Seeking Innovation Through Corporate Venture Capital

By Eric Marcks & Mangyo Kinoshita

Global Venture Capital Investments at Record Levels

The past several years have been banner years for venture capital (VC) investment worldwide. 2015 marked a record year for both number of investments and amounts invested in start-ups, with a 150% increase in number of investments and a 265% increase in amounts invested between 2011 and 2015 *(Chart 1)*. Although the first quarter of 2016 has seen a slowdown in global venture capital activity, investors' appetite for stakes in start-ups is unmistakable.

Corporate Venture Capital (CVC) Too

Investment in start-ups has long been dominated by private VC firms, but over the past decade, VC markets have seen steady growth in investments by corporations. This model of investing, known as corporate venture capital, or CVC, is now an established part of the VC landscape in the United States and in other countries with dynamic VC markets.

CVC has been around since the advent of the VC industry in the 1960s but really began to take off in the past decade. *Chart 2* shows the remarkable growth in global CVC investment in the past five years: a 185% increase in number of investments and a 335% increase in amounts invested between 2011 and 2015. The number of new CVC funds established each year, too, has increased steadily, as is shown in *Chart 3*. Nearly 20% of all venture capital financings in the world have included CVC investments in the past few years. And CVC is doing well: more than half of the 74 start-ups in the US with a valuation of more than $1 billion (so-called "unicorns") in 2015 had CVC funding (including at least one, Evernote, that had received funding from a Japanese CVC: DoCoMo Capital).

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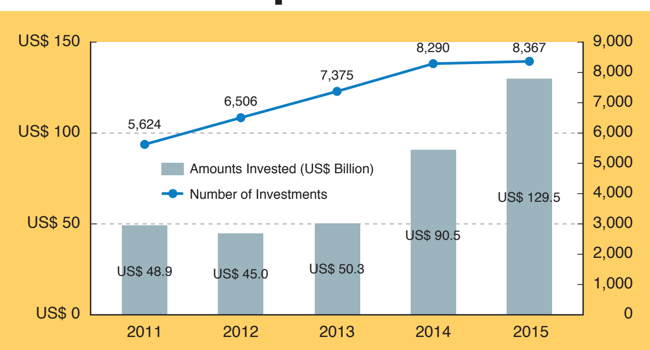
It is estimated that about 60% of all CVC activity occurs in North America, about 20% in Asia, and slightly less in Europe. This geographical distribution is reflected in the list of the most active CVC funds across the globe. As can be seen in the *Table*, nine of the 10 most active CVC funds were based in the US, but many of the remaining 90 most active CVC funds are headquartered outside the US. Japanese CVC funds are well represented, with two in the top 20 (Gree and Recruit) and a total of 12 in the top 100.

CVC is present in many industries. Internet start-ups grab the lion's share of CVC investment, with close to 50%, followed far behind by mobile and telecommunications, computer hardware and services, software, and healthcare.

What Is CVC?

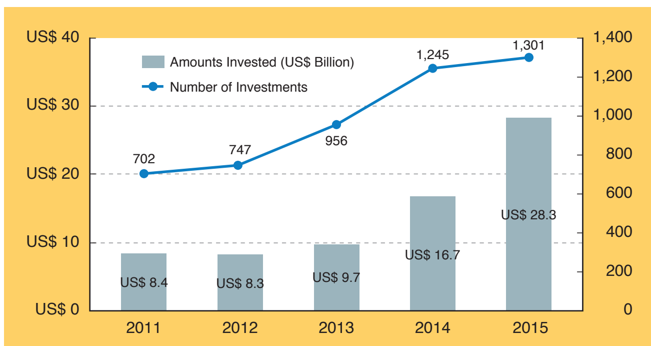
What is CVC, and why has it become so popular? CVC is a subset of venture capital. Venture capital is commonly thought of as investment in early-stage, emerging growth companies, often in the technology

CHART 1
Annual global financings to VC-backed companies



Source: KPMG and CB Insights

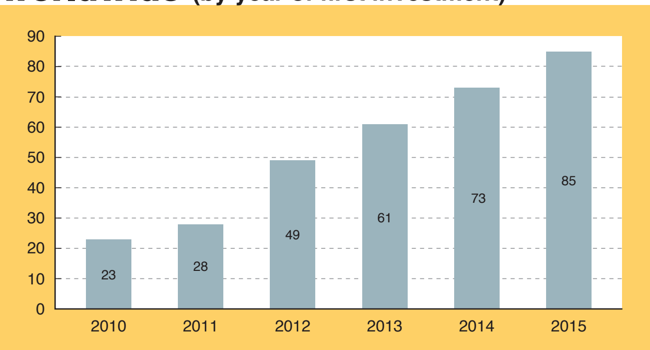
CHART 2
Annual global CVC investments



Source: CB Insights

CHART 3

Number of new CVC groups worldwide (by year of first investment)



Source: CB Insights

TABLE

Top global CVC firms, 2015

• 1 Intel Capital	• 16 Bertelsmann Digital Media Investments
• 2 Google Ventures	• 17 Verizon Ventures
• 3 Qualcomm Ventures	• 18 Hearst Ventures
• 4 Salesforce Ventures	• 19 Novo Ventures
• 5 GE Ventures	• 20 Google Capital
• 6 Comcast Ventures	**• 31 YJ Capital**
• 7 Samsung Ventures	**• 32 SMBC Venture Capital**
• 8 F-Prime Capital	**• 34 Mitsui & Co Global Investment**
• 9 Bloomberg Beta	**• 43 Dentsu Digital Holdings**
• 10 Cisco Investments	**• 45 Rakuten Ventures**
• 11 SR One	**• 47 Takeda Ventures**
• 12 Legend Capital	**• 52 ITOCHU Technology Ventures**
• 13 Novartis Venture Funds	**• 54 Mitsubishi UFJ Capital**
• 14 Gree Ventures	**• 73 NTT DoCoMo Ventures**
• 15 Recruit Strategic Partners	**• 86 Nissay Ventures**

Note: Rankings are based on number of unique global company investments. Japanese ventures in bold.

Source: CB Insights

sector, in exchange for equity — usually preferred equity. Most VC activity is conducted by VC firms, whose main business is to raise money and to invest that money in start-ups. VC firms seek above all to maximize their investors' financial return by investing in start-ups.

CVC, on the other hand, is venture capital conducted by operating companies whose main businesses are to make things or provide services rather than to make investments in start-ups. Most companies that engage in CVC do so not to realize financial returns on their CVC activities, but rather for strategic reasons, in particular:

— to keep abreast of market and technological trends in the relevant industry

— to get a "first peek" at new technologies

— to "outsource" R&D to start-ups

— to secure opportunities to enter into commercial/strategic relationships with, or to acquire, innovative start-ups and/or their technologies and/or staff.

Not all CVC companies invest in start-ups exclusively for strategic reasons. Some CVCs focus solely on strategic reasons, but most seek both strategic and financial returns, to greater or lesser degrees, while some invest primarily for financial returns.

Start-ups have changed the way we communicate, learn, do business — indeed, live. Most of us think of the way in which companies like Amazon, Apple, eBay, Facebook, Fast Retailing, Google, Microsoft, Netflix, Space X, Tesla, and Uber have changed or are changing the world we live in. Business leaders, on the other hand, also have to think about all of the companies and industries that have died out at the hands of these and other start-ups.

Not knowing what new technology or service is being developed is a frightening prospect for business leaders. The fact that the cost of launching a technology start-up has fallen from $5 million in 2000 to $5,000 today means that the number of potential competitors is greater now than it has ever been. Engaging in CVC is one way to attempt to understand how industry and technology are changing and to keep on top of this change.

How Do Companies Engage in CVC?

There are, broadly speaking, four approaches to conducting CVC.

Direct Investment. The company makes a direct investment in a start-up. These investments typically arise when an employee at the company learns of a start-up and the employee's business group decides to invest in the start-up. These investments are treated like other business transactions within the company, which means, among other things, that they are subject to the same internal approvals as other transactions.

The advantage of this opportunistic approach is that it is simpler and requires lower capital commitments than the other approaches described below, and for this reason it works well for companies that are just starting to test the waters in CVC.

There are several disadvantages with this approach, however. First, employees handling these investments can change with each investment, depending on the business team within the company with responsibility for the industry or sector of the target start-up. The lack of continuity in CVC deal teams means that the company's experience in CVC is diffuse and difficult to share, which in turn prevents companies from developing expertise in CVC. Another disadvantage with this approach is that because the CVC investment is subject to the company's usual approval process, decision-making can take a long time, which may not be compatible with the quick pace of VC deals, as explained further below. Finally, this opportunistic approach makes it harder for the company to develop a coherent CVC strategy for the entire company.

Please note that the statistics about CVC in the first part of this article do not include direct investments; if direct investments were included in the statistics, CVC activity would be even more significant.

CVC — through a wholly-owned subsidiary. Many companies active in CVC establish a separate legal entity whose mission is to invest in start-ups and manage those investments. This entity is staffed primarily by professional VC investors hired as employees of the entity, and to a lesser extent by company employees. These dedicated company employees, while at the CVC entity, devote all their time to VC activities to manage the investments and learn the VC business.

These companies sometimes establish streamlined approval procedures for investments in start-ups.

This approach requires greater capital commitments than the direct investment approach — in particular, hiring and retaining competent professional VC investors is very expensive — but it has the advantages of allowing the company to pursue a coherent and company-wide CVC strategy through a single entity and to benefit from the expertise of professional VC investors, while also developing CVC expertise within the company.

CVC — through a partnership. The company and a third party establish a partnership whose mission is to invest in start-ups. The third party is a professional VC investor who acts as general partner of the partnership and makes investment decisions and manages the investment portfolio and the company is the limited partner. The partnership might also have a limited number of company employees who would devote all their time to VC activities while at the partnership.

From the company's perspective, this approach is similar to the subsidiary approach described above, with one important exception: in a partnership, the general partner has discretion to make investment decisions, which means that the company, in its capacity as limited partner, has less control over the CVC entity's activities than if the entity were a wholly-owned subsidiary.

If given a choice between being the general partner of a partnership and being an employee, a US professional VC investor will in most cases choose the former option because VC investors receive better tax treatment if they are general partners of a partnership than if they are employees.

Investing as limited partner in a VC fund. Finally, many companies invest as one of many limited partners in VC funds. The advantage of this approach is that other than making a capital commitment the company does not need to expend resources on CVC; it simply lets the VC fund invest as it deems fit. This hands-off approach, however, means that the company will not have the opportunity to gain experience and develop expertise in CVC.

This approach also deprives the company of any control over investment decisions and removes the company from the front lines of negotiations with the start-ups, thereby making it more difficult for the company to establish strategic relationships with start-ups.

Investing as a limited partner in a VC fund is generally seen to be better suited to financial investors than to strategic investors.

Points to Keep in Mind When Engaging in CVC

Speed. VC investments can move very fast. It is not uncommon for an investor to have only two or three weeks (sometimes even less) from the time it learns of a financing to the time it has to sign off on the agreements and wire the funds. Nor is it uncommon for the lawyers to be negotiating and finalizing the transaction documents up until closing. The speed at which the VC community operates presents significant challenges for corporate investors that must comply with burdensome internal approval procedures. It is imperative for companies that seek to enter CVC to establish streamlined approval processes that allow them to make decisions quickly and to exhibit flexibility when confronted with the inevitable last-minute changes that are so common in this industry.

Commercial arrangements. Strategic investors sometimes invest in start-up companies to enter into commercial relationships with those companies, for instance, a license to a start-up's technology or a right to distribute a start-up's products. It is important to note that start-up companies outside of Japan typically do not demand that potential commercial partners be shareholders; more importantly, being a shareholder will not necessarily give the shareholder an edge over other potential commercial partners. In our experience, start-ups select business partners primarily on technological and economic merits, without regard to shareholding relationships. As a result, if a company is investing in a start-up because it believes the investment is necessary to secure a commercial opportunity, it is imperative for the company to condition the investment on the execution of the commercial agreements. Once a company has invested in a start-up, the company loses significant leverage to negotiate commercial agreements. In many cases, a better strategy is to negotiate a commercial agreement involving the coveted technology rather than investing in the start-up.

Access to a start-up's technology. Strategic investors, as opposed to financial investors such as VC funds, often invest in start-ups to get a first peek at new ideas and technology. Start-ups are understandably reluctant to grant access to their technology to shareholders; start-ups generally provide financial information and business plans to major shareholders, but rarely — if ever — information about their proprietary technology. And of course, start-ups will be even less willing to grant such access to competitors. Therefore, if a company's objective for investing in a start-up is to learn more about its technology, the company must negotiate in advance of the investment the right to have access to the start-up's technology. Companies engaging in CVC must understand that merely investing in start-ups will usually not provide the companies with access to the start-ups' technology.

Conclusion

More and more companies are discovering the benefits — and in some industries, the necessity — of engaging in CVC in this technologically transformative era. While CVC can deliver significant benefits, it must be implemented with care, lest the significant investments required to engage in CVC go to waste. As discussed above, there is no single model or strategy for CVC. Each company must decide whether it might benefit from CVC — and by no means does every company need CVC to thrive — and if it decides to move forward with a CVC program, it then needs to consider which variety will yield the best results. JS

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