CORPORATE VENTURE CAPITAL – WINDOW ON THE WORLD

Keeping a Finger on the Pulse of New Technologies and Markets

The Key Role
of Corporate Venturing in the Innovation Strategy
of Industrial Companies

MACKEWICZ & PARTNER
MANAGEMENT CONSULTANTS

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Appendix:

1. Foreword

Corporate venture capital: Long-term prospects

It is not so long ago that investing in young high-tech companies was almost considered to be a "license to print money". This point of view has now changed fundamentally. In today's period of consolidation, a young company has to demonstrate substantial prospects before an industrial group will consider investing corporate venture capital.

From the investor standpoint, this is understandable as finance departments are putting pressure on their companies to concentrate on core businesses in times of limited financial resources. On the other hand – and this is a clear message of the CVC study conducted by Mackewicz & Partner – large companies are still not utilizing their own innovation potential sufficiently and often applying unsuitable tools to do so. As a result, strategic cooperations with small innovative companies still play a key role. It is therefore true to say that CVC engagements are and remain key elements of a future-oriented innovation strategy.

Irrespective of economic developments, most industrial companies appear to have recognized this fact and continue to stand by their CVC strategies in spite of recent market exits. Decisive for the success of these strategies are however clear goals and CVC programs based on these goals. Also key is investment behavior governed by potential long-term returns and synergy effects between investor companies and venture companies rather than economic fluctuations. A clear innovation strategy has to be backed up by systematic CVC activities.

Five years ago, Mackewicz & Partner presented their first CVC study, thus defining key guidelines for the then young market. At that time, corporate venture capital development had only just begun in Germany; the newly founded CVC firms of DaimlerChrysler and Deutsche Telekom were among the pioneers. This new study has again been conducted in a key phase of the market's development: CVC strategies have to be redesigned and the foundation has to be laid for the future. This Mackewicz study is in some respects a continuation of the first one. T-Venture supported the study precisely for this reason. I would like to take this opportunity to thank all sponsors who joined us in supporting this study, one of which was a relatively young CVC firm, Autovision, a Volkswagen subsidiary.

Such newcomers give the market new impulses and prove that corporate venture capital remains a key future building block for companies – and thus represents an important element for a successful economic center in the 21st century.

Dr. Thomas W. Kühr, CEO of T-Venture Holding GmbH, Bonn;
Member of the Board and Head of the CVC Working Group of the German Venture Capital Association e.V.

2. Preface

In October 1997, we presented the findings of the study conducted with the support of Deutsche Telekom AG and T-Venture Holding GmbH, Bonn. The study was entitled "Venture Capital and Corporate Venture Capital: Financing Alternatives for Young Technological Companies. This study, well received both within the sector itself and by the specialist press, was published during a period of awareness building and growing interest for venture capital in Germany.

The results of the study showed that traditional sectors with limited growth potential dominated the German industry portfolio. At the same time, it was established that Germany's relatively high R&D spending did not automatically lead to economic success stories. It also became clear that companies that captured innovation potential and achieved economic success in growth markets were highly important to economic development. Small, innovative companies played a key role in this context. Banks were insufficiently prepared to evaluate innovative companies and therefore reserved in granting loans. Venture capital firms also favored partnerships with companies already established in the market. Young technological companies therefore fell into a financing vacuum. Although early phase investors in Germany had already assumed a leading position in Europe in 1997, less than five percent of young technological companies in search of capital were successful in finding a venture capital partner.

Against this background, an increasing number of startup initiatives by corporate venture capital firms were seen. Industrial companies aimed to capture strategic advantages with their independently operating VC units by developing cooperation partners with high-potential technologies and products. They also focused on identifying and capturing attractive new businesses and achieving growth by placing new products in established markets. In addition, industrial groups aimed to encourage inhouse startup potential through venture capital activities, thus improving the group's image. Last but not least, the aim was also to achieve ambitious returns targets.

This newest study shows the development of the sector from the boom phase to its current consolidation. It shows what corporate venture capital firms can really achieve and what prerequisites have to exist for successfully operating CVC units within an industrial group. Practical experience to date is illustrated with a number of examples. We conclude with an outlook on development scenarios for the corporate venture capital sector.

In order to ensure well-founded statements, we conducted comprehensive, indepth interviews with both representatives of corporate venturing firms and the responsible managers of CVC units in industrial groups. We would like to take this opportunity to thank our interview partners once more for their willingness to share their experiences with us.

We would also like to extend our thanks to the three companies that commissioned this study for the trust-based, good, and constructive cooperation. Finally, we would like to thank Mr. Ferdinand Kögler, who played a leading role in initiating this project as Director of Marketing and Relationship Management at T-Venture, and whose competent support as sparring partner was invaluable throughout the project.

Detlef Mackewicz, Mackewicz & Partner

3. About this study

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Each company having to establish its position in the competitive landscape with innovations, and therefore considering corporate venturing, has a very different and individual starting situation. The market leader in a given sector will pursue a different strategy to its close competitors. A telecommunications group wishing to use the newest technologies, will aim to achieve a different set of goals with its CVC unit than an automotive group that wants to use innovations in its vehicles.

There is therefore no magic formula for successfully designing corporate venture capital initiatives. This study aims to help develop suitable approaches for designing corporate venture capital programs taking into account the specific company situation.

Corporate venture capital firms from the US and Europe have not yet become well-known for their enormous successes. The list of engagements that were discontinued shortly after starting up is far longer than the list of successful initiatives viewed long-term. Many corporate VC initiatives have not only disappointed their own groups but also several companies in which they had a participating interest. There are a variety of reasons for the many failures of CVC initiatives, yet in many cases the complexity of the undertaking seems to have been underestimated.

Nevertheless, there are industrial companies that have successfully transformed themselves with means similar to corporate venturing and have prevailed in competition or even developed into world market leaders. The **Sulzer** company was originally a foundry and manufacturer of steam turbines, yet thanks to its innovativeness and ability to reinvent itself it successfully made the technological leap to gas turbines and created a completely new business with the listed Sulzer Medica (now Centerpulse). This new business was then spun off at a profit following completion of the company's restructuring into a purely technological group.

As part of this study, we conducted a total of 50 interviews. The interviews represent 31 different corporate venturing initiatives. Specifically, we conducted interviews with 13 industrial companies, 31 corporate VC firms and six independent market experts. In some cases, both the parent company and CVC firm were included (a list of the companies where interviews were conducted can be found in the appendix).

Closer examination of individual companies shows that of the 31 CVC initiatives analyzed, own CVC units were set up in 26 of the cases. These are either units within the industrial group or a legally independent management entity founded by the industrial companies. In one case, an industrial company has since dissolved its CVC initiative. Three of the corporate venture capital firms surveyed stated that they had almost reached the end of their "fund cycle" and were facing the challenge of setting up a follow-on fund. Two of the companies we surveyed have already succeeded in doing this. Another two companies surveyed have

not yet set up an own corporate VC initiative but gained experience in the sector by investing in funds. Two other companies have either no demonstrable experience or intend to set up a corporate venture capital unit respectively.

The corporate venture capital initiatives covered by this study represent financial resources in the order of EUR 4.4. Thus, industrial companies have set aside an average EUR 142 million for each corporate VC program. To date, the corporate VC firms in question have provided about EUR 2.0 billion in venture capital to 729 portfolio companies. In theory, the corporate VC initiatives covered in our interviews therefore still have liquid resources of EUR 2.4 billion at their disposal. An explanation for this impressive sum lies in the low average age of CVC activities of large companies of 4.3 years. This lies far below the usual fund duration of ten years.

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4. Executive summary

Importance of innovations for the performance of economies and industrial companies

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Innovations have key economic importance for highly developed countries with low levels of raw materials. High-level demand, intensive competition, favorable production conditions, and research competence make a location particularly interesting. Since 1992, Germany has been constantly losing its share of world trade in the area of R&D-intensive goods. German companies have not been able to achieve high income with a high level of employment based on success in international competition. In an economic growth analysis of seventeen leading industrial nations in 2001, Germany and Japan were ranked lowest. Innovation is becoming increasingly prominent as a powerful lever in the fight for competitive advantage. In spite of this, both knowledge transfer in the business world and transformation of research findings into market successes have substantial improvement potential. Only few companies have all the skills needed to identify new businesses and to expand into these. In addition to the possibilities provided by research & development, corporate strategy, and M & A, individual industrial companies also like to use venture capital investments as a tool for innovation, growth, and renewal.

Corporate venturing as element of the innovation strategy of industrial companies

In response to our question on features that characterize innovative companies, we were able to identify the following criteria during our study. These are listed below according to how frequently they were mentioned:

- New products account for a large share of revenues
- Large number of patents
- Highly developed innovation culture
- High R&D budget
- Use of new technologies also in production
- Official suggestion process within company

In our interviews, we gained the impression that only a few companies have institutionalized innovation management as an integral part of the organization.

Innovations are more than just groundbreaking inventions. Based on experience, companies only maintain top positions in the market if they are in tune with the opportunities and risks of markets and competitors. Revolutionary market changes were often initiated by startups characte-

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rized by their fast reactions and dynamism. In order to recognize trends early, to evaluate these and – if promising – to capture these for the company, conventional methods (central research, M&A, corporate strategy) are only suited to a certain extent. Managers in operational units often lack the time and authority for this. It is rather the case that job advertisements force managers into a role that often even forbids them from doing anything other than their set tasks.

Although corporate venture capital is considered to be a useful and key tool for promoting growth and innovation, it is important to remember that only a small part of innovation activities in large companies can be covered by corporate venture capital. Experts in this field assume a share of one to five percent of the annual R&D budget.

Corporate venture capital activities appear to be particularly useful if companies are considering entering immature and uncertain markets where limited knowledge is available. By way of a specially created unit with its own capital, industrial companies can either actively invest directly in individual startups, or more passively invest in carefully selected existing funds.

If we consider the dimension of R&D projects in the two- or even three-digit millions, these are clearly weighted differently to CVC investments in terms of related risk. CVC investments represent far lower sums awarded to several companies. In the case of R&D projects, large sums are invested in a highly focused manner with uncertain prospects, while CVC investments provide an opportunity of broader diversification of financial resources.

Goals of corporate venturing initiatives

Corporate venturing initiatives are usually set up to pursue several goals. For the majority of companies we surveyed, strategic goals are the most important. However, achieving adequate financial returns also represents a key component of a CVC engagement. If we compare the possibilities of private VCs with those of corporate venture capital activities, the latter are characterized by industry experience – provided they are otherwise as good as the private initiatives.

Therefore, if an industrial company is convinced of the strategic importance of its investments, then taking into account the usual failure rate of individual venture capital investments, financial success of the CVC initiative can be assumed.

During our study, we identified six key goals of CVC programs.

Key goals of corporate venture capital

CVC programs can be put into six groups according to their priorities:

"Innovators"...	"Sellers"...	"Observers"...
✓ Optimize exisiting business ✓ Import new technologies, products, and business processes **Examples:** DaimlerChrysler Venture, T-Venture	✓ Support sales of own products ✓ Establish group standards **Examples:** INTEL, Ericsson Innova	✓ Gain insights into new technologies and emerging markets ✓ Use findings for R&D and strategic planning **Examples:** SONY, Sulzer Innotec
"Renewers"...	**"Entrepreneurs"...**	**"Investors" ...**
✓ Capture new business areas ✓ Identify diversification approaches **Examples:** Freudenberg, Degussa	✓ Tap potential of patents not yet used ✓ Make use of peripheral activities **Examples:** British Telecom with Bright Star, Siemens Technology Accelerator	✓ Achieve good financial returns ✓ Gain insights into new technologies and emerging markets **Examples:** France Telecom with Innovacom, EDF Partenaires

Source: Mackewicz & Partner

In the course of the interviews we conducted, it became apparent that 80% of the CVC programs analyzed did not have clearly formulated goals and instead pursued many different goals. This can lead to tensions and inefficiencies, with the result that the strategic and financial goals originally pursued are not reached. The different sets of goals vary fundamentally in the level of interaction needed with the group units, the time horizon for achieving targets, and the level of maturity of the venture company (venture phase).

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Interaction of corporate venture capital firms and industrial companies

The key goals of a CVC initiative determine the most suitable organizational design of the program between the two extremes of a unit closely linked with the group or a largely independent external unit. The foundation for a successful CVC engagement can only be created by clearly formulating goals and rigorously orienting the CVC program towards these goals.

The results of our interviews show that the provision of capital for a CVC program is rarely based on fixed fund volumes that can be calculated long-term. Typically, allocation of financial resources takes place based on annual budget planning or balance sheet financing and thus differs greatly from private VCs' closed funds which usually have a duration of ten years. This constellation harbors various risks and in our opinion the allocation of binding financial resources should be avoided both in terms of the amount and the availability over time (usual venture capital duration of eight to ten years).

Corporate venture capital as integral part of the venture capital market

Corporate venture capital is not a mass market product. Capital is supplied very selectively to carefully chosen companies that have to meet the highest requirements. Investments by corporate venture capitalists in Europe of EUR 544 million in 2001 in relation to EUR 1.046 billion in the previous year, represent a share of 13 percent of total early-stage investments in Europe. Over 50 percent of the CVC initiatives analyzed did not begin their work until 2000. This "late birth" saved a number of CVC firms from having to go through the ongoing consolidation process that older CVC firms and private VC firms are having to undertake. Since the beginning of corporate venturing in the 1960s, a hasty retreat from the VC business can be seen with every economic downturn. To date, CVC investments have unfortunately proven to be very volatile, with many industrial groups starting their activities late on in boom phases and then dissolving these early in times of recession.

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In spite of the latest market exits of prominent CVC firms, we believe that the majority of the industrial companies we interviewed are standing by their CVC strategies. Corporate venture capital will establish itself in Europe as a useful and important tool for promoting growth and innovation. Mackewicz & Partner believes annual CVC investments of EUR 2 billion to be realistic for Europe, although this sum may well not be reached in the next five years.

In order to achieve these goals, however, the following factors for success should be taken into consideration:

- Corporate venture capital is a long-term business – the CVC initiative has to have a fixed and "non-cancelable" budget at its disposal
- The goals of corporate VC units have to be clearly defined and the corresponding organizational form chosen
- CVC units have to think and act like private VC firms
- The team of a CVC initiative should consist of industrial group employees and experienced VC professionals
- The management board has to know the ground rules of the venture capital business and provide the CVC initiative with active and committed support

Presumably, in the ongoing process of cost-cutting and consolidation, the first positive economic signals will lead to companies once more looking at the possibility of innovations, new products, and new markets. At this point, corporate venture capital initiatives will once again start to inject new life into the venture capital sector as a whole. In theory, these should possess a knowledge advantage that underlies the increasing professionalization of future corporate venturing initiatives.