Strategy 2: Corporate Strategy
Final Group Assignment

Corporate Venturing

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Contents

Contents .........................................................................................................................2

Introduction....................................................................................................................3

Challenge 1: Clarify your objective...............................................................................3

   The objective implications in pursuing a purely financial strategy: “You can’t beat
   the VCs at their own game”.......................................................................................3

   The objective advantages in pursuing a purely innovative/commercial strategy:
   “Play your own strengths” .........................................................................................4

Challenge 2: Which set-up for the Corporate Venture Capital unit?.........................5

   Portfolio Management ...............................................................................................6

   Knowledge transfer....................................................................................................6

Challenge 3: How do we attract and retaining talent? ...................................................8
Introduction

The purpose of this paper is to comment on the challenges that Corporations find when deciding to setup an equity investment arm: Corporate Ventures (CVs). We will focus on three different challenges, covering the reasons why Corporations decide initiate CVs, the main structural differences between CVs and Venture Capital (VCs) firms, and finally some of the main compensation difficulties and tensions that CVs can generate. This paper explores specific examples and general studies about some of the historic errors and success stories that large corporations have in this industry. While highlighting the challenges, we will also present suggestions about what CVs can do in order to minimize risks.

Challenge 1: Clarify your objective

The first challenge that CXOs and corporate boards must face when deciding to set up a Corporate Venture unit within their organisations is to get the objective right: There must be an alignment between the financial returns expected with the strategic direction and market knowledge that the corporation possesses.

This is mostly sustained by the fact that a company cannot easily or immediately transform itself into a Venture Capital firm, and that by playing on its strengths, it can better capitalise on the innovations spinning from the investments as well as finding and exploiting related business opportunities.

*The objective implications in pursuing a purely financial strategy: “You can’t beat the VCs at their own game”*

A corporation should not enter into a Corporate Venturing program unless it is prepared to fully assume the mode of a Venture Capital structure and mode of work. The corporation has to start with the initial basic question: what is the objective in setting up a Venture Capital unit?

There are two main answers to this question, and although not purely binary in its solution, it ranges from a purely financial approach to a combined innovative/commercial one.
In the financial approach, the company sets up the CV unit to diversify its investment portfolio, to maximise returns on investments not related to the core activities of the corporation and, as a consequence mitigate risk.

In the initial stages of venture life cycle there tends to be a difficulty in assessing the strategic value of the development. Most investment firms will tend to focus on the financial aspects and expected returns. This folly tends to focus firms to bypass the analysis of the strategic benefits that the investment may provide.

This is not necessarily a bad thing. The business model that pure Venture Capital firms can sustain in their portfolios due to their freedom in assessing the type of investments they can undertake is different to that of corporate firms, which are accountable to their shareholders, and will tend to be more restricted in the kind of investments that they can undertake. Hence, due to this freedom that they possess, the returns of the Venture Capital firms tend to be higher than those of the Corporate Ventures, This case can be further illustrated by the example of ITT between the 1950s and mid 1970s, when a diversification programme was aggressively pursued taking a telecommunications company into markets as diverse as hotel management and insurance without a clear objective other than financial diversification.1

Although the case of ITT’s mismanagement extends further than just its acquisition and venturing decisions, it’s diverse and unfocused investments contributed greatly to the demise of the corporate strategy.

**The objective advantages in pursuing a purely innovative/commercial strategy: “Play your own strengths”**

Due to the large amounts of capital and liquidity in the markets, corporations are setting up Corporate Venture units. However, corporations have to be aware of the need to align their venture portfolios with the overall corporate strategy.

Although the financial goal of the investment is still an important part of establishing such ventures, those that are strategically aligned to the corporate objectives can

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leverage the strengths of the parent corporation. As in the David and Goliath theory, the smaller entrepreneurial venture can benefit from the scale and distributive channels of the parent corporation.

For example, in the Biomedical Health Industry between 1991 and 1999 there was despite fluctuations an apparent consistency where over time strategic returns consistently exceed financial returns of up to 20% higher in terms of WACC. Similarly, at Intel Capital, the Corporate Venturing unit of Intel, a process was implemented where the financial review of the expected performance of the investment was matched with an operational, marketing and innovative audit performed by the managers of the business units of the organization. This process ensured that with the approval of both teams, the investments fulfilled both the financial and strategic requirements that the organization needed to ensure future innovation.

There is also the argument that the access to possible investments tend to be easier for corporations when they are related to the markets they are in. This is not only through the formal networks but also the social and informal networks of the employees and participants in the industry. This enables both the corporations to reach out to new investments, and the ventures to reach out to Corporations to discuss possible investments. This also diminishes matchmaking costs by keeping out the middlemen.

**Challenge 2: Which set-up for the Corporate Venture Capital unit?**

In order to be able to play on its strengths, the parent corporation should understand the organisational implications in pursuing an innovative and commercial strategy for its venture unit. The research on CVs suggests that corporations should particularly look at two organisational dimensions that are often overlooked when setting up the venture unit:

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2 Damodar, Aswath, "Cost of Capital per Industry Sector"  
• Portfolio management: the parent corporation should ensure that sufficient resources are dedicated for a rigorous monitoring of the portfolio companies

• Knowledge transfer: the ultimate success of the venture unit lies in the parent corporation’s ability to leverage knowledge between its business units and the venture companies.

**Portfolio Management**

One of the main areas, where corporations usually have a disadvantage against VC’s is the intensive oversight that venture capitalists provide to firms in their portfolio. One survey by Gorman and Sahlman, found that VCs visited their portfolio companies an average of 19 times per year, with over 100 hrs of direct contact between the VC and managers of the venture. This intensive oversight was demonstrated by Lerner, who found that VCs generally increased their participation during times of CEO crisis. VCs’ intensive monitoring gives them the information necessary to commit to a course of action in a short amount of time. Their arrangements with their limited partners mean that their decisions will stand without further review by other levels of management.

It is increasingly complicated for corporations to drive such an intense level of oversight over their portfolio companies. In order to achieve this, they would need to dedicate high cost resources, which would be able to spend a large amount of time following the ventures and analyzing better ways to help them succeed. This is a costly exercise by corporations’ standards, where making the quarter financials is generally a non negotiable.

**Knowledge transfer**

Corporate VCs enjoy a key advantage over private VCs: their ability to share and leverage industry knowledge between the portfolio companies and the business-units of the sponsoring corporation. Such a knowledge transfer can impact the entire investment process, from deal selection to portfolio monitoring to exit strategy. Knowledge transfer can ensure strategic deal selection, facilitate capture of strategic value and help manage a portfolio against financial and strategic objectives.

3 Designing Corporate Ventures in the Shadow of Private Venture Capital. Henry Chesbrough
For deal selection, working closely with business managers and industry experts from the parent corporation can help CV managers in targeting promising companies and accessing high potential entrepreneurs. As an example, Intel overcame the challenge of identifying venture investments with potential strategic value by pairing Intel Capital investment professionals with the business units as the business units formulate strategy and execution. These dedicated professionals had the opportunity to learn the details of a specific market and to coordinate their activities with the business-unit general managers. Knowledge transfer also represent a competitive advantage during investment closing and specifically during due diligence. The Lucent Venture unit (NVG), for example, is interested in projects that can maximise one or more complementarities with Lucent’s assets. Much of NVG’s due diligence process involves extended discussions with internal Lucent business managers to identify important industry trends and missing elements in Lucent’s internal offerings. These discussions helped to validate the business potential of a new venture. They also helped to align the ventures with the overall strategic direction of Lucent’s businesses.

A key and structural advantage stems from the corporation’s ownership of important knowledge-based complementary assets. When it comes to portfolio monitoring, knowledge transfer is an efficient way to maximise synergies and support the development of the portfolio companies. Certain technologies for instance require the development of complementary technologies in order to deliver value, and corporations would have advantages over private VCs in coordinating these complementarities. Unfortunately, many corporations fail to prioritise liaisons between business units and portfolio companies. Such transfer of information can be realised through the formal implementation of a knowledge transfer function. The responsibility for this function should be clearly and specifically assigned within the parent corporation. This is illustrated by Motorola, which improved information transfer with its portfolio of venture investments (Motorola Ventures) by creating a

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4 Corporate Venture Capital – Managing for Strategic and Financial Returns – Corporate Executive Board - 2000

5 Designing Corporate Ventures in the Shadow of Private Venture Capital - Chesbrough - 2000
knowledge transfer team that is tasked with developing relationships between each start-up company and the parent corporation. As such, Motorola engineers can monitor if the acquiring technology fulfils expectations, make exit recommendation, or identify opportunities between start-up and business-units in order to make sure that managers can really benefit from innovation.

While they may do well to mimic certain VC practices, corporate venture structures ultimately will only work if they can deliver strategic benefits to their sponsoring companies. To realize these benefits, these structures must do more than mimic independent venture capital. They must leverage the potential advantages of corporate ventures through the set up of an organisation that ensures rigorous portfolio management and efficient knowledge transfer.

**Challenge 3: How do we attract and retaining talent?**

The third challenge is for companies to attract experienced, competent people, and retain the key entrepreneurs and leaders within the organization. Compensation has always been a problem for companies in running a CV unit. Block and Macmillan interviews with venture managers revealed that they all would like to see compensation programs related to the venture’s rewards to the firm, but that they would have acted the same way regardless of the compensation program.

Although incentives and compensation don’t appear to have much impact on the management of the venture, they may affect the organization’s ability to retain exceptional people who are offered better incentives elsewhere as well as managers’ willingness to take the career risks involved in venturing. But, putting in place the right incentives program is a complex issue.

One major problem stems from the practice of paying the managers of the CV more than their peers and sometimes even more than senior corporate executives creating internal inequity. If the rewards offered to the CV personnel are perceived as unfair

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6 Corporate Venture Capital – Managing for Strategic and Financial Returns – Corporate Executive Board - 2000

by the rest in the company, it might undermine their support to the corporate venture personnel.

When designing a compensation plan the risks faced by managers of independent VCs versus CVs must also be weighed. Although an independent VC do not have to deal with corporate bureaucracy, the CV manager takes less financial risks and has far more potential support in terms of knowledge and human and physical resources. This view was supported by Chesbrough stated in his example of Lucent that since the CV personnel were taking less risk than their independent counterparts, their compensation should be less.8

It is also necessary to motivate the corporate venture manager to stay aligned with the company’s objectives. Venture capitalists, regardless of their nobility of purpose, are primarily interested in making money by investing relatively small amounts in firms that will increase in market value and produce profit for the venture capital partnership through the sale of shares within a five to seven-year time frame. A corporate venture manager on the other hand should not only have this mentality. A corporation can invest in a new venture to improve its performance or protect itself against competition. The measure of a venture’s success is its impact on ROI, market share, market position, growth rate and reputation, not how much its stock can be sold for within seven years.

Finally, a CV manager should also be willing to accept more external control than their counterparts on the outside. This also might introduce a new problem. Many corporate venture managers leave to outside firms due to frustration at not being supported in pursuing an opportunity of their choice or a growing need for greater independence than can be achieved within the corporation.

There are many different ways of compensating the corporate entrepreneur and the staff of the corporate venture. The most important decision in is to align the incentives to meet both the needs of the company and the individual. Geographically and organisationally separating the organization from the parent company may also decrease the amount of perceived unfairness in the incentive scheme.

There are three characteristics of incentives:

Firstly, the management must identify whether the incentive is short-term or long-term. A short term incentive will encourage the manager to prioritise short term goals and seem to be more effective when the product is strategically linked to existing product lines of the parent company whereas long term incentives are better suited when the venture is not linked to the parent company.9

Secondly, whether the incentives are performance related or performance unrelated. Research on this topic has been divided and different studies have had different findings on whether there is financial benefit in the performance based incentives. However these incentives have improved the morale and team work of these units, thus increasing the value and productivity.10

Thirdly there are two groups of incentives: financial incentives and non-financial incentives. The choice and balance between these two must be tailored to the needs of the person being hired and can be readjusted as time passes and the persons needs and life-stages change. The financial incentives include equity and stocks (including phantom shares), salary and salary increases, fringe benefits and bonuses.

Equity options can be in the form of shares in the parent company or venture. If the venture is not a separate legal entity, phantom shares can be given. The phantom share has a predefined artificial value. In this area the question of inequality is best dealt with by making the manager invest a percentage (e.g. 15%) in the venture, because peers will perceive the increased risk profile as well as the potential reward.

Salary and salary increases can either be a performance adjustment of the base salary or the salary increase. GTE used a salary contribution programme with 10% of the salary was contributed to the venture. At a profit of $100 000 the full salary is restored and increased incrementally according to the profits.

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AT&T technologies organised this into three risk levels. The first level was the standard compensation, the second was an agreement to freeze salaries until the venture generated a positive cash flow and received a one time bonus of 150% of their salary and the third was contributing 15% of their salary with a return of up to eight times the amount if the venture was successful.

Fringe benefit incentives included sponsorship of sabbaticals or studies or scholarships for the children of the manager. Bonuses can be structured in different ways and can be related to different performance levels such as ROI, sales, cash flow or completion of milestones. Du Pont used discretionary bonuses to venture champions and teams while DCA Food Industries linked bonuses to a percentage of the profits made by a venture.

The second group of incentives are the non-financial incentives such as recognition, autonomy, promotion, authority, power and responsibility. Studies by Quinn, Block and Macmillan showed that many people appreciate non-financial incentives more than the financial incentives, but should be coupled with financial incentives into an incentive scheme that satisfies both the objectives of the parent company and the employee.11