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Can Venture Capital Help Companies Innovate?

How to use outside investments as a source of innovation

BY CHRIS CARTER

In 2004, Motorola Ventures, the venture capital arm of Motorola, invested \$500,000 in Camero, Inc., a small company developing a portable radar-imaging system that could help rescue forces such as fire departments save lives by seeing images through walls.

That modest half-million dollar investment, which was part of \$9 million in total financing that Camero received from a syndicate of venture capitalists, led to a final product that probably would have cost Motorola more than \$100 million to develop on its own.

“This was a highly strategic investment on our part,” Matthew I. Growney, co-founder & managing director of Motorola Ventures says. “By investing in early stage companies like Camero, we accelerate access to new technologies, new markets, and new talents. Motorola Ventures helps the company to innovate—faster than we could if we developed these technologies through traditional research and development channels.”

Unfortunately, while a small number of firms like Motorola and Intel have successfully adopted a venture capital (VC) model to help identify and invest in innovation, other firms have struggled with venture capital initiatives. Dell and Applied Materials, for example, recently closed their venture arms’ doors after years of poor investments and low returns.

A well-functioning and well-capitalized corporate venture capital group has the potential to be a tremendous source of innovation for a corporation, but building a successful venture group often proves remarkably difficult.

Simply applying the business model used by independent venture capital firms rarely leads to success in the corporate setting, where firms have very different strategic goals, internal processes, and compensation systems.

But, by understanding the challenges facing corporate venture capital groups and by relying on a set of principles that have defined other successful corporate efforts, companies can use venture capital as a source of innovation.

The growth of venture capital

Early venture capitalists sought to nurture new firms and support the commercialization of new technologies. In fact, the founder of the first VC firm, General George Doroit, saw venture capital as a way to contribute to the economic development of New England.

In 1957, Doroit invested \$70,000 in Digital Equipment Corporation. By 1971, that investment was worth an

incredible \$355 million. Such remarkable returns attracted new venture investors who were more interested in achieving financial returns than creating innovation.

The venture capital industry has since matured into a structured asset management business. Last year, more than 1,000 VC firms in the US invested \$21.7 billion in companies ranging from start-ups to pre-IPO businesses with millions in revenue. While top venture firms now manage funds exceeding \$1 billion, many of their corporate counterparts have had limited success.

The unique challenges of corporate venture capital

Corporate venture capital initiatives are often sold internally as a way to make easy money. After all, who knows industry dynamics better than the executives of one of the leading players? Shouldn’t having access to a large corporate research and development group be a huge advantage?

Unfortunately, the answer to these questions is often a resounding “no.” As it turns out, good industry knowledge alone isn’t enough to succeed in the highly collaborative and dynamic world of venture investing.

In fact, more often than not, ties to a parent corporation present significant obstacles to successfully launching a venture group. Corporate efforts tend to struggle due to:

1. A lack of dedication to the core venture capital model
2. Short investment horizons

3. Inappropriate compensation models
4. A poor balance between financial and strategic goals

1. A lack of dedication to the core venture capital model

Venture capital firms focus solely on the value of their funds. Corporate groups, however, exist within the context of the parent organization, whose senior executives have a host of concerns and priorities well beyond their venture investments. Consequently, corporate VCs often spend more time managing politics than investments.

Worse, corporations often do not create a dedicated fund when starting a venture group, but rather fund investments on a case-by-case basis. As such, corporate VCs must seek approval for new investments, as well as later-stage funding of existing investments.

At best, this can prove time consuming; at worst, it ties the hands of the venture managers in a way no independent VC would accept. Getting corporate approval can be especially difficult when a portfolio company is disruptive to the core business—and, ironically, these are exactly the types of investments a corporate VC should be making.

Furthermore, without a dedicated fund, potential portfolio companies and other co-investors might lack confidence in the longevity of the corporate group, leading to fewer deal opportunities. History has shown that when business slows, corporate venture initiatives are often the first to go.

2. Short investment horizons

Generally, independent funds have a 10-year life cycle: The first five years are focused on investing capital, the last five years on harvesting those investments. While such a time frame makes sense given the illiquid nature of venture investments, many cor-

porate VCs are forced to move more quickly.

All large companies rightly rely on financial forecasts to monitor their operating units. Such rigid forecasts do not accurately reflect the reality of venture investing, however, and can lead corporate venture groups to operate on an artificially short time frame.

Even if only created as loose “projections,” managers know the importance of these figures to senior executives and will do whatever it takes to meet the numbers, distorting their behavior.

Why would the corporate venture managers do this? Executives assigned to a corporate VC group often expect to stay in the position for less than three years. In order to achieve tangible results that can be ascribed to them—and that will lead to promotion—managers try to generate returns quickly.

This type of regular job-switching, which is common in a corporate career-development path, doesn't suit the VC model, which relies on managers following deals from investment to harvest.

3. Compensation models

VCs are typically compensated by taking 20 percent of the profits generated by a fund's investments, a potentially large sum. In fact, the annual compensation of many successful venture capitalists exceeds that of many CEOs.

Explaining this compensation model to public investors would be extremely difficult. And yet, the corporation needs to offer an attractive compensation package in order to attract quality investing talent. The resulting compromise is often a hodge-podge compensation package that ends up satisfying no one.

4. A poor balance between financial and strategic goals

The goal of the traditional venture model is solely to generate large financial returns. To do this, most VCs have broad investment strategies. They seek high-potential companies from a wide array of industries.

For example, the highly successful venture fund Kleiner, Perkins, Caufield & Byers defines its investment focus this way: “We're constantly on the lookout for ideas with the promise to invent new business categories or radically alter existing ones. Our focus is on new technologies and new applications of technology that will drive high-impact change.”

Such a broad investment strategy makes little sense for a corporate group that has a dual mandate to generate returns and gain strategic insights for the parent company. Corporate VCs have little incentive to adopt this type of industry-agnostic strategy because unsuccessful investments outside the parent's core markets are highly subject to scrutiny and second guessing.

As a result, corporate groups cannot be judged by the same metrics as independent funds, which are evaluated solely on the internal rate of return (IRR) of the fund. In a corporate setting, IRR is an incomplete measure that fails to take into account both the narrower investment mandate of the group and the strategic benefits the parent receives from investments.

Building a successful, sustainable corporate venture capital group

Companies like Motorola, Intel, and 3M have all successfully launched venture initiatives. Understanding the reasons behind their success shows how corporate venture capital can generate both innovation and financial returns for the parent corporation.

Make a commitment

Without a commitment from senior management to leverage the corporation's assets and stay the course throughout the VC investment cycle, any effort is bound to fail. Senior management must give operating managers a clear mandate—backed with financial incentives—to support the efforts of the venture group, even when such efforts are potentially disruptive.

Staying the course means just that: Create a dedicated fund and commit capital and resources for at least five years. Then, use a combination of strategic metrics and return on investment calculations to measure the program rather than the kind of close quarter-by-quarter oversight that is appropriate to an operating division.

Put strategic interests first, but measure investment returns

To maintain the support of senior management and the board of directors, corporate venture capital investments must offer the parent company ongoing strategic benefits, such as access to a critical technology or a new product that fills a gap in the firm's offerings.

Motorola, for example, seeks technological, financial, and customer impact from all investments. Motorola venture director Growney estimates that the firm has a commercial relationship with more than 80 percent of their portfolio companies, which reinforces the value of the venture group within the firm.

When the benefits of an investment are not immediate, as with an early stage investment, the venture group must communicate how the investment complements the corporation's strategy. MIT Professor Edward Roberts, the founder and chair of the MIT Entrepreneurship Center, recalls how he saw 3M's corporate VC arm successfully do this during a two-day

meeting he moderated for the company.

"The invited guests and presenters were the CEOs of 10 early-stage, high-technology companies in which 3M had invested," he says. "The 3M executives were there to assess the potential fit of the emerging technologies into the company's future business portfolio and to engage these young entrepreneurs in one-on-one discussions."

By bringing senior executives together with leaders of the portfolio companies, 3M management was able to understand the potential long-term value of investments that might not create immediate financial returns. Often these relationships benefit the portfolio company and help accelerate its growth, improving the odds that the investment will be a financial and strategic success.

Develop a hybrid compensation plan

Corporate VCs will never be compensated exactly like independent venture capitalists, but that does not mean they should be on a traditional compensation plan. Instead, use creative performance compensation structures, including granting options, phantom stock, or allowing co-investment.

These can prove lucrative for a talented corporate venture manager and make working in the group more attractive. Such a plan is also more likely to retain successful managers who otherwise might move to an independent fund.

Work with the portfolio companies

A corporate venture group established just as an investment arm is likely to struggle in the market. Without the strategic and operational expertise of the corporation, the group is simply another source of capital and, given the issues mentioned above, a less attractive source than many other players.

Indeed, when a corporation invests in a start-up and then doesn't follow that investment with what would seem to be a logical operating relationship, it can send a damaging message. When investment is backed with a working relationship, both parties benefit. This can lead to better deal flow, as other VCs will want to work a team that can accelerate a start-up's growth.

An alternative corporate venture model for mid-sized companies

With innovation becoming more vital than ever to a company's long-term viability, more and more firms are looking to corporate venture capital as a way to stay on top of their markets.

Companies with more than \$10 billion in revenue can typically afford the large commitment—often \$10 million a year, plus operating expenses that can easily reach 15 percent of annual investment volume—necessary to really start a venture arm.

Unfortunately, many mid-size firms lack the resources or scale to become meaningful venture capital investors. And even for those that have the available capital, the learning curve can be so steep that the effort seems unwise: Companies report spending up to 5 years and \$10 million in "wasted" investment before seeing signs of success.

As MIT's Roberts points out, most mid-sized companies have much less slack in their R&D portfolio than large companies.

"They can't afford the money or time to staff and initiate exploratory projects outside of their core businesses," Roberts said. "They are more likely to become victims of commoditization of their businesses because they haven't nurtured growth alternatives."

A new "outsourced" corporate venture model is emerging that might be

able to help companies with a limited venture investing budget. The recently founded Synchrony Venture Management is dedicated to making small, focused strategic investments for mid-sized companies.

Unlike traditional funds that seek corporate limited partners, Synchrony manages each of its corporate investor's capital separately. This allows Synchrony to avoid conflicts between the strategic goals of varied corporate investors and the fiduciary responsibility of managing pooled funds.

More important, by managing these funds individually, Synchrony can tailor investments to suit each corporate investor. Synchrony's investment criteria states that the firm puts the strategic benefits of its investment first, with ROI potential as only one of several deal screens. By removing direct ties to the parent company, Synchrony can resist many of the potential conflicts that plague in-house corporate venture capital funds, such as quarterly earnings pressures and Wall Street compensation-reporting requirements.

According to company founder and managing director Adam Caper, "Synchrony allows a corporate investor to stay current on new innovations and efficiently deploy a firm's limited pool of external investment dollars across a broad range of opportunities."

Synchrony believes it will have access to premium deals because other VCs will want to co-invest with the firm to gain the market access and technical expertise that Synchrony's corporate partners can offer.

Properly implemented, corporate venture capital can be a great source of innovation and market understanding, but the obstacles to proper implementation are substantial. To have the best chance of success, make sure that when you launch a corporate venture initiative, the group is given the capital commitment and senior

management backing that it will need to thrive.

Corporate efforts can succeed, but remember to define success properly, taking into account both the financial and strategic benefits that accrue to the corporation. Managed properly, corporate venture capital can be a great source of innovation for a company. ♦

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