BAIN & COMPANY

Corporate Venturing

By John Donahoe, Phil Schefter, and David Harding

Management fad or lasting trend?

Corporate venturing has increased dramatically in recent years as companies seek to grab ever more profitable growth.[1] This has raised two important questions. First, is it a management fad or a lasting trend? And second, is it for everyone or a select number—are some companies better positioned to create shareholder value through corporate venturing? ***(See Figure 1)***

The answer, in headline form, is that corporate venturing is here to stay. But equally important is this caveat: It should serve as just one element in a management tool kit for profitable growth. It is a tool that companies with strong core businesses should apply *selectively* to exploit opportunities related to the core.

***Figure 1*: Management fad or lasting trend?**

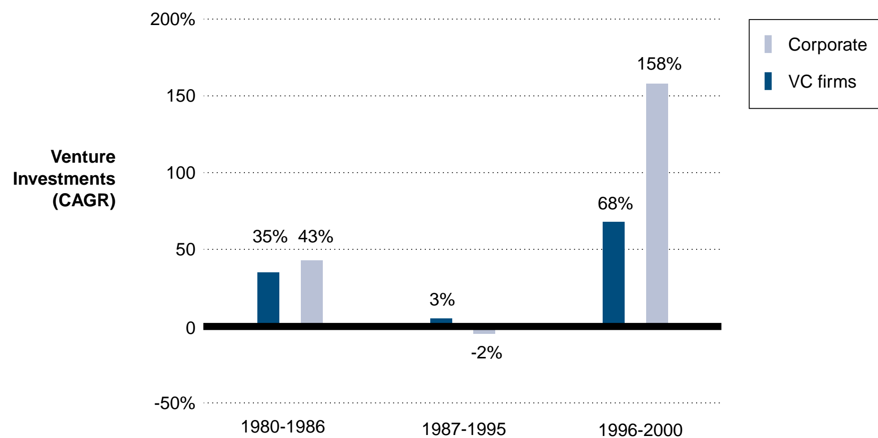

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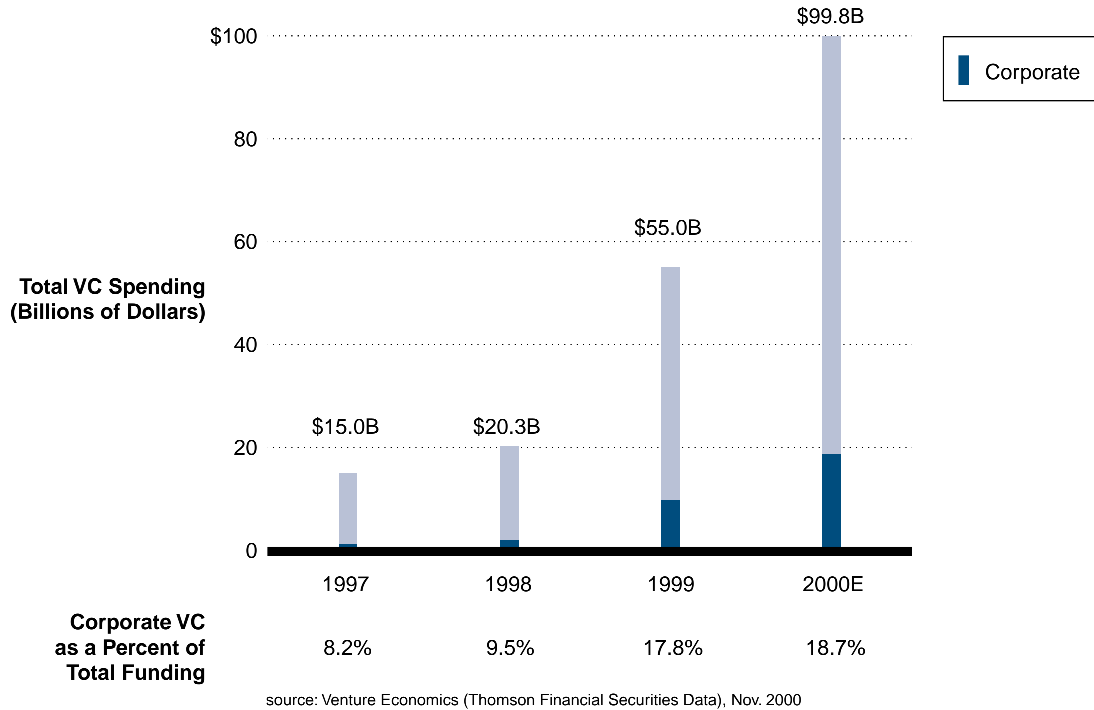
Figure 2: **Corporate venture capital spending**



Passive investment vs. active business building

To determine corporate venturing's strategic potential for your company, it's important to differentiate two types of venturing.

The first is corporate venture capital, which involves passive investment in companies outside your firm. ***(See Figure 2)*** Successful corporate venture capitalists, like Dell Computer, American Express or Cisco, place two categories of bets. In one category, they make strategic investments in technologies that are, or have the potential to be, critical to their core businesses. Cisco, for example, takes 10 percent stakes in promising start-ups to monitor growth ahead of potential acquisition. American Express makes similar investments. These are just two companies among many that have long used this approach in their research and development. Some corporate venture capitalists also make opportunistic investments to generate cash to feed the core. This approach became increasingly popular the last several years as the Nasdaq flew higher and higher. In Dell's case, the company used its brand to get in on initial public offerings, then, when early returns were high, quickly liquidated its stake. But beware: A company that loses sight of corporate venture capital's strategic objective, and focuses only on maximizing investor return, risks siphoning precious resources from its core business.

[1] Driving the recent growth of corporate venture capital investing are three underlying conditions: First, high returns in the venture capital market have attracted many new players, including corporations. Second, rapid technology changes have led corporations to hedge by investing in new technologies that pose a potential threat to their core business. Third, increased profitability in recent years has produced excess cash that companies can either return to shareholders or invest.

The second form of corporate venturing, and the subject here of broader discussion, entails investing in ideas that spring from *within* your company. These investments are "active," aimed at building new, independent businesses either inside or outside the organization that relate back to the core business. In the 80s, many corporations adopted private equity disciplines—aligning management incentives, leveraging debt and focusing on core business opportunities. Similarly today, more and more corporations are finding success applying the disciplines of venture capitalists, in capturing and funding ideas. *(more on this topic on page 8)*

The trends behind the trend

Two circumstances in particular are increasing attempts at business-building. The first circumstance is likely to endure: It's the ongoing threat of successful start-ups. Many start-ups today spring from new technologies and business models that are fundamentally restructuring industries. Clayton Christensen, in *The Innovator's Dilemma,* captured the powerful way startups have disrupted traditional markets. Christensen suggests corporations respond to this trend by forming small divisions to move into new markets created by disruptive technology.

The impetus for such business-building is unlikely to disappear. The past decade is replete with examples of street-level start-ups that might have been founded by traditional industry leaders. Witness Extended Stay America's staking of unclaimed territory, or "white space," in longer-term hotel lodgings that could have been Marriott's. Or Home Depot's capture of do-it-yourself customer territory that could have been annexed by Ace Hardware or Sears. Or Dell Computer's direct channel challenge to Compaq and IBM. Indeed, the new economy's wake-up call to corporate venturing came with Amazon.com's landgrab of online book retail, right out from under bookstore giants Barnes & Noble and Borders. ***(See Figure 3)***

One driver of corporate venturing is likely to endure: It's the ongoing threat of successful start-ups. Many start-ups today spring from new technologies and business models that are fundamentally restructuring industries.

Increasingly, major corporations are keeping a keen eye on business-building opportunities. As promising newcomers nibble, then chomp, away at related markets, established firms feel the urgency to build new businesses themselves. They want to leverage corporate assets—brands, customers, suppliers, or capabilities—in order to secure a piece of the action.

The second force behind business-building is likely ephemeral. The high valuations that many start-ups, particularly in the e-commerce space, had initially received, stepped up interest in business-building. Not wanting to miss out, established firms have started businesses with the intention of later spinning them off and reaping the rewards.

The Nasdaq's recent plunge has dampened some enthusiasm for spin-outs. It has cooled the fad. Nevertheless, the fundamental value of corporate venturing remains—it's an appropriate tool to explore new business models and harness new technologies. Corporate venturing, while not for everyone, is one of a number of useful growth tools for the right companies.

***Figure 3*: Corporate ventures that could have been**

Recent Success Story	Business	Potential Corporate Founders
Amazon.com *Founded in 1994 by Jeff Bezos through venture capitalists.*	Online book retail; General retail. Sales of $1.6B.	Barnes & Noble, Borders
Dell Computer *Michael Dell began in dorm room in 1984.*	Direct sales of PCs, laptops, and servers. Sales of $25.3B.	Compaq, IBM
E*Trade *Founded in 1982 by W. Porter for stockbrokers. Went retail in 1996.*	Online Stock Brokerage. Sales Sales of $621M.	Second-tier brokerage firms
Express Scripts *Founded in 1986 by a St Louis-based drugstore chain and HMO Sanus.*	Manager of pharmacy programs. Sales of $4.3B	Larger drugstore chains (CVS, Walgreens), pharmaceutical companies
Extended Stay America *Founded by Wayne Huizenga in 1995.*	Hotel chain for stays of one week or more. Sales $442M.	Marriott
Home Depot *Founded 1980 by fired employees of Handy Dan's Home Improvement.*	Home goods retailer. Sales of $38.4B.	Ace Hardware
InfoSpace *Bootstrapped in 1996 by former Microsoft employee.*	Reseller of website content. Sales of $37M.	Dow Jones
Iomega *Founded in 1980 with VC backing.*	Zip storage drives. Sales of $1.5B.	Predecessor product was an idea developed and rejected by IBM
Metro One Telecomm *One of the fastest-growing companies of 1999.*	Directory/directional services for wireless phones. Sales of $93M.	Baby Bells; Rand McNally
Staples *Founded in 1985 with VC and founder's money.*	Office supply retail. Sales of $8.9B.	U.S. Office Products; United Stationers; Kinko's
Starbucks *Began as retailer & wholesaler. Coffee shop expansion in mid-80's.*	Coffee shop empire. Sales of $1.7B.	General Foods (Maxwell House), P&G (Folgers)
Stericycle *10th fastest-growing company in 1999.*	Medical waste disposal. Sales of $188M.	CleanHarbors (environmental cleanup), Quest Diagnostics (medical testing labs)

Which corporations venture most successfully?

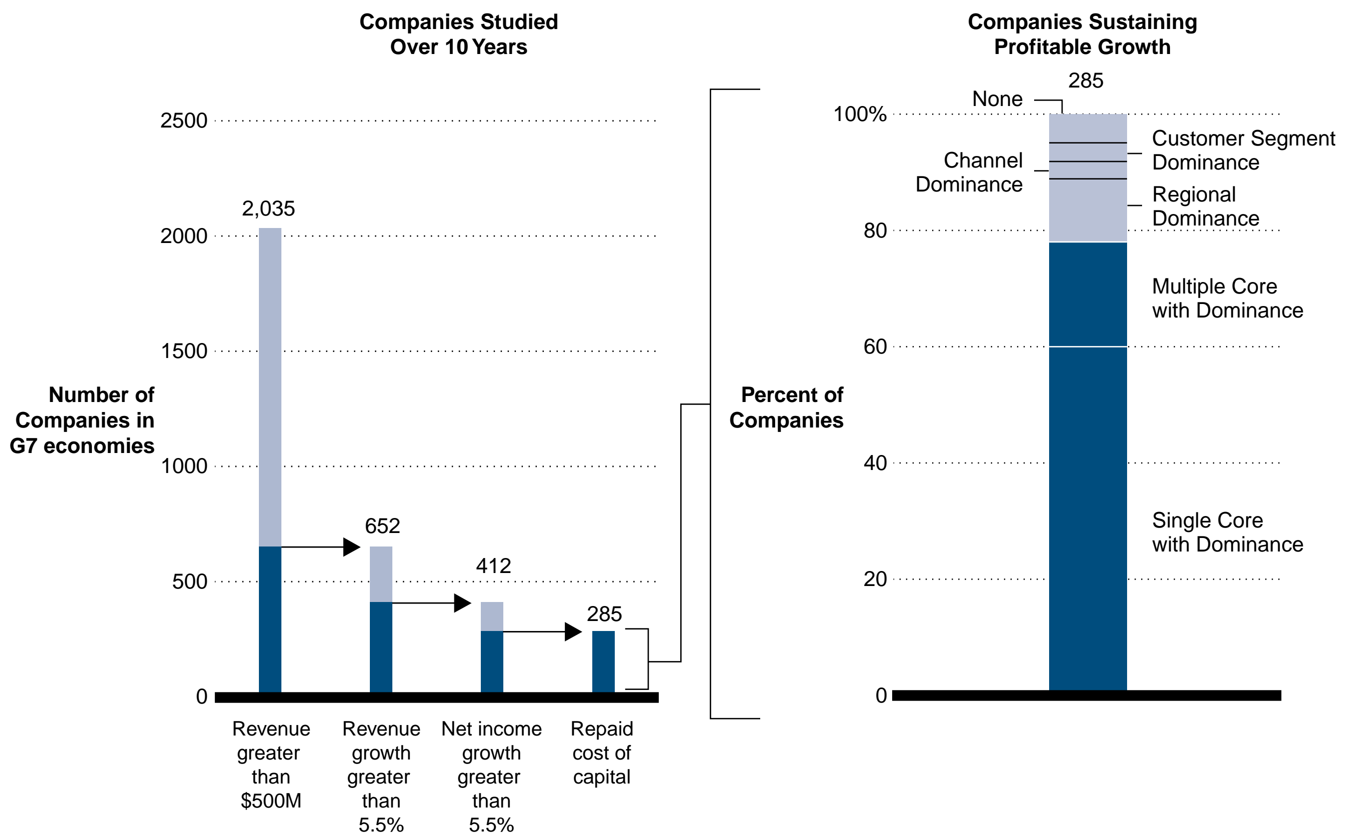
When Bain & Company analyzed 2,035 publicly held companies (with annual revenues over $500 million) in the United States, Canada, Britain, France, Germany, Italy, and Japan, we found that only 14 percent had achieved sustained, profitable growth for a decade. Only 285 firms had posted revenue and profit growth, year-on-year, of at least 5.5 percent, while repaying their cost of capital. What distinguished these performers from the rest? A strong core business, or multiple cores, that dominated their industries.[2] ***(See Figure 4)***

This rare, valuable trait—a strong core business that dominates an industry—primes a company to pursue successfully a broad set of corporate venturing opportunities. For companies with a weak core, however, such opportunities are limited. The first priority of these companies should be to strengthen their core, not divert people and capital into new ventures.

Compare these recent examples:

Priceline leapt too far from its strong core and landed hard. The dot-com built a market leadership position in reverse auctions in industries with highly variable capacity and low marginal costs—airline seats and hotel rooms. But before it sufficiently strengthened its core, it moved into entirely different sales processes. It launched ventures in mortgage lending, groceries, and

***Figure 4*: Importance of a strong core**



[2] Chris Zook and James Allen, Profit from the Core: Growth Strategy in an Era of Turbulence. Boston: Harvard Business School Publishing, 2001.

gasoline sales. The result? For the year 2000, when TheStreet.com Internet Index lost 78 percent of its value, Priceline's market capitalization plummeted 98 percent. It had to shut down newer businesses like groceries and gas. To compound matters, while building less-related businesses, Priceline became vulnerable to attack on its core air ticket auctions from airline consortia.

On the other hand, Internet companies that lost the least value in 2000 were those that built businesses close to their cores. Ebay, the most successful online auction, ventured from its core consumer auctions to business auctions, which built on the company's base technology and processes. It lost only 58 percent of its market cap, about half the average for the sector.

In short, businesses with underperforming cores or limited management depth should thoughtfully evaluate whether they can divert people and capital from the core to pursue venture opportunities.

The "why": Strategic rationale for business-building

Building from a strong core

Companies with strong core businesses should ensure a clear, strategic rationale before leaping to launch ventures. There are three rationale that companies with strong cores should use. The first is to reinforce their core business by broadening it or deepening it. The second is to expand into businesses highly related to the core, and the third is to explore new business models without distracting their core team.

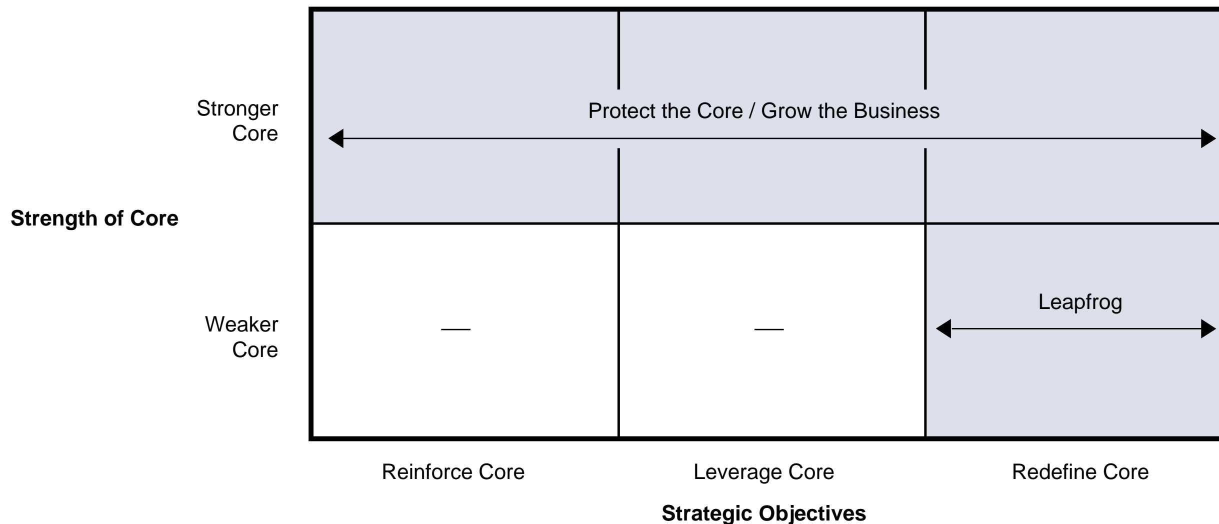
Publisher Ziff-Davis used the first rationale to move into online media—ZDNet—and thereby broaden and deepen an existing core of publications. Through its venture in Hain-Celestial, food maker Heinz used the second rationale to expand into the highly related business of health foods.

Finally, ventures can explore altogether new business models, typically based on one of two key rationale. ***(See Figure 5)*** First, a company may form a venture to explore new businesses without distracting from its core. Take, for instance, American Express's recent joint venture, "MarketMile," a platform for online trading of stationery, computers, office equipment, and even temporary staff for companies. By investing alongside electronic marketplace maker Ventro and venture services firm eVolution Global Partners,[3] Amex hopes to get in on the ground floor of new business markets for its core charge card. Or consider LevelSeas, a joint venture involving eVolution, commodity shipper Cargill, and oil groups BP Amoco and Royal Dutch/Shell to auction cargo space on seagoing vessels.

The second rationale for exploring a new model is to test potential for transforming the core. A successful new model can be filtered back through the core business, essentially redefining it. This is particularly true if the new model is born of a market disruption that ultimately redefines the core's economic environment, technology, or customer demographics. Remember the oft-told tale of Schwab.com? The company ventured online in 1995, as dot-com start-ups like E*trade began nibbling at its business. It launched an Internet brokerage unit, eSchwab, in-house, to defend and strengthen its core. But by 1997, Schwab had to address inherent channel conflicts in pricing and services. So the discount broker made a bold decision: to allow the new venture to transform the core. It priced all trades at $29.99, giving up revenue and margin in its offline accounts. And it

[3]eVolution Global Partners, founded in April 2000, is a joint venture of Bain & Company, venture capital firm Kleiner Perkins Caulfield & Byers, and partners of private equity firm Texas Pacific Group.

Figure 5: **Strategic framework**



melded its electronic services into a new division, Schwab.com, which became the firm's centerpiece.

How risky was this? Analysts had predicted Schwab would lose as much as $125 million in revenues in the first year. But by January 1999, just one year after Schwab integrated its online unit with the rest of the business, online assets nearly doubled to $219 billion. A year later, the firm's online customer base had nearly doubled, with online accounts totaling nearly $420 billion. Indeed, such was the success of Schwab's redefined business model that today 70 percent of new assets come in through street-level branches, while about 85 percent of trades take place online. Although Schwab, like other brokerage houses, has been hit by slowing investor activity in 2001, both channels are indispensable to sustaining Schwab's profitable growth.

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Building from a weak core

Companies that pursue business-building from a weak core often do so in a desperate attempt to improve themselves. Unfortunately, expanding a weak core does not make it strong. Instead, such moves usually distract management time and attention. One of the only successful rationale for venturing from a weak core is to replace it with a new, stronger one. Prescient military contractors made such moves as defense budgets shrunk. PerkinElmer Corp, of Wellesley, Massachusetts, for example, successfully leapt in 1995 from manufacturing an array of military navigational instruments and detonators to making instruments for high-speed genetic mapping. Among heavy industrials, Finland's Nokia moved from pulp mills and other conglomerate holdings to focus on telecommunications in 1982. Building businesses related to this new core, it became the world leader in cell phones. And in retail, Woolworth, a variety-

store chain in decline, in 1974 built a venture in athletic footwear, Footlocker. In 1993, the company restructured around Footlocker and a related venture in sporting goods called Champs. Shortly thereafter it closed the variety stores and renamed the company The Venator Group. The new core now accounts for 60 percent of revenue. Such successes at leapfrogging a weak core are striking, but relatively rare.

The "how": Executing successful ventures

Once a company determines building a business makes sense, it needs to decide how to proceed. It needs to make a host of decisions related to process and a major decision as to whether to build the venture inside the organization or outside.

Disciplining the process

On the process front, venture capital disciplines have been critical to the success of the current wave of business-building. Corporate venturers have adopted venture capitalists' systematic approach to screening ideas, staging and allocating capital, deploying strong management and governance with incentives for results, as well as closely charting progress and managing the exit from the venture.

Building internally vs. externally

On locating the venture, your rationale informs the "how." It helps answer the following questions: Is a given idea best incubated internally, as a semi-autonomous division? Or externally, as a spin off?

A few rules of thumb: If the idea is askew to the core business, like Woolworth's Footlocker or Amex's MarketMile—or is a defensive move that would cannibalize the core, like Barnes & Noble's online response to Amazon—it's best built outside the company to limit distraction, or worse, sabotage. Procter & Gamble, for example, spun off its venture in online customized cosmetics, reflect.com, which risked cannibalizing P&G's customer base at

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Max Factor. Likewise, AMR's ticketing unit, Sabre, spun out its online ticketing venture for consumers. The new venture, Travelocity, would cannibalize Sabre's core travel- and airline-agent customers.

By these rules, Charles Schwab's decision to build eSchwab in-house was courageous and contrarian. Yet even eSchwab was run *like* an independent division, with its own P&L and its own staff, cordoned off in a separate part of the building to sharpen management focus and insulate against naysayers.

Schwab's subsequent moves more closely followed the rules. ***(See Figure 6)*** In June 2000, it began building an internal business, related to its core, by purchasing U.S. Trust. This extended the company's boundaries into an adjacent service segment: full-service brokerage. And it moved the firm into a new customer segment: wealthy investors. In yet another effort to expand its core, this time into a less highly related business, Schwab created an external venture in investment banking. It founded the investment bank Epoch Partners, in partnership with Ameritrade, TD Waterhouse, and venture capitalists Kleiner Perkins Caufield & Byers. As of this writing the jury is still out on the first venture, and in on the second. In June 2001, Schwab and its co-investors made a disciplined exit from Epoch. They sold Epoch to the Goldman Sachs Group, concluding that investment banking was not going to work as an online business. "It was just not going to happen for us to reinvent the investment banking business," Schwab's co-CEO David Pottruck told *The New York Times*. "There's much too strong an in-place structure to that industry."[4]

[4]Patrick McGeehan, "New-Era Banks Slip Into the Past," *New York Times*, 22 June 2001, Technology section, p.1.

There are also purely tactical reasons to build businesses externally. The scarcer a company's resources in cash and talent, the more likely it will have to build externally to create stock options that can attract investment partners and outside expertise. Wal-Mart, though flush with cash and retail talent, gained Internet-sector expertise by launching its online channel as a joint venture with Accel Partners. Venturing externally can also constitute a tactic for insulating the parent's earnings-per-share from any losses in the new venture, justifying the appointment of a new board, or minimizing sales tax.

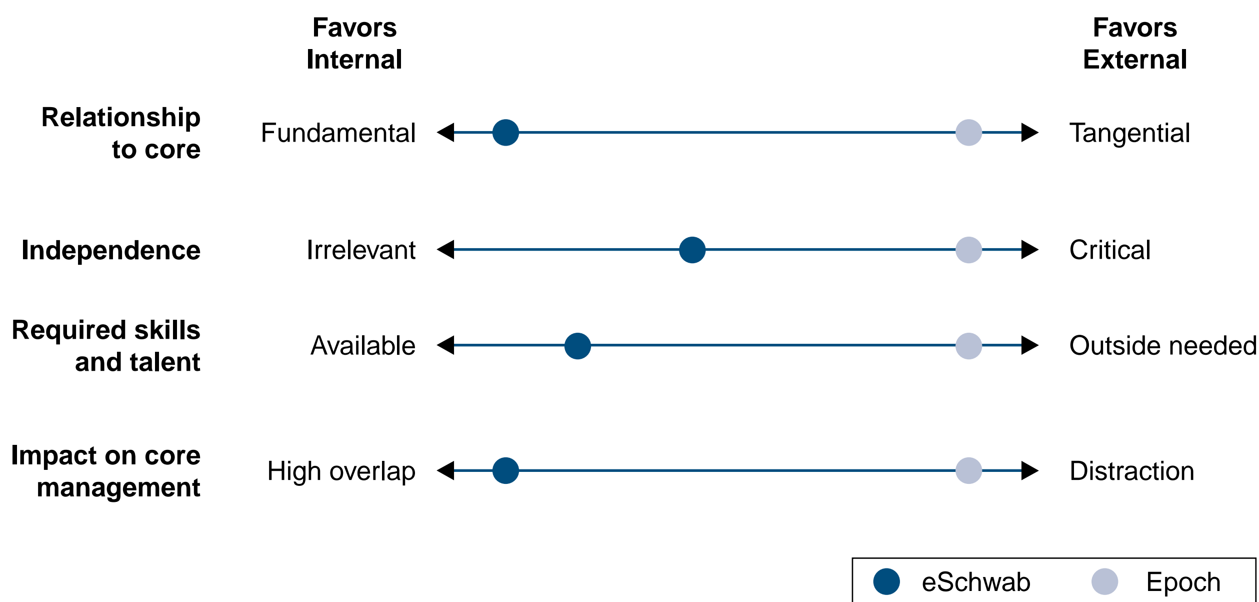
Best practices in implementation

In order to identify best practices in overall implementation, Bain analyzed a cross section of successful, business-building ventures dating back to the 70s. They include several cited above—Schwab.com, Heinz's investment in Hain-Celestial, and Woolworth's launch of Footlocker. They also include Barnes & Noble's response to Amazon, IBM's circa-1980 investment into the then-emerging personal computer market, and wireless technology leader Lucent's New Ventures Group.

The case of Lucent New Ventures Group

Despite the fact that Lucent has recently fallen on hard times, the company is widely acknowledged as mastering the key components of building new businesses. In fact, Lucent established its New Ventures Group after its own extensive investigation of best practices in new business creation. The group's mission is to reinforce and expand Lucent's core, by making the most of Bell Labs' $4 billion of investment in research and development. Established in 1997, Lucent New Ventures Group has funded 31 projects within three years.

***Figure 6*: Internal vs. external trade-offs**



Here's how it manages the process to optimize results.

- First, Lucent New Ventures Group selects only high-potential ideas.

  Lucent reasoned that much of venture capitalists' success begins with their exposure to an enormous number of venture ideas. Likewise, Lucent New Ventures Group strives to maximize idea flow. While the majority of ideas come from Bell Labs, the group also mines ideas from Lucent's business units, individual employees and some external sources.

  Just as important, Lucent screens ideas decisively, eliminating poorer prospects, and funneling the promising ones to the most appropriate team. Ideas that fit within the core business immediately go to new business development. Remaining ideas that constitute a new business opportunity move to the New Ventures Group. And ideas that represent merely a licensing opportunity shift to Lucent's intellectual property division. Any other ideas are shelved or rejected.

- Second, it applies venture-capital-style funding.

  Many large companies mismanage venture financing in two ways: They overfund it, insulating the new venture from the rigors of fiscal discipline. Or they fail to cut their losses in a timely fashion, prolonging an ailing venture.

  To avoid such pitfalls, Lucent spells out a four-stage development process for new ventures. Continued funding depends on meeting the objectives established for each stage.

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- Third, it deploys strong management and governance.

  To overcome the inertia that often thwarts innovation within a large organization, Lucent ensures its New Ventures Group has effective champions and leaders. The group's president reports directly to the Chairman, putting the group on equal footing with Lucent's 10 other operating divisions. Within the New Ventures Group, the Executive Leadership Team includes a diverse group of senior executives who can provide cross-functional expertise and advocacy.

  Lucent incubates talent as well as new venture ideas. To develop its bench of entrepreneurs, it maintains a cadre of 20 Entrepreneurs in Residence, high potential candidates for future new-venture CEO positions. Each is responsible for helping to manage the venture-creation process within one of five technology groups.

- Fourth, it establishes the right incentive structure.

  Like a start-up, Lucent offers new venture managers and employees equity and/or compensation based on reaching milestones at each stage of a new business's development.

- Finally, it charts and closely manages the exit.

Value realization—or exit—is built into Lucent's four-stage plan. Once a new venture has been commercialized, its future is routinely assessed and fate decided. The new venture is either integrated into Lucent's core, sold privately, taken public,[5] or eliminated.

With this process, Lucent's $80 million annual investment in corporate venturing has achieved an attractive rate of return—70 percent for each of its first three years. Only two ventures, of the 31 funded, were terminated within this time. And the New Ventures Group has attracted $225 million from third-party investors. Lucent has integrated several new ventures into the core business including Elemedia (voice IP software) and Lucent Digital Video (full videoconferencing solutions).

Key questions for execution

Depending on your company's resources and abilities to implement a venture, you'll face a number of key questions:

- How closely is the opportunity related to the core?
- Should you develop the idea inside or outside of the current business?
- Should you take outside money or fully fund it yourself? Do you have the currency required?
- Should you use internal managers or hire from outside? Is the right talent available within your ranks?

Where a company concludes outside partners are required, there are a number of creative ways to structure the venture. Bain & Company, for example, founded its latest venture externally, in partnership with organizations that brought venture capital know-how and private equity discipline to the endeavor. Bain invested alongside premier venture capitalists—Silicon Valley's Kleiner Perkins Caulfield & Byers and partners from the Texas Pacific Group, a top private equity firm to create eVolution Global Partners, a venture services firm. Bain released talent—four partners—to build the business on the outside where it wouldn't distract from Bain's core business consulting services. The spin-off operates out of separate offices in San Francisco and London.

Is this management trend for you?

At the end of the day, launching a new business to achieve profitable growth can be a bit like launching a rocket into orbit. Too little propulsion and the rocket will fall back to earth; too much, and it will fly off into outer space, uncontrolled and, useless to its makers. The window for success is narrow. You need a robust analysis of that window of opportunity and a careful plan to get there.

So, too, for corporate venturing in the years ahead. Its revival may be the lasting legacy of the dot-com era. But its reincarnation requires that corporations start with robust strategy and vision for expanding their businesses and clearly defined plans for achieving them. Today, you need to get both the "why" (rationale) and "how" (execution) right to successfully launch a new business and keep it in orbit. And be warned: Not every company is ready for space travel.

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[5]Theoretically. As of 12/2000, Lucent had yet to stage an Initial Public Offering for one of its ventures.

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