



British
Private Equity &
Venture Capital
Association

The Missing Piece

How Corporate Venture Capital can
transform UK finance and funding

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Executive Summary

The United Kingdom has a relationship with discovery and innovation which, quite rightly, is a source of enormous national pride and hope. However, for all our capacity for scientific discovery, it is somewhat disconcerting that the UK has slipped so far behind other technological leaders like the United States in efforts to commercialise scientific discovery.

During the Industrial Revolution, Britain's innovators were highly effective at sourcing the capital required to fund technological development. Since the Second World War, however, a gap has opened up between the UK and USA, in large part due to America's willingness to embrace forms of venture finance to fund innovation. Today the world's most innovative regions – such as Silicon Valley, which struck upon the modern model of venture capital in the 1950s – are those where venture finance is found in abundance. This relationship between access to venture finance, the flourishing of technological innovation, and the ability to deliver successful commercialisation is well established. Since the early 1990s, successive governments from both sides of the political divide, have come to realise the value of venture finance and have energetically sought to redress this gap. To do so they have deployed a range of initiatives and agencies with the intent of capturing the potential of our capacity for innovation by unleashing a deluge of private capital. Policy after policy was deployed with that aim of incentivising all equity investors to come to the party.

All it seems, except one.

Corporate Venture Capital (CVC) is the catch-all phrase used to describe a wide variety of equity investment undertaken by corporations. At its most basic level, CVC describes an equity investment made by a corporation, or its investment entity, into a high growth and high potential, privately-held businesses. This makes CVC appear very familiar to private venture capital VC, and in many ways they perform the same economic role – the identification and nurturing of the innovative businesses of the future. However, whilst the structure and practice of venture capital is very similar from firm to firm, the structure and practice of CVC is enormously diverse, as each unit is adapted to work harmoniously with its corporate parent's culture and strategic objectives.

Developing an understanding of CVC's role in the UK is important since CVC combines the impact of corporate balance sheets with business acumen and industry knowledge. CVC, therefore, has the potential for significant economic impact, but this potential is currently stifled by policy, regulatory barriers, and most of all, a lack of understanding of the role of CVC investment into high growth, typically early stage high tech, Small and Medium Enterprises (SMEs).

The efforts of successive governments to encourage angel and VC investors over the last decade has shown the value Ministers place on sources of private capital. For a period under the previous Labour Government, CVC investments were also incentivised via the Corporate Venture Scheme (CVS). However, the circumstances surrounding the decision by the Labour Government to discontinue the CVS when it came up for review in 2010, and the lack of CVC-specific policies from the current Coalition Government betray a lack of understanding of the industry, and create gaps in Government strategies to unlock sources of private investment for SMEs. On the one hand, Ministers exhort businesses to get busy spending the money on their record

Policy Summary

breaking balance sheets, and on the other hand the Government appears unaware that it presides over policies which create hurdles and disincentives which hold back greater investment in high growth start ups.

A recent briefing¹ from the professional services firm, Deloitte, calculated there was around £488bn in cash and equivalents sitting on the balance sheets of UK corporates. Nearly a third of this vast pile of cash has accumulated since the start of the recession. At the same time, the Government has identified gaps in the funding of SMEs and is rightly seeking private sector investment to plug them. Policymakers, therefore, must come to grips with CVC. They must develop an appreciation for its role as a source of equity investment, and they must understand the remarkable diversity of models and styles of investment behaviour and structure. The challenges are many, but if Government can develop sensible, supportive policies, CVC may well turn out to be 'the missing piece' they seek.

For many years policymakers have been incentivising venture capitalists and angel investors through a range of fiscal incentives designed to harness the potential of private venture capital. The benefit to SMEs has been the growing availability of finance which encourages their growth. What is missing, though, are policies that make a compelling case for corporates themselves to invest in SMEs. In previous years, the Corporate Venture Scheme aimed to encourage CVC activity through fiscal incentives. However, its relatively modest success and eventual discontinuation were evidence that policymakers haven't quite grasped the nature and role of CVC. This is something that must be addressed; with cash on corporate balance sheets at historic highs, the capacity for corporates to become investors certainly exists. What our discussions with CVCs for this report have identified is a lack of policies which make the business case for CVC impossible to resist.

To research this report, the BVCA interviewed CVC investors from a number of high profile corporations. The interviews comprised a discussion on the details of respective CVC programmes, and then a discussion on the sorts of policy issues they face as corporate investors. What their responses show is that whilst there is great diversity in the CVC programmes adopted by corporations, there is a surprising degree of consensus about where policy changes can deliver maximum benefit. This consensus can be divided into two main areas: a request that government and policymakers focus on the needs of SMEs, whilst understanding the role of CVC in the area of venture finance; and feeding from this, areas where direct policy action is required to remedy specific investment challenges.

Executive Summary

Knowledge

Whilst policymakers have made great strides in recent years to understand and accommodate the needs of early stage investors like angels and venture capitalists, the modest success and discontinuation of the CVS, along with the policy issues identified by the CVCs show that there appears to be little understanding that corporate venture capital plays an equally vital role. Policymakers can tackle this problem from two directions:

Put SMEs First

Policymakers should start viewing the market for equity finance through the eyes of SMEs by ‘thinking like’ SMEs in the first instance. For SMEs, the direct investor (eg. CVC or private venture capitalist) is far more important than the indirect investor (eg. pension fund or corporate) as it is the direct investor who brings specific expertise along with capital. Current policy treats CVC different to other forms of equity finance, which forces SMEs to make trade-offs that can be detrimental to their business in the long term. Policies which create a level playing field for all direct investors will ultimately benefit SMEs.

Get to Know CVC

Policymakers must develop a greater understanding of CVC and its place in the early stage investment market. Many of the specific policy actions recommended by this report are a consequence of understanding the role of CVC.

Action

Corporate investors must act in accordance with the investment environment they face, meaning that regulations and incentives have a direct effect on investment behaviour. The following areas of direct action would provide greater incentives for corporates to become more involved in venture capital activities. By levelling the playing field for early stage investors, Government can stimulate a broader funding marketplace for SMEs.

Harmonise Rules for Venture Investors

The single greatest policy challenge facing CVCs surrounds the seemingly technical issue of consolidation rules for corporates and their effect on early stage investment. Recognising the need to ensure buy-in from global accounting standard setters, the solution is to treat CVC investors the same as other early stage investors like VCs and angel investors.

The problems for CVCs surround accounting standards requiring corporates to recognise their share of an investment’s profit or loss and equity on their own balance sheets once they reach a threshold ownership stake of 20%, yet SMEs seeking finance often offer equity stakes far in excess of this amount. While this threshold is 20%, other factors impacting the power to participate in financial and operating policy decisions may also be considered. As a consequence, in practice this level can be lower. Controlling stakes of 50% or more typically require full income statement and balance sheet consolidation. Other early stage investors may not be subject to these consolidation requirements where they benefit from exemptions available to investment funds – the main differentiator between the types of investor being that one also seeks strategic as well as financial returns. The consequences are many: syndication, normally beneficial, can become a problem when it is forced by statute; CVC and VC investors operate under different rules resulting in unaligned incentives; SMEs lose access to R&D Tax Credits; and an investor’s ‘no-man’s land’ is created in practice between 20% ownership and 75% ownership, when corporations become eligible for loss relief on investments.

Ultimately the most damaging effect is that consolidation shuts many potential corporate investors out of the market, reducing the availability of funding. Participation in CVC, like any form of equity-risk investment, is ultimately a function of risk appetite and resources. The biggest businesses can easily absorb losses on consolidated investments; smaller companies cannot. The market for corporate venture capital is being artificially restricted; reviewing the consolidation requirements for corporate venture investors would remove this restriction.

Harmonise Incentives for Venture Investors

Another area where early stage investors are subject to different treatment are early stage investment incentives deployed by the Government. The Enterprise Investment Scheme (EIS) and Seed Enterprise Investment Scheme (SEIS) need minor tweaks to enable CVC investment, as currently, they virtually preclude start-ups from seeking vital venture level investments to continue their growth.

Make the UK a Global Centre for CVC

The UK is already home to many aspects of finance and business. The UK also welcomes corporate investment in the form of the creation of developmental facilities. CVC is the missing piece of this corporate investment puzzle. With the right policy mix an already strong pull for corporate investors could become impossible to ignore and the UK could become an international powerhouse of CVC.

An aspect of creating a compelling case for any potential investor is a stable regulatory environment as businesses which invest in the UK do so seeking a stable regulatory regime. CVC is no different, but like other forms of corporate investment the uncertainty surrounding Britain's relationship with Europe undermines this stability.

Corporate venture capitalists often invest in businesses that require a highly trained and skilled workforce to grow and thrive. Therefore the Government is encouraged to continue its efforts to place a greater focus on training STEM (Science, Technology, Engineering and Mathematics) graduates.

Less welcome, unfortunately, are the mixed messages surrounding immigration and access to visas for skilled workers and graduates. The Government should consider its rhetoric on illegal immigration as confusion about its intention continues to harm the UK's ability to attract and retain global talent.

CVC Briefing

What is CVC?

Corporate Venture Capital (CVC) is a catch-all phrase used to describe a wide variety of forms of equity investment exercised by corporations. At the most basic level, CVC describes an equity investment made by a corporation or its investment entity into a high growth and high potential, privately-held business. Beyond this basic definition, the range of models and systems deployed by these corporations is as diverse as that of the types of corporations themselves. As a consequence, attempts to define CVC further risk excluding some forms of CVC which could provide valuable insights for the rest of the industry.

What are its objectives?

In general, there are two main objectives to corporate venturing; developing the strategic capabilities of the parent corporation; and providing a source of financial return for the parent corporation. If we imagine a line between these two objectives, CVC programmes will be designed or will evolve to sit at some point on this spectrum. The objectives of the CVC programme will quite naturally fit the overall objective of the corporate parent. The variation in CVC is a consequence of the variation of corporate objectives, which can themselves shift over the course of time. This variation increases further as some corporations deploy multiple CVC units designed to meet specific and occasionally competing objectives.

What are its key characteristics?

Given the dual focus of CVC, the characteristics of each programme are based on variables relating to the strategic focus and funding of the venture unit. These variables are described in the table opposite and cover four primary aspects of the fund: Purpose, Structure, Talent and Success Measures.

How does CVC differ from VC?

At this point it is worth noting that whilst CVC has elements in common with venture capital (VC), it is quite different. Private venture capital is a singular pursuit; the General Partners (GPs) of the VC firm assess and invest in high growth potential businesses by deploying funds raised from external investors known as Limited Partners (LPs). They hold the committed capital in a fund for a set period of time (typically 10 years) dispersing returns gained from the sale of investee businesses both during and at the conclusion of the fund's lifetime. The sole objective of such a fund is financial return via capital gains, as this is how the VCs themselves are assessed by their investors. CVC, on the other

hand, differs in a number of ways. Firstly, CVC activities may comprise either the GP role, or the LP role, or a combination of both. Secondly, whilst the sole objective of a VC fund is financial return, CVC performance will likely be assessed on both strategic and financial metrics. As a consequence, whilst VC firms have quite homogenous business models, CVCs are a menagerie of enormously diverse business models, making it a much more interesting industry to observe, yet inherently far harder to summarise and evaluate.

	Corporate/Direct Investment <i>(Balance Sheet)</i>	Internal Dedicated Fund <i>(GP Model)</i>	External Fund <i>(LP Model)</i>
Purpose	Gain direct business and technology experience in emerging areas	Emerging business and technology with more autonomy for step out options	Develop internal VC capabilities whilst gaining market awareness and understanding
Structure	Direct investment, funding each deal, closely related to business divisions and future business opportunities	Corporate acts as LP in a 100% captive fund. Greater fund autonomy	GP external firm LP corporate part investor Decision on investment GP in fund parameters
Talent	Internal corporate talent	Mixture of external VC hired and internal corporate talent	Experienced VCs and potential secondees from corporate
Success measures	Measurement of direct strategic inputs	Primarily financial with a level of strategic exposure	Predominantly ROI
Examples	BP, Bosch, ARM	Reed Elsevier Ventures, Bloomberg Beta	Siemens Venture Capital (SVC), Physic (Unilever)

The Role of CVC in the UK Economy

Learning from the present, not the past

The most remarkable feature of the development of CVC over the last fifty years has been its evolution (see feature on p. 58). Although it began as a reasonably unstructured method of maximising the latent potential of corporate balance sheets, for many years CVC became highly structured and inflexible in its methods and application. Models and structure became the primary consideration as they were seen to determine the likelihood of success. Corporations considering a corporate venture capital programme were recommended by academics and consultants to adopt a model and adhere to it rigorously. In the wake of the Dotcom crash, authors such as Campbell et al.² captured the mood of many in academia by judging that the reason many CVCs failed was their inability to stick to a model and objectives, as their paper explains:

Now, four years later, corporate venture investment levels have fallen by 75%. Many venturing units including those of Diageo, Marks & Spencer and Ericsson have closed down, and others are struggling to justify their continued existence. Only a relatively small number, including those of Intel, Johnson & Johnson and Nokia, are continuing undeterred with a good track record and proven business models.

What went wrong? Our research indicates that the biggest mistake companies made was setting up venturing units with mixed objectives and mixed-up business models.

The authors have a point when they talk of mixed objectives; however it may be that they ascribe too much importance to the models utilised by CVCs. Certainly it seems harsh in the wake of the Dotcom Crash to ascribe the failure of CVC programmes to business models without considering the range of other factors at play during this period – the excess of capital; lack of viable deals; and lack of experience in the investment team are but a few amongst many reasons for the collapse of CVC programmes.

Moving forward to the recent financial crisis of 2008, and the five years of economic uncertainty that followed it, compared to the Dotcom Crash, the recent economic situation has been far harsher and sources of finance, including equity finance, have taken longer to recover. Yet in spite of these challenges, generally, CVC has been thriving. To understand why, this report will focus on the practices of CVCs today. By providing insight into how these CVC programmes operate, this report will provide policymakers and stakeholders with a better understanding of the nature of what drives CVC as well as the policy challenges they face in the course of doing business.

2. Campbell, A., Birkinshaw, J., Morrison, A., van Basten Batenburg, R., 2003. The Future of Corporate Venturing. (cover story). MIT Sloan Manag. Rev. 45, 30–37.

Diversity

When reviewing the range of corporate venture capital programmes that are based or make investments in the UK, by far the most startling observation is the sheer diversity of programmes.

As discussed earlier, one of the main differences between CVC and private venture capital is that the latter focuses purely on attaining financial returns on investments. This is not to say they neglect the strategic direction or the longevity of the portfolio company, but when VC funds themselves are judged, it is based on measures of financial returns. On the other hand, the performance of CVC sits on a spectrum between financial and strategic returns, and whilst measuring strategic returns can prove challenging it is a vital part of the rationale of CVC activity. Of all the CVC programmes profiled for this report, no two sat at the same point on the strategic-financial performance spectrum; Reed Elsevier Ventures, for example, is highly focused on maximising financial returns with a broader view on strategic fit, whilst BP Ventures is intensely focused on strategic fit.

Sources of funding are another major area of difference. The majority of CVC programmes profiled deploy corporate financing methods such as on and off-balance sheet investment, but these are by no means universal. Other methods deployed include closed-end funds that bear close resemblance to private VC fund structures, and investment into other equity investment funds known as Limited Partner investments.

These are but two sources of diversity, and when taken in conjunction with differing approaches to talent and staffing, to interaction with corporate parents and the more typical variations in investment behaviour, it is clear that the corporate venture capital universe is a place of great diversity. A useful metaphor for modern CVC is a human fingerprint – all fingerprints contain basic structural elements: arches, loops and whorls – yet combined with the unique DNA of each individual, these elements of finger prints combine to form infinitely diverse designs. So it is with modern CVC; basic components of funding sources, investment behaviours and investment objectives combine with the unique culture of their parent company to produce a huge diversity of programmes.

For policymakers, developing an understanding of the scope of this diversity is vital before any policy is developed which could affect corporate investment behaviour. Policy designed to aid one type of programme may be disastrous for another.

The Role of CVC in the UK Economy

Applicability

The ability of SMEs to raise finance in the last five years has been challenging to say the least. Throughout this period there have been persistent calls from many in Westminster for banks to increase their lending to SMEs to meet demand for growth capital. However, whilst the intentions of those harriving the banks is good, it may not solve problems for SMEs in the way intended, as for some businesses, debt finance supplied by banks is not an appropriate source of growth capital. In particular, for businesses that are seen as risky investments, such as those deploying new innovative technologies, or businesses that must grow rapidly, equity finance like venture capital may be more appropriate. So it is welcome that in recent years, there has been an increased awareness in Government of the benefits of growth equity finance. There remain, however, gaps in understanding of the equity funding market.

With this in mind we can consider the appropriateness of CVC in the suite of growth equity finance options. The popular imagination of many start-ups and those in Government focuses almost exclusively on private VC, which is understandable given they are the most visible actors in this field. Corporates, when they are considered, are seen to sit at the end of the growth chain, acting to acquire more mature businesses in trade sales. This is certainly a major function of corporates, especially at a time when balance sheets are very strong following years of withheld investment. However by focusing purely on this aspect, the benefits that CVCs present to start-ups could be missed; these include:

Strategic Fit

Virtually all CVCs place value on the potential strategic impact of their investments, enabling new businesses to interact with the overall structure of the corporate parent so both may benefit from potential of new business sources. It is rare for corporations to go on to acquire businesses in which they invest, but some, like BP Ventures, see this as an important aspect of their venturing activities so look for opportunities within the supply chain as a rationale for acquisition.

Instant Supply Chain

Some CVCs, such as Intel Capital, Qualcomm, and ARM invest to build out their business ecosystem. They do so in the knowledge that a strong supply chain creates growth and value for their own business. Consequently, businesses who receive CVC investment can expect that due consideration has been made as to how they could integrate into existing supply chains as a business partner in their own right. For a start-up this brings opportunities for rapid growth, as well as improved product development capabilities.

Tailored Business Support

Few forms of growth investment can rival CVC for business support. Stable, yet rapid, growth and product development are crucial for start-up businesses

as they expand in their early stages. The ability to do so with category expertise adds enormously to the value of an investment received from CVC. Businesses like Cisco and Bosch bring their wealth of category and product experience to the table along with their capital, by providing tight integration into existing business units and corporate R&D. However some CVCs, realising that separation from the corporate parent can be just as important as integration, offer business knowledge with the freedom for their investments to grow separately. Examples such as Reed Elsevier Ventures and Intel Capital operate in this way.

Time to Mature

The final and arguably the most important attribute many CVCs offer is time – time for the investee company to develop and build its capabilities. This comes mainly as a function of the relative rarity of close-ended funds within the CVC universe. Within the time constraints of a close-ended fund, there is a greater imperative to grow the investee company rapidly to maximise financial returns. A strategically-focused CVC does not feel the same pressures. This is not to say that there will not be expectations of growth and some degree of financial return. Research by Alvarez-Garrido and Dushnitsky³ found this difference of approach to time and return provides the greatest benefit in the food and pharmaceutical industries, in the development of cleantech, and in media companies. This makes the situation for the UK of even greater national importance as all these industries are areas of specialisation for the UK. Indeed, recently, the pharma and cleantech industries have experienced a particularly challenging fundraising environment due to the particularly long time required to bring products to market.

What is at stake?

In a recent briefing⁴, the professional services firm, Deloitte estimated that there is currently £488bn in cash and equivalents sitting on the balance sheets of UK companies. This is an increase of around one third compared to the start of the financial crisis in 2008. At the same time, data from the Federal Reserve⁵ in the United States estimated a total US\$2.2tn sitting on US corporate balance sheets (up from US\$1.5tn in 2007). These extraordinary figures were seen as a consequence of high levels of uncertainty during the recession; corporate balance sheets are incredibly strong by historic standards. Even if only a fraction of this cash is deployed in CVC, what is clear is that at a time when the UK is beginning to recover, there is an enormous potential source of private investment waiting to be deployed. Given that the amount of investment from the start of 2012 until mid-2013 in CVC was £300mn in the UK and US\$757mn⁶ in the US, there is vast potential for greater corporate activity, so long as policy can be crafted in a way that encourages and incentivises CVC.

3. Alvarez-Garrido, E., Dushnitsky, G., n.d. Publications and patents in corporate venture-backed biotech. *Nat. Biotechnol.* 31, 495–497.

4. Deloitte Monday Briefing of 25/9/13 - <http://www.mondaq.com/x/265072/Economic+Analysis/Deloitte+Monday+Briefing+Looking+For+An+Investment+Boom>

5. Source: CNN Money – <http://finance.fortune.cnn.com/2012/06/06/2-trillion-cash-obamas-fault/>

6. Source: Global Corporate Venturing (<http://www.globalcorporateventuring.com/>) – July, 2013

The role of CVC in the UK economy

As the BVCA works ever more closely with the CVC community, our aim is to encourage the development of policies which place CVC investors on a level playing field with other growth equity investors. Like any form of equity investment, CVC requires knowledge of the market, capital to deploy and an understanding of the risks involved.

How can policy help?

It is not only big corporates who can get involved with CVC; any company can play a role should it find benefit within the risks of this form of investment. What is clear from the profiles displayed in the next section is that there are no hard and fast rules for CVC. However, when asked to identify the challenges they face in the current investment environment, CVCs collectively identified current policies which discourage all but the largest businesses from playing a part. This is the opportunity for policymakers – to remove hurdles so that corporates are left to make decisions based on their own capabilities and strategic need. After all, the ultimate beneficiaries of improved policies will not just be corporate investors, but the SMEs desperately seeking to grow their future.

CVC Profiles

Having established the nature of contemporary CVC and its potential impact on the equity investment market, we will profile a number of CVC programmes which operate from or invest in the UK.

Based on a series of interviews with CVCs, we have been able to gain insights into the nature of their programmes, the contribution they make to the parent corporation and how the interplay between parent and CVC unit has led to the development of entirely unique investment programmes. Our interviews with these CVCs also enabled us to identify the challenges they face that could be resolved through policy action. These responses are aggregated in the Policy Recommendations section.

CVC Profiles

1.

Intel Capital

Overview

One of the longest standing CVC programmes with a track record of more than 20 years and numerous successes to its name, Intel Capital has been patiently working away as a stalwart of the industry. Since 1991, Intel Capital has invested over \$10.9bn into nearly 1,300 portfolio companies worldwide including the UK. Today it manages a portfolio of nearly 400 companies, and shows little sign of slowing down, having completed 59 investments, including 18 new investments and 41 follow-on investments, in the first six months of 2013.

Investment Platform Characteristics

Intel Capital is 100% owned by Intel, and unlike a typical venture capital or private equity fund which has a limited lifespan, Intel Capital is able to take a more strategic view on the developmental timeframes of its investments.

As with many CVC programmes, Intel Capital serves to advance the strategic capabilities of Intel, investing in businesses which complement its existing products and supply chain as well as providing insight on future technology directions. To satisfy its remit, Intel Capital must have a broad geographic and financial scope. On a global basis, Intel Capital typically invests between \$300-500mn annually into new ventures as well as its existing portfolio. This figure puts Intel Capital amongst the top global investors in all forms of technology-focused venture capital.

These aspects – large scale, open ended and strategically focused – allow Intel Capital to focus on return on investment in a broad context (both strategically and commercially) and over a sufficient timeframe to maximise return. Therefore a crucial aspect of the investment process is understanding the best time and method of exit. Exits are typically made through trade sales and occasionally IPO; only a small fraction of the total historic Intel Capital portfolio ends up being acquired by the company itself.

Quick Facts

Name:
Intel Capital

Coverage:
Global

Financing Method:
Open ended, off-balance
sheet, direct investment

Sector Focus:
TMT (Technology, Media,
Telecommunications)

Stage Focus:
Early stage/A Round
and beyond

**Typical Initial
Investment:**
\$5-10mn

**Typical Equity
Stake:** <20%

Intel Capital

Investment Activities

As one of the technology industry's most experienced CVCs, it is unsurprising that Intel Capital seeks to be the lead investor in the majority of its deals. As with many CVCs, Intel Capital targets minority stakes of approximately 20%.

Experience also allows Intel Capital to take advantage of a range of opportunities – investing anything from \$1mn up to \$50mn, and from A Round investments to later stage investments (though in Europe the sweet spot for investment stage is B Round as these businesses are seen to benefit most from the capabilities that Intel Capital can bring to the deal). This is not to say that investments in early stages are small – where the opportunity demands it, first round investments between \$30mn and \$50mn have occurred; however the average investment fits the range familiar to many private VC firms – around \$5-10mn. Intel Capital is also able to introduce other investors to companies through its own syndicate programme, where the transaction structure or size would benefit from additional co-investors.

Over time, Intel Capital's sector focus has widened as it has taken a broader view of its business ecosystem. Given Intel's focus on chip manufacturing, previous investments have centred on users of such products – enterprise software, data centres, digital media and mobile phones. However as the integration of chips has become more ubiquitous, so Intel Capital's investment criteria has expanded to the point that they now include the full range of what would typically be considered TMT (Technology, Media, Telecommunications).

The nature of such strategic investment activities can make it a challenge to measure results – financial returns are relatively easy to measure, however strategic impact is difficult, as Erik Jorgensen of Intel Capital says of strategic returns:


Where we've settled on is that you can't really measure the strategic returns from your investment. They're there and tangible, but you can't put a hard number on it and say, "... we got a 20% strategic return on the deal."

On financial returns, however, Intel Capital keeps a firm eye on the bottom line, aiming for top quartile financial returns when benchmarking itself against other global VC funds. This type of focus ensures investor discipline is maintained.

Corporate Interactions

As might be assumed for a programme with such longevity, Intel Capital has a solid working relationship with Intel's other business units and leverages a matrix structure to ensure investment opportunities from around the world can be discussed and compared with each other as well as with current R&D programmes within the parent corporation. If the opportunities display strong financial potential and are a fit strategically, the investment process can proceed.

A high degree of talent is required for such a programme to be successful. Amongst a global staff of approximately 200, there is an investment team of around 60-70 who are usually sourced from private VC funds. Staff work within functional conditions familiar to private VC – investment staff attend the



boards of the businesses in which they invest, and are remunerated when Intel Capital successfully exits the investment. Intel Capital (like many CVCs) work in this way as they believe it ensures the highest calibre of talent are attracted to and are retained by the company.

Summary

Intel Capital presides over one of the longest standing and most successful global CVC programmes. Its adaptive approach to CVC has provided an example to many other corporates who have since entered the field of investment. Its ongoing success, and that of its investee businesses, provides an example of the value corporate venturing brings via its role as an early stage investor.

CVC Profiles

2.

Qualcomm Ventures

Overview

Qualcomm first began its involvement in venture investments in 1998-99, seemingly the ideal moment for a chipset manufacturer to become more deeply involved in the tech industry and put the capital languishing on its balance sheet to work. Given the massive growth in the tech market at that point in time, it was unsurprising that this informal involvement was swiftly followed by the formation of Qualcomm Ventures in 2000 (though in hindsight, the timing of this decision may have resulted in some indigestion at senior levels in the parent corporation). However, unlike many who started out investing during the tech bubble, Qualcomm did not cut and run when the bubble burst. Today, Qualcomm Ventures has invested in nearly 100 companies worldwide with about €100mn of capital committed to invest in European businesses.

Investment Platform Characteristics

Qualcomm Ventures was created to put the parent company's balance sheet to work and the programme today still reflects that – the fund is open ended with investments made entirely off balance sheet. The fund operates out of four main regions – the US, Europe, China and India – with \$500m, €100m, \$100m and \$100m available for investment respectively. In the UK the committed capital is broken down into three areas which are detailed in the *Investment Activities* section below.

The programme was established with three main aims in mind: firstly, to gain financial returns from smart investments; secondly, Qualcomm was chasing the strategic benefits of building out its supply chain and driving adoption of relevant technologies, therefore it strove to push the adoption of 3G and 4G technology. Qualcomm Ventures aimed to do both by supporting demand from consumers through services like apps, and supply, via investment in areas such as network and infrastructure. This is expressed by Jason Ball of the Qualcomm Ventures investment team:



Quick Facts

Name:

Qualcomm Ventures

Coverage:

US, Europe, China and India

Financing Method:

Open ended, off-balance sheet, direct investment

Sector Focus:

Technology relating to 3G/4G adoption

Stage Focus:

Early stage/A Round and beyond

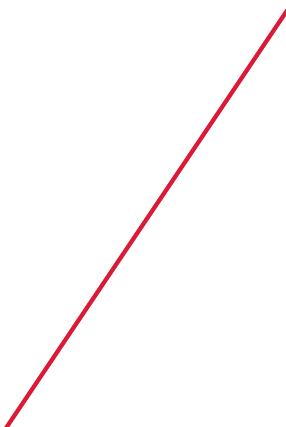
Typical Initial Investment:

\$2-\$10mn

Typical Equity Stake:

<20%

Qualcomm Ventures



We're in the middle layer. We're inside the handset and there are great things around the handset to get you to buy better, faster, handsets because we sell another chip. Those are the three layers we live in. It's all fundamentally to drive more 3G and 4G chip sales.

The final aim of the programme was as a sensor, to provide the company with a forward view of technological development. Whilst seemingly intangible, this is a crucial function. In this case, the direct link of the investment team into the CEO, CFO, CTO, Chairman and other senior executives ensures they receive information, market and industry insights that would otherwise be forced to filter their way through the rest of the organisation, potentially weakening their impact or corrupting the information.

Investment Activities

Qualcomm Ventures takes an active role in a number of stages along the development chain for SMEs, from early stage seed funding through to high-growth venture funding. To meet this broad range of investment stages, it deploys three component programmes each targeting a different stage of SME development. The first programme, targeting seed stage entrepreneurs is known as QPrize; it provides \$100,000 for each region to invest in promising start-ups, with the global QPrize Winner receiving an additional \$150,000. The second programme is a \$5mn global allocation pool, with individual start-up investments averaging around \$250-300,000.

The third venturing programme is the largest allocation and provides investment at a level typical of VC; first round investments of \$2-\$10mn with increasing levels of investment for later stage investment rounds so as to ensure Qualcomm Ventures' stake does not become diluted. Stakes never exceed 20%, however, so as to avoid having to consolidate for accounting purposes. It is estimated that the largest position held in any company was around \$70mn.

Whilst the geographic spread of investments focuses on major regions – the US, Europe, India and China – the activities in Europe provide an interesting insight into Qualcomm Ventures' views as to the relative strengths of different national markets. Traditionally more UK-focused with their activities, investment managers are increasingly looking across Europe and specifically into Scandinavia, where recent mobile successes such as Rovio (creator of the hit app, Angry Birds) and Spotify (a mobile music streaming service) have indicated that mobile and smartphone based start-ups are flourishing in the area. Given Qualcomm Ventures' desire to help encourage demand in mobile (and of 3G and 4G as mentioned earlier) it makes sense to seek out these opportunities, and such success tends to breed more local capability.

Like many CVCs, Qualcomm Ventures must walk the line between strategic and financial returns, with the former much harder to measure with traditional metrics. Some investments may at best make a 1x or 2x return, however they are vital in helping the overall business to maintain a technological edge. But this strategic consideration cannot be a substitution for strong financial performance – an aspect of the investment that is always important both within Qualcomm Ventures and its portfolio businesses. As Ball explains:

We do both types of investment on a sliding scale. We look at both [strategic and financial return]. However we are primarily financially driven. It's going to be strategic anyway in broad terms, so we couple strategic investments with financial returns.

Corporate Interactions

The last 15 years or so has been a turbulent period for the technology industry as a whole. Qualcomm Ventures has had to maintain a tight working relationship with its parent. As explained earlier, the investment team is tightly linked into the high level management of the parent company. Within the global team of twenty there are Qualcomm insiders, talent from other CVCs, hires from private VC firms, ex-bankers, management consultants and start-up founders. These globally dispersed team members are in regular contact, discussing deals and sharing market intelligence. Investment teams also have solid links with in-house R&D and relevant business units. This provides a range of benefits, probably the most important of which is the lack of overlap with internal R&D activities. This ensures that opportunities for discovery are maximised and wasted resources are minimised.

Summary

Qualcomm Ventures provides an excellent example of the resilience of strategically minded CVC programmes – despite starting amidst the uncertainty of the Dotcom Boom and subsequent Crash, they were able to survive and benefit from the experience. This persistence enabled them to be in a position to continue to invest during the recent recession and benefit from the inevitable (though somewhat slow to arrive) recovery.

CVC Profiles

3.

Reed Elsevier Ventures

Overview

Of the many industries to feel the disruptive effects of the growth and expansion of the World Wide Web, publishing was one of the first and, ultimately, one of the hardest hit. It was against this backdrop of rapid and existential change in the publishing industry that the publishing group Reed Elsevier formed Reed Elsevier Ventures (REV) in 2000 with the expressed aim of providing a window onto a rapidly changing technological landscape.

Investment Platform Characteristics

REV has many of the same characteristics as a private venture capital fund; it makes investments from a series of closed ended funds, each with a lifespan of 10 years though with a single LP, Reed Elsevier. Because its funds are close-ended they follow the typical evolution; the initial period of investment leads onto a period of management, with a harvesting period at the end of the fund lifecycle. Every few years REV raises a new fund with its parent, Reed Elsevier, in much the same way as a traditional VC raises a new fund from its LPs.

Somewhat unusually for a CVC, REV also enjoys the sort of autonomy in investment decision-making that traditional VCs enjoy, setting the investment philosophy internally whilst working broadly to a common strategy with the parent company. As Tony Askew, one of two founding investment partners describes it:

Reed Elsevier has a venture fund to provide it with a window on innovation and a lens on the massive disruptions that are taking place in the media and information market. We operate as a VC to fully align our goals and incentives with the entrepreneurs that we invest in and the other VC investors at the table. Our strong relationship with Reed Elsevier enables us to bring to bear a very large international information and media company for introductions and for strategic benefits on both sides.



Quick Facts

Name:
Reed Elsevier Ventures

Coverage:
US, Europe, Israel

Financing Method:
Closed ended fund,
10yr lifespan


Sector Focus:
Internet & digital media;
data and analytics;
healthcare ICT

Stage Focus:
Early stage/A Round
and beyond

**Typical Initial
Investment:**
\$5-\$7mn

**Typical Equity
Stake:** <20%

Reed Elsevier Ventures



However whilst strategy is a vital aspect of the role of REV, the structuring of the unit, the closed end nature of the fund and fact that Reed Elsevier acts as an LP rather than investing off-balance sheet are clear signs that REV placed a priority on the financial performance of its investments. So compared with many other CVCs, REV sits towards the more financially-focused end of the scale, as Askew explains:

The discipline of Reed Elsevier Ventures is to deliver financially and have a strategic impact.

If its investment philosophy is a function of a degree of distance from their LP, working closely with Reed Elsevier delivers a benefit of efficiency. A small investment review team comprises only the two REV investment partners as well as the Chief Financial Officer and Chief Strategy Officer of Reed Elsevier. This small group size allows for a far more rapid decision-making process; when investing in syndicate with VCs, REV is often able to make investment decisions as fast if not faster than syndicate partners, making them more attractive to prospective portfolio companies.

Investment Activities

The VC-like focus of REV on financial returns provides many advantages in their investment activities. Because the founders came from a VC background, they were able to bring their experience to REV's behaviour in the market. Consequently, REV is able to play a range of roles from lead investor to syndicate partner as the situation presents itself; this sort of flexibility opens up a greater variety of deals as does their good working relationships with the VCs themselves.

The strategic and financial objectives shape investment activities; the former dictates their sector focus, the latter the investment stage. As one of the world's largest information companies, Reed Elsevier faces disruption from many directions; the flip side of this sees many areas of opportunity for REV. Consequently they invest in three main sectors. The first is large scale data and analytics, encompassing many deep science businesses and those which require a high degree of technical capability to use advanced technologies and methods to disrupt existing market places. Their marquee investment in this sector is the highly respected and fast growing data analytics firm Palantir. The second sector also integrates with an area of strategic focus for Reed Elsevier, healthcare information (including healthcare IT). Technological innovation, such as the potential of change inherent in Big Data means the healthcare industry which is dependent on information, is an area of great investment potential for REV. The third sector of interest is general internet and media with a focus on information handling. In this sector REV has taken stakes in businesses covering diverse areas from information delivery to online advertising. Their standout investment in this area so far has been the online translation tool Babylon which is now publicly listed in Israel.

Typically, REV invests into A and B Rounds, though depending on the opportunity may occasionally invest at seed stage. First round investments is around \$5-7mn with later rounds seeing increased commitments to avoid

dilution. As with many CVCs, REV is mainly a syndicate investor. As a result of this REV often work closely with VCs, especially as their fund structure and practice operate in a similar fashion to their independent business partners. Whilst most of investments to date made by REV are based in the US, particularly San Francisco's bay area, they have investment reach covering the US, Europe and Israel and have made investments in many technology hubs beyond Silicon Valley, such as Boston, New York, Tel Aviv, London, and Berlin.

Corporate Interactions

Interestingly, although the unit has been active for more than 12 years, there has been little change to the operating structure; this is an indication of its efficacy. However this longevity would be impossible without the strong understanding of the value that REV and Reed Elsevier provide for each other, an example of this is how REV is able to extract benefit purely from the day to day activities of an investor:

We've probably met now over 30,000 companies over the last 12 years or so. That's given us a view on transformation of the media and technology markets, which Reed Elsevier couldn't possibly have had any other way. We interact on that piece by regular briefings and presentations internally where we want to deliver and synthesise the information of the market intelligence into something that's readily digestible and relevant.

This close interaction with the parent and the ability to continually provide value is essential, especially in the early stages of a fund when the commercial benefits of a more VC-style structure can be more difficult to ascertain. The relationship also breaks down personal barriers which may arise due to the need for REV to source talent externally; this would be a challenge for a corporate parent without the mutual respect that Reed Elsevier and REV have for one another.

Summary

As we have established, CVC appears in a variety of forms – Reed Elsevier Ventures shows that corporations can operate more like private venture capitalists should they choose. This structure allows REV to avoid the consolidation issues experienced by most CVCs, but requires talent incentives and partnership commitment by the corporate parent. These conditions would be a challenge for many corporations to accept.

CVC Profiles

4.

ARM

Overview

ARM is a world leader in the design and licensing of microprocessors. In recent years with the increasing prevalence of mobile computing via tablets and smartphones, ARM's ability to design high performance/low power microprocessors has seen chips based on their designs dominate this market. ARM's commercial success has been due to the ability to stake out a lucrative role in a highly competitive industry. Its business model has relatively low overheads – ARM does not fabricate the chips it designs – but incredibly high barriers to entry due to the specialised nature of its intellectual property (IP) output.

With their crucial role in the development process in mind, the origin of the ARM CVC programme came from the realisation that the company doesn't sit in isolation. Rather, it sits at a nexus of a business supply chain; the stronger that supply chain, the better for ARM. As Michael Dimelow of ARM says:

We're very dependent on thousands of partners, whether they're chip manufacturers, software partners, equipment manufacturers, operators, service providers, you name it.

ARM's CVC activities are directly impacted by this realisation; to build out the capabilities of its business partners means the strengthening of ARM's position at the centre of a supply chain and consequently increased and more consistent sales of its products.

If the rationale for the development of a CVC programme was its position as a neutral player in a business network, the impetus to begin investing was also led by that network. Following a number of approaches for investment by business partners in its network, ARM began to make equity investments and stepped up its CVC activities around 2008.

Investment Platform Characteristics

As with many CVC programmes, ARM invests entirely off balance sheet as this provides many benefits such as allowing time for target companies to reach their potential. This does have an impact on the potential for financial returns,



Quick Facts

Name:

ARM

Coverage:

Europe, US

Financing Method:

Open ended,
Off-balance sheet

Sector Focus:

Typically technology in
industries adjacent to
integrated circuits

Stage Focus:

Early stage/A Round

Typical Initial

Investment:

Varied

Typical Equity

Stake: <20%

ARM

however; as the CVC programme is a form of externally sourced R&D this approach aligns with the company's objectives:

Even when investment opportunities are not technology focused, you're still looking at ways to outsource areas of business, such as supply chain management. Maybe because you think, "here's a great bunch of people that are solving some really important and therefore valuable problems, we don't know enough about it and so would like to learn and/or collaborate."

As becomes clear, ARM has taken a very organic approach to its entry into CVC – no models of investment were selected, the company simply pursued a programme that best fit their organisational capabilities, as well as their strategic and financial objectives. In doing so, they have unconsciously adopted a feature that is common to many modern CVC programmes – organisational best fit.

Investment Activities

This very organic and tailored approach could easily be mistaken for trial and error; instead, though, it displays a very sophisticated approach and gives insight into the culture of ARM where R&D is the source of its competitive difference. As Dimelow describes, it was very much a learning process on all sides:

As an example we made an investment in 2009...with the goal of keeping an eye on how the team and their technology developed in the market... Our rationale originally was to keep an eye on the technology. We thought the team was pretty good... That helped us make other decisions, internally and externally.

It was also the opportunity to understand their business ecosystem better:

We did an investment in a start-up in the server space. We had no presence in the server market and we wanted to simulate ARM partnership to start thinking about how we enter that market.

To ensure company strategy stays at the heart of investment decision-making, ARM utilises a small but high-powered executive team comprising the CFO, CTO and the VP of Strategy. Together, this group aims to ensure investments have a strategic rationale but remain financially viable. In keeping with this close-knit approach at executive level, the investment team itself is small. Only a handful of investment, technical and financial specialists are spread between the US and the UK, primarily making investments in these regions, though there is some limited exposure in Asia.

As would be expected with an investment approach based on the development of a business ecosystem, ARM starts by building out the closest parts of their business ecosystem such as direct suppliers, supply chain, chip fabricators and original equipment manufacturers (OEMs). Having considered opportunities within this group, ARM will look further afield as a way of tracking future business challenges:

Provisionally, we'll think about things that are close to our technology roadmap; outside the divisions we might look further afield to things that are genuinely truly exploratory and potentially disruptive.

Corporate Interactions

A challenge for any young CVC programme is the ability to survive and thrive once the original sponsors of the programme have left the company. With the recent departure of founding CEO Warren East, ARM may have faced similar challenges were it not for a number of key aspects of the programme, all of which are outgrowths of the relationship with the parent.

The first was the evolutionary nature of ARM's move into CVC; because companies within their business network were already approaching ARM seeking investment, the rationale for becoming involved was made simple. Provided it continues to make strategic sense and is conducted with financial discipline, this evolutionary approach will remain a key characteristic of the programme.

The second aspect of the programme, aimed at ensuring longevity, is in part driven by internal business units, as Dimelow says:

We have attachment to business units to make sure we're getting the feed out from the BUs and they're clear on what they want.

The third key aspect is the effective use of talent. ARM doesn't remunerate staff through carried interest, but as with a private VC firm, it selects staff from its business units to act as board advisers for its investments. These actions ensure not only the most beneficial application of vested interests, but it creates close relationships to its own business units whilst maintaining staff motivation.

The fourth and final method of integration is the use of the small but senior investment committee described previously. The high level group is not only able to make decisions that are in the best interests of the whole company, their senior positions ensure the compliance of the whole organisation during the early stages of the relationship with the investee business.

Summary

As one of the UK's most successful technology companies, ARM proves that CVC is within the capabilities of UK companies should they choose to get involved. Their model of adaptability and working within existing skill-sets provides a case study for other corporates looking to commence their own programmes.

CVC Profiles

5.

Unilever Ventures

Overview

The creation of Unilever Ventures (UV) in 2002 was the result of a set of strategic decisions taken at executive level. At the time, then CEO Niall Fitzgerald was aware that existing models of organic growth were struggling, and conditions in the M&A market made for an expensive route to growth. Unilever had also observed the rapid rise of the Internet as a source of business disruption and was interested to see whether these developments could translate into consumer products, as John Coombs of Unilever Ventures explains:

Unilever Ventures was set up in a belief that Unilever was very good at its core business model of boxes on supermarket shelves with TV advertising, but if there were different business models involved that Unilever wasn't very familiar with; it needed new capabilities.

To help provide these new capabilities, UV was created as a direct investment unit beneath a wider umbrella unit, Unilever Corporate Ventures (UCV), which acts as an LP investor in a number of venture capital and private equity funds such as US-based fund, Phisic Ventures, as well as to UV itself.



Quick Facts

Name:

Unilever Ventures

Coverage:

US, Europe, Asia and India

Financing Method:

Off-balance sheet, 5yr allocations, direct investments

Sector Focus:

Food and beverages, personal care, business support (eg. Marketing); Sustainability

Stage Focus:

Seed to A Round

Typical Initial Investment:

\$100,000-\$10mn

Typical Equity Stake:

>20%

Unilever Ventures

Investment Platform Characteristics

The first thing to note about UV is that it doesn't operate as a fund. Instead it operates via fixed capital allocations to be invested over a 5 year period; investments themselves are made off the balance sheet. Over the last 10 years UV has had €600m in committed capital and it has recently agreed its latest allocation of €350m. This allocation comes as emphasis shifts away from fund investments towards more strategically aligned direct and co-investment

Along with the gradual shift in investment strategy, UV has expanded the geographic reach of its investment activities – beginning in Europe, potential investments in the US and Asia are now very much on the radar for the investment team. This expanded geographic range commenced in 2011 in line with Unilever's growth focus on emerging markets.

Investment Activities

The investment thesis behind UV has evolved as the organisation has matured and technology itself has evolved; over time the capability of technology (especially) has become highly beneficial to fast moving consumer goods (FMCG) companies like Unilever. Today UV investment activities focus on three main areas. The first is a combination of its core product capabilities: Personal Care; and Refreshment and Foods that promote healthier lifestyles. The second is business support; Unilever are renowned for their highly evolved marketing capabilities, so investments in digital marketing start-ups enable both the ability to maintain a lead in this area as well as provide sight of new trends and capabilities driven by technology. The third area of focus surrounds Unilever's stated commitment to business sustainability; UV therefore invests in technologies that enable Unilever to reduce its own reliance on input resources such as chemicals and water, as well as technologies which enable more effective recycling and reuse of these chemicals.

Within these reasonably tight sectoral parameters, UV invests across the range of investment stages – from start-up capital of €100,000 upwards to over €10m depending on the opportunity and stage of investment. UV will also typically make follow-on investments where the opportunity presents itself. In most cases UV takes a significant minority or majority stake along with board representation.

Corporate Interactions

Unsurprisingly given its alignment with the strategic needs of Unilever, UV has a very close relationship with the parent company. Beyond focus on sectors, this relationship is manifested in two key ways: through the tight alignment with the various business units; and the integration with overall corporate R&D. The former of these is made clear through the choice of UV's investment sectors and provides a number of advantages, from close alignment with corporate strategy to the deployment of UV investment managers to assist the due diligence processes. It also enables investment companies to benefit from high quality advice coming from the parent, allowing start-ups to harness their potential for innovation whilst enjoying access to the range of Unilever's business capabilities. At the R&D end, the integration allows the parent company to learn new processes and technologies to apply back into the

main business, as well as give corporate R&D a lens on future innovation. The existence of UV further benefits the parent company as it allows a funding source for spinout businesses from within corporate R&D.

The strategic role of the venturing unit then is very clear, but it takes a particular skill set to deliver these benefits. For this reason, Unilever Ventures' talent policies begin to look far more 'venture' than corporate, and were born out of a very pragmatic logic. The belief was that the venture unit would be unable to attract talent without venture style incentives and a carried interest structure, and furthermore if internal staff were trained to do VC work, they would be targeted for recruitment by independent VC firms. Unilever's investment in their development would be lost. Therefore the heart of UV's talent policy can be pinpointed to allowing investment managers to make their own investment decisions and providing them with a carried interest incentive. In this way the 10 person Unilever Ventures team sits apart from the corporate parent; however with the close integration provided through relationships with the business units and corporate R&D, the chances of internal conflicts are mitigated.

Summary

For some corporates, CVC investment occurs in sectors with a rather narrow focus; however given the sheer scope of Unilever's business, the breadth of UV's remit is substantial. Understanding their investment rationale should enable many other corporates to realise precisely how valuable CVC investment can be in providing a window on future market threats and opportunities.

CVC Profiles

6.

BP Ventures

Overview

BP corporate venturing started in the mid-2000s as BP sought to expand its reach into alternative and renewable energy. The initial focus of the ventures team was biosciences and the application of biosciences to energy, particularly the development of alternative energy and fuels. To achieve this, on-balance sheet investments were made indirectly via funds which focused in these areas, and directly into businesses such as SGI Synthetic Genomics and Mendel. These investments sat within BP's central technology group with the intention of providing a greater understanding of, and capability in, biofuels and bioscience – comprising part of BP's wider innovation portfolio.

Around late 2008 and early 2009, SGI Synthetic Genomics and Mendel became the core of a new investment entity called Alternative Energy Ventures (AEV). Its primary aim was to make venture-style investments into alternative energy start-ups in support of BP's Alternative Energy business. Areas such as renewables, carbon capture and storage (CCS), as well as energy efficiency technologies were the focus. This move was taken as a pre-emptive action to manage future uncertainty; with so many technologies in these areas it was unclear which ones would emerge successfully. Therefore, in the face of such uncertainty it made sense for BP to spread technology risk. Highly active during the period 2009-2011, AEV made around 15-20 investments in total.

In late 2011, AEV rebranded to become BP Ventures, primarily as there were many investment opportunities in the core upstream and downstream areas of the business that looked attractive yet didn't fit within the AEV umbrella. Two investments made in 2012 were cases in point: one was in drilling and completion technology; and the other in the potential of biosciences in the degradation of heavy oils, reflecting the broadening of BP Ventures' remit in support of core BP businesses.

Today BP Ventures has 35 active investments, 29 of which are direct investments in companies; with \$190m of committed capital.



Quick Facts

Name:
BP Ventures

Coverage:
Global

Financing Method:
Open ended, on-balance sheet, direct and indirect investments

Sector Focus:
Energy (hydrocarbons and sustainability)

Stage Focus:
B Round (typically)

Typical Initial Investment: >\$5mn

Typical Equity Stake: <20%

BP Ventures

Investment Platform Characteristics

The investment platform has evolved over time, but three core principles remain unchanged:

- Investments are primarily for strategic value, with a returns hurdle;
- BPV is not a fund, and all investments are on balance sheet;
- Investments are minority (typically less than 20%) with the expectation of an exit.

Like many CVCs, BP Ventures conducts its investments on a continuum between strategic impact and financial return, although (as referenced above) compared to many other CVCs its position is further towards the strategic end of the scale. This is not to suggest that it does not work to a financial imperative, rather that the impact of financial decision-making is focused on ensuring the unit is financially viable rather than the expectation of VC-style multiples on returns. Dominic Emery of BP puts it this way:

Having a returns boundary condition is key to keeping us – and the company – honest on the realism of their financial outlook.

Investment Activities

The industry sector investment activities are made across a broad range of opportunities in the energy sector – from exploration through to production, refining, chemicals, lubricants, as well as alternative energy opportunities. Unsurprisingly, given the global scope of BP itself, BP Ventures is also a global investor, and the typical requirements of achieving commercial scale in the industry means that many of BP Venture's investments start at B Round, with more limited seed and A Round funding. Emery again:

We will usually invest in support of our core businesses, but there are a few examples where a technology could be so disruptive to our business models, that we invest to understand its potential (or otherwise).

Corporate Interactions

The interaction of BP Ventures with the BP businesses is critical. The first key area of interaction is strong advocacy within the BP parent, through both the business and technology lines.

The second area of interaction between CVC and corporate strategy has always been a close one. From the origins of the programme as AEV through to BP Ventures today, a common “spine” has run through the relationship: beginning with its strategic links to corporate R&D, through to its focus on the needs of the core business, to ensuring flexibility to align with the direction of BP corporate.

The final key area of interaction has been the approach to talent and staffing of the programmes. From the very beginning, BP has understood that creating a venture programme from scratch would require the development of essential skill sets where little existed previously. As a consequence, its early recruitment policies, its initial investments into keystone business and its involvement as a fund level investor were all actions taken with the development of capabilities

in mind. This approach required a greater number of people to be brought in from outside the organisation to establish the programme. Over time though, the mix of BP insiders has increased as the required skill sets have become embedded within BP Ventures, and as a result of BP's remuneration structures. Somewhat unusually for the CVC world, BP Ventures does not use typical remuneration models such as carried interest to incentivise staff. However, the rotation policy with the BP parent ensures that there is an available supply of capable talent coming through the programme, ensuring a continual reinforcement of links between BP the parent and BP Ventures, helping to ensure the longevity of the programme:

In the early years of the Ventures organisation we found that we were unable to provide a clear career path for team members, and we had a high attrition rate. Now that a ventures role is seen as part of wider career development, we have had no leavers, and in fact have added to the team.

Summary

The existence of a powerful strategic rationale is a key feature of CVC investment practices and BP Ventures has shown a tight alignment with corporate strategy throughout the last decade. Many corporations could benefit from this approach, however most do not have the resources to enable them to absorb challenges such as balance sheet consolidation. BP's commitment to innovation points the way to the opportunities available should accounting rules be reconsidered.

CVC Profiles

7.

Castrol innoVentures

Overview

Despite being part of the same organisation, BP Ventures and Castrol innoVentures operate as different investment entities. The catalyst for the creation of Castrol innoVentures (innoVentures for short) was a moment of insight gained during a strategic review between the head of strategy for the automotive manufacturer, BMW, and the board of BP in 2010. BMW presented its vision for the future of the automotive industry, including its response to growing consumer demand for the electrification of vehicles. Inspired by this vision, BP realised the pace of change would create opportunities for innovation, in particular, for parts of the BP portfolio such as their lubricants offering, Castrol.

Following the review, an internal Castrol project was set in motion with the objective of harnessing opportunities for innovation. During an intense three to four month period, Castrol engaged a number of key customer groups across a range of business ecosystems spanning the geographic reach of the organisation – effectively from Shanghai, through Europe to California. Out of this investigation, innoVentures' objective was established – the team was to create new businesses to fit with the lubricants business of BP, yet which stretched beyond the heritage of lubricants products. In practical terms this meant investment in businesses and products in adjacent markets, and exploration of opportunities to take a broader approach to innovation. Methods applied would include: organic business creation; business development; a mixture of licensing insights; in-licensing or out-licensing; and finally use of venture investment methods. This final tool was vital for helping to accelerate both internal investments and the creation of new technological capabilities.

Within just six months, innoVentures had compiled the strategic objectives of the program, the operational methods that would be deployed to achieve these objectives, and finally the financial commitments that would be required to back the operations in the first few years. Staffing of the unit was complete by March 2012, allowing team members to develop their own understanding of the business environment and technologies most needed by customer groups. The first investments began later in 2012 and comprised both direct investments into businesses, as well as indirect investments into funds.



Quick Facts

Name:
Castrol innoVentures

Coverage:
Global

Financing Method:
Open ended, on-balance
sheet, direct and indirect
investments

Sector Focus:
Materials; Engineering;
sustainability tech;

Stage Focus: A & B
Round (typically)

**Typical Initial
Investment:**
About \$2mn

**Typical Equity
Stake:** <20%

Castrol innoVentures

Investment Platform Characteristics

Given the range of operational methods deployed, innoVentures is best described as a corporate venturing unit, though corporate venture capital is only one of the tools they deploy. Given their capabilities, the group prefers to focus on direct investment; however, if the volume of quality direct deals proves insufficient, indirect fund investments are deployed.

Allowing for flexibility, the financial commitment to the unit's activities is not fixed, however in practice it is around \$100m over four years. Within that four year cycle, annual allocations are broken down, and investments are made off-balance sheet.

Although the overall objectives of the unit are strategic, investments are made subject to financial hurdles. The logic behind this is straightforward; investments made in one area will result in a lack of investment in another, and so a financial rationale must be provided. As Jonathan Tudor of innoVentures explains it:

Consider BP as a whole. If we're going to build a new petrol station somewhere the economics of that are pretty clear and well understood for us; as we've done it so many times before, we know what the IRR and multiple returns are going to be. So we need to demonstrate, at least on paper, that we know the returns are going to be better than that.

Strategic returns are measured on a case by case basis. Tudor cites two examples that give an idea of the breadth of innoVentures' scope as well as its methods for identifying opportunities. The first is an investment in a North American repair parts business; Castrol made this investment with the aim of closing a knowledge gap. The repair parts business' customer base is independent auto repair shops and is an area in which Castrol can apply its deep knowledge of branding and positioning. In return Castrol is able to gain an understanding of successful digital marketing tactics. The second example is potential investment in a Chinese business which seeks to recycle engine oils more efficiently. This is an example where the demand for capability has not originated from within Castrol, but investment potential has been galvanised by to the technology's future applications.

Investment Activities

Castrol innoVentures' investment activities are separated into four technical categories: Next Generation Engineering; Responsible Castrol; Smart Mobility; and Intelligent Operations.

'Next Generation Engineering' is focused on the hardware of engine and drive-train, seeking technologies that will improve performance and efficiency. The types of technology considered here include kinetic energy recovery systems deployed during braking.

'Responsible Castrol' seeks technologies that focus on sustainability such as the electrification of vehicles, the use of digital technologies to enhance performance, road safety, or fuel efficiency. innoVentures recently closed a seed round with a business called Peloton which allows heavy articulated vehicles to run in convoys to enhance fuel efficiency.

'Smart Mobility' seeks technologies which provide a customer-centric approach to car care. This is based on the insight that customers spend far more on their vehicles than purely for purchase and disposal and that aspects of service and repair are often considered daunting. innoVentures considers technologies which allow customers to take more control of the service and repair aspect of their vehicles by using existing mobile technologies that are more familiar to customers.

'Intelligent Operations' aims to maximise the capabilities of Castrol's supply chain through improvements in operational efficiency; a key area of focus is the use of data analytics.

As a result of its concentration on emerging technologies, innoVentures has a natural fit as an A and B Round investor, with follow-on a natural consideration. Their sweet-spot for first round investments is around \$2m in capital – though the example of Peloton indicates that seed stage investments below \$1m are also considered. It is likely that businesses at this stage will be pre-profit, yet showing growing revenues. innoVentures will look to take stakes of around 15%, though will go beyond the 20% threshold in certain circumstances. An observer seat on the board is a minimum requirement.

Geographically innoVentures is able to utilise Castrol's global coverage, so is able to cover investments from Shanghai to Palo Alto.

Corporate Interactions

Alignment between innoVentures and its corporate parent provide it with a practical blend of trust and flexibility. The majority of the innoVentures team come from within BP and many back office functions are managed by BP. These relationships allow most interaction to occur over email. The flexibility is provided by the management structure – due to the sheer size of BP, excessive oversight would be counterproductive, so a large degree of oversight for investment decisions is delegated to the investment team. Provided investments are made within a strategic remit, and financial hurdles met, there is little pushback from BP corporate.

Summary

Castrol innoVentures provides an excellent case study of the financial trade-offs that are required for CVC programmes – capital invested in CVC cannot be allocated to safer, more predictable outcomes. Yet as innoVentures shows, the capital invested into CVC can have beneficial outcomes not just for the parent corporation itself or the investee, but for aspects relating to the sustainability of the economy.

CVC Profiles

8.

Cisco

Overview

Cisco's corporate venture capital activities have evolved over the last twenty years and are a natural consequence of the company's innovation strategy which is comprised of three different elements:

- Build – Cisco's own R&D activities
- Buy – Corporate M&A
- Partner – The creation of joint ventures and equity investments

This final aspect is based on Cisco's desire to develop its business ecosystem through the creation of lasting business partnerships, and whilst Cisco does not have a separate CVC function, 'Partner' is a natural fit with the objectives and activities of CVC. Interestingly, Cisco combines the partnering activities with its M&A function in a group simply known as Corporate Development (Corp Dev) and readily undertakes direct and indirect investments depending on the circumstances.

This variation on direct versus indirect investment activities grew as a result of the developing role of the Corp Dev team itself. Initially the team was based at the company's headquarters in San Jose, California, making direct investments into North American businesses only. However, as Cisco went from having several million dollars in revenue to several billion dollars, and the US became a more developed market, it became clear that Cisco needed to expand its scope. Cisco began by making indirect investments in new regions as a presage to an expansion of the direct activities of the Corp Dev team. The first target for expansion was Europe, then India and China. Alongside their investment activities these offices also aim to build partnerships with other local investors like VCs and institutions such as government.

Investment Platform Characteristics

The equity investments undertaken by the Corp Dev team are highly strategic and aim to build out Cisco's business ecosystem through the creation of new entities, and on very rare occasions, feeding the company's M&A activities.

Quick Facts

Name:

Cisco

Coverage:

US, Europe, India, China, LATAM, Russia

Financing Method:

Open ended,
Off-balance sheet

Sector Focus:

Typically technology in industries adjacent to Cisco's existing business

Stage Focus:

Typically B Round, occasionally A Round

Typical Initial Investment:

\$2-5mn

Typical Equity Stake:

<20%

Castrol innoVentures

The decision to make direct or indirect investments is based on geographic capabilities. In regions where Cisco has a presence such as North America, Europe, India and China, they prefer direct investments; in other regions where Cisco does not have a presence, such as Russia and Latin America, they will invest indirectly as an LP into a local specialist fund.

The investment capital itself comes from Corporate, with business support provided by one of the business units (known internally as the 'Executive Sponsor'). Ultimately the P&L from the investment entity will sit with that BU.

Investment Activities

Cisco's CVC activities allow it to track technology in areas adjacent to their own capabilities, as well as those developing in niche areas. When making equity investments, Cisco will typically try to partner with one or more leading financial VCs who will lead the investment, though in a small percentage of deals Cisco will lead terms instead.

As a preference, Cisco will prefer to seek a licensing agreement, so the rationale for an equity investment must be strong. If the decision is made to take an equity stake, a number of circumstances must be met. Firstly, the target business will need to have secured its first major customer or have cleared validation trials as a service provider. Secondly, the investment sweet-spot will need to be at around \$2-5mn for a first round investment. Thirdly, the equity stake taken is likely to be a minority stake of less than 20% of equity.

In recent years Cisco has started to expand to a broader range of deals, and today will consider what it terms 'team-based' deals, meaning those where the technology is not as closely aligned to Cisco's current capabilities but in which the company may take an interest in 5-7 years. In such cases Cisco will look for an A Round investment with a financially-focused VC. Cisco manages to avoid some of the problems of misalignment that come with co-investing with VCs, the first of these surrounds growth expectations over time. Here Cisco mitigates by ensuring they work with VC partners who have plenty of category experience, as Pratima Aiyigari from Cisco explains:

There are stories of some problems with growth expectations out there, but I personally haven't had any. We need to work with VC partners who understand the issues facing potential investment targets before we invest. For example the service provider businesses – the cycle of getting through procurement for service providers is very long. So we look for a VC who has experience in this area so knows how long things can take. This helps to mitigate potential issues of misalignment over time.

A second challenge is the alignment of Cisco's own strategic investment rationale with a VC who is more focused on financial returns. Here Cisco resolves the problem – as the strategic partner, Cisco is able to help provide both strategic advice and a source of business growth. This leads to increased revenues and ultimately to an increase in value for the company. The success of these deals means that Cisco has strong working relationships with VCs and each provides referrals of potential investments.

Summary

That Cisco has not sought to establish a separate entity to manage equity investments shows the degree to which CVC activities are an integral part of the company itself, though this will not necessarily be the case for every business with a CVC program. The lesson to learn from Cisco is in its deliberate efforts to engage with investment partners like VCs, whether as co-investors or as LPs. Understanding the need for working with partners who have aligned interests despite their differing objectives allows Cisco to operate effectively on today's deals as well as build effective and productive partnerships for tomorrow's deals.

CVC Profiles

9.

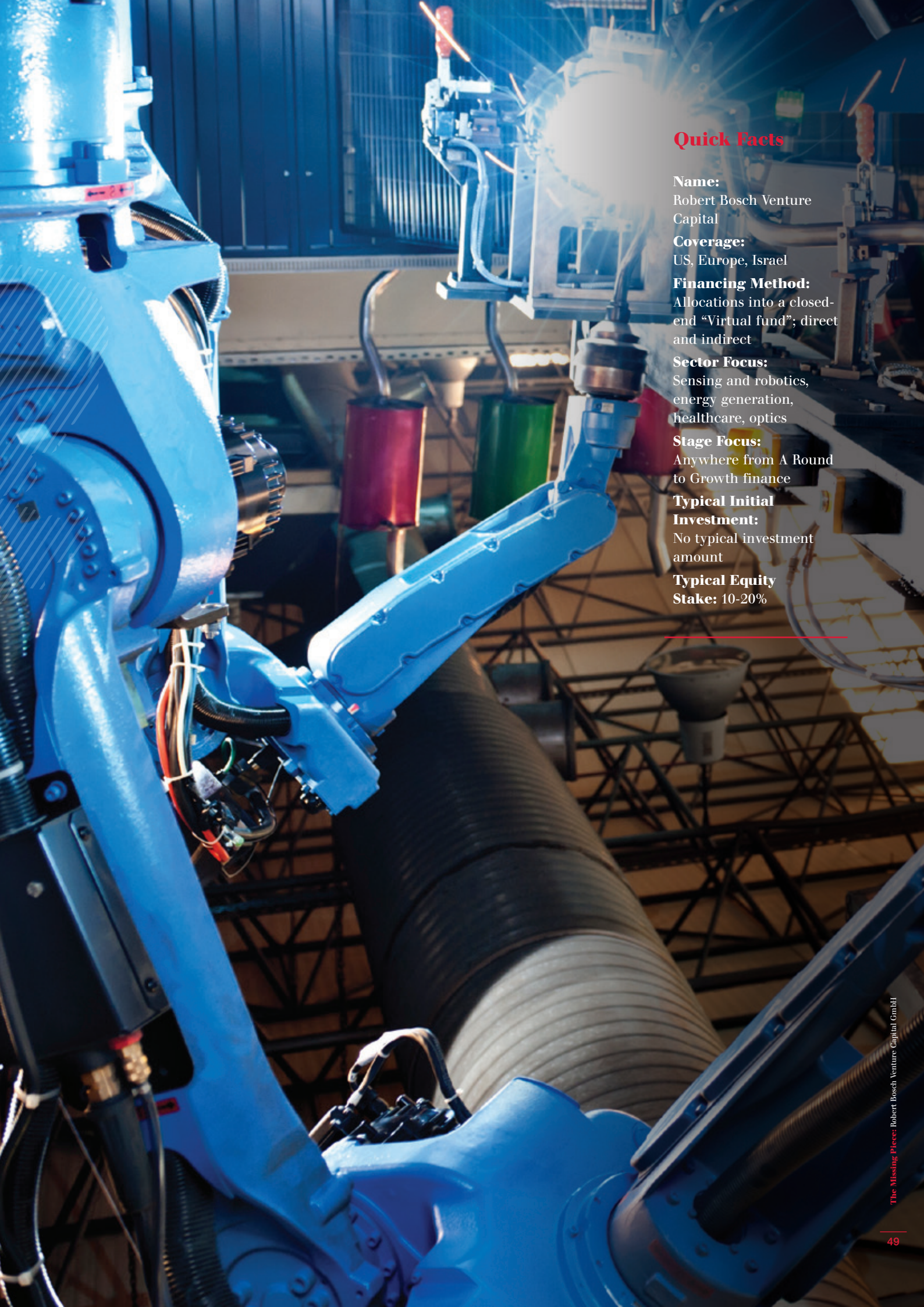
Robert Bosch Venture Capital GmbH

Overview

Robert Bosch Venture Capital GmbH (RBVC) was established in 2008 following an extensive background study into the subject by a team led by Markus Thill – now one of two Managing Directors of RBVC. Thill came to Bosch with extensive experience of both VC and CVC dating back to the 1990s and believed that the CVC model based on bringing external innovation to the corporate would provide an excellent fit for Bosch, allowing it to meet both opportunities and threats emanating from the start-up world. Like many CVC units, RBVC was created with strategic objectives in mind. It rationalised that there was little point creating a unit based on a solely financial rationale – given that even if the unit had a €100-200mn fund producing a net IRR of 20% it would make little impact on the free cash flow of a €50bn revenue company like Bosch. So the benefit to the organisation was less the five or six direct investments made each year and more the ability to provide a view on interesting start-up technologies around the world.

Investment Platform Characteristics

Bosch corporate is the sole investor into RBVC, with a fixed allocation of funds over a set period of time, effectively allowing RBVC to operate as a virtual 'fund'. The allocation is delivered in lump sums of around €50mn per annum during the three to four year investment period at the start of the 'fund', equating to a fund of roughly €150-200mn. This operation of a virtual fund allows Bosch to benchmark the performance of RBVC against not only other CVCs but other private VCs as well, an indication that although strategic benefit is important, value for money and return on investment are expected. As Markus Thill explains:



Quick Facts

Name:

Robert Bosch Venture Capital

Coverage:

US, Europe, Israel

Financing Method:

Allocations into a closed-end “Virtual fund”; direct and indirect

Sector Focus:

Sensing and robotics, energy generation, healthcare, optics

Stage Focus:

Anywhere from A Round to Growth finance


Typical Initial Investment:

No typical investment amount

Typical Equity Stake:

10-20%

Robert Bosch Venture Capital GmbH



We need to aspire at least to be amongst the best funds from a financial perspective because otherwise why would people want to co-invest with us or why would an entrepreneur want our money? So in that sense we behave like a normal VC in the marketplace, and our shareholders ask us also to benchmark ourselves not just against the best CVCs but also against the best VCs.

Where RBVC does behave more like other CVCs is the degree of leeway provided for delivering strategic return. Although the lifespan of the virtual fund is officially ten years, managers are allowed discretion to extend this period to ensure their investments are given the best opportunity to come to fruition. This has its advantages and disadvantages, as Thill says:

... we would not abandon a company which we believe has high potential only because on paper it's now the 12th year of the fund's lifetime; the only bad news is that we'd be punished on the carried interest side.

Investment Activities

RBVC describes itself as a “balanced stage investor”, meaning that although it will happily make direct investments at A Round, it is also comfortable investing at B Round and the growth rounds beyond. Also, the unit makes a mixture of both direct and indirect investments with a 2/3 majority of these direct. Direct investments typically involve stakes of 10-20% in order to take a similar stake to other balanced stage VC investors, and provide the opportunity to work with other board members.

Geographically, at present RBVC is invested in businesses in North America, Europe (including the UK), and Israel, and are considering investments in Asia. But the company's deal-flow stretches beyond these regions and even as far afield as Australia and New Zealand. The objective of this extensive deal-flow is to provide a window on potential opportunistic investments into start-ups with relevant new technologies. Such opportunities – around 1,000 per year are reviewed by RBVC for a potential investment or other collaborations with the Bosch group and decisions are made by internal Bosch units on more than 150 of those opportunities on whether commercial relationships, such as licensing or joint development agreements are appropriate. Beyond this internal rationale, investments must have potential to be profitable over time, and must of course enable RBVC to maintain its own high standards of financial performance.

When considering its strategic mandate, RBVC considers a diverse range of sectors, though they fall into a number of clusters. The first surrounds automation and control. This could include Microelectromechanical Systems (MEMS), power electronics and robotics – areas that require a high degree of hardware capability. The second cluster is “Local Energy”; this does not involve large power plants but rather mobile or stationary localised energy technologies such as smart micro-grids, or generation, distribution, storage and efficiency solutions. The third cluster is something RBVC calls “Enabling Technologies”, which includes areas such as technologies enabling the “Internet of Things and Services” other technologies, for example those

around the convergence of physical and IT security. Some examples of this are a Holographic Laser Projection (HLP) technology for small and portable solutions, based near Cambridge (UK), and another of their UK investments, an infrared sensing company in Edinburgh.

The final cluster surrounds health, with the basic rationale of creating more cost-effective and efficient healthcare systems, an example of which would include a non-invasive cardiac output and hemodynamic monitoring system using proprietary technology.

Corporate Interactions

The internal and external relationships between RBVC and other Bosch units as well as the larger VC ecosystem is deliberately strong – they rationalise that it is impossible to derive the sort of strategic and financial returns required without deep links. Of the fifteen investment staff, roughly half are hires bringing with them VC industry and wider industry knowledge, and the other half come from within Bosch. Everyone in the team from partner-level down has at least ten years of industry experience; this is important for forging trust with stakeholders both within Bosch and the wider industry. The strong internal links enable RBVC to be in a better position to mitigate the challenges in areas such as corporate compliance that come with straddling the world between private VC and corporate R&D.

Summary

This profile is yet another example of the variety of investment models deployed by corporates as they pursue their investment objectives. Whilst it is not a route many CVCs have pursued, RBVC deploys a “virtual fund” model with the intention of maintaining the tough financial accountability of a private VC whilst also ensuring that the usual rules of corporate compliance and strategic rationales are met.

Policy Recommendations

After a slow start in the 1980s and 90s, policymakers have made rapid strides over the last fifteen years by creating policies that have incentivised private venture capital, and encouraged corporate investment in development facilities. The result of this enthusiasm has been a range of policies that encouraged private investors to fund SMEs, and saw ever more corporates build facilities to support SMEs. The missing piece of the puzzle, however, is policies which make a compelling case for corporates themselves to invest in SMEs.

The Government has previously been supportive of corporate venturing activities via the Corporate Venturing Scheme⁷ (CVS) which was introduced in 2000 to an initially positive reaction from corporate investors; 74 companies received a total of £18mn in its first year alone. However like so many venturing activities, the CVS suffered with the bursting of the Tech Bubble, investment fell to £8mn by 2006-07. Though investment activity actually *climbed* during the recent financial crisis, the scheme was not renewed in 2010 following a parliamentary select committee recommendation, and nothing has replaced it since. A report in July 2012 from the RSA⁸ recommended the reinstatement of the scheme though with improvements to terms such as levels of investment and levels of corporate tax relief, bringing them into line with current corporate investment practises. Such updates would allow historically strong corporate balance sheets to be unlocked and there's certainly the capacity to invest in corporate venture capital.

However, the reinstatement of the CVS would only address part of the problem. Of wider significance are those areas identified during the interviews for *The Missing Piece*. As the profiles show, there is great diversity in the CVC programmes. However, this is not the case when interviewees discussed areas for policy improvement. Instead there was a high degree of consensus. Whilst areas of direct fiscal intervention such as the CSV are appreciated, the consensus amongst interviewees is that two underlying areas need to be addressed. First, the need for policymakers to understand SMEs and their investors; and secondly, specific policy areas where action is required, including accounting rules, investment incentives, development of regulations, and policy areas which enable a more dynamic investment environment:

Knowledge

In recent years great strides have been made by some Government departments to better understand the new capabilities of new technologies. Prominent examples include the revamped GOV.UK website; efforts to open up Government data to public scrutiny; the expansion of the role of UK Trade and Investment to push the case for UK business; the use of behavioural economics in policy development (the so-called Nudge Unit); and greater engagement with high tech communities across the UK. The common thread running through each of these is the importance of placing the customer, user, citizen or business at the centre of policymaking and Government activity.

7. For details of the now-defunct Corporate Venturing Scheme visit: <http://www.hmrc.gov.uk/guidance/cvs.htm>

8. Mawson, J., 2012 Corporate Venturing in the UK. The RSA

When applied to the challenges cited by the CVCs profiled, two areas emerge where knowledge-development is essential:

Put SMEs First

Applying this user-first thinking to understanding SMEs can derive enormous benefits. SMEs seeking equity investment have very particular needs; for Government to develop effective policies surrounding growth investment, they must first begin to develop policy that considers these needs. Although the Government has expressed its desire to have corporates become more active with the cash on their balance sheet, the existing policy framework discourages many from early stage corporate venturing. In the current market place for investment in high risk, high growth SMEs, corporates invest at a distinct disadvantage to other forms of private capital such as angel investors and private venture capital, both of whom gain advantages via accounting rules and other regulations (see over).

The most straightforward, short-term way to resolve this problem is for policymakers to develop policy with the SME's investment needs in mind; SMEs want as many potential investors as possible. By viewing policy with the mindset that puts SMEs first, the fundraising process effectively becomes a marketplace. This marketplace view allows SMEs to seek the source of investment most appropriate to their needs – for example a strategic investor vs a financially-focused investor – without being forced to disregard one investor due to unfavourable regulatory implications.

Get to know CVC

With an SME-first mindset established, it is clear that policymakers should understand all forms of equity finance. In the last decade or so, significant efforts have been made in Government to both understand and support the role of the venture capital community in the UK economy. With this understanding in place, effort should now be directed to building an appreciation of the role of CVC. This report showcases the historical development of the industry (see Appendix) and features a number of profiles in an effort to capture the sheer variety of models of investment practised today. This variety is a consequence of the understanding – gained through many failed iterations – that for CVC to work, it must adapt itself so as to work effectively with the corporate parent. This variety, however, makes the development of policy around CVC difficult. The only solution is to build a thorough understanding of CVC as it is practised in the UK today and to combine this with an appreciation of its role in the equity finance arena. This report can provide policymakers with insights into the areas where these differences lie, but ultimately it serves to provide impetus for a more rigorous examination of the industry.

Policy Recommendations

As the economy moves into a recovery led by consumption and exports, private investment will be required to ensure this recovery becomes sustainable. Corporate investors will become a key pillar in the overall strategy for growth and all policy options that will enable this development should be considered. However any future policymaking must be informed by the realities of CVC in all its varieties, for the unintended consequences of poorly designed policy will hinder growth potential.

Action

Whilst the development of a new mindset may take time to become embedded there are a number of areas where action can deliver tangible benefits. Ranging from advocating new approaches to accounting standards, to delivering a clearer message surrounding immigration, these actions will require a combination of policy change within Government and the need to push for negotiations with global partners.

Harmonise Rules for Venture Investors

Although it is a seemingly technical accounting issue, the single biggest problem faced by CVC investors occurs when they take a stake of 20% or more in a company. Under accounting standards, a 20% stake is generally considered a watershed where two major issues coincide. Firstly, at 20%, investors are seen to exert a 'significant influence' over their portfolio company; and secondly, accounting standards require investors that aren't traditional investment funds to record their share of an investment's profit or loss and equity onto the overall corporate balance sheet. While this threshold is 20%, other factors impacting the power to participate in financial and operating policy decisions may also be considered. As a consequence, in practice this level can be lower. Controlling stakes of 50% or more typically require full income statement and balance sheet consolidation.

In a typical corporate M&A, where one company acquires another established company with a financial track record and an established board, the 20% watershed is an important delineating point. By contrast, in early stage investing and corporate venturing, when an SME has little financial record, few assets and fledgling corporate governance, the imposition of different accounting standards based on a 20% threshold, could be considered rather arbitrary. For a business with perhaps a few hundred thousand dollars in assets, any party making a significant capital injection (CVCs typically invest well over \$1mn) would expect a degree of influence, yet CVCs are forced to take a range of unusual steps to avoid being seen to take significant interest. Other early stage investors such as angels and VCs may benefit from consolidation exemptions available to traditional investment funds which in practice allow for a level of investment more in line with the amount of equity on offer from start-ups seeking venture investment – often around 30%. Further, information on investments presented at cost or fair value provides more meaningful information on the commercial arrangements in place.

This then is the kernel of the problem; whilst both CVCs and other early stage investors are looking to fund SMEs (often in syndicated investment teams), accounting standards treat them differently, creating potential for conflicts of interest. Recognising the need to ensure buy-in from global accounting

standard setters, the solution is to treat CVC investors the same as other early stage investors like VCs and angel investors.

In the meantime, for CVCs and their portfolio companies, the consequences of this inconsistency are substantial:

Carrying Losses

Consolidating balance sheets makes a lot of sense in a regular corporate acquisition; the incoming investment will have an established financial track record and though it may carry debts, will likely have cashflows that will contribute to the group in the longer term. A great deal of consideration will have been placed on the financial and strategic impact to the acquirer's group longer term. A start-up investment, on the other hand, will have little financial track record and, inherently, carry greater risk. It will likely accrue losses year on year and, given the risky nature of early stage investment, may fail. From a corporate venturing perspective, consolidating such businesses does not reflect the commercial reality of the investment arrangement with the corporate.

Forced Syndication

Few CVCs (if any) take stakes of 20% or more in their SME investments. If the SME is offering a stake of more than 20%, the CVC will be forced to syndicate. Syndication itself is not a problem, and there are plenty of academic studies into the benefits it can bring to SMEs. However, syndication should be a *choice* for the investor or SME to make, rather than having it imposed. Imposition can often lead to complexity in management relationships and lack of true alignment of incentives between syndicate partners.

Uneven Playing Field for CVC Investors

Unlike corporate investors, angel investors (including EIS and SEIS investors) and private venture capitalists may benefit from consolidation exemptions when significant influence or control is exerted. Indeed, CVCs will often avoid taking board seats to avoid being seen to exert significant influence so as to retain the ability to consider their stake as 'assets for resale'. The result of both these rules is an unbalanced marketplace for investment and effectively an unfair playing field for investors.

R&D Tax Credits

Recent research by Alvarez-Garrido and Dushnitsky⁹ using a dataset of companies over the period between 1990 and 2011 found that corporate venture backed start-ups are more likely to generate innovation – as measured by patenting activity and other indicators of innovation – than start-ups backed by private venture capital. Clearly then, the research output of CVC backed SMEs is of significant potential, however such SMEs are disqualified from the tax credits because they have taken CVC investment.

9. Alvarez-Garrido, E., Dushnitsky, G., n.d. Publications and patents in corporate venture-backed biotech. *Nat. Biotechnol.* 31, 495–497.

Policy Recommendations

Although for practical purposes they are separate business entities, SMEs with a CVC investment in excess of the consolidation limit will be assessed based on the consolidated balance sheet. This will almost certainly push them beyond the upper limits for employee numbers, balance sheet and revenue. Enterprises who are R&D focused will no doubt take this into account when assessing funding sources, placing CVC investors at a disadvantage.

Strange Bedfellows

If CVCs and VCs do syndicate on an investment, the result is two parties who are not aligned under the same regulations. This places the model of venture investment at risk because the model relies on an alignment of incentives to succeed.

Ownership No-Man's Land

Current accounting standards create odd disincentives – with an ownership stake below 20%, the CVC can value its investment at fair cost value; at 75% or above, the corporate becomes eligible for loss relief on failed investments. Between these two stakes is an unenviable position – according to accounting standards the CVC has enough influence to warrant consolidation, yet is not eligible for relief should that investment fail.

Shutting Out Potential Players

Probably of greatest concern to a government keen to push corporate investment is that the requirement to consolidate losses deters many smaller corporates from engaging in CVC. A larger corporation can absorb losses on their balance sheet relatively easily and with little impact upon their share price. Smaller PLCs, however, do not necessarily enjoy the same capability, thereby deterring a valuable source of potential capital investment.

To solve the problem, the harmonisation of rules for early stage investors is required; however policymakers should be wary of harmonising around the lowest common denominator (i.e. the 20% levels currently experienced by CVCs) which, as we have seen, causes investments to be constrained by non-commercial factors. Instead, we recommend that, policymakers should seek to set rules for consolidation and control that are more in tune with the equity stakes sought by those seeking investment – high growth SMEs. The current rule of thumb for an equity offer at a first round venture investment is about 30%, though this level should be quantified should policymakers choose to address this issue.

Harmonise Incentives for Venture Investors

EIS and SEIS

Although designed to directly benefit start-ups and high-risk growth businesses, the nature of tax relief supplied by these policies in their current form means that entrepreneurs who have previously received EIS and SEIS investment are indirectly disincentivised from seeking further investment because a business will lose its qualification for EIS or SEIS should it come under the “control” of another company. This terminology can prompt EIS and SEIS investors to prevent a qualifying business from even considering CVC investment for fear of losing their tax relief. This lack of growth finance retards the growth of the business. This is not a criticism of the objective of

EIS and SEIS, but is an unintended consequence of how investors utilise these programmes in practice. A resolution to this issue could be to allow EIS and SEIS investors to sell equity stakes to subsequent investors should they choose, or to look at grandfathering relief on existing investments when later investment rounds are made into the business

Make the UK a global centre for CVC

Encourage Corporate Involvement

All of the policy recommendations are designed to encourage greater corporate investment in the UK. The ultimate objective for Government is to get corporates to become involved in as many forms of investment as possible. The efforts of successive UK governments have seen corporates encouraged to build production and traditional R&D facilities, these efforts should be extended to include more technology development facilities like those of Amazon, and Google's Campus which recently set up in East London. These facilities, along with more corporate LP and GP activity should be on every Government investment activity wish-list.

Provide Long Term Assurance

The ongoing uncertainty of the relationship between the UK and the EU presents many challenges for CVCs who regularly invest across borders and for substantial periods of time. Lack of clarity on the result of any referendum on UK involvement in the EU adds further risk on any investments. This affects both those who invest from outside the UK into UK-based businesses, as well as UK-based corporates who invest in UK-based SMEs with the aim of trading with other EU countries.

Build Capability Enablers

Amongst CVCs there is a consistent demand for policies which increase the availability of skilled workforces. Given that almost all CVCs are investors in technology in some form, great concern surrounds the need for the UK to produce a workforce with the knowledge and skills that supports the needs of the knowledge economy. In particular, graduates of Science, Technology, Engineering and Mathematics (STEM) are most in demand, for the R&D departments of corporates and as the valuable employees their venture investments need to achieve their commercial potential.

In line with the need to ensure a good supply of skilled and capable staff are ongoing concerns about current immigration policies and perceptions of those policies overseas. The common belief amongst interviewees was that in a world market with huge demand for STEM workers, policy should make immigrating to the UK simple; they believe more should be done to focus on encouraging highly skilled migrants and tone down the current rhetoric which makes the UK appear unwelcome to all immigrants.

Appendix

Development of CVC

To understand the position of CVC today, it is worth understanding its development since its appearance in the 1960s. In the years that followed, CVC activities have continued at a fairly steady levels of investment, but they have leaped forward during certain periods of rapid development. To date there have been broadly three waves, with an emergence of a fourth wave underway.

First Wave – 1960s-70s

The first wave dating from around the 1960s to the early 1970s was driven by three factors: the need to diversify rapidly growing corporations; to exercise correspondingly healthy balance sheets; and the recognition of the success of the private venture capital model. At this time the primary manifestations of corporate activity focused on external start-ups or employee-based internal ventures, with very few corporations encouraging what we would recognise as spinout businesses with financial and technical support from the parent. The first wave was brought to a close by the twin influences of the oil shocks of the 1970s and the collapse of the IPO market.

Second Wave – 1980s

The second wave arrived in the 1980s and focused on areas such as high technology and biotech. But the development was curtailed by the financial crash of 1987 as risk appetite waned.

Third Wave – 1990s to early 2000s

The third wave arrived in the 1990s, unsurprisingly mirroring the focus on internet based businesses and the phenomenal growth of private venture capital later in that decade. A wide range of corporations piled in, with over 400 technology-focus venturing arms during this period creating levels of investment far in excess of anything seen in previous waves. As with the private venture market, this wave was brought to a sharp end by the Dotcom crash of 2001-02.

Key Development Points

CVC has taken time to develop a role in the innovation process, and as this review of historical developments illustrates, the four main points are:

CVC was pro-cyclical

Corporate venturing followed private VC and was comparatively late to the market; and consequently its ability to make good financial returns was hindered.

CVC was driven by excess capital on corporate balance sheets

The need to deploy excess cash accentuated the pro-cyclical nature of the investments and as balance sheets tightened, venture units were wound up.

CVC was based on a model

Models were typically selected as if from a menu and often bore little relation to the culture or attitudes of the parent corporation. This created an inevitable tension between the two parts of the organisation.

CVC programmes were short lived

As a consequence of the above observations, CVC operations were rapidly wound up in the wake of the collapse of the market, resulting in a loss of experience and organisational learning. This in turn prevented the parent organisation from being in a position to take full advantage of subsequent market upturns.

Fourth Wave – mid-2000 to the present

Bearing in mind the developments of the past 50 years or so, the latest wave differs in some crucial areas and points to a new direction for CVC.

In previous waves, CVCs typically adopted rigid models and structures for their investment units, and although these models have evolved and expanded with each wave, the top CVCs today have evolved further, adopting a tailored approach to better suit their own corporate structures. This individualised approach to CVC means the venturing teams better align with their companies, reducing the potential for internal friction.

Along with this more individual alignment, CVCs now also take a far more long term view, balancing strategic and financial imperatives, not just one or the other as was the case in previous waves. This change in attitude has delivered genuine benefits with many of the top 50 global CVC units boasting impressive track records going back over a decade or more. As a consequence, today the best CVCs find themselves at the very start of the economic cycle, with the funding and capability to exploit this position.

The following sections of this guide detail the methodology used by the top CVCs to develop their own funds, and which can be applied by many other corporations looking to develop resilience in the face of future uncertainty.

Additional Resources

Background on Corporate Venture Capital

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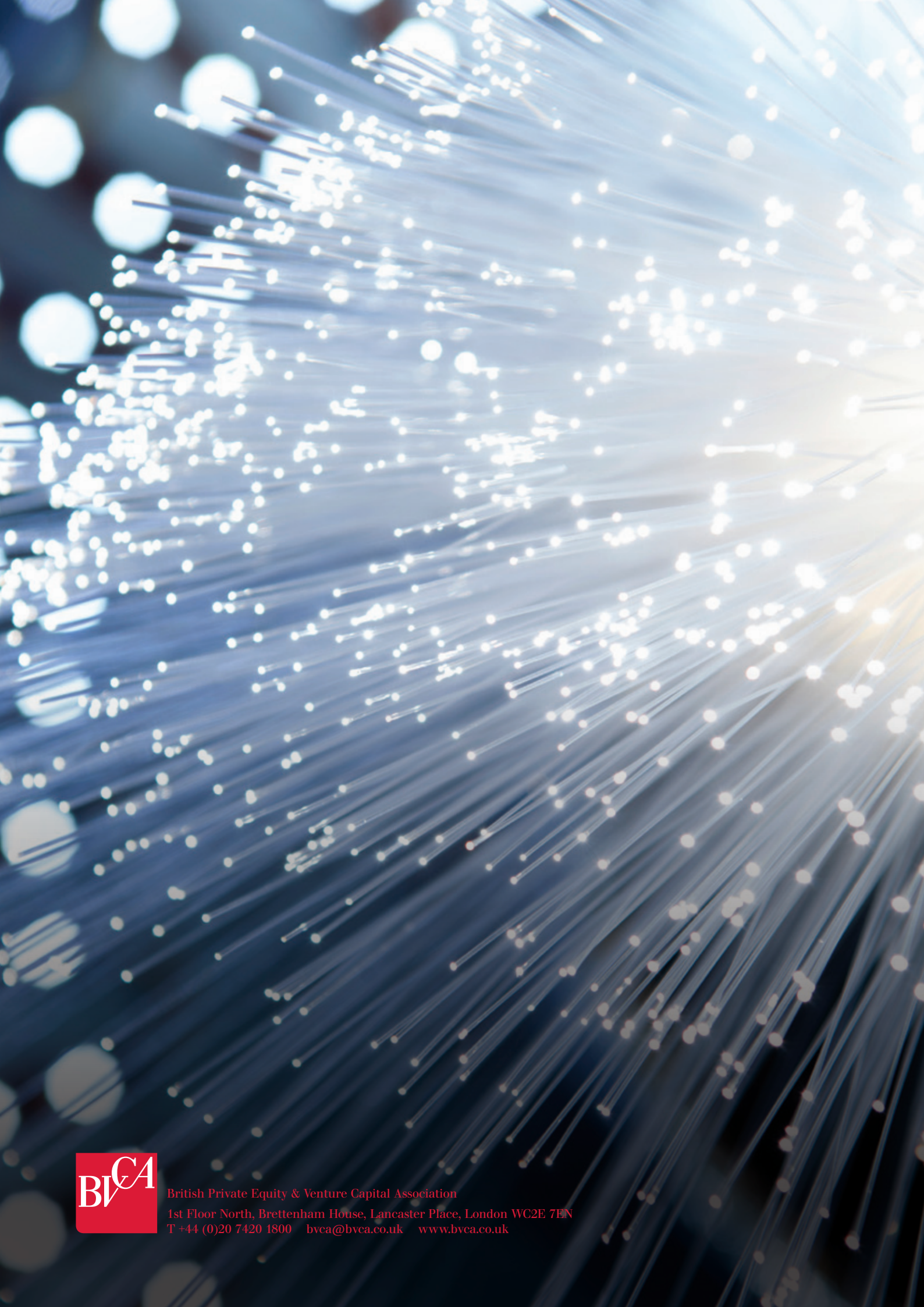
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