these barriers are in play in a different way at each company, ▶

there is no one-size-fits-all approach. However, there are five critical decisions areas.

- Goal
- Governance
- Strategic themes
- Resources and processes
- Role of the businesses

These decisions are a way to acknowledge and institutionalise that innovation requires a different structure than business as usual.

Goal

What are we trying to achieve? The first and most fundamental decision for the combined group is its goal – and "innovation" is not an acceptable answer. It needs to be specific enough to inform the group's structure. For example, if the goal is to create entirely new businesses, then the group is likely to require freedom to set up new corporate entities, go off-brand, and in some cases do spin-outs. In contrast, if the goal is to help drive the existing businesses, then fewer degrees of freedom are required.

Governance

How do we make decisions and determine how we are doing? Once the goal is determined, the next critical step is establishing a governance structure for making decisions. A well set-up governing body – whether a single person or a group – can choose to take risks and set an example for action for the rest of the company.

Broadly, two levels of decision-making happen for a combined corporate venturing and innovation group.

- Portfolio decisions: This is not equity investment portfolio management. It is more macro, applying to the entire range of the group's activities across incubation and equity investment. It covers elements such as strategic themes, types of innovation, time horizon, and stage of incubation process start-up arc. It also ensures the pipeline of opportunities and investments is healthy and capable of generating some wins.

Over time, you can measure the portfolio's composition and health to guide decision-making on specific opportunities. The people responsible should be the same individuals that participate in setting strategic themes – a very senior group, potentially including or solely consisting of the chief executive (CEO).

- Specific investment decisions: The two big structural questions are whether the same entity governs both incubation go/no-go and equity investment decisions, and whether the business units (BUs) are part of the decision-making process. If the goal of the group is closer to the core, then the BUs are at least likely to play a role in incubation project go/no-go decisions.

For equity investments, when the goal is non-core growth or there is concern about keeping a firewall between the BUs and the confidential information of the companies in the investment portfolio, the BUs could be excluded from decisions, but potentially providing some level of input.

Here are two illustrative examples of how these issues may combine, showing the closer the goal of the group is to the core, the more complex the governance structure is likely to be.

Goal is growth adjacent to the core businesses

- Innovation portfolio council consisting of the CEO, chief financial officer (CFO), senior vice-president (SVP) of strategy and general counsel.
- Venture capital investment committee consisting of the CFO, SVP strategy, and head of the corporate venturing and innovation group.
- Incubation investment council consisting of the BU heads, key functional heads, and head of the corporate venturing and innovation group.

Goal is significant non-core growth

- Same group makes all decisions and consists of the CEO, CFO, SVP strategy, and head of the corporate venturing and innovation group.

Strategic themes

Strategic themes focus internal communications and decision-making, provide rigour to the selection of projects and investments, and add context for portfolio management. Because they are for internal use, strategic themes are most powerful when tailored for resonance within the company, and may not map to external technology or "space" definitions.

Themes can come from a long-term vision exercise, from a BU strategy, or from some other corporate strategy. When possible, the corporate venturing and innovation group should adopt themes that align with the existing strategy or vision of the company. When necessary, such as when there is not a longer-term strategy with which to align, the group should seek consensus among stakeholders around new themes, facilitating the development of strategy and vision as appropriate.

Resources and processes

The corporate venturing and innovation group needs its own budget and a staff capable of executing incubation projects.

It may not be obvious at first, but even when the goal is helping the core, the group's self-sufficiency will be key to its success in collaborating with the rest of the organisation. Compared with giving the BUs extra budget to be innovative, the BUs may actually be more innovative by seeding and guiding an idea without the burden of doing and paying for everything. Instead, they can tap a separate budget and a set of people specialised in defining, testing and iterating new ideas.

Even in the absence of an incubation group, a ven- ▶

ture capital team with pocket money to seed BU pilots with portfolio companies can be highly effective.

As an example of what the corporate venturing and innovation group can offer a BU, the group should have a project framework for rapid prototyping and evaluation of opportunities, including those with partners. In my experience, if you have the right process and people, an on-ramp stage of 100 days and $100,000 can often overcome the uncertainty that would otherwise preclude even starting. In addition, having a group where ideas can safely fail fast will remove some of the hazards BU leaders might perceive in trying new things.

Role of the business units

Some readers may object that, to take an innovation effort seriously, BUs need to contribute budget and people, otherwise, there is no real commitment. For some companies, that means augmenting the corporate venturing and innovation group with BU budget and resources on a per-project basis.

However, BUs may not have flexibility to contribute resources to opportunities that are unplanned during a year or otherwise have an inability to act. As a result, a non-resource-based way of showing commitment is required, such as participating in decision-making and championing opportunities.

Beyond the project-specific arrangements between a BU and a corporate venturing and innovation group, the group needs a consistent way to stay close to each BU, unless the goal is to pursue only the most disruptive of opportunities. My experience is that instead of being ad-hoc, the mechanism should have a constant planned rhythm.

For smaller companies or those with fewer businesses, the head of the corporate venturing and innovation group can meet the BU leadership teams regularly. In companies with many businesses, the group can identify the equivalent of "account managers" for each BU. These people may become indirect members of the BU leadership team, participating in all their regular meetings.

This allows the corporate venturing and innovation group to have input to strategy and help identify ideas with BUs in an organic, continuous way, rather than waiting for specific occasions in which everyone is supposed to come together to envision the future and innovate.

Bringing it together

For companies building expertise and capabilities in the process of innovation, structure matters. You need to address it at the beginning, as you are bringing together a group like the corporate venturing and innovation group. Otherwise, no matter how good your ideas or opportunities, they will be subject to the same innovation barriers that motivated your creation of the group in the first place.

To solve the problem – as opposed to moving it – you need to structure the group to be distinct and specialised yet connected in the right ways to the rest of the organisation. It is not easy, but it is far easier than improvising your way to innovation.

3 Commercial pilots under uncertainty

For the last article of this series, we focus on piloting revolutionary initiatives, the ideas that can open entirely new businesses for a company, or reinvent legacy businesses stuck in the status quo. Such initiatives are revolutionary because they lack precedent within the company, are transformational or have disruptive implications for the core business. Pursuing them means facing high uncertainty and the need to learn by doing.

For these challenges, you want a dedicated incubation group that has the autonomy and specialised skills to think differently, act differently and learn on behalf of the entire company.

To illustrate the way this team thinks and acts differently, below are some tips and tricks for piloting under uncertainty.

Reset the context for failure

For all stakeholders – including the incubation group's project team and governing body – the focus should be on learning and adapting, with failure defined only as not doing so. Everyone involved should expect that at least some of the starting assumptions will be wrong and that the goal of the pilot is to acquire information to get closer to right. That way, the team can assess and act on learnings objectively, rather than be defensive about things not going to plan.

That said, some projects' best learning and adaptation will be to fail fast. Maybe the pilot exposes a fatally flawed market assumption or a technical roadblock. Quickly finding such killers should be seen as an accomplishment. It saves the company time and money, and it steers the overall innovation portfolio to redirect resources efficiently from dead ends to promising avenues. In that regard, you want a group that is built to succeed via productive forms of failure.

Pilot early and often

With high uncertainty, the value of speculating and debating about an opportunity in the abstract is limited. The faster you can get something to market for the purpose of learning, the more quickly the arguments can be based on facts rather than assumptions. Likewise, the more you ▶

can break up a big pilot into a series of smaller ones, the more cheaply you can buy down the risk and uncertainty. This early tangibility can be critical to overcoming scepticism that might otherwise stymie a big idea.

Have hypotheses and goals

Although the focus is on learning, the pilot process still requires rigour and discipline to achieve that goal. At the start of each pilot, you will want to be clear on:

- What you want to learn.
- A hypothesis for the answer.
- Criteria for a go or no-go decision to the next phase.

If identified in advance, these three elements allow the team to hone in on what it is trying to learn when crafting the pilot. They will also provide guidance to the team during the pilot when it is faced with the potential for midstream interventions or adaptations.

As the team monitors the pilot against its hypotheses and goals, and gathers other lessons, it will want to share the emerging results, with, for example, the core business or governing committee. Proceed with caution. Both good and bad news travels fast and quickly loses the context of early results or emerging trends.

Define a public moment

Pilots need urgency or they can get stuck in the planning stage, especially when elements of the pilot are dependent on other parts of the company that are focused on executing for the core business.

As the team and its internal partners figure out what to do, is perfectionist about how to do it, or gets pulled into other efforts, timelines for milestones can slip by. Speed and capital-efficiency evaporate.

A fantastic forcing function to drive momentum is committing to a public moment with customers or channels. Whether it is a soft launch to a few customers, a joint press release about a beta offering to a small customer segment or a training session for distribution partners, once a date is committed and communicated in advance, everyone knows the game is different. A pilot project often needs that extra impetus.

Embrace the kludge

A kludge – quick workaround – is a good-enough solution. In creating a pilot, a kludge is often sufficient, if not desirable, because you do not know where it will lead. Some pilots will end up as throwaways, and most will end up pointing the way to significant changes. So don't overinvest up front on technologies or expensive work processes that are subject to disposal or change. Create the minimum viable solution for achieving the pilot's goals, then use the budget and time you saved up front to build what you have learned is the right thing.

A few examples:

- If the pilot is expected to lead to a handful of people calling a helpdesk and you are not looking for call centre lessons, then route the calls to the innovation team rather than running them through the company's call centre and having to train a few hundred representatives.
- If the pilot needs to integrate with a corporate database but is not testing that functionality, then just get a one-time copy of the database, or a subset of the database. Don't spend the extra time and organisational capital to integrate with the live database until you need to.

Engage and prepare the core business

Communication and coordination with stakeholders in the core business is critical if the opportunity is one that will ultimately land there. The incubation team partners the core business stakeholders throughout a project, beyond the day-to-day tasks of setting up the operational aspects of the pilot. They work with, but outside, the core business to ensure initiatives have support and, if successful, have a way to transition successfully into the core business.

Have an adaptable and creative team

The incubation team needs to be results-oriented but flexible in how it gets there. It needs to be adaptable – ready and willing to change quickly. Creativity is valued, not only up front for the concept, but also for running the operational aspects of the pilot, including kludges.

Finally, the incubation team must be committed to the innovation process first and then to the broad opportunity – not the specific instance – second. As discussed above, it must recognise that killing or changing a project is not failure. The leader of the corporate venturing and innovation group plays a critical role in helping the team – and sometimes the governing committee – to manage its emotional attachment to any single opportunity, guiding it to value the process and the portfolio.

In summary, when piloting transformational or disruptive opportunities, applying the tips and tricks described here can increase the chances of success. They support the incubation team's structural design to bring the focus, agility and speed of a start-up into the environment of a large corporation.

In 2011, Jacqueline LeSage Krause's team at The Hartford won Global Corporate Venturing's award for best practices in financial services for combining incubation and investment. She currently divides her time between San Francisco and New York, focusing on new entrepreneurial ventures in healthcare, insurance and consumer services.

The value in investment

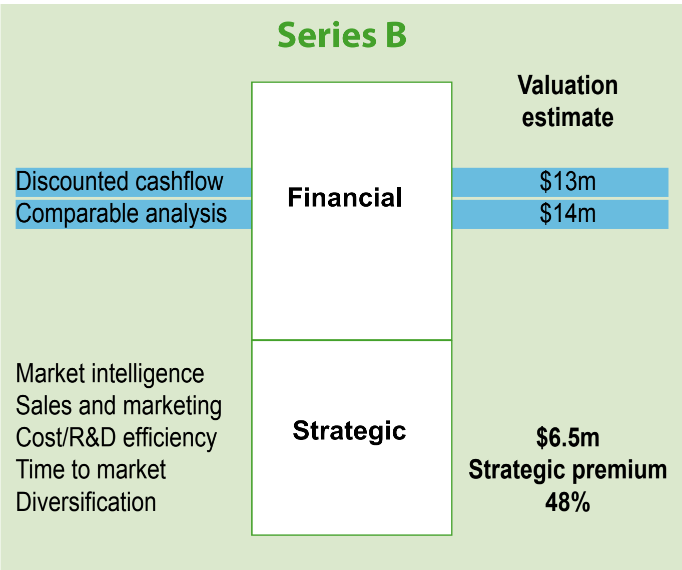
**Russ MacTough,
head of strategic advisory services
and technology sector lead,
SVB Analytics**

In advising corporate venturing groups on valuing early-stage ventures, the following question has surfaced frequently: How much of the proposed valuation is financial versus strategic, and does it matter?

We will use the following investment scenario as an example:

Series B pre-money	**$20m**
Capital raise	**$5m**
Ownership	**20%**
Post-money	**$25m**
CV investment	**$3.75m**
CV ownership	**15%**

Whether the corporate venturer is leading the round or co-investing, a conscientious analysis of the target's financial value is essential. For the corporate venturer that is measured on financial return and mandated to invest in areas deemed strategically important, future investors and acquirers may not value the assumed "synergies" as highly. For the portfolio company whose financial performance trails expectations, and most do, the impact on future valuations and the possibility of a down-round can be significant. Returning to our example, we can graphically depict the situation:



To test the proposed $20m pre-money valuation, best practice would be to measure value by benchmarking the target and its forecasts against private and public peers and to conduct a discounted cashflow (DCF) analysis. It is important to have access to accurate, timely private company data to benchmark a set of forecasts or a proposed transaction. Care must also be taken with DCF models to understand the underlying assumptions and their sensitivities.

Assume that a DCF and comparable analysis generated an estimated pre-money equity value of $13.5m. Based on a $20m pre-money from the term sheet, the implied strategic premium is $6.5m, or 48% over financial value. Is this level of strategic premium justified?

Listed the box on the left are several typical "synergies" noted in the corporate development world. Most of these are derived from mergers and acquisitions, and to apply them directly to an early-stage, minority investment may overstate their value. Consider that as a corporate investor you will almost always be purchasing less than 20% of the target, and may or may not have a board seat or board observer rights. The amount of control you have over the target's tactical and strategic decision making is limited, and the measureable benefit to the corporate venturer's parent company may take years to materialise, if at all.

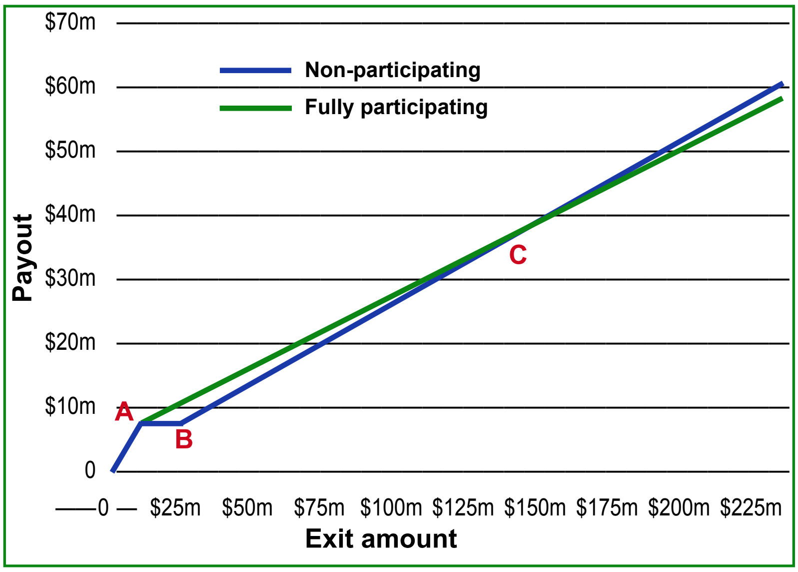
It is also worth noting that for an early-stage investment, the parent company may bring as much strategic value to the table as the actual target company. Providing access to distribution channels, brand awareness, and sales and marketing or research and development strengths can provide a target company with a true competitive advantage. The higher the premium you pay now ties up more capital in smaller ownership stakes, thus eating into your eventual internal rate of return (IRR – a measure of investment performance) and potentially limiting the number of bets you can place on the table.

Rounding out our example, assume that 18 months after the series B the company has fallen behind on its forecasts, is running low on cash, and needs to raise a series C, in all fairness, a pretty typical scenario. Having revised its forward-looking projections down and its capital requirements up, the company is offered terms at a pre-money of $22.5m by a financial venture capital firm (VC). Because "synergy" is no part of the equation for the financial VC, the valuation feels fair; the company's financial value after the series B was $13.5m plus the $5m of cash it raised. ▶

This implies appreciation in value from $18.5m to $22.5m in 18 months.

Unfortunately, this would imply that the corporate venturer's investment lost about 10% of its value in only 18 months. Had the pre-money valuation on the series B been $15m instead of $20m, the corporate venturer's investment would have appreciated 13%. Substantiating a valuation lower than the company's expectations can be made significantly easier by conducting a thorough and informed analysis of the market, the company, and comparable VC transactions in the space.

Additionally, the ability to evaluate a set of financial projections critically by identifying key drivers and their likely variation, benchmarking forecasts against comparable private companies, and estimating cash-burn levels through sensitivity analysis provides a clearer understanding of the financial value of an investment and its potential cash needs, and, in turn, the implied magnitude of any assumed synergies.



Alternatives to pre-money in negotiations

There are many levers in a term sheet aside from just the pre-money which not only contribute to expected return but can help bridge the gap when expectations around valuation are not aligned. Participation rights, dividends and warrants are some, though not all, of the ways in which this can be accomplished. Also, separating an investment into tranches based on milestones is a way to hedge risk.

For illustration purposes, we will use another example to highlight the use of participation rights. As a quick refresher, fully participating preferred stock means that in a liquidity event you not only get paid your liquidation preference, but also get to convert to common and share in any remaining proceeds. Non-participating preferred stock involves an economic decision – take your liquidation preference and not share with common, or forgo your liquidation preference and convert to common, comparing per share payouts.

Suppose a corporate venturer offers a pre-money valuation of $20m for series B preferred stock with no participation rights. Hoping for a higher valuation, the target company or its existing investors counter with a pre-money valuation of $25m but with full participation rights. Having diligently investigated the underlying financial value of the investment, a range of $20m to $25m is supportable, so the question is: "Are the participation rights valuable enough to offset the increase in valuation?" The answer is best demonstrated graphically, as it is a function of the value at exit *(see graph)*.

On the Y-axis is the payout to the series B shareholders, and on the X-axis is the value of the company at exit. Below an exit value at point A ($8m), there is no difference between the two deal structures. Between points A and C ($8m to $140m) fully participating preferred stock offers a higher return, but the delta narrows between points B and C. Beyond point C, the higher ownership percentage from the lower pre-money valuation offsets the lack of participation rights.

Ultimately, the decision is a reflection of the investor's level of risk aversion and view of the company's long-term potential. Silicon Valley tech-focused VCs generally choose non-participating preferred stock because venture capital is viewed as a game of "strike-outs" and "home runs". When the target "strikes out" and returns 0 to 1-times invested capital, participation rights are meaningless, but if a targets hits a "home run" the incrementally higher ownership can quickly outpace the value of participation rights.

In a deal-making scenario, the financial economics are identical for VCs and corporate venturers. However, the sensitivity to a corporate reporting structure – quarterly reporting, profit and loss, impact of writedowns and so on – or other factors may make knowing you are covered for singles, doubles and triples more appealing. In the end, it is critical that a corporate venturer have a framework for evaluating trade-offs in deal structure and valuation.

Final thoughts

There are certainly other considerations in valuation that are not reflected in purely financial models. Having the opportunity to co-invest with a top-tier VC may be valuable. Investing in a potentially strategic company can provide exclusive market insights and intelligence. Adding a certain piece of a strategic puzzle to your portfolio may increase the value of your other investments by rounding out your vision.

These are all valid considerations, but given the opportunity to hedge downside risk and deploy capital more efficiently, corporate venturers should take the extra step to understand an investment's underlying financial value.

IP: managing a critical asset

Corporate venture capitalists, just like traditional venture capitalists, need to understand the critical importance of intellectual property to the success of start-ups. Intellectual property (IP) has become critical to the success of companies, both large and small.

In 2012, courts awarded two $1bn damage judgments for patent infringement – Apple won a $1.1bn judgment against Samsung for infringement of patents relating to its smartphones, and Monsanto won a $1bn judgment against DuPont for infringement of patents relating to its genetically modified, herbicide-resistant crops.

Patent sales among large companies are increasing, such as the $4.5bn sale of patents by Nortel to a consortium and the $1.1bn sale of patents by AOL to Microsoft. These trends are also seen in mergers, such as Google's acquisition of Motorola for $12.5bn which was driven in large part by Google's desire to access Motorola's patent portfolio.

These trends are also seen in start-ups. IP property, particularly patents, are becoming an increasingly important part of the asset value of start-ups. For example, Friendster was sold to MOL Global for a reported $39.5m and MOL Global sold the 18 patents in Friendster's portfolio to Facebook for a reported $40m. Our experience in mergers – in which the firm was rated first in 2011 by Thomson Reuters – is that companies acquiring start-ups are very carefully scrutinising the IP of potential targets.

IP is also critical to enable start-ups to participate in the new dynamics of innovation – the speed of innovation requires collaboration with third parties to develop products in the short timeframes demanded by modern markets and the power of platforms to leverage the contributions of third parties in other ways.

The iPhone is a great example of collaboration – Apple supplies the design and operating system, but all the other parts are provided by third parties, and the iPhone acts as part of the iTunes/iOS platform that leverages third-party content, from music to video to apps, to satisfy customer demands.

The OpenStack Foundation is an example of a new form of collaboration in which more than 150 companies are working together to develop an open-source cloud stack. Many start-ups are participating in the foundation, including Piston Cloud Computing, Mirantis, MorphLabs and Dreamhost. They are working with large companies such as HP, Rackspace, NEC and AT&T. The participation of these start-ups is based on the value of their IP.

These changes mean corporate venturers should ensure their portfolio companies have an IP strategy consistent with their business plan. The IP will be critical to a company's ability to work collaboratively with other companies to develop their products. And the IP strategy should be designed to protect their products and services from potential competitors.

Mark Radcliffe, partner, DLA Piper

Another potential layer to this analysis arises if the corporate venturer is developing "platform" across its portfolio of companies. In this case it needs to review the IP strategies of the portfolio companies to coordinate them in implementing the platform strategy. For example, does the coordinated IP strategy have gaps that could create problems in protecting the proposed platform? This strategy must also take into account the distinction is between the platform and third-party applications. These decisions can be crucial to the platform, as demonstrated by the more than 50 patent suits around the Android operating system. IP strategies for protecting platforms are new and continue to evolve.

With the shift of IP from a series of dusty legal documents kept in a filing cabinet by the start-up's counsel department, to a critical financial asset of their portfolio companies, corporate venturers must understand IP basics. The four basic forms – patents, trademarks, copyrights and trade secrets – are summarised as follows: patents protect inventions; trademarks protect words, designs and images that indicate the source or origin of goods; copyrights protect artistic works such as software, books and music; and trade secrets protect information not commonly known in the industry and which the company has made reasonable efforts to keep in confidence.

The best method of remembering IP is its application to the Coca-Cola can, which has all four of these types of intellectual property – patents protect the metals used to make the can and the process of filling the cans; trademarks include the words Coca-Cola, one of the most valuable in the world; copyright protects the design on the can, including swirls and other devices; and trade secrets protect the formula for Coca-Cola, one of the most valuable trade secrets in the world.

Start-ups need to develop and maintain an IP strategy ▶

combining all four of the major forms of IP. The strategy must take into account the time it takes to have a patent issued – three to five years unless certain accelerated procedures are used – and ensure the issued patent continues to be useful for the start-up as its business changes.

A start-up should also consider buying patents to ensure it has protection while its own patents are pending. For example, Facebook has been active in purchasing patents and has already used such purchased patents – when Yahoo sued Facebook for patent infringement, Facebook asserted eight patents in a counterclaim and six of the eight patents had been purchased.

IP is frequently a start-up's most important asset and corporate venturers need to ensure their portfolio companies have an effective strategy to develop such IP assets, and are implementing the strategy.

Preparing for an M&A exit

Matt Oshinsky, partner, DLA Piper

The initial public offering (IPO) market for venture-backed companies continues to be very limited and, thus, the vast majority of these companies will exit through a merger or acquisition (M&A).

In the third quarter of 2012, 96 US-based venture-backed companies were purchased but only 10 went public. Based on our global experience, this trend is likely to continue for the foreseeable future.

Thus, corporate venture investors need to ensure their portfolio companies understand the M&A process and take action, in advance of an offer, to prepare the company for sale.

Portfolio companies need to focus on four important issues – building the management team, the economic returns to key constituencies, organisation and scrutiny of the company's records, and developing a strong intellectual property (IP) portfolio and understanding the third-party IP rights needed for the business.

Building the management team

This effort will benefit the business even in the absence of an immediate M&A exit, but it is critical to expedite in advance of a potential sale. First, hiring top-tier, experienced managers can enable the chief executive (CEO) and others to focus on critical strategic issues to increase the company's value. And it will also free the time and energy the CEO is required to devote to the M&A process itself.

Second, the addition of new senior managers can shine a light on the friction points in the business, such as difficult or underperforming staff, sustainability of growth or building more robust systems to manage growth. The reduction or elimination of these concerns before a buyer kicks the tyres can substantially increase the value of a portfolio company.

Third, a more complete and seasoned management team can drive a significant increase in exit value. The relatively modest cash outlay and equity dilution involved in bringing on seasoned executives can be more than offset by the increase in exit value inherent in delivering a more robust team to the buyer, which may have its own troubles finding and retaining such people.

A more professional management team can also help allay any concern on the buyer's part that the departure of the founding team after the acquisition will reduce the value of the portfolio company.

Core constituencies

Shareholders should have a complete understanding of the existing liquidation and voting rights in the portfolio company's venture financing documents. Any well-executed M&A plan requires running a detailed liquidation model at different exit valuations, well in advance of receiving an offer. When combined with a careful review of the shareholder voting provisions and the capitalisation table, this analysis will bring into sharper focus the financial returns to all constituents and the issues that may create problems if the economic incentives are misaligned.

Particular focus should be placed on returns to founders and other employees, because no deal can get done, from either the seller's or buyer's perspective, without sufficient employee buy-in. The board and shareholders should assess, long before a term sheet is in hand, whether the employee base has sufficient economic incentive or whether an equity refresh or a carve-out plan are desirable.

Management carve-out plans have become common for portfolio companies with a large stack of shares with preference over other classes of stock and, thus, the likelihood that a company will be sold at a price less than the amount of preferences and without a management carve-out plan, management would receive no consideration. These ▶

plans ensure management remain engaged because they will share in the value of any exit.

The board should also understand that the buyer will be focused on retention of the desired personnel and will be likely to have a view on sufficient deferral of any payments to employees to encourage their retention.

Review the records

This issue is the least glamorous part of an exit, but it is nonetheless essential that management organise all the portfolio company's records, and then scrutinise contracts, customer relationships, accounting practices, human resources issues, tax issues, IP matters and the like for potential red flags. Corporate venture investors should recommend that their portfolio companies review these issues at least annually.

The due diligence process inherent in M&A is much more detailed and invasive than a venture financing. For example, many buyers are concerned about potential liability for IP indemnity and are particularly sensitive to contracts providing unlimited liability for such infringement. This concern arises because a start-up company, due to its limited resources, is not likely to be a target for IP litigation, but large buyers do have the resources to be targets and such an obligation could be very expensive.

Well in advance of opening the kimono – sharing sensitive information – to a buyer's business development, legal and accounting teams, management of a portfolio company should undertake the mitigation of any issues that come to light in internal review.

Management must also decide how many employees to bring over the wall and so who will be provided with knowledge of a potential transaction. The more employees who are aware of the transaction the more complete the diligence, but the greater the likelihood of leaks.

IP and third-party rights

IP has become an important source of value for most technology companies. These IP rights can include patents, copyrights and trademarks *(see Mark Radcliffe's article)*. The quest for IP can also lead to the sale of major public companies.

In addition to developing its own IP, the portfolio company should understand what third-party rights are necessary for the continued development and sale of its products because such rights may need to be transferred to, or licensed by, the buyers. Many buyers are particularly sensitive to the use of open-source software under the General Public Licence (GPL) family of licenses because of the potential requirement to license the patent portfolio of the buyer.

Bring in the experts

M&A transactions are complicated and the expectations of buyers change over time. Experienced M&A lawyers and investment bankers can provide a valuable perspective on the proposed transaction.

An experienced M&A lawyer or banker would be involved in a dozen or more transactions each year, but a successful entrepreneur might sell four to five companies in a lifetime. Such lawyers and bankers will know the pitfalls and current trends in M&A. These experts can provide significant organisational support and guidance in the sale process and enable managers to focus on their jobs.

Spinning out a unit with the corporate as sole LP

Byron Dailey, associate, and Steven Yentzer, partner, DLA Piper

The most common way to embark on corporate venturing is for the corporation to invest its funds directly in portfolio companies with one or more employees managing the investment activities. However, for a variety of reasons, a corporation may determine that this model is too inflexible and the approach does not maximise the effectiveness of the operation and opportunities for success.

There are many different ways to structure a corporate venturing operation but many strategies and goals can be well served by spinning out the unit into a separate fund entity, usually a limited partnership, in which the corporate parent makes a capital commitment as a limited partner (LP).

This is the most straight-forward version, as the fund managers operate the fund, acting through a general partner (GP) – itself a limited partnership – and a management company, which is typically a corporate entity in a contractual relationship with the fund.

In this structure, the management company receives a management fee to cover operating expenses, iincluding salaries of the fund managers, and the fund managers, through the GP, have a right to carried interest, a percentage, usually 20%, of the fund's profits.

Compared with the direct investment model, this structure is flexible and is better suited to achieve a number of goals for a corporation engaging in venture investing, but there are issues a corporation needs to consider before taking this step.

Why spin out?

Flexibility in compensation of fund managers: When a corporate venturing operation is housed within the corporation, the fund managers are corporate employees and are typically, and often necessarily, compensated like normal corporate employees rather than like independent fund managers. They have an annual salary and perhaps an annual bonus.

And many big corporations advance their best employees not by giving linear promotions or raises but rather by shifting them to higher openings in completely different departments. So their compensation and advancement are not aligned with the long-term performance of the fund. As a result, in a market where good fund managers are in demand, an in-house corporate venturing operation can lose its talent quickly. I have helped spin out more than one corporate venturing fund principally to fix this problem.

Long-term commitment of capital: Portfolio companies and co-investing venture capital (VC) firms are often wary of a corporate investor's commitment to invest in a portfolio company over an extended period of time. Since an LP invests in a fund by way of contractually agreeing to contribute capital for investments and expenses over an extended period of time, spinning out a corporate venture operation can facilitate a similar arrangement for a corporate venturing fund.

Technically, it is hard to commit a sole LP in this manner, since a supermajority of the LPs usually have the ability to shut down the fund or remove the GP. But these are drastic actions for an LP to take, and thus a spin-out fund structure projects a greater commitment to long-term investment than a wholly in-house operation.

Quicker, more nimble operations: Employees running an in-house corporate venturing operation at a big company are unlikely to have authority to invest the company's money without going through cumbersome corporate approval channels. These approvals could lead to lost opportunities and diminished ability to compete on an equal footing with independent VC funds. If the parent corporation is an LP in a spun-out fund, then it has by definition delegated greater investment and divestment authority to the fund managers.

Of course, a corporation that is the sole LP could demand approval or veto authority over investment decisions or anything else, but it is likely that a corporation that is comfortable with spinning out its venturing operation has also become comfortable with delegating at least some degree of greater authority to the fund managers.

Retain benefits of corporate affiliation: If the sponsor corporation is the sole LP, or even if it is just a major LP, of a spun-out fund, the fund will retain all the competitive advantages enjoyed by an in-house corporate venturing operation that it has by virtue of its close affiliation with a major corporation.

The corporation may be able to share technical, research and development (R&D), marketing or other expertise and capabilities. And it may be an advantageous customer or supplier or introduce the portfolio company to customers or suppliers. If properly structured, the parent corporation will be able to assist the fund with conducting or analysing diligence related to potential investments.

Finally, the corporation may be a candidate to be a strategic partner or even an acquirer. And the imprimatur of its indirect investment can lend valuable credibility to the portfolio company.

Structurally ready for outside LPs: Sometimes a corporation will spin out its venturing operation as a first step to opening the fund to third-party investors. If the spun-out fund is properly structured like an independent fund, accepting capital commitments from outside LPs is in theory a simple process.

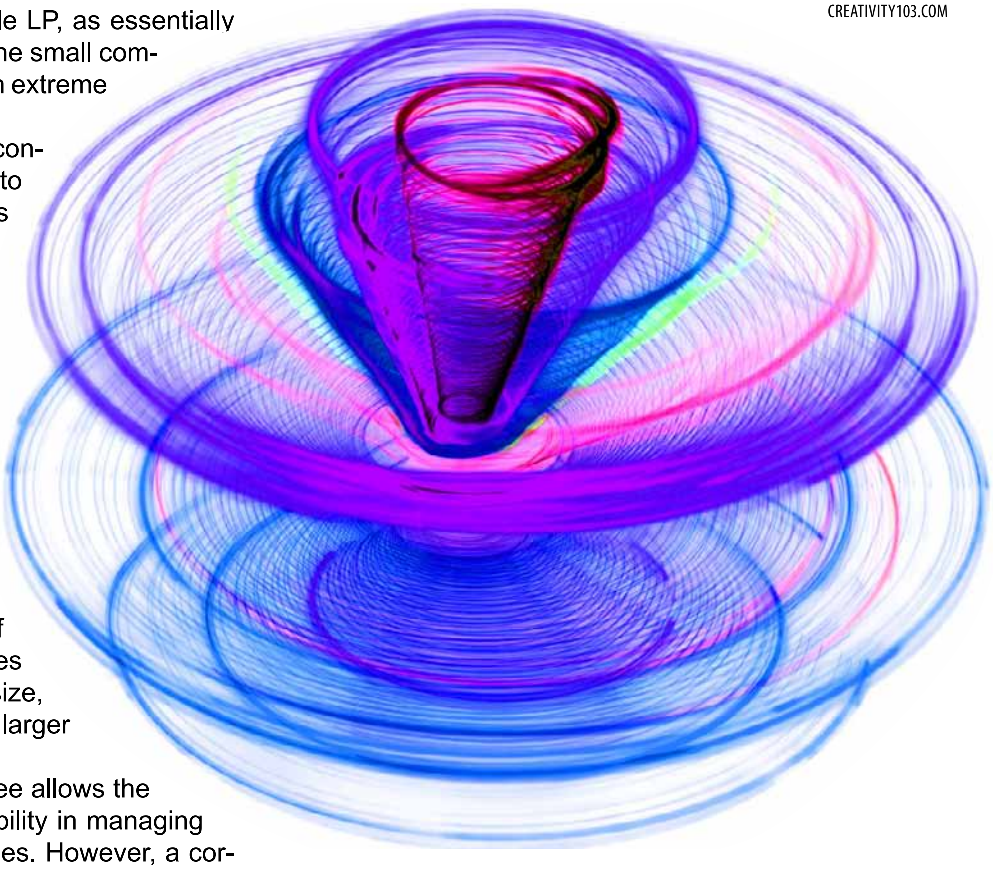
In my experience, however, a corporation that is the sole LP will take advantage of its ample leverage to impose a variety of non-market limitations on the independence and autonomy of the fund and its managers. This arrangement is reasonable when there is only one LP, but it also means that if the fund does succeed in attracting third-party investors, the provisions imposing these non-market limitations will need to be revisited and renegotiated.

Major issues in spinning out

Degree of autonomy: A major issue in any spin-out of a corporate venturing programme will be how much autonomy the fund managers have in managing the fund and how much control the corporate parent retains.

In principle, if the fund managers in their individual capacity own and control the fund's GP and management company, they should have much greater leeway to make decisions for the fund than they would have as corporate employees managing an in-house venture operation. However, any major LP in any fund will be able to negotiate some degree of enhanced influence over the fund ▶

through contractual means. And a sole LP, as essentially the sole source of capital, other than the small commitments of the managers, will have an extreme amount of leverage.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Large corporations are inherently conservative and may use this leverage to win veto rights over a variety of actions that involve risk – such as investment and divestment decisions. There will be a multitude of provisions in the fund agreement where these issues of autonomy, influence and control can be negotiated and traded between the corporate LP and the fund managers.

Management fee: Management fees are amounts paid by investors to the fund to cover operating expenses. Usually these fees are paid as a percentage, often 2%, of committed capital. Given that expenses are directly proportional to fund size, sometimes the percentage is lower for larger funds.

A percentage-based management fee allows the fund managers a high degree of flexibility in managing fund expenses and determining salaries. However, a corporate parent may feel that the spin-out itself is already a significant concession to the managers, in which case it may insist on a budgeted fee. A budgeted fee obligates the fund managers to submit a budget for expenses in advance for approval, say annually, and use that budget, rather than a percentage of the fund size, as a basis for determining the management fee.

Exclusivity, corporate opportunity: The fund managers joining the spun-out fund will want to know that they are not going to be competing for investment opportunities with the corporate parent or any of that corporation's other spun-out corporate venturing funds. The fund managers ideally would like the corporate parent to commit to bringing any investment opportunities that lie within the fund's ambit to the fund. On the other hand, the corporate parent may want to reserve certain kinds, or sizes, of investments for itself in its pursuit of strategic goals.

The corporate parent may also want to limit the fund's investment scope, either in order to leave the remainder to itself or to be able to spin out additional corporate venture funds for different investment categories or different geographies.

Treatment of legacy investments: For a variety of reasons, the corporate parent may want to spin out previously made direct venture investments into the spun-out fund. These investments are frequently called legacy investments. In other words, part of the corporate LP's capital contribution to the fund would be an in-kind contribution of securities in certain portfolio companies.

This approach is common but it can be complicated. The corporation and its accountants will have to consider valuation questions at the time of contribution. The corporation and the fund managers will have to negotiate whether and how to apportion carried interest on any gains ultimately realised on these investments. And although actually transferring the securities is not usually legally complicated, there is always the potential for practical challenges when dealing with a variety of portfolio companies.

Carried interest: An especially important issue to the fund managers is the determination and allocation of carried interest. Carried interest is a percentage of the fund's profits paid to fund managers through the GP in order to motivate the managers to achieve aggressive returns for the fund.

Normally, in an independent fund, the LPs would negotiate only the total amount of carried interest, usually 20%. However, a corporate LP will often be interested also in having visibility into the allocation of portions of this carried interest among the fund managers. And if the fund starts out with only a few managers, the corporate parent may see a full 20% as overly generous to divide among people who were working only recently for ordinary corporate compensation. As a result, the carried interest may initially be determined on a more transparent individual-by-individual basis, rather than letting the fund managers decide on their own how to split up a full 20% carried interest.

These issues illustrate the need for careful consideration and planning for these transitions.

Making partnerships work

Robert Ackerman, founder and managing director, Allegis Capital

The logic behind collaboration between corporations and start-up companies – together with their venture backers – is clear and compelling. Start-ups have a reputation for efficient innovation and market disintermediation while corporations have established paths to global markets and mass. As markets grow increasing competitive, both groups need to reimagine how they pursue their future ambitions. The question is not so much "whether" but rather "how" they engage for sustainable success.

Venture capital investing is a high-risk, high-reward endeavour, a business where experience matters and the lessons necessary for success are not taught in business school. While the figures may ebb and flow, the industry adage that it takes seven years and $50m to train a venture capitalist remains intact. Unfortunately, most corporate venture programmes do not have the luxury of a seven-year $50m postgraduate education for their practitioners.

These facts of life argue for collaboration between corporations and experienced venture capital firms – each contributing expertise, resources and relationships to support the growth of innovative start-ups. The challenge for corporations is that the venture community is a tight-knit club of individuals and firms that have worked together in the trenches over an extended period – through good times and bad – building trusted relationships. Corporations often find themselves on the outside looking in.

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Make no mistake, a young company – and its backers – in desperate need of capital will welcome anyone who can write a cheque when their options are between slim and none. For a corporation in this circumstance, the cashed cheque does not mean acceptance into the club. Shortly after I began my career in venture capital, I received a call from one of the most recognised venture firms in the country offering to show me an investment. I excitedly shared the news with my far more experienced partner who advised me to run. His rationale – if they are calling you, it is because everyone else has turned them down. Fortunately, today I am in a very different position, but it has taken 16 years to get here.

While capital is important in the venture community, the ability to mitigate risk, accelerate growth and erect barriers to entry while improving the probability of success is always in short supply. You often see this in how venture capitalists syndicate with one another to assemble these synergies and improve their probability of success. This is the opening for corporate investors looking to engage the start-up community. Whether a corporation partners as a limited partner (investor) with a venture firm, thereby becoming an associate member of the club, or chooses to go it alone, an ability to deliver value that improves the potential success of a start-up is essential.

Corporations approaching venture capital firms and their portfolio companies should lead their discussions with what they can deliver in term of value to advance the success of a given start-up. Once involved with a company, the corporate investor needs to deliver on the value-add promised. This is where a corporation differentiates itself and earns the trust and respect of venture capital investors. Those that can do this on a sustainable basis over a number of years become members of the club. And this is a club you need to be a member of if your goals are long-term profit and success.

Conversely, failure to deliver on promises of strategic value can severely undermine the credibility and desirability of a corporate investor. While a corporate investment team cannot guarantee how its corporate parent will engage with a start-up, realistic expectations should be set, managed and delivered. When things do not go right, the corporate venture team needs to be proactive in getting things back on track. In one of my former portfolio companies, a corporate investor's parent made a benign decision that had a significant adverse impact on our shared investment. Their investor representative went to bat aggressively to see that decision changed as it related to our portfolio company. Another corporate investor in the same company failed to deliver on stated commitments – turning what could have been a major strategic win into a significant competitive disadvantage for our shared portfolio company. Reputation is ▶

everything in the venture community. It takes a long time to build and no time to lose.

Corporations are often viewed as suspect within the venture community due to their history of personnel turnover and lack of long-term commitment – here for two or three years and gone. Short-term relationships seldom warrant the respect or consideration that is a hallmark of success within the club. A corporation that can deliver value that demonstrably reduces risk and contributes to the success of a start-up goes a long way towards filling out a competitive application for club membership.

As with the most successful ventures, the devil is in the detail when it comes to making corporate venture partnerships work. The fact that "work" means different things to different constituencies within the innovation ecosystem only compounds the challenges.

The corporation is looking to tap into the innovator's ability to enable new markets and create new products that can be profitably leveraged into established or aspirational customer bases through existing distribution infrastructure – in short, broad, competitive advantage. The innovator is often looking to access those customers and distribution channels without becoming captive to the corporate partner.

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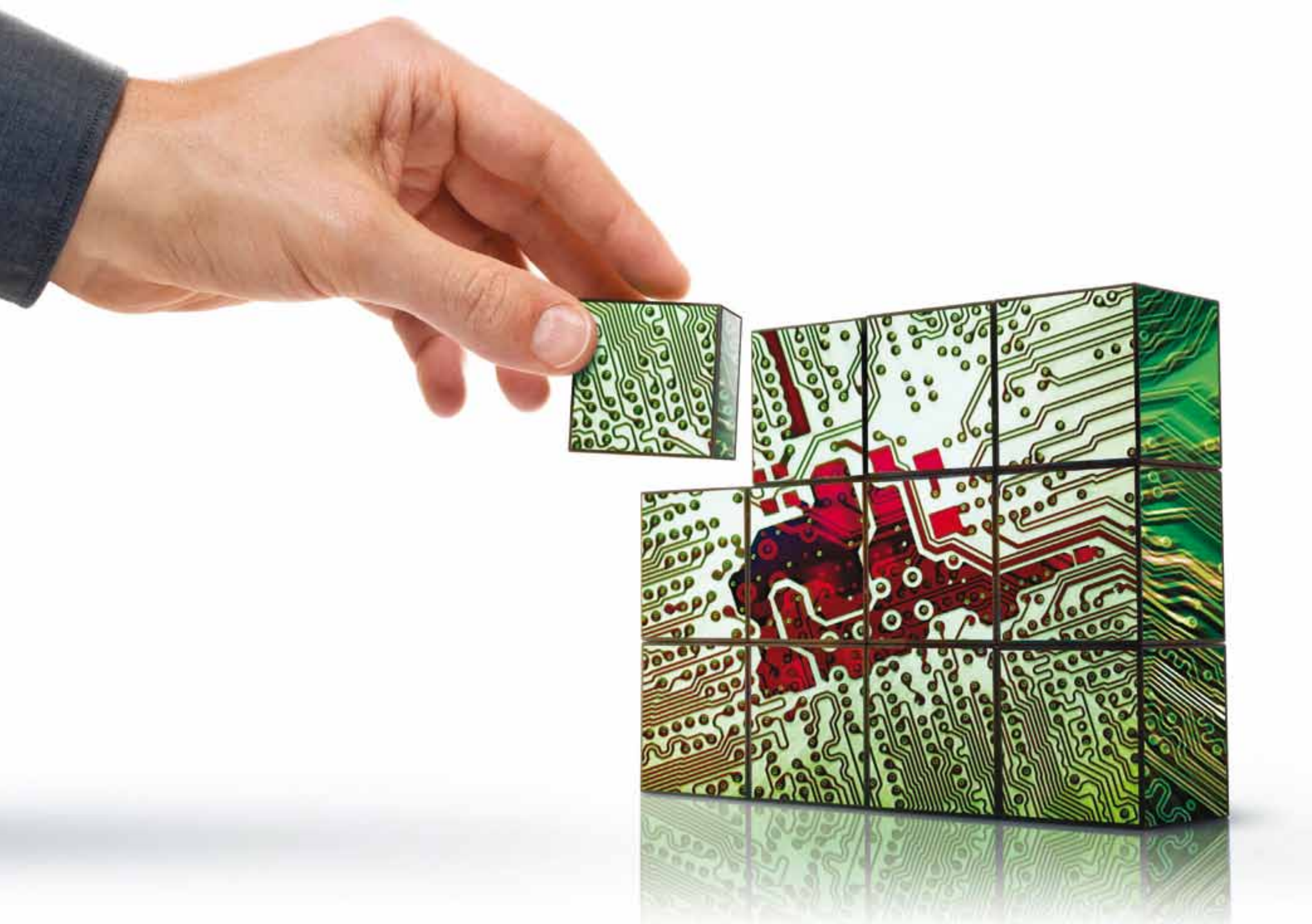
In many but not all cases, the corporate partner wants to buy the cow at the lowest possible price and the innovator looks to sell the cow's milk to the corporation. The venture capitalists – "lower my risk", "help accelerate my company's growth", "improve my probability of a positive outcome – help me make more money."

The alignment of these disparate perspectives is essential to the success and sustainability of a corporate venture programme, with the responsibility for success falling to the corporation. At the 35,000-foot level, a corporate venture programme should be guided by two principles: first, say what you will do and do what you say, and second, do no harm. In terms of tactical implementation, a few best practices have emerged over my 20 years at the intersection of start-ups, venture capitalists and corporate partnerships.

- Identify and articulate precisely what value you can and will bring to the innovation ecosystem. Know internally how you will deliver this value to your innovation partners. Your credibility will be on the line so this is no time for wishful thinking or hubris.
- Respect your partners. Resist the temptation to ask for consideration from your investment over and above that received by others at the table. A common theme among corporate investors in the dot.com period was a desire for warrants or special deals simply because of their presence in the deal. "Our presence will add credibility" and "we need incentives to mobilise our team" were reasons often cited. Your partners at the table rightfully feel they are bringing more to the discussion than capital. Don't hold yourself out as special.
- When developing a strategic partnership with an innovator, approach the discussion on an arm's-length basis in terms of critical business points. Be guided by the principle that consideration is given for value received. Remember that for the innovator, the strategic partnership is viewed as a force multiplier – it should not be seen as a tax. When structuring incentives, ensure there is a clear correlation between value delivered and the compensation and recognition received. Often, strategic leverage can be positioned as a lower-cost and higher-impact alternative to raising additional capital. This is an approach that resonates with both innovators and their venture backers.
- Align resources within your corporation in advance of your need to call on them. Speed is one of the innovator's greatest advantages. A corporation needs to position itself to work within the time parameters that drive innovators. A strategic partnership that does not accelerate an innovator's path forward is not viewed as a competitive advantage. Engaging line-of-business management proactively in advance of potential partnerships provides a foundation for broader ownership of a strategic relationship within the corporation.
- When partnerships with an innovator are not tracking to plan, take ownership of the problem and work aggressively to address the cause – whether it lies within the corporation or within the innovator's organisation. Proactive problem solving is one of the best ways to establish a reputation as a preferred partner within the innovation economy.
- Work to maintain team stability within the corporate venture organisation. The innovation ecosystem – driven by relationships – rewards stability and continuity. At the same time, venture investing has been described as an internship-based career, one that requires and benefits from extensive experience. To be sustainable, corporate venture programmes need to be structured so as to develop and retain expertise and relationships.

Every corporation needs to develop and manage its venturing programmes in a manner consistent with its corporate culture. Accordingly, there is no one right or wrong approach as to how a corporate programme should be managed. At the same time, the above principles are at the heart of those corporate venture programmes that have stood the test of time, and continuity has been demonstrated time and time again to be one of the critical factors for long-term success in the innovation economy. ■



Variety creates opportunity

Venture capital has historically been a procyclical activity in which more is invested at the end of an economic cycle during boom years and so firms can go back to investors and raise their next fund while sentiment is positive.

While corporate venturing units can gain succour from the potential stability of multibillion-dollar parents, they have traditionally been more procyclical than independent venture capital firms (VCs), meaning they are set up at the end of one cycle only to be closed a few years later after investing the initial tranche of money.

The current wave of corporate venturing activity, therefore, comes during an interesting period, as economic growth is relatively slow and sentiment weak in a number of large countries and regions, such as Japan and the European Union. The more than 200 corporate venturing fund and programme launches since 2010 seems to reflect the needs of companies to grow their equity through innovation rather than necessarily relying on financial engineering and debt.

These launches have had goals ranging from purely strategic to purely financial, and included and a mix of organisational approaches, from annual budgets using money from the corporate balance sheet to commitments to funds managed by independent teams.

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Given that an investment period in venture capital is often about three years – usually less in boom times and more in economic downturns – the fact that so many groups, more than 230, have at least a four-year track record indicates they have gained a solidity in their funding across what is effectively multiple funds.

But as a corporate venturing unit matures there are often changes in financing and organisation strategies.

While some groups, such as chip maker Intel, retain an annual budget, usually investing between $300m and $500m a year, they have also set up specific funds to target areas of particular interest, such as developing an ecosystem around its Ultrabooks or the car.

Often these specialist funds are an opportunity to bring in third parties potentially to reduce or leverage the funding requirements of the company or to include strategic partners from complementary areas. However, at this point, the corporate venturers often need to become more independent of a single parent by creating a general partnership and management firm.

France-based train operator SNCF spun out its venturing team to form Ecomobilité Ventures as an independent team and raise a fund to include third parties, such as phone operator France Telecom and advertising agency Publicis, to look at the future of sustainable transport.

The independence from a separate management company also usually allows the corporate-backed venture fund to have more flexibility in pay *(see article by Byron Dailey and Steven Yentzer)*.

Gaurav Tewari, partner at SAP Ventures, the corporate venturing unit of the Germany-based software provider, said: "SAP has incentivised SAP Ventures by committing to a fund [as a limited partner (LP)] with its own management fee and carry [share of investment profit]. So my agenda becomes maximising shareholder value, and like any good VC I want to leverage my network and channels, which is our sole LP – SAP.

"The corporate connection is the optionality we bring to our portfolio companies, but as SAP is a separate legal entity we do not share information with them beyond what the portfolio company accepts."

For groups able to return cash to their parents, one way to increase their flexibility while still being part of a parent firm is to set up an evergreen structure, such as that used by Swisscom, which means they can reinvest the proceeds from deals in new rounds rather than having to return to the parent every year or few years to ask for more money and so expose themselves to any coincidental cash weakness in the parent.

While corporate venturing can be seen as part of the research and development function, it is rare for units to lose money on deals consistently without becoming vulnerable to closure. This generally leads surviving groups towards a portfolio of early-stage deals and funds that can generate interesting ideas and experiments at a faster pace and broader remit then internal researchers typically focus on, and later-stage deals that can show an exit route faster and so return cash to the parent or for reinvestment.

But just as in the wider venture capital industry, there are more companies backed than profitable exits each year, so corporate venturing units that reach the middle stages of four to nine years' experience can find their portfolio expanding, resulting in difficult management decisions if they intend to continue delivering strategic and financial rewards.

At that point, how they communicate the results and their governance structure can influence whether the team can continue to function into the future.