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Cass Business School
CITY UNIVERSITY LONDON

For the Buck or for the Future

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MARC is the Mergers and Acquisitions Research Centre at Cass Business School, City University London – the first research centre at a major business school to pursue focussed leading-edge research into the global mergers and acquisitions industry.

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Overview

It is a world where almost all companies are either seeking to find, or are fearful of, the next disruptive 'unicorn'. Global demographic and environmental change, in conjunction with "digital transformation across all sectors, increasing shareholder and regulatory scrutiny, and the heightened presence of global competitors" (EY, 2015) are amongst the 'megatrends' significantly impacting the strategies of large corporates.

Against this backdrop the number of Corporate Venture Capital ("CVC") units worldwide doubled between 2012 and 2014, as corporates increasingly view CVC as part of the solution to assist them to "identify life-threatening changes to their business early, so that they can adapt or, better yet, get in on the act" (Economist, 2014).

There is general academic agreement that CVC has a positive effect on firm performance, although the studies caution that these benefits are not guaranteed and ventures may take several years to become profitable, as with any VC investment. Furthermore, recent studies provide empirical evidence to substantiate the claim that CVC-backed ventures fare better than independent venture capitalist-backed ones, as well as indicating that CVC-backed entrepreneurial ventures receive higher valuations at IPO compared to ventures funded solely by traditional VCs.

Given the growing importance of this area and the new maturity of the field (no longer just a pro-cyclical corporate 'nice to have') Cass Business School has carried out an interview-based study to ascertain key questions and corporate needs to be able to answer if it is to take a first step into this high risk/high reward, but possibly essential, field.

Study description

Data was collected through semi-structured interviews with nine practitioners from CVC units of large, global corporates. See the Appendix for details of the CVC units involved.

- The study sought to: examine how CVC units prioritise strategic versus financial objectives
- understand how CVC units define their investment boundaries (the importance of 'internal fit')
- investigate how CVC investors appraise potential investments to ensure they are capable of meeting, in particular strategic objectives
- examine how CVC governance structures differ and how they seek to align the interests of the corporate and the CVC team
- understand how CVC practitioners measure strategic returns and define 'success' as further verification of objective prioritisation

Our **conclusions** are in the form of the **three questions** that a corporate must be able to answer before proceeding: (For more detail see the conclusion of this report)

- **What is the intended primary objective of the CVC programme?**

- **What is the best way to configure the CVC unit?**
  - Not just in terms of employees, but also authority and incentivisation

- **How should investments be appraised?**
  - Not an easy one, given the multiple potential responses to the first question

And, as usual, get the CEO on board.

"Most CVC programmes tend to be CEO-driven, and if they're not CEO-driven and don't continue to have the support from the CEO, it becomes really problematic for the longevity of the group."

What is CVC (and what is it not)?

We would definite it as “a minority (equity) investment by an established corporation in a privately held entrepreneurial venture” with high-growth potential. This would include both direct investments and investment into funds dedicated to that corporate.

What it isn’t

For the purpose of this report we do not include internal venture capital within the corporate structure.

While a conventional VC’s sole objective is to generate a financial return (a capital gain), from the sale of investee businesses, the reasons why corporates may choose to undertake CVC activities are more nuanced and the CVC fund’s performance is more likely (but not always), to be assessed on the basis of both financial and strategic returns, making the analysis of the unit’s strategy and success problematic, something this report seeks to address.

A further difference between VC and CVC is that CVC funds have been observed to invest across a wider spectrum of the ‘business lifecycle’ as compared to traditional VC funds (which have a narrower focus), and syndication opportunities often arise for CVC units to invest alongside PE investors, not just VC investors.

It is also not necessarily about making investments in companies that eventually are bought 100% by the parent. In 2014 Google acquired Nest Labs for $3.2bn. One of the beneficiaries of its rise in value (from an $825m valuation a year before) was Google Ventures, Google’s CVC arm. However despite the headlines this created, this is not the norm and in this instance it was only the second portfolio company to be sold to Google. Google Ventures has sold as many portfolio companies to Yahoo and Cisco systems as to Google.

PitchBook data shows that the average rate of successful exits to a CVC’s parent is just 3%. And Intel Capital, considered by many to be the gold standard for CVC, only sold 7 out of 259 successful exits to Intel.

Characteristics of CVC

So if exiting to the corporate does not define CVC’s and is not a good characterisation vis a vis ‘normal’ venture capital, what are some of its characteristics?

Figure 1: Practical models for the pursuit of CVC (Adapted from Clark (2013))

	Corporate / Direct Investment	**Internal Dedicated Fund**	**External Fund**
Structure	• Direct investment funding each deal ‘off-balance sheet’ • Investments closely related to BUs and future business opportunities.	• GP Model: Corporate acts as LP in 100% captive fund. • Fund retains greater autonomy than ‘Direct’ model, but still answerable to single LP.	• LP Model: GP is external firm, whilst corporate is LP ‘part investor’. • Decision on investments is in hands of GP (based on fund parameters).

Henry Chesbrough (UC Berkeley) wrote, ‘in addition to acting somewhat as an incubator and producing explicit financial returns for the parent company, corporate VCs are also in the business of making “enabling investments”’. These combine financial gain with operational gain.

This ‘enabling’ strategy can mean the investments have more time and capital committed pre IPO. The median holding period for a company that has received CVC funding is around 6.25 years, in contrast to a ‘normal’ VC backed business where the figure is around 4.5 years.

Figure 2: Median Holding Time (Years) for VC backed Companies (Source: PitchBook)

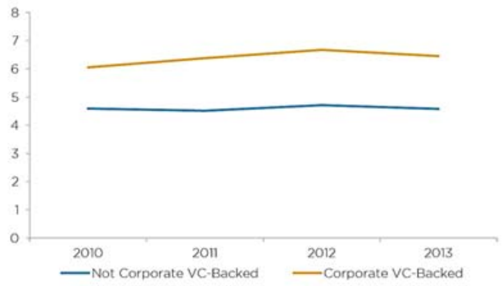
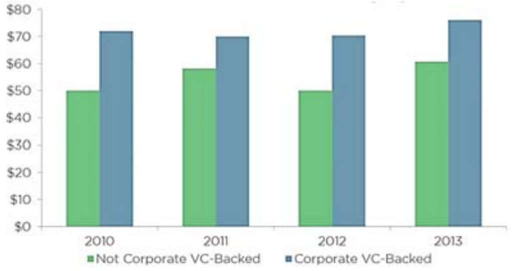


Figure 3: Median VC-backed Exit Size ($M) (Source: PitchBook)



This, logically means larger exits, a median exit size of $70m+ in the four years post the financial crisis. This compares to an overall average in that period of around $55m.

Why is this a big moment for CVC?

The first 'waves' of CVC investment were characterised by peaks occurring at the end of economic cycles. This is characteristic of VC overall and for CVCs we would expect this pattern to be exaggerated, given the reliance on the parent's balance sheet. By the mid-1970s a quarter of Fortune 500 firms were reported to have active CVC programmes (and famously 3M and DuPont). This 'first wave' was dented by the oil shocks and subsequent recession, the second mid 80s peak by another recession, the third by the tech bubble, and the fourth by the global financial crisis….or was it?

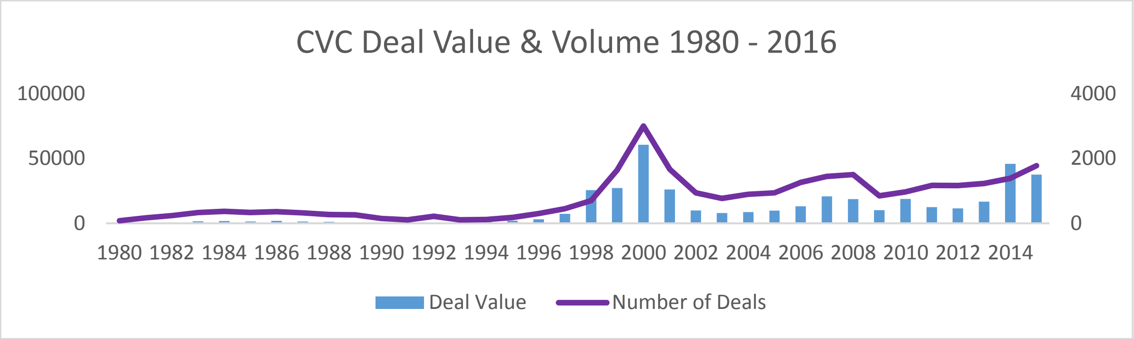
While the figure below makes it clear that the amounts of CVC equity invested fell back in 2009 following the 2008 global financial crisis, despite the five years of economic uncertainty which ensued CVC has been thriving. *The Economist* (2014) suggests that the number of corporate-venture functions worldwide doubled to 1,100 between 2012 and 2014. Figure 4 below shows the overall global trends in terms of volume and number of CVC deals.

Global Corporate Venturing reports that nearly half the top 100 companies in the Fortune 500 are actively pursuing CVC, albeit only 23.2% of the full 500 in Fortune's list are doing so. Likewise Ernst & Young observed in 2015 that 19% of respondents to their 'Global Corporate Development Survey' currently have a venture fund, while nearly half expected the number of venture funds in their industry to increase.

CVC has also become more geographically diverse. The Asian market is at the forefront of the latest trend, given "China and India were second and third respectively in terms of the value of corporate venturing deals sealed, with US$10billion and US$3billion invested by syndicates involving corporate venturing units […], driven by large investments – especially those by China-based internet companies Alibaba, Tencent and Baidu, which have also been highly active in the US."[1]

It appears that CVC has broken clear of cyclicality and become a more permanent part of an ever more impermanent world. Whether this is due to the significance of disruptive technology or not, it has implications in terms of its purpose, whether strategic or financial.

Figure 4: CVC Deal Value & Volume 1980-2015 (Jan to Jun Only) (Source: ThomsonONE)



[1] Lewis, T. Global Corporate Venturing, Feb 2015

What should be the purpose of CVC?

The 'purpose' of CVC is not obvious to define, whether you look for direct financial returns or more intangible strategic benefits. In fact we would break the potential benefits into three areas (and we highlight the findings of our study in each):

1. Financial returns

While it was not the intention of this study to examine financial returns, it was deemed important nonetheless to provide an overview of the way companies approach financial returns, given that they are an important aspect of CVC activity.

A majority of interviewees suggested that their primary financial objective was to be a 'self-sufficient' division; thus covering costs and replenishing capital for future deployment in investments.

All interviewees suggested that they were required to report regularly on the financial health of their portfolio – the majority employ 'standard' VC-metrics; internal rate of return (IRR) and cash-on-cash multiples, as a basis for reporting and quantifying returns upon exit.

While a number of interviewees suggested that they ensure returns are commensurate with their co-investors on projects, only one 'off-balance sheet' investor indicated its CVC unit benchmarks and publicises its financial returns against traditional VC:

"Externally, we publicise that we achieve top quartile returns. We're investing with 'Tier 1 VCs', so our returns are top quartile."

2. Strategic returns

The difficulty of tracking and measuring strategic returns is almost self-evident. Interviewees were therefore asked to explain their approach to quantifying and tracking 'strategic value' added to the corporate by the CVC unit. A majority of interviewees confirmed that strategic returns remain a challenge to track, however some have succeeded in defining methods for quantification of their value. When looking at investments close to 'core business', interviewees from several CVCs stated that these were easier to quantify numerically, because you can estimate elements such as the market potential of a new compound or methodology, a new product launched in a different geography or a cost saving. However, only one employs a 'strategic hurdle' requirement:

"We say that we will deliver back to our core businesses a 5-10x strategic value to the business versus our equity stake. So what does that mean? The discounts we get on the service or products that we invested in and all the savings they get through more rapid deployment of the technology must be 5-10x more. And we have done that a number of times now."

Beyond specific investments, a number of interviewees suggested that CVC has a more important role in the corporate's wider venturing and renewal processes. A small number of interviewees stated that they track and report on collaborations and inter-firm relationships which have come about as a result of CVC activity, but have not resulted in investment. The interviewee from one summarised their approach to articulating strategic benefits in this regard, as follows:

"The strategic piece we do through two or three means. One, we describe the collaboration that exists between portfolio companies and BUs. […] Secondly, we document and track all, what we call, "non-portfolio activities"; the things we do that don't lead to investment but lead to some potential value for [us]. Particularly, these are introductions to companies that our company either didn't know about, or hasn't looked into.[.] Finally, we track the softer things like introductions; going to, or speaking at conferences; getting involved in EU activities related to innovation, government subsidies, R&D; and helping incubators or accelerators.

We use these three elements as evidence of 'soft-value' that we've created."

3. Resource transfer

The table below presents a qualitative assessment of the degree of ‘resource transfer’ to and from a Corporate Parent (CP) as a result of CVC activities. The majority benefit from a “high” level of resource transfer from investee companies.

Figure 5: Assessment of resource transfer through CVC investment

	Resource Transfer		**Explanation / Justification** *(Reinforced by interview extracts provided in **Error! Reference source not found.** above)*
	To Parent	**From Parent**	
CVC 1	⇧	⬄	3 in 4 investments targeted at making improvements to existing operations, with strategic benefits quantified during early stages of investment appraisal process.
CVC 2	⬄	⬄	Investment scope is broad, with a primary emphasis on financial returns. However, the interviewee’s view on their most “successful” investment was one which was subsequently acquired and went on to be a product which has achieved over a billion units of sale.
CVC 3	⇧	⬄	Investment thesis targets complementary sectors; the CVC unit has generated significant (£bn returns) from a recent exit and acquired a small number of its portfolio companies.
CVC 4	⇧	⬄	Investments closely aligned with existing BUs with a focus on improving innovation. Investments have led to M&A opportunities which have significantly enhanced the parent company’s existing offering. Nearly all the investee companies have resulted in inter-firm collaborations.
CVC 5	⇧	⇧	Investments aligned with existing BUs – strategic rationale and benefit to investees is defined during the early investment process. Portfolio investments have been acquired and significantly enhanced BU offering.
CVC 6	⬄	⬄	Wide investment scope – external LP-GP structure provides incentive to focus on financial returns above strategic relevance for CP. They had missed out on acquiring a portfolio company which would have made added value and cited a number of examples of situations where the CVC team had not invested but had achieved other types of strategic link.
CVC 7	⇧	⬄	Investments must have strategic relevance. Example: acquired one investment to form the foundation of a customer offering with over 1-million customers and committed a further £0.5bn in further funding.
CVC 8	⇧	⬄	This CVC is early in its establishment, having only made two investments. Its focus is very much on strategic enhancement of its customer offering. They have established an internal team to maximise collaboration with investee companies, as well as those it acquires and licenses.
CVC 9	⬄	⬄	Investments have a strategic focus, with a remit to provide a view on industry disruption – “success” defined in terms of most significant financial return to CP. They missed out on an opportunity to acquire the portfolio company, which has gone on to become a substantial player in the media space and now competes with them in a number of respects.

Key: ⇧ = High, ⬄ = Medium, ⇩ = Low

So how do you measure success?

And given this complexity of outcomes, how do you define success?

Interviewees were asked to describe what "success" means to them in the context of their CVC unit. A number of responses focused on 'organisational success'; bound closely to achieving strategic and financial investment objectives; with a particular focus on innovation as well as team longevity.

"The ultimate success is to have ventures sit at the heart of our innovation ecosystem within [the parent], to be recognised as a centre of excellence within…for venturing and partnering with the external business environment, and to have a self-financing and sustainable team and portfolio.

So, where are we on that journey? We've had some significant successes recently - on the financial side, we exited an investment which has covered our annual budget plus more this year. On the strategic side, we've had huge success. We've deployed five technologies into the organisation, the strategic value of which has been 3x our budget. So, we're hitting that metric too."

In the main, those who gave examples of individual investments did so to highlight that it had resulted in the parent company developing early experience of a new technology and/or science, which resulted in the parent acquiring the investment and creating significant new revenues for them, as the following example demonstrates. Note that these comments could easily be critiqued as being 'soft' on metrics and 'heavy' on anecdote but again emphasises why the focus of this report is on putting in place a sound structure upfront given the difficulty of 'post-game' analysis.

"We invested, back in 2007/8, in a very speculative, early stage company that was developing a new technology. [We] would never have spent the money on that research work, because it was research in a technically very difficult area and people had been working without success for many years. The company was taking a slightly different approach, so we invested strategically and speculatively. Shortly after, it made the technical breakthrough which opened up a market worth potentially hundreds of millions of dollars."

Which goal (financial or strategic)?

The importance of each has varied over time. A 1988 study showed that financial returns were the primary objective of the majority of early CVC initiatives, albeit a (sizeable) minority also emphasised the pursuit of strategic objectives. However, more recent studies substantiate the strategic role of CVC activity and notably one claims that *"the fraction of solely financially orientated CVC programmes [are] on the decline".*

Initial academic research into the linkages with business strategy focused primarily on the optimal extent as to which a venture must be tied to the activities of the corporate parent; referred to as *"desired tightness of coupling or fit between corporate parent and venture."*

Mid-1990s research concluded that independent ventures are more successful precisely because they are free of corporate bureaucracy and therefore more flexible. Then again, a later study found, based on an assessment on 'economic' and 'relational' dimensions, that a close 'internal fit' between a venture and parent is positively associated with venture performance. While this is useful, it provides little guidance for corporates on the practical steps to consider for their CVC programmes towards the strategic outcomes they might hope to achieve, or how to strategically drive CVC activities.[2]

[2] Ginsberg & Hay, European Management Journal, 1994.
Dougherty, Entrepreneurship: Theory & Practice, 1995.
Thornhill & Amit, Journal of Business Venturing, 2001.

As shown in Figure 6, those CVC units which place a higher strategic importance on their CVC activities tend to invest in opportunities with a higher degree of ‘internal fit’. The exception is where businesses have a degree of consumer interface – CVC units associated with these types of businesses seemingly tend to place less importance on ‘internal fit’ with existing business, given they are focused somewhat more on responding to consumer trends which evolve more rapidly, and are particularly susceptible to variation driven by digital development and disruption.

Clearly there is conflicting evidence as to both what ‘purpose’ gives the most successful results and what factors are key to success. The important thing is to define the purpose of ‘your’ CVC and hence be able to answer the connected question as to the degree to which you should ‘free’ the CVC unit or integrate it within the organisation. Prioritising strategic and financial returns creates a natural tension in addition to that created between internal and ‘external’ R&D.

“I know a couple of CVC investors who talk about fostering a creative tension between R&D internally and external investments by investing away from aligned product. In our case, that doesn't work -- at least, we haven't figured out how to do that because, as I mentioned before, what we always try to ensure we know is “what else will [we] bring to the table for the investment other than money?””

Figure 6: Summary of CVC Unit objectives, Internal Fit, Governance and Resource Transfer

	Importance of objective		**Degree of Required ‘Internal fit’ with Existing Operations**	**Resource Transfer**	
	Strategic	**Financial**		**To Parent**	**From Parent**
CVC 1	⇧	⬄	High	⇧	⬄
CVC 2	⬄	⇧	Complementary / Low	⬄	⬄
CVC 3	⇧	⬄	Complementary	⇧	⬄
CVC 4	⇧	⬄	High	⇧	⬄
CVC 5	⇧	⬄	High	⇧	⇧
CVC 6	⬄	⇧	Complementary	⬄	⬄
CVC 7	⇧	⬄	High	⇧	⬄
CVC 8	⬄	⇧	Complementary	⇧	⬄
CVC 9	⇧	⇧	Complementary	⬄	⬄

Key: ⇧ = High, ⬄ = Medium, ⇩ = Low

What benefits can be observed?

Based on analysis of interviews conducted, this study has observed that CVC is capable of delivering the following five key benefits to their CP:

1. A window on emerging technology

…"So we were really founded to provide a...what you would call a lens on the emerging technology disruption, feeding that viewpoint into the senior management's thinking and really providing them with a way to understand what was happening in the space."

2. Market tracking

"However, if I can find technology or products which have hundreds of millions of potential value which [we] may never have seen or had access to, that has much more impact, much more than the capital itself!"

3. Add value to in-house R&D

"[we] moved towards investing in a core portfolio of technologies that help our current businesses and have invested on a roughly "three out of four basis"; so on average three deals focused on delivering technologies complementary to our core."

4. Enhance customer offering

"My remit is to look for opportunities with a strategic alignment to the existing business; primarily retail and brands, however, in order to find products to put underneath those brands."

5. Capture supply and/or stimulate demand

"Firstly, smart investments which generate financial returns; secondly strategic benefit derived from building out the supply chain and driving technology adoption."

You will note the lack of a 'financial objective', indeed, the 'financial benefits' (returns) of a CVC programme might often fail to make a significant impact at the corporate level, described by one interviewee as *"a rounding error"*.

Again, those CVC investors who sought to invest furthest from the parent company's core activities were more commonly observed to have 'consumer-facing' elements to their business, requiring an eye on disruptive consumer trends, which were often tangentially (rather than directly) related to the core business.

In the main, those investing closest to their core operations cited investments which their parent had subsequently acquired as examples of situations where CVC was most successful. By investing early, they were able to gain an insight into emerging technologies and products and when these products were at a stage that the entrepreneurial venture threatened the parent company's market positioning, or offered the opportunity to add significant revenue-generating new products to its portfolio, the parent was in a strong position to take advantage of its knowledge. Note however that this is strictly an anecdotal comment given sample size and that, as cited above, exit is not necessarily a common method.

What are the questions to ask when setting up a CVC unit?

A list of 'best practice' observations is not felt possible at this time, largely because of the lack of a 'one size fits all' model (as discussed above in terms of even the most basic objectives). Nevertheless, a company considering pursuing a CVC strategy should bear the following questions, comments and considerations in mind:

Figure 7: Key Considerations for Establishing CVC Operations

Key Question	Key considerations	Explanation
What is the intended primary objective of the CVC programme?	**Strategic vs financial**	If the response to this question is financial returns alone, a company may be better placed investing through 'traditional VC'. If the response is 'strategic ' as outlined above, the company should most likely consider an 'off-balance sheet' investment model in priority over an external (limited partner/general partner (LP-GP)) model as the former appears to enable financial and operational flexibility, whereas the latter appears more aligned with financial returns.
	Define objectives carefully	Appreciate that CVC is only one means to capture innovation and is likely not a "panacea" for the company's management team, neither is it likely to create a consistent M&A pipeline.
What is the best way to configure the CVC unit?	**Employees**	Should the CVC team be comprised of existing corporate staff, or external VC professionals? Existing staff will likely have better internal networks, but lack venture investment experience, and vice-versa. VC employees may also be more used to an incentive scheme (e.g. carried interest) which does not easily align with corporate remuneration packages to incentivise long-term loyalty.
	Delegated authority	Depending on investment stages and CVC budget, the company may wish to give the investment team 'delegated authority' up to a certain financial threshold. The investment team should be subject to appropriate 'checks and balances' to ensure any investments made under delegated authority meet CVC objectives.
	Employee incentives	Incentives must align employees' interests with long-term fund objectives and reward performance. Whilst 'carry' may not be favoured, if the company wishes to attract/retain capable investment professionals, it may be required. Equivalent schemes may be more appropriate, with claw-backs to motivate 'the right' type of investment and provide the company with checks and balances.

How should investments be appraised?	**Investment Committee**	The investment committee composition should be formalised and aligned with the fund’s strategic objectives. Relevant, senior company board members should have oversight. Continued senior ‘sponsorship’ of CVC is a necessity to maintain a focus on innovation, and to ensure the board is aware of how entrepreneurial ventures are driving disruption in the company’s markets of interest.
	Investment Appraisal	Consider how closely aligned a potential investment’s ‘internal fit’ should be – must it align with existing BUs, or does this exclude opportunities which may be disruptive? A requirement to outline potential strategic benefits with BUs and to require a BU sponsor is likely to limit investment scope.
	Strategic and financial hurdles	Consider the appropriateness of strategic hurdles and quantify them where possible. Appreciate that CVC involves ‘risk’ and it may not always be possible to mitigate, however that alone doesn’t mean a potential investment is a bad one – it may mean it’s just a highly disruptive technology or business model.

Appendix

Figure 8: Case Studies: Date of Establishment, Team Size & Geography

	Established	Team Size	Team's Primary Geographic Focys
CVC 1	2007	9	US, Europe (and 'Rest of World')
CVC 2	2000	20	US, Europe, Israel, India, Korea, Brazil, China
CVC 3	1985	10	US & Europe
CVC 4	2009	8	Europe, US, Israel, South America
CVC 5	2001	13	Europe, Asia & US
CVC 6	2006	3	Europe & US
CVC 7	2011	3	Europe & US
CVC 8	2014	1	Europe & US
CVC 9	2000	4	US & Europe

Figure 9: Case Studies: Investment Parameters Summary

	Investment Model	Typical Investment Stage Focus	Typical Investment Size	Typical Equity Stake
CVC 1	Off balance-sheet	Mainly Stage B to E	£2-10m	<20%
CVC 2	Off balance-sheet	Early Stage, Series A and beyond	US $1-10m	<20%
CVC 3	Off balance-sheet	Early Stage, Series A and beyond	US $100k (proof of concept), then $5-10m	<20%
CVC 4	Off balance-sheet	Series A and B	€1-5m	<20%
CVC 5	Internal dedicated fund (Single LP-GP Relationship)	Series A onwards	€1-5m	<20%
CVC 6	External Fund	Series A and beyond	£1-2m	<20%
CVC 7	Off balance-sheet	Series B and beyond	£2-5m	<20%
CVC 8	Off balance-sheet	Agnostic	No set criteria	No set criteria
CVC 9	Internal dedicated fund	Series A and B	$5-7m	<20%

Series refer to stages in the VC funding process

Notes on Authors

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Data and Methodology:

Data was collected through semi-structured interviews with nine practitioners from CVC units of large global corporates. The corporates were from nine different industry sectors, one being headquartered in North America, the other eight in Europe. The practitioners had senior roles in the businesses, whether it be Partner (in three cases), Director, Principal, etc.

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Cass Business School
In 2002, City University's Business School was renamed Sir John Cass Business School following a generous donation towards the development of its new building in Bunhill Row. The School's name is usually abbreviated to Cass Business School.

Sir John Cass's Foundation
Sir John Cass's Foundation has supported education in London since the 18th century and takes its name from its founder, Sir John Cass, who established a school in Aldgate in 1710. Born in the City of London in 1661, Sir John served as an MP for the City and was knighted in 1713.