Corporate venture capital (CVC)

A critical driver for enterprise growth in turbulent times

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The current COVID-19 crisis is driving the world toward global financial turmoil – forcing CEOs and CFOs to urgently address the immediate financial challenges resulting from this pandemic.

However, forward-looking CEOs and CFOs should use this opportunity to make critical investments through corporate venture capital to set up their companies for long-term success and secure their company's future.

Table of contents

3 Preface

4 The rise, fall and rebirth of corporate venture capital

7 Need for corporate venture capital in tumultuous times

10 Corporate venture capital drives enterprise transformation and growth

Preface

The world is on the precipice of a potential crisis whose magnitude and ferocity are difficult to fully comprehend. The black swan event unleashed by COVID-19 has profoundly impacted every nation, every community and every industry. Cities and countries are on lockdown, supply chains have ground to a halt, medical infrastructures are at breaking points and consumer sentiment is at an unimaginable low. Pundits and experts suggest that the world is hurtling toward a global crisis.

However, despite the tragic health implications for so many and the troubling economic conditions, there is hope at the end of the tunnel.

There are plenty of indications that suggest that on the heels of this unprecedented economic turmoil, the world may experience an equally unprecedented period of growth. Prior to COVID-19, US economic indicators such as 3.7% unemployment[1] and robust corporate earnings growth[2] were extremely positive. A strong recovery is highly likely with the US continuing to drive the global economy. A confluence of forces and trends is poised to further fuel the recovery.

Despite health concerns presented by COVID-19, most baby boomers will come out of this epidemic unscathed. They represent one of the largest generations in the world and certainly the wealthiest generation in history. They are approaching retirement and plan to spend their hard-earned savings. When they eventually pass away, they will trigger the largest generational wealth transfer in history — with the primary beneficiaries of the wealth transfer being the millennial generation. At the same time, the millennials will be approaching the peaks of their careers and taking leadership roles in business and government.

Many young startups, as well as leading technology, health care and energy companies, will return to doing what they do best — developing disruptive technologies that will continue to produce new business models, new ways of working, new health care solutions and all the other innovations that drove much of our economy before COVID-19. Venture capital firms sitting on record piles of cash will continue to invest during and after the downturn. Their investments will produce exciting new companies that will drive the next wave of growth across all industries around the globe.

Of course, some businesses may not survive the crisis, but the ones that do will be leaner and more digitally transformed. These "winning" businesses will have exposure to new business models, develop relationships with new types of customers, employ the world's best talent and effectively exploit disruptive technologies. Their outcome will not be determined by the cost cutting and belt tightening made during the financial crisis but by the bold investments that put them on a path to come out of the crisis stronger than they went into it.

One of the most effective ways for companies to strategically deploy capital to drive future growth and financial returns is through corporate venture capital (CVC). CVC investing should be a critical growth driver in every CEO's and CFO's toolbox — along with M&A, market expansion and new service/product development.

In tumultuous times, when CVC programs are often among the first victims of cost-cutting measures, they are in fact more important than ever.

The rise, fall and rebirth of corporate venture capital

To understand the role of CVC investing in the future, we must first learn from the past

Corporate venture capital is not new. In fact, the emergence of CVC mirrors the birth of traditional venture capital. The 1960s and 1970s saw the formation of leading venture firms like Kleiner Perkins and Sequoia. The same period also saw many leading American corporations starting to make minority investments in fledgling new businesses. Companies like Boeing, Exxon, DuPont, 3M and GE all put millions of dollars into young startups.

However, some might rightly argue that corporations were investing in early stage companies long before venture capital firms even existed. In 1917, General Motors (GM) was just a scrappy young startup. Like many startups, it was struggling to grow, became over-leveraged and needed capital. John J. Raskob, the CFO of DuPont, engineered a capital infusion into GM that resulted in DuPont eventually owning 43% of the automobile manufacturer.

The DuPont investment represents the archetype CVC deal — an established company in one industry making an investment into a young and growing company in an adjacent industry. By all indications, it appears that Raskob's rationale for doing the deal was not dissimilar to the rationale behind many of today's successful CVC investments. Successful CVC investments require carefully balancing long-term strategic goals with financial returns.

For DuPont, the strategic goal was to grow America's fledgling automotive industry — an industry that relied heavily on DuPont products (Fabrikoid, Pyralin, paint and varnish[3]) to manufacture its cars. The eruption of WWI drove tremendous demand for vehicles, and the post-war years were a boom for the US auto industry. DuPont's investment generated incremental revenue from sales of products to GM for decades to come and simultaneously offered DuPont a meaningful equity stake in a company that went on to become the largest auto manufacturer in the world (by most metrics including revenue and market capitalization).

Exhibit: Keys to successful corporate venture capital

Common pitfalls and sources of CVC failure, learned over the last 100+ years of corporate venturing

Lack of strategic integration	**Lack of well-defined objectives**	**Insufficient resources and infrastructure**	**Limited integration into core business**
CVC investments cannot be side projects for operating executives but must tie directly into the BOD's/CEO's long-term strategy and vision.	A CVC team must have well-documented objectives that clearly define how they will meet strategic goals *and* deliver financial returns.	Corporations operating on quarterly or annual horizons must align goals and expectations with 8–10-year CVC investment time horizons.	While CVC teams must operate independently, they need to be closely integrated into every area of the core operating business.
Inadequate processes and oversight	**Insufficient skills, experience and credibility**	**Short-term time horizon**	**Misaligned risk profile**
Great investment opportunities don't come from luck and serendipity but from a methodical and rigorous process.	CVC is not a vehicle to reward top performers with a high-profile role; CVC requires hiring experienced and credible investors.	Companies cannot "dip their toes" into CVC but must set up the function with the capital, resources and support needed to succeed.	Corporations typically have low risk profiles and struggle to tolerate the high risk and high failure rates of CVC investments.

Source: Highnote Foundry

While DuPont took a short-term view and invested for strategic reasons, the long-term financial returns of the investment ultimately exceeded anything Raskob could have imagined.

Over the 100+ years since DuPont made its investment in GM, countless large companies have explored corporate venture capital investing in the hopes of replicating DuPont's success. Through various booms and busts, CVC investing has seen peaks and valleys. During the early 2000s, many "old economy" companies jumped into venture investing due to a bad case of FOMO (fear of missing out). These companies observed Silicon Valley venture capitalists generating extraordinary returns from young internet companies, and the dot-com bubble became a venturing gold rush. Unfortunately, as with all gold rushes, those who came late, lacked experience/skills and didn't have a well-thought-out plan were the ones who lost money.

Corporate investors learned the hard way that successful venture investing requires much more than just the willingness or ability to write a check to a hot startup. Corporate leaders learned that venture investing is not a passive investment that can be left in the hands of the company's strategists, lawyers and/or accountants who are eager to "play VC." Venturing — irrespective of whether an investment is a VC or CVC — is a hands-on activity that requires rolling up sleeves and getting deeply involved in every aspect of building and scaling a high-growth early stage startup.

In the hands of inexperienced executives, many of the world's greatest companies lost a combined $10b[4] chasing dot-com startups, and these companies pulled out of CVC just as quickly as they jumped in.

The early 2000s were actually a formative era for CVC. The dot-com crash separated the winners from the losers and helped elucidate the critical characteristics of successful CVC investing. The painful lessons learned in the early 2000s helped educate the next wave of CVC. Twenty years later, these lessons still inform the key components of a successful CVC model.

But of course, in the decade following the dot-com crash, corporations were skittish about venture investing. Companies that continued to invest were doing so at a reduced frequency and smaller check size. Many corporations were aware of the reputation they had in the venture capital community — venture capitalists loved to publicly call out corporate investors as "dumb money." The consensus was that most corporations were merely "playing VC" and chasing deals that real investors would never consider. For the few corporate venture investors who did identify good deals, venture capitalists would often lock them out of the deals or simply refuse to participate in any deals that included a corporate investor.

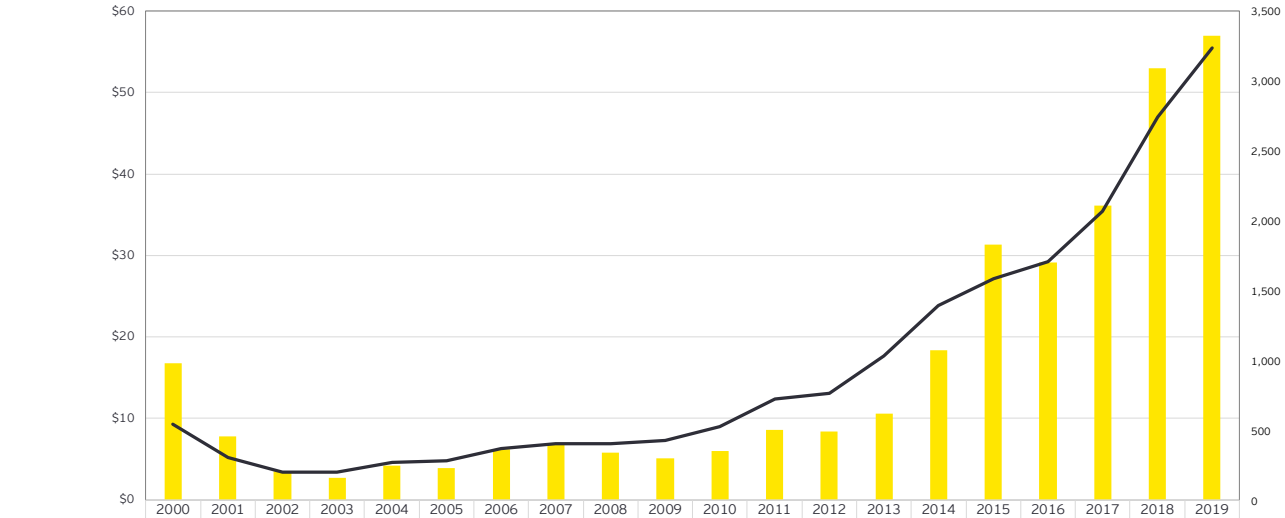
While many corporations sat on the sidelines, innovation did not stop. The wave of successful (and not so successful) dot-coms created a large population of experienced entrepreneurs who had valuable startup experience and no interest in returning to corporate jobs. These entrepreneurs propelled a new wave of startups that venture capital firms were happy to fund.

Out of the ashes of the dot-com explosion came a steady increase in entrepreneurship and venture investing — which started to pull many corporations off of the sideline and back into the venture investing game. The 2008 recession created a small dip in corporate venturing activity, but the explosive growth of mobile, AI, VR, big data, cloud computing, SaaS solutions and other innovations continued to fuel investment activity through the recession. In the decade following the 2008 recession, CVC participation grew at a frenetic pace from 423 CVC deals worth $5.1b in 2009 to 3,234 CVC deals worth $57b in 2019.[5]

The most recent wave of CVC growth was not driven by the FOMO that propelled corporations during the dot-com bubble. Instead, corporations started to recognize the strategic and financial impact of being an active participant in early stage startups. The days of CVC investments being speculative side projects have mostly come to an end. CVC investing has evolved into an essential component in the agendas of many CEOs and CFOs. CVC investments started to take their place alongside M&A, new market expansion, digital transformation and new product/service development as critical enterprise growth drivers.

Unfortunately, the exogenous shock to the economy brought on by the COVID-19 crisis is expected to put a damper on CVC activity. However, we strongly believe that now more than ever, maintaining (or even expanding) CVC activities not only could be critical to surviving the crisis but could also offer companies an advantage that could help them leapfrog their competitors as global economics return to stability.

Exhibit: CVC growth
Annual global disclosed CVC deals and funding (2000–2019)



	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Investments ($b)	$16.8	$7.8	$3.5	$2.7	$4.2	$3.9	$6.2	$6.8	$5.8	$5.1	$6.0	$8.6	$8.4	$10.6	$18.4	$31.3	$29.1	$36.1	$53.0	$57.0
Deals	543	302	200	201	271	282	368	404	400	423	526	721	765	1,029	1,390	1,581	1,705	2,068	2,740	3,234

Source: EY Foundry Analysis, CB Insights, PitchBook

Need for corporate venture capital in tumultuous times

When the going gets tough, the tough get on with investing

When businesses and economies hit a bump in the road, the natural instinct is to take defensive measures. But the COVID-19 pandemic will create much more than a bump. All businesses will be forced to expertly traverse a treacherous mountain filled with numerous unforeseen existential dangers.

Since the days of the Great Depression, businesses have relied on variations of the same sets of tools to navigate through treacherous times: securing cheap debt, share buybacks, cheap M&A, exiting underperforming businesses and, of course, cost cutting.

A slew of recently published articles, white papers and commentary from journalists, academics, industry analysts, researchers and consultants reveal an abundance of defensive advice. The advice covers a wide assortment of topics like optimizing short-term cash flow, reducing OpEx, restructuring vendor deals, optimizing pricing and reconfiguring supply chains. While some recommendations may be better than others, none of the recommendations are inherently incorrect. However, most of the currently available advice is incomplete or, at the very least, extremely shortsighted for companies that may be in an opportunistic position.

Taking steps to secure near-term revenue, reducing costs, managing cash flow and maintaining liquidity are of course important actions for all companies. However, now is not the time to be exclusively defensive, but instead, it's the time to act strategically and seize the opportunity to secure the company's long-term future.

An often cited study of the previous three recessions showed that companies that aggressively cut costs during recessions didn't flourish in the long run. In fact, they had the lowest probability (21%) of pulling ahead of the competition when markets recovered. The study showed that companies that balanced fiscal tightening with investing for growth were most likely to outperform their competitors after the recession.[6]

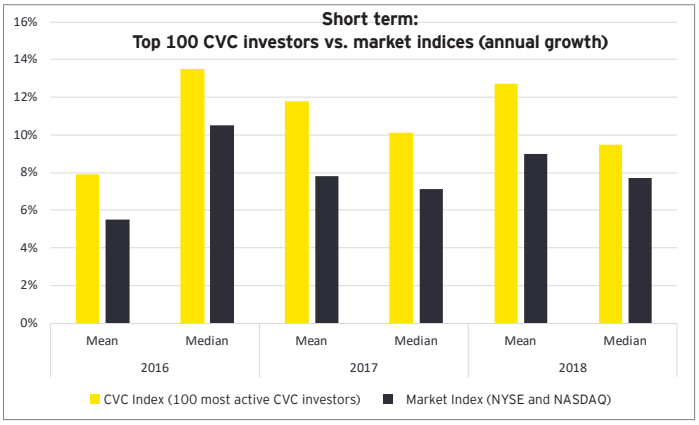
History has shown that incumbent companies that emerged from recessions stronger than they were before the economy went downhill, all shared one key characteristic: unlike their less forward-looking competitors, these companies were committed to maintaining (or increasing) investments during the tumultuous time.

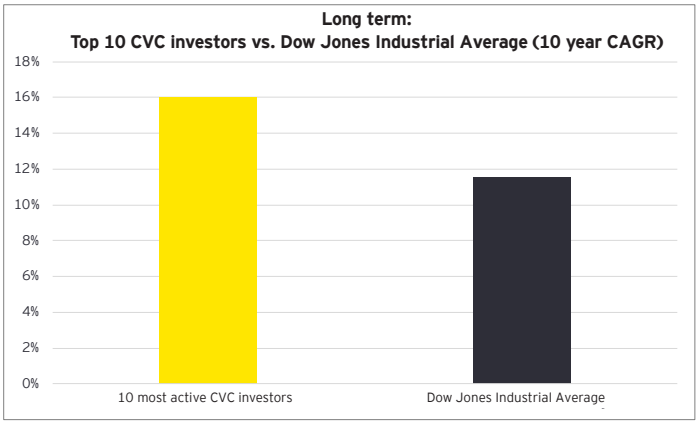
Going into this recession, most companies are sitting on top of healthy balance sheets. The tremendous economic growth most industries experienced prior to the COVID-19 crisis led to an abundance of cash. In the US alone, public companies are sitting on $1.5t in balance sheet cash[7] with $121b in committed CVC yet to be deployed. Additionally, with central banks cutting interest rates, borrowing costs have tumbled to unprecedented lows — offering treasurers and CFOs access to capital at discounted levels.

Data has shown that corporates who have been the most active CVC investors have outperformed their peers and the overall market in both the short term and the long term.

Exhibit: CVC impact

Companies most active in CVC investing outperform their peers in the short term and the long term.





Source: EY Foundry Analysis, Touchdown Ventures, Google Finance

While many leading technology companies have run very successful CVC teams, companies across all industries, including financial services, CPG, media and health care, have seen the strategic and financial benefits of an effectively structured and well-managed CVC program.

A downturn in the economy is an opportunity to manage the company's balance sheet as a strategic tool by methodically balancing cash, debt, working capital and capex to create "fuel" that can ignite and power a company's engines for decades to come.

Economic downturns offer forward-thinking companies unique opportunities to invest in the future. Many of these opportunities present themselves only during economic downturns, and missing out may mean not only forgoing tremendous upside potential but also ignoring a potential future existential threat.

Economic downturns have also been great opportunities for companies to invest in themselves. A number of incumbent companies used the 2007/2008 recession to set themselves up for explosive growth. Companies like Adobe, Apple, Netflix and others, invested in making transformations of their business models, which dramatically improved their industry positions, pushed them into new industries and increased total market share. Enterprise transformation begins with investing in internal initiatives but is more likely to be successful when combined with the strategic and financial benefits of corporate venture capital.

The upcoming economic crisis is setting the table for two converging forces to produce an attractive environment for corporate venture investing.

1

Increase in entrepreneurship and startup creation

Economic downturns have historically resulted in entrepreneurial explosions with many of the most successful companies across a wide variety of industries being born during down cycles.

The 2007/2008 recession saw the birth of countless startups that became multibillion-dollar global leaders in their respective industry segments. These companies introduced disruptive technologies and business models. As a result, many of these startups took significant market share away from complacent incumbent companies that chose to "batten down the hatches" during the recession.

The unfortunate reality of the upcoming recession is that many highly skilled, highly experienced and highly technical individuals will find themselves out of work. With costs to launch a startup already at record lows and government stimulus programs supporting new business formation, many of these individuals will likely turn to entrepreneurship.

If history is any indication, over the next two or three years, multiple "future unicorn" startups will be founded. These startups will not be just valuable enterprises, but they will threaten and disrupt the very corporations that are currently focusing exclusively on cost management.

2

Increase in access to investment opportunities

Venture capital firms are generally immune to recessions because their funds operate on 8–10-year horizons. VC firms enjoy management fees, which fund their operations during the fund's life. VC firms will not stop investing during the recession, and because many have raised historically large funds, they will be under enormous pressure to continue aggressively deploying their capital.

Despite the toll COVID-19 has already taken on the stock market, corporate earnings and employment, VC firms are continuing to raise massive funds. Just as the world was going into lock-down, General Catalyst announced the closing of $2.3b in commitments across three funds, including $600m dedicated to early stage ventures and $1b dedicated to growth stage ventures ($10m+ in revenue).[8]

VC firms sitting on large funds will not be able to generate sufficient returns from small investments, so they will be forced to continue looking for large deals that have the potential to deliver the IRRs their limited partners demand. The economic downturn will suppress the explosive valuations we have been seeing recently and megadeals with overfunded and oversubscribed rounds are coming to an end. As a result, many attractive startups will not be sufficiently lucrative for traditional VC firms to pursue — no matter how compelling the technology or business model might be.

With depressed valuations and declining interest in smaller deals from VC firms, it will be a buyer's market for corporate investors willing to put their capital to work. Deals that might have previously attracted VC firms and locked out many corporate investors will now become available to corporates. Additionally, during tough economic times, early stage companies will seek to accelerate the time to revenue, making the strategic benefits of a corporate investor's access to customers, marketing and distribution critical.

Corporate venture capital drives enterprise transformation and growth

Improving what's inside the company should begin with looking outside the company

Long before the first patient ever contracted COVID-19, nearly all of the world's leading companies were already embarked on enterprise transformation journeys. Some companies were just starting their journeys while others were well on their way, having spent many years and millions of dollars transforming all aspects of their operations. The pace of innovation over the last decade has been unrelenting, and large companies needed to radically transform just to keep up.

No company is immune to disruption. Dramatic changes to business models are forcing companies across all industries to reinvent themselves to remain competitive and unlock opportunities for future growth.

Corporate venture capital complements existing transformation initiatives by opening the enterprise to embrace and absorb the innovation taking place outside the company.

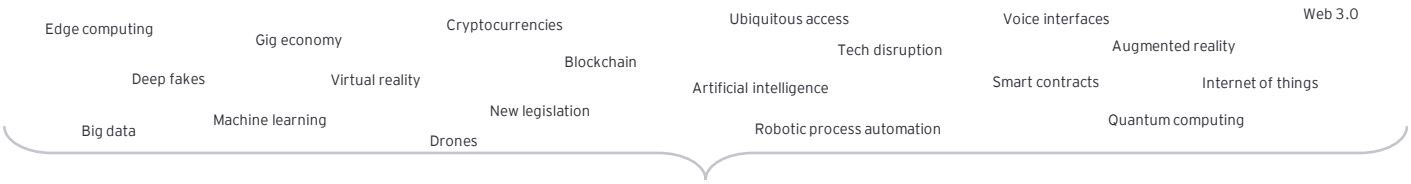
Exhibit: Business model disruption
Companies across multiple industries are forced to adapt, evolve and transform.

Health care
Health care legislation and technology innovation driving new business models for providers and payers while shifting to patient-centric care

Media and entertainment
Digital delivery models and unbundling of content providing consumers with more choice, improved experiences and better value

Financial services
Digital technologies democratizing access for consumers and lowering costs/fees through disintermediation of third parties

Consumer
Changes in consumer behavior and expectations require redesigning customer touch points and reimagining omni-channel strategies



Evolving and improving the core business is an essential first step to addressing disruption, but **pursuing growth through corporate venturing is critical to long-term viability and prosperity.**

Source: Highnote Foundry

It's reasonable to argue that in today's rapidly transforming and uncertain environment, *not* participating in CVC programs carries far greater long-term risk to an enterprise than participating in CVC.

A carefully implemented and well-managed CVC program offers incumbent companies five critical advantages in navigating their transformation journeys and ultimately leapfrogging their competitors.

All enterprises differ from each other, and the value they place on the advantages of CVC investing will affect how they set up and operate their CVC programs.

Exhibit: Corporate venture capital advantages
Effective CVC programs deliver tremendous long-term value to enterprises.

Strategic advantage	Position enterprise to be proactive and offensive in extracting value from innovation	▸ Extend innovation capability (enhanced R&D) ▸ Transform internal operations and culture ▸ Market credibility, PR and thought leadership
Financial advantage	Positive return on invested capital from equity in risk-adjusted portfolio of high-growth ventures	▸ Exit to IPO or M&A ▸ Dividends and revenue share ▸ Use balance sheet instead of OpEx for R&D
Commercial advantage	Leverage to drive revenue and reduce costs in partnerships and business development deals	▸ Access to new markets, channels and customers ▸ Licensing, distribution and reseller partnerships ▸ Co-marketing arrangements
Information advantage	Early access to insights about future trends, disruptive technologies and changes in customer behavior	▸ Early access to strategic technologies and IP ▸ Insight into competitive activity ▸ Identification of "white space opportunities"
M&A advantage	Access to pipeline of potential acquisition targets with due diligence advantage for portfolio companies	▸ Superior deal flow for M&A ▸ Deeper insight into target company operations ▸ Enhanced synergies and easier integration

Source: Highnote Foundry

Unfortunately, many CVC programs have failed because they lacked a clear and well-defined strategy for maximizing the value of their venturing activities. It's easy for CEOs and CFOs to become excited by the tremendous value a CVC program can deliver and rush in without giving sufficient consideration for what outcomes they desire from their CVC function.

Successful CVC programs require a methodically developed strategy that is closely aligned to the enterprise's corporate strategy. Successful programs require a careful articulation of how they will balance the strategic, financial, commercial, information and M&A advantages they intend to provide to the enterprise.

A methodically developed CVC program strategy with a clear investment thesis, well-articulated objectives, rigorously managed metrics and a diversified portfolio is essential for success. Critical to the CVC strategy is an understanding and accounting for the differences between a traditional VC and a CVC. Corporations should not seek to mimic or attempt to recreate a VC inside their walls. Instead, an effective CVC strategy will specifically address the challenges and structural constraints of investing inside a large corporate environment.

Exhibit: Venture capital vs. corporate venture capital
Corporate venturing is fundamentally different from stand-alone venture capital.

	Venture capital firm	Corporate venture capital
Objectives and measures	▸ Purely financial and reputational	▸ Capture insights ▸ Create partnerships ▸ Enhance capabilities ▸ Enter new markets ▸ Stay close to disruption ▸ Potential M&A ▸ Financial returns
Portfolio strategy	▸ More disruptive and broader market focus ▸ Substantially more investments ▸ Riskier "bets" – i.e., more failures ▸ Returns primarily from "homeruns" ▸ Return multiple expected (10–20–40x) ▸ Stakes can range from 5% to 70% ▸ Board seat	▸ Targeted market focus ▸ Fewer deals ▸ Safer "bets" i.e., minimize failures ▸ Very few "homeruns" if any ▸ Return multiple expected (1.5–5x) ▸ Smaller (minority) stakes ▸ Board observer
Budget and investment capital	▸ General partner management fee and carry ▸ Multiple LP investors committed to a 10-year fund ▸ Urgency to invest capital	▸ Full-time staff – with operating budget ▸ Balance sheet funded ▸ No urgency to invest capital

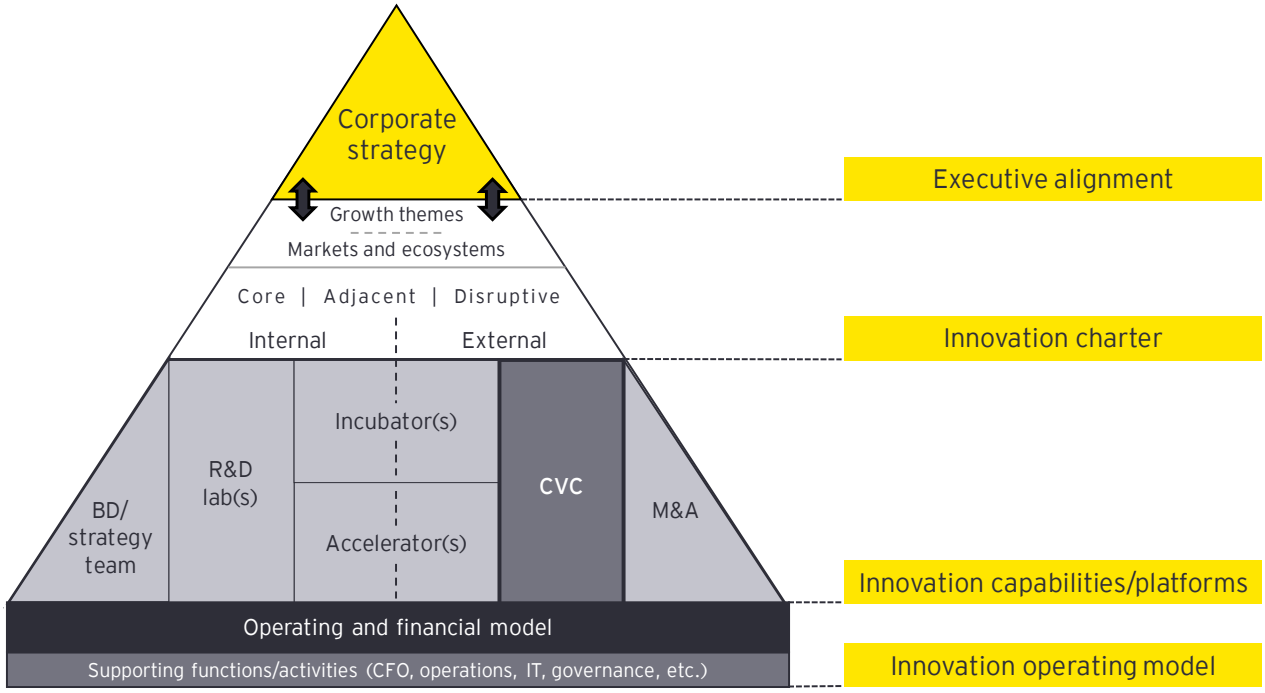
Source: Highnote Foundry

The current environment makes setting up and operating a CVC program the right way more critical than ever, and CFOs must rely on the unique expertise of experienced investors who have consistently delivered returns from venture investments. Experienced investors know how to develop and execute a CVC strategy that will effectively balance the strategic goals of the enterprise against the need for strong financial returns.

A corporate venture capital function is only one part of a company's comprehensive growth and innovation strategy. The CVC team will sit alongside business development/strategy teams, R&D labs, internal incubators/accelerators and the corporate development teams who are pursuing M&A. It's vital to define the goals and desired outcomes of each growth/innovation function so that they have clear operating parameters and are working effectively in close collaboration.

A framework such as the Enterprise Innovation Architecture (EIA)™ can be extremely helpful in defining a company's comprehensive "Innovation Agenda" and aligning it with the overall corporate strategy.

Exhibit: Enterprise Innovation Architecture™
Growth through innovation starts by aligning the corporate strategy with a well-designed enterprise innovation capability.



Source: Highnote Foundry

The Enterprise Innovation Architecture (EIA) was developed by members of EY Foundry based on decades of VC, CVC and startup experience across a wide variety of industries. Each of the four elements of the EIA addresses the crucial steps to developing an effective venturing program. Specifically:

Executive alignment – Defines overall corporate growth strategy and short/med/long-term objectives; educates and aligns around what innovation means to the firm and what the firm hopes to achieve from its innovation investments

Innovation charter – Identifies growth themes that will achieve desired objectives and support the overall corporate strategy; assesses and selects the most relevant markets and ecosystems

Innovation capabilities/platforms – Determine sources of growth (internal, external or both); allocate capital, staff, assets and focus across the full range of corporate innovation activities

Innovation operating model – Operates EIA in close collaboration with BOD and/or executive team; maintains alignment with corporate strategy and measurable corporate objectives

EY Foundry is a team of entrepreneurs, investors, management consultants and Fortune 500 operating executives who have a track record of generating billions of dollars in investor exits from ventures they have built, scaled and operated.

EY Foundry's proven experience and rigorous market-tested Enterprise Innovation Architecture can help senior executives set up their companies for unprecedented growth on the other side of this crisis.

Now more than ever, a company's ability to recognize and extract value from innovation will separate success from failure. CVC offers the most direct path to reap strategic and financial rewards from new business models, emerging technologies and disruptive innovation.

Recognizing the potential impact that a well-built and well-managed CVC program can offer companies — especially in tumultuous economic conditions — C-suite executives must answer the critical strategic question: can we afford not to participate in CVC?

About EY Foundry

EY Foundry creates transformational growth for Ernst & Young LLP and its clients through startup acquisitions and investments, new business incubation and digital transformation. The group is composed of professionals with strategy, product management, operations and technology skills and experience. EY Foundry has an active portfolio of digital businesses, including EY TaxChat™, EY Navigate™ and EY CryproPrep™. EY Foundry was formed through the acquisition of Highnote Foundry (www.highnotefoundry.com), a management consulting/venture capital firm.

Authors

Chirag Patel

Principal, Ernst & Young LLP
EY Foundry
https://www.linkedin.com/in/chirag-patel-33425/

Chirag is the founder and leader of EY Foundry – a corporate venturing unit, headquartered in New York City.

Chirag is a seasoned executive, management consultant, entrepreneur and venture capitalist. He has a successful track record in developing and executing growth strategies for Global 1000 companies and emerging startups.

As a leader with deep executive leadership, P&L management and boardroom experience, he has been a successful three-time CEO in the enterprise SaaS, consumer digital, health care and financial services markets. As someone who is active in the startup and venture capital communities, he is a trusted advisor to investors, entrepreneurs and Global 1000 executives.

Iliya Rybchin

Senior Advisor
EY Foundry
https://www.linkedin.com/in/iliya/

Iliya was a co-founder of Highnote Foundry and currently works with EY Foundry helping clients with corporate venturing, growth and innovation.

Most recently, Iliya was SVP, Corporate Development & Ventures at A+E Television. In addition to launching new ventures for A+E, Iliya ran the A+E Consumer Products business unit, where he was responsible for all global e-commerce, DVD, merchandise, publishing, gambling/gaming and event businesses.

After beginning his career in consulting, Iliya has more than 25 years of experience working in and running innovation labs, R&D groups, corporate strategy teams and new business development departments at leading companies in media, telecom, financial services, and information services.

End notes

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US SCORE no. 09150-211US

2004-3471698
ED None

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