Five Things Companies Get Wrong about Corporate Venture Capital

Many corporate executives are uncomfortable taking the levels of risk that VC requires.

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At a Glance

- Hundreds of companies are setting up corporate venture capital arms, hoping to tap into the foresight, energy and promise of technology innovators. Unfortunately, many squander the opportunity by managing these VC efforts the same way they would manage an M&A or business development unit—that is, too cautiously.
- Venture capital works best when it plays by a set of rules that are higher risk than most corporate executives are used to. VCs invest in innovations that are far from product-ready, and many fail to pan out—the price of developing unproven ideas. Corporate VC executives must be given latitude and permission to risk failure.
- Corporate VC arms need to recognize that they are entering a realm where their corporate brand counts for less than a reputation for trust and reliability. Patience is also crucial: Even successful VC bets can take many years to deliver.

One of the best ways to avoid being disrupted in your industry is to become the disrupter.

That's why so many companies are setting up corporate venture capital arms—nearly 800 were active in 2018, up from about 220 only five years earlier. Executive teams feel the pressure brought on by innovative disrupters who, backed by venture capital, are attacking their markets. They know they need to reach further out than their business development and R&D teams can take them, and the best way to do this is by becoming an active participant in the VC ecosystem. For many, this means setting up their own funds and innovation teams, often in Silicon Valley.

But this is a difficult pivot for most corporations. VC firms operate with a higher risk-reward profile than most companies do. The economics of venture capital dictate that most investments will fail to deliver their promised returns, and those that pay off take many years to do so. Plus, by definition, venture capital operates in unproven territory, investing in technologies years before the arrival of a product, let alone revenues. Neither of these factors are an easy sell in a culture that measures profit and loss on a quarterly basis, and where sponsoring a failure can be a career-limiting move.

Despite these risks, more and more corporations are deciding they need to play in this arena, hoping to gain insight on what's coming next and avoid being disrupted.

When done right, corporate venture capital can be a valuable way for companies to create a competitive advantage, since it affords a view that may be three or four years ahead of what the public (and competitors) are able to see. Think of it like the icebreaker forging ahead of the larger ship. It can also help improve deal and transactional skills, inject some Silicon Valley culture into the corporate DNA, and

Corporate venture capital 2018, by the numbers

773
Number of corporate venture capital arms globally

$254B
Total VC funding

23%
Percentage of that funding contributed by CVCs

$53B
Amount contributed to VC funding by CVCs

2,750
Number of CVC deals

Sources: CB Insights; KPMG

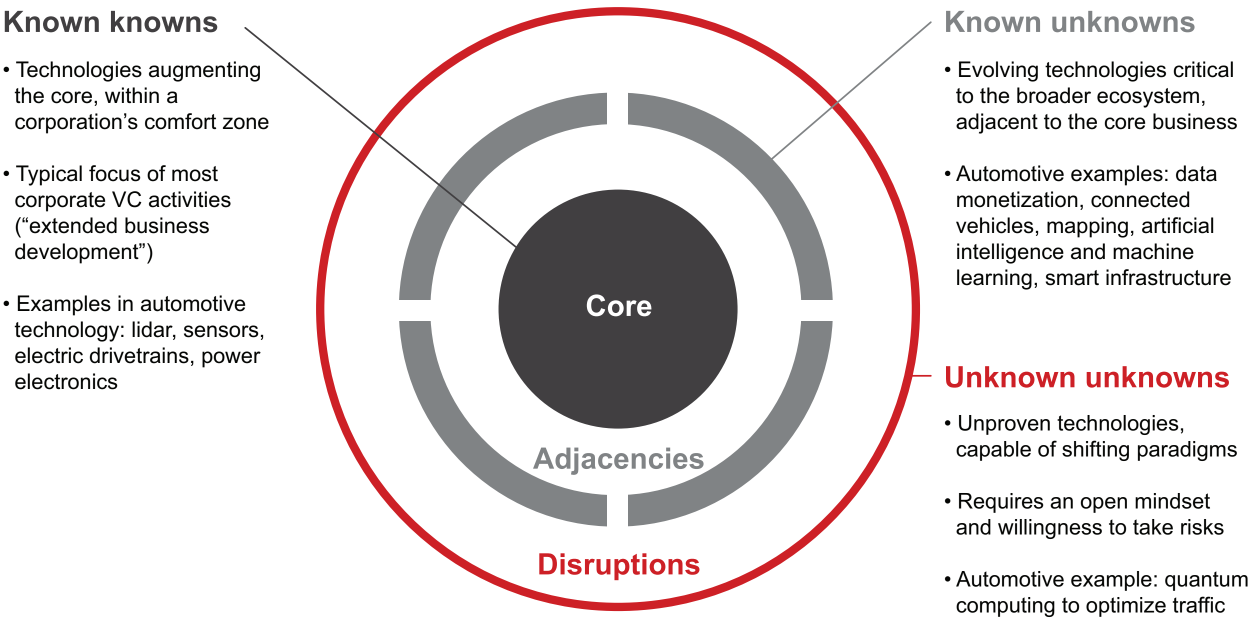
create new opportunities in R&D, business development and M&A. A team that listens to 100 pitches and invests in only 5 of them has still learned a great deal about the state of innovation from the rest.

However, corporations need to develop some new muscles to make venture capital work within their culture. Executives need to understand the specific role that venture capital plays in their innovation strategy. They need to view it as the tip of the spear, rather than an extended arm of business development. The corporate VC team should have the mandate of looking well over the horizon to identify potential disrupters, a perspective that requires steering clear of legacy thinking. Successful disrupters take outsized risks and often rely on methods that are anathema to a conservative corporate culture. Most long bets fail, and corporate executives can make such bets only if they believe they won't be punished for backing failures.

Getting comfortable with venture capital

For venture capital to thrive within the corporate sphere, you may need to rethink its role in your innovation strategy. Most corporations use their VC arms to find "known knowns"—technology or products that they know already exist and can be used right away to improve their business *(see Figure 1)*. But in fact, they should be doing this through their business development and R&D units. The real value of a VC arm is to discover "unknown unknowns" and, to some extent, the "known unknowns." These are the things that will break new ground and disrupt the industry.

Figure 1: Corporate venture capital can only succeed when it's encouraged to pursue ideas outside the core business



Source: Bain & Company

Consider Uber, which failed to attract several large automakers as early investors because, when it was founded in 2009, it was primarily an app for hailing town cars. Automakers had little interest, seeing this service as far from their core business. But Uber was the birth of a radically new business model, which is poised to disrupt the entire auto industry. And automakers today spend millions building their own ride-hailing services or partnering with established ones.

Our work with the venture capital community and corporate venture capital units brings to light some key lessons that companies should consider as they develop their own CVC arms.

- **A strong corporate brand won't create excitement.** Companies sometimes enter the VC arena thinking their brand, experience and scale will ensure a warm welcome. They may not realize that sources of funding are abundant, and most entrepreneurs can choose whom they want to take money from. Silicon Valley networks are based on trust and reputation, and entrepreneurs want investors in their corner who can help them build their companies. Corporations have a hard time competing. They may invest in start-ups in early rounds but fail to make follow-up investments, or they may send in executives to work with the start-up and then swap them out for others. Entrepreneurs may wonder whether they'll still be around for the next round of funding. Any CVC arm will need to build its reputation as a good early-stage investor, which takes years of experience.

- **Shopping lists don't work.** The next disruptive idea is not likely to be something you're already looking for, so CVC arms need the freedom to pursue ideas that aren't directly related to the business—indeed, things that may not yet have a clear business proposition. Many companies miss the chance to invest in start-ups because they view the opportunities too narrowly, searching for "known knowns." When Tesla founders Martin Eberhard and Marc Tarpenning were seeking a first round of funding, neither VCs nor auto-industry players were interested in the idea. Top-tier suppliers even refused to sell parts to them. VCs and auto-industry executives couldn't see the potential in a plan to introduce a major new car line in the US—all electric and run by novices—for the first time in more than half a century. Imagine where EV technology could be today if one of the majors had bought in early.

- **Don't look for a payback in two years.** Few disruptive ideas will pay off quickly. Corporate venture capital must commit to stay in the game long enough to find and fund the one idea that makes it all worthwhile. In recent years, the time to payoff appears to be lengthening. Start-ups are waiting longer to go public, due to the abundant availability of venture capital. In 2018, the median age of a company backed with venture capital was 11 years at the time of IPO, up from only 8 years in 2006, according to PitchBook. Most corporations are not used to waiting so long to see cash flowing from an investment, and venture capital is often one of the first areas cut during hard times. It can take 10 years or longer to see strategic benefits, since venture capital, if done right, focuses on early-stage innovation rather than product development.

- **Taking a minority stake is okay.** Because most corporations are conditioned to want a controlling stake in investments, few take a truly strategic approach to VC. They often make a majority investment in a single technology or start-up and hope it's the right one—which it rarely is. A better approach is to seek out optionality: smaller minority deals, within the framework of a broader innovation strategy, that give you a seat at more tables, allowing you to see technology as it develops and continuously evolve your investment thesis to pursue new opportunities.

- **Corporate diligence processes and investment committees don't work.** Since start-ups typically lack a product or revenue, corporations would have a difficult time applying the type of due diligence found in their M&A playbook. VC investment decisions are based on different criteria—the team, the market, the potential—and are made with much less certainty. CVC teams need greater freedom than a traditional M&A team. Squeeze them too hard and they will choose only "safe" deals, which isn't venture capital.

Corporate venture capital can be extremely valuable in today's environment of digital disruption, but it's difficult to do right. Savvy executives will learn how to get out of their own way. They will give greater freedom to their CVC teams, allowing them to be the proverbial sand in the oyster, the irritant that ultimately creates the pearl. Most of all, they will encourage their teams to take greater risks based on uncertain potential—and not punish them when bets don't pan out. Only by understanding and playing by this different set of rules can executives extract the greatest value from their corporate venture capital initiatives.

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