Why now may be the time to start a corporate venture fund

EY Parthenon

Building a better working world

Whether the goal is to explore new technologies and markets, fill capability gaps or gain insight into potential M&A targets, CVC can be an integral part of the corporate toolbox

Large corporations have both been inspired and challenged by technology startups launching new business models, products and services during the past decade. Many of these digital solutions, which were already in demand, have seen dramatically increased speed of user adoption during the COVID-19 pandemic. In order to accelerate their own digital journeys, corporations can employ corporate venturing, choosing from multiple approaches ranging from investing off-balance sheet, to setting up a dedicated internal fund, to creating a separate fund with multiple limited partners (LPs).

Most companies ultimately end up with a separate fund structure and multiyear capital commitment, as this proves most effective for them. In this article we examine corporate venture capital (CVC) funds as a key approach for companies to invest in upstart companies and other cutting-edge technologies.

Companies with CVC funds hedge their risk while exploring opportunities through a portfolio of minority investments in startups. This helps them tap into future growth opportunities, not only during the current period of disruption, but also moving beyond into the post-pandemic world. When executed well, CVCs can become a powerful complement to other tools such as in-house R&D, partnerships, joint ventures and startup M&A to accelerate digital transformation.

In fact, now may be the perfect time for corporate venturing. While multiples have not been as impacted by the pandemic as in previous downturns, the current uncertainty means companies with available cash might be able to find some investments at a discount, especially if startups with longer-term priorities face a short-term cash crunch. Big tech companies increased their startup investments from $7.6b in 2019 to $16.7b in the first eight months of 2020, according to CB Insights.

However, CVCs may need to be selective and proactive in the origination of investments in startups to find the best value deals.

This article was created in cooperation with Mach49, the growth incubator for global business.

About Mach49

Mach49 offers a unique approach to helping global companies start, run and improve venture investing. Mach49 deploys a new concept called "General Partner in Residence" where it supplies an experienced general partner from a top-tier venture fund to help start a new venture firm inside large companies. In addition, Mach49 helps source new deal flow, conduct due diligence and manage portfolio fund execution. Learn more at mach49.com.

Using CVC to gain insight

CVCs provide a way for established companies to extend their ecosystem in key strategic areas, while getting early access to new technologies and capabilities. This enables them to gather insights and enhance their current business without having to incur the hefty costs of building from scratch or making a complete acquisition.

Hence, CVC deals are becoming more popular: the value of CVC-backed deals more than tripled to $57.1b in 2019 from 2014, according to CB Insights. Yet while the number of corporate venture arms has also grown, more than 80% of S&P 500 companies still do not have a dedicated CVC arm. These companies may be missing an opportunity since CVC funds have the potential to create even higher returns on investment than traditional VCs.

A series of key questions can help an organization determine the best way to set up and operate a CVC fund, tying it to the company's strategic innovation agenda so it is fully supported by the board and leadership of the company.

How do I make the case to stakeholders to support the creation of the fund?

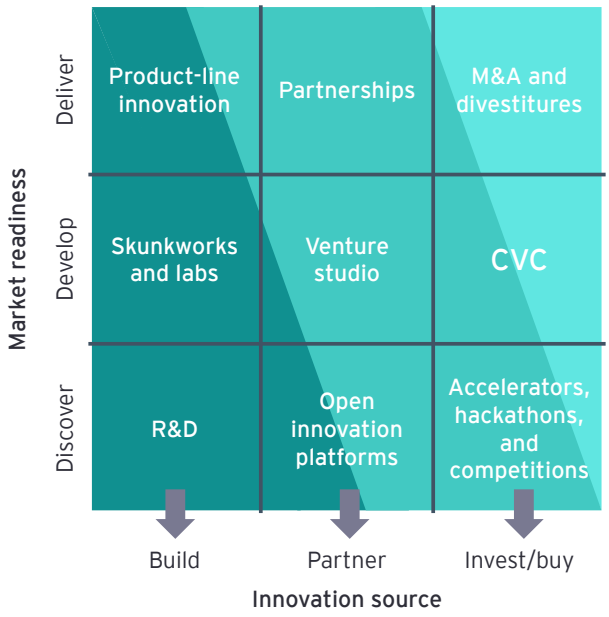
A CVC fund may never get off the ground without CEO and board support, as it needs to be closely tied to the corporate strategy. Executives who are trying to launch such a fund should identify the capabilities, products or markets that are missing in the company's portfolio and understand how CVC can help fill these gaps.

For example, a global industrial automation and electrical equipment company was interested in a specific technology, but had to decide whether to incubate its own solution from scratch, invest in the startup company or buy the startup outright. After establishing an initial partnership with the startup, the team opted to first make a small investment to signal its support and maintain insights into the technology. Over time, the company became convinced of the technology's legitimacy and potential value and leveraged its existing position to buy out the equity stake held by a major VC in that particular startup.

Leadership realized that the CVC investment offered more optionality down the line for areas the company was interested in exploring. It could get involved with concepts much earlier in the process and become comfortable with them over time, rather than taking on substantial risk from the onset by buying the startup or using the company's internal incubation program. Today, this Global 1000 company now has a broader $500m CVC fund based in Silicon Valley. The company has been building a portfolio of startup investments with a focus on energy management, e-mobility, intelligent industrial automation, robotics and cybersecurity, aligning with the parent company's future growth strategy.

CVC is an essential part of a company's digital incubation toolbox

Digital incubation toolbox



Why CVC?

- **Move faster than in-house capabilities** in exploring new technologies and business models.
- **Fill capability gaps** by leveraging the agility, and innovative solution of startups.
- **Drive growth in adjacent and new markets** using a portfolio approach by placing a series of small bets.
- **Learn and stay current on emerging trends and technologies** engaging with the startup and venture capital (VC) community.
- **Broaden your M&A strategy and manage risk** proving out acquisition targets before committing fully.

Legend

Inside-in	Inside-out	Outside-in

Characteristics of successful CVCs

Although their structuring can vary, successful CVCs tend to share similar characteristics. They are typically staffed with dedicated investor talent, based out of Silicon Valley or other startup hubs. They have dedicated funds to invest over a period of multiple years, and they establish clear goals for their capital, with both strategic and financial metrics that will be used for measuring success. Showing clarity and gaining early alignment on these goals and metrics can help win CEO and board support that will last, long term, even through management changes and strategy shifts.

What are the differentiators for my fund?

Entrepreneurs with quality ideas and ventures today have no shortage of capital available to them, and investors often must compete to participate in the best deals that come to market. As a result, many corporate investors often struggle to penetrate deal syndicates and in some cases are viewed as "dumb money" by traditional VCs.

Therefore, CVCs should try to find ways to differentiate themselves in the venture market. First and foremost, they should try to distinguish themselves from the "tourist CVCs" – corporate venture funds that are "playing VC." There are many defining characteristics of tourist CVCs that need to be avoided:

- **Staff without investing experience –** Many tourist CVCs staff their teams with successful executives from inside the corporation. However, success in the corporate world does not correlate with success as startup investing.
  Solution: Staff your CVC with experienced VC investors and/or serial entrepreneurs. Consider bringing in outside help to set up the CVC and learn investing best practices.

- **Salaried staff –** CVC staff who are compensated via traditional corporate compensation models are often not incentivized to take risks or to facilitate the startup's success over the long term. As a result, CVCs are often plagued with high employee turnover, making it difficult to effectively manage a portfolio over the requisite time frame for the investments to reach adequate maturity (five to seven years).
  Solution: Establish a CVC compensation structure that rewards risk and investment success via carry or phantom stock while being aligned with corporate compensation guidelines, where possible.

- **No dedicated funds –** Many CVCs invest off-balance sheet or via opex. This approach puts follow-on investments at the mercy of annual budgeting processes and short-term time horizons.
  Solution: Establish a dedicated pool of capital with a time horizon of seven years or even longer.

- **No clear value proposition –** Silicon Valley is less interested in your money. CVCs often fail to promote and execute on their native advantages as large companies, which include valuable assets and scalable capabilities such as infrastructure, brand recognition and scale that can be valuable to startups. Even more importantly, access to customers and channels is the most attractive feature of a CVC for high-quality startups.
  Solution: Define the value-add capabilities the corporation can bring to its investments early on and establish executive accountabilities and internal processes so the company can successfully execute on these promises. These can include access to distribution networks, proprietary intellectual property (IP) and technology, mentorship from industry leaders, or access to new customers.

- **Partner within the ecosystem to develop a startup pipeline –** Promising startups attract investors quickly and are less likely to cast a wide net to attract funding; your CVC's active engagement in the ecosystem will be critical to build relationships with entrepreneurs in the ecosystem and identify promising startups early in their life cycle.
  Solution: Establish presence in the innovation hubs where your target startups operate. While presence is important, incubator/accelerator partners can play a key role in supplementing your capabilities in targeting startups.

One financial services CVC became well-regarded in the CVC community when it helped two-thirds of its portfolio companies establish commercial relationships. The CVC accomplished this by establishing parent-startup collaboration platforms internally to engage executives and founders and create incentives for both sides to enhance the value of their partnership. Those platforms produced several new offerings, including a B2B payment automation service.

How will investments be sourced and executed?

Similar to a traditional venture capital firm, a successful CVC fund can build a diversified portfolio of startup investments, in alignment with its strategic mandate. The CVC fund may also proactively screen, filter, engage in due diligence, close the deal and capture value from the startup investment until it exits the investment.

Companies can leverage a variety of techniques to identify investments, but one effective method involves proactive outreach to entrepreneurs and other VCs that are active in areas where the fund is focused. This is an area where CVC advisors can help by leveraging their networks to provide access to those VCs and entrepreneurs that companies may not otherwise be able to reach.

This active search for investments can even pay off in indirect or adjacent areas that the company did not originally consider to be a priority. In one instance a multinational corporation with a core capability in sensor technology was introduced to a startup in the robotic delivery space, which was adjacent to one of the company's core lines of business. Through the diligence process, the company learned that the startup was already using its sensors in an autonomous vehicle, which led to not only an investment, but also to a strategic partnership between the two firms to develop sensors and related technologies for a future delivery robot.

Successful CVC funds generally have some autonomy or internal processes to help enable fast decision-making, meaning that a startup investment can be approved within days, not weeks. This is critical, because if a CVC is seen as dragging its feet on one deal, it may not be able to get into the next one.

C-suite executives are often part of the board to provide strategic guidance and general oversight. Other executives from R&D, M&A, corporate development or business unit leadership might be part of the advisory board to establish links between the individual startups and the parent company. Regardless of the investment committee composition, it is critical that all players involved be committed, responsive and accommodating with their time, particularly when a high-value investment is on the line.

The management of the deal flow and transaction cycle from screening to close to exit should be closely aligned with the financial and strategic goals of the CVC fund. The connection between investments and these goals should be able to be clearly articulated. For example, a large automotive OEM (original equipment manufacturer) CVC focused on investments in mid-growth-stage startups related to on-demand mobility in order to bring valuable insights and partnership opportunities for the company's carsharing service platform. Communication with stakeholders and partnerships with VCs, startup incubators and other experts in the startup ecosystem is essential to identify the best startup opportunities and expand return on investment.

How will the core business and the fund interact?

CVC funds need to balance financial and strategic goals to capture the highest value and potential synergies from their investments. Some CVC funds take a more hands-off, purely financial approach, while others actively build networks among portfolio companies to spark inspiration, skill building and collaboration. Some engage their own R&D organization on specifically defined collaboration projects with startups to drive business.

If the goal of the CVC fund is to fill strategic needs and capture synergies between the parent and the startup, it will be important to involve executives from the core business, whether to suggest gaps where CVC investment may be needed or to work closely with founders to build new offerings. Successful CVC funds invest in startups that fall into clearly defined focus areas for the company — ones where there is an operating model and infrastructure to capture synergies and value between the startup and the parent company. The value creation logic should be a part of the screening, due diligence and exit strategy.

In another case, a global financial services company established a CVC fund to participate in disruptive technology plays in the sector to grow the business and hedge risk early on. Given the strategic focus of the CVC, it was important to establish links and accountabilities between the company and the startups in the fund. Business executives from the company were involved in "venture days" to screen potential investment candidates and take accountability for potential learning or partnership opportunities. While the focus of the investment is in financial services, the fund invested in direct-to-consumer companies early on to learn how customers buy in digital ecosystems and ultimately applied these learnings to the company's financial services offerings.

In order to foster cooperation between the core business and the fund, CVCs may also deploy an internal communications plan to share the benefits that corporate venture investing has for the business.

How do you measure success?

Historically, 80%–90% of startup investments fail. Boards need to become comfortable with a portfolio approach that hedges risks and expands returns, and they should reflect this comfort in communications with stakeholders. Working with seasoned advisors who have deep knowledge of venture capital can help improve the hit rate of the CVC and increase the overall success of the fund.

While traditional VCs typically care solely about financial outcomes, CVCs have additional strategic returns to track. In other words, successful CVCs can speak to their return on innovation, not just their return on investment.

Strategic success for CVCs may be measured in several different ways, including:

- The number of deals in strategic focus areas sourced or evaluated
- Financial impact (i.e., EBITDA or revenue growth) as the result of investing in a startup
- The number of business units engaged in pilots or commercial relationships with portfolio companies
- Knowledge transferred from the startup investment to the CVC fund (and, subsequently, to the parent)

Financial metrics for CVCs can include:

- Multiple of invested capital
- Individual portfolio company return on investment
- Portfolio internal rate of return (IRR) vs corporate ROIC (return on invested capital)
- Portfolio IRR vs. median VC fund returns
- Pull-through revenue (i.e., incremental revenue in core business driven by startup and vice versa)

Five key takeaways:

1. Be clear about your financial and strategic goals and design the CVC accordingly.
2. Aim for early wins that accelerate your rate of learning.
3. Silicon Valley needs more than your money: while dedicated capital is important, being able to tangibly add value to startups is crucial to get into top deals.
4. Measure the return on innovation (the strategic value) and not just the ROI.
5. Integrate your corporate venture activities into a wider corporate innovation and digital transformation strategy.

Leading practices to set up a CVC fund

Design

- Purpose and objectives
- Venture strategy and focus areas
- Performance metrics
- Internal alignment, socialization and sponsorship
- External ecosystem partnerships and messaging

Setup

- Legal structure
- Investment criteria
- Investment governance and processes
- Parent/startup synergies and platforms
- Organization chart and staffing plan
- Outreach and relationship building strategy

Execute and build startup portfolio

Pre-investment

- Industry and technology research
- External relationship building
- Deal sourcing
- Lead prioritization

Post-investment

- Board participation
- Portfolio support
- Collaboration and partnerships
- Follow-on funding
- Exit analysis

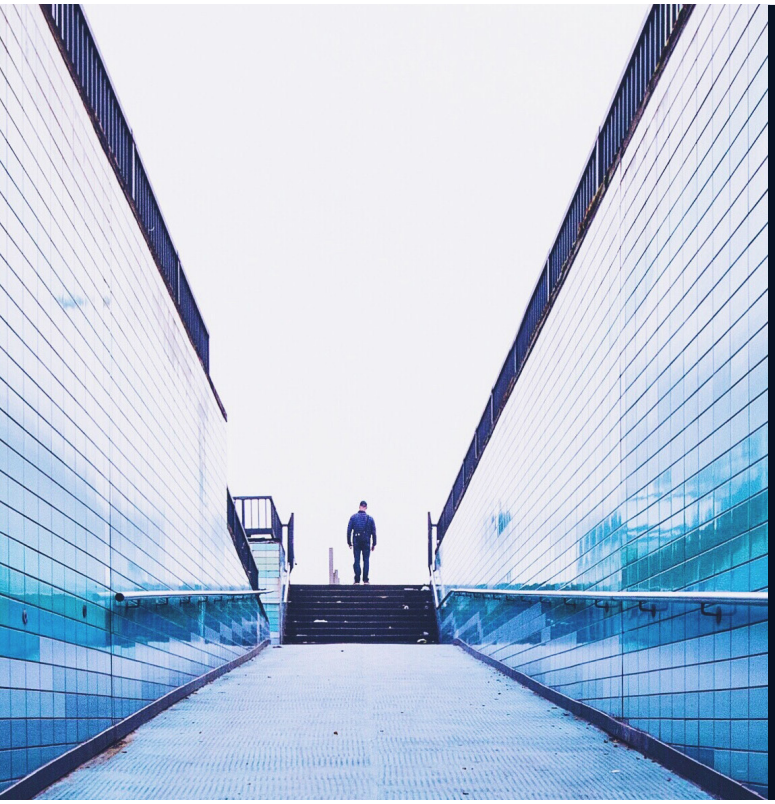
Investment

- Due diligence
- Negotiation
- Term sheets
- Financing options (e.g., convertible notes)
- Value capture/ synergies

Operations

- Fund administration
- Mother ship management
- Parent/startup platforms
- Recruiting/compensation
- Public relations
- Marketing

Source: Mach49 and EY-Parthenon

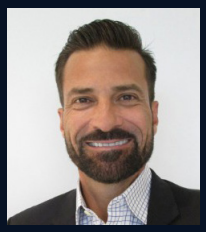


Conclusion

CVC can be a good tool for staying current on emerging trends and technologies, identifying growth areas for a company, de-risking M&A, and moving faster than traditional R&D. Companies might consider CVC investing now to reap future benefits from new products, technologies and geographies. At the same time, companies may be able to generate a higher ROI based on lower prices potentially available during this time of market disruption.

However, it is essential to not just focus on financial returns but on a "return on innovation," by aligning the strategy of the CVC with the goals of the core company. This may require patience, but will help boost long-term value.

Contacts



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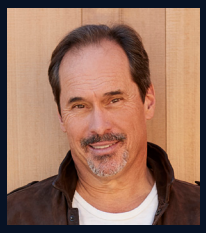

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About EY-Parthenon

EY-Parthenon teams work with clients to navigate complexity by helping them to reimagine their ecosystems, reshape their portfolios and reinvent themselves for a better future. With global connectivity and scale, EY-Parthenon teams focus on Strategy Realized — helping CEOs design and deliver strategies to better manage challenges while maximizing opportunities as they look to transform their businesses. From idea to implementation, EY-Parthenon teams help organizations to build a better working world by fostering long-term value. EY-Parthenon is a brand under which a number of EY member firms across the globe provide strategy consulting services. For more information, please visit ey.com/parthenon.

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