Corporate Venture Capital
Managing Equity Investments for Strategic Returns

Study Objective

This brief is intended for companies that are pursuing (or intend to pursue) equity investing in start-ups to realize strategic gains. Although corporate venture capital (CVC) activity may provide agreeable financial returns, companies face several major challenges when managing equity investments for strategic returns. Targeted specifically at the CVC manager charged with directing strategic equity investments, this study addresses the following key questions:

- What tools enable identification of strategically relevant deals? (pp. 11–20)
- What activities facilitate the transfer of strategic value to the corporation? (pp. 21–26)
- How can CVC managers measure strategic returns to the corporation? (pp. 27–38)

For companies contemplating the more fundamental question of whether to initiate strategic equity investing in the first place, this brief includes an appendix that addresses four key launch considerations for determining CVC investing strategy. (pp. 39–47)
Note to Members

This project was researched and written to fulfill the research request of several members of the Corporate Executive Board and as a result may not satisfy the information needs of all member companies. The Corporate Executive Board encourages members who have additional questions about this topic to contact their research manager for further discussion. The views expressed herein by third-party sources do not necessarily reflect the policies of the organizations they represent.

Professional Services Note

The Corporate Strategy Board has worked to ensure the accuracy of the information it provides to its members. This project relies upon data obtained from many sources, however, and the Corporate Strategy Board cannot guarantee the accuracy of the information or its analysis in all cases. Further, the Corporate Strategy Board is not engaged in rendering legal, accounting or other professional services. Its projects should not be construed as professional advice on any particular set of facts or circumstances. Members requiring such services are advised to consult an appropriate professional. Neither the Corporate Executive Board nor its programs are responsible for any claims or losses that may arise from any errors or omissions in their reports, whether caused by the Corporate Executive Board or its sources.
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**With Sincere Appreciation**

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### Special Thanks

The Corporate Strategy Board would like to express its gratitude to the following individuals who were especially giving of their time and insight in the development of this study:

<table>
<thead>
<tr>
<th>Name</th>
<th>Organization</th>
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<tbody>
<tr>
<td>Mr. Jim Bixby</td>
<td>SeQual Technologies, Inc.</td>
</tr>
<tr>
<td>Mr. Brad Burnham</td>
<td>Venture Management Services Inc.</td>
</tr>
<tr>
<td>Professor Hank Chesbrough</td>
<td>Harvard Business School</td>
</tr>
<tr>
<td>Mr. Clinton Harris</td>
<td>Grove Street Advisors</td>
</tr>
<tr>
<td>Mr. Dominic Palmer</td>
<td>Andersen Consulting</td>
</tr>
<tr>
<td>Mr. Kenneth Rind</td>
<td>Israel Infinity Fund L.P.</td>
</tr>
<tr>
<td>Mr. John Taylor</td>
<td>National Venture Capital Association</td>
</tr>
</tbody>
</table>
The Corporate Strategy Board expresses its appreciation to all of the individuals and organizations who have so generously contributed their time and expertise to our work. Their contributions have been invaluable, and we extend our sincere thanks to all of these advisors:

<table>
<thead>
<tr>
<th>Name</th>
<th>Company</th>
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<tr>
<td>Ms. Kelly Battles</td>
<td>Hewlett-Packard Company</td>
</tr>
<tr>
<td>Mr. Richard Birney</td>
<td>IBM Corporation</td>
</tr>
<tr>
<td>Mr. Peter Buhl</td>
<td>Nokia Corporation</td>
</tr>
<tr>
<td>Ms. Katherine Carney</td>
<td>The St. Paul Companies, Inc.</td>
</tr>
<tr>
<td>Mr. John Cayce</td>
<td>United Parcel Service, Inc.</td>
</tr>
<tr>
<td>Mr. George Cooney</td>
<td>Nortel Networks Corporation</td>
</tr>
<tr>
<td>Mr. Clifford Detz</td>
<td>Chevron Corporation</td>
</tr>
<tr>
<td>Mr. Kishore Dhupati</td>
<td>Armstrong Holdings, Inc.</td>
</tr>
<tr>
<td>Dr. Brenda Gavin</td>
<td>S.R. One, Limited (SmithKline Beecham plc)</td>
</tr>
<tr>
<td>Ms. Terry Godfrey</td>
<td>Intel Corporation</td>
</tr>
<tr>
<td>Mr. John Hanley</td>
<td>Lucent Venture Partners, Inc.</td>
</tr>
<tr>
<td>Mr. Michael Holstein</td>
<td>IPALCO Enterprises, Inc.</td>
</tr>
<tr>
<td>Ms. Cathy Hong</td>
<td>United Parcel Service, Inc.</td>
</tr>
<tr>
<td>Mr. Wouter Jonk</td>
<td>Royal Philips Electronics N.V.</td>
</tr>
<tr>
<td>Mr. Jack Klinck</td>
<td>Mellon Financial Corporation</td>
</tr>
<tr>
<td>Dr. Dirk Lupberger</td>
<td>Siemens AG</td>
</tr>
<tr>
<td>Mr. Blake Modersitzki</td>
<td>Novell, Inc.</td>
</tr>
<tr>
<td>Mr. James O’Connor</td>
<td>Motorola, Inc.</td>
</tr>
<tr>
<td>Mr. Jerry Okerman</td>
<td>3M Company</td>
</tr>
<tr>
<td>Ms. Clare Sokolowski</td>
<td>Rohm and Haas Company</td>
</tr>
<tr>
<td>Dr. Brad Vale</td>
<td>Johnson &amp; Johnson Development Corporation</td>
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</table>
THE ARGUMENT IN BRIEF

Observation #1 Propelled by heightened interest in emerging technologies and a strong economy, corporate venture capital (CVC) activity has grown dramatically in recent years. The corporate share of total venture capital spending rose from 2 percent in 1994 to 15 percent by 1999, as the number of companies formally pursuing CVC also increased.

Observation #2 Soaring stock market valuations across the last two years have led a record number of corporations to invest in start-ups for financial gains. Some companies are realizing hundreds of millions of dollars in financial returns through asset-sale contributions to earnings.

Observation #3 Despite this strong financial draw, most companies cite strategic interests as the foremost driver of CVC activity. Those corporate investors primarily pursuing strategic gains usually seek access to technological developments that threaten existing business models and industry structures.

Observation #4 Equity investing for strategic returns, however, presents significant problems for CVC managers. Corporate Strategy Board interviews with more than 25 companies point to three frequently cited challenges: 1) securing strategically relevant deals, 2) transferring strategic value to the corporation and 3) tracking and analyzing strategic gains.

Observation #5 Challenge #1: Securing Strategically Relevant Deals—Inconsistent venture screening methods and investing criteria that lack alignment with corporate strategy can yield fewer strategically relevant deals. As a result, CVC managers must develop a rigorous process to identify ventures that both align with corporate objectives and possess the highest strategic relevance to the corporation.

Observation #6 Challenge #2: Transferring Strategic Value to the Corporation—Operationally focused business units initially tend to lack interest in early-stage start-ups that are not yet prepared to contribute strategic value to the corporation. Consequently, CVC managers bear the responsibility for creating favorable conditions for strategic value transfer between the start-up and the operating units.
Observation #7  Challenge #3: Tracking and Analyzing Strategic Returns—The lack of standard quantitative metrics with which to measure strategic returns and the lag time before realizing strategic gains hamper accurate assessment of strategic performance. Without reliable performance indicators, CVC managers struggle to make informed strategy-based equity management decisions.

Observation #8  Drawing on lessons learned by interviewed companies, this study profiles a group of leading practices that CVC managers can use to address corporate investing challenges. Three sets of activities support an equity investing approach designed to realize strategic returns on investment.

Observation #9  First, Screening for Optimal Deal Selection—Alignment between investment screening criteria and corporate strategy objectives underlies most fruitful deal selection efforts. Successful CVC managers employ screening tools on a consistent basis to winnow the high volume of available deals to those with greatest strategic relevance to the business and the highest likelihood of generating strategic gains.

Observation #10  Second, Facilitating Strategic Value Transfer—Forward-looking CVC managers lay the foundation between the start-up and the operating unit for a future business relationship, which serves as the vehicle for strategic value transfer to the corporation. In doing so, CVC managers pursue activities designed to nurture the start-up and persuade business units of the potential value of a commercial relationship.

Observation #11  Third, Monitoring Strategic Returns—Effective deal tracking methods provide for regular monitoring of strategic returns to support ongoing analysis of equity performance. CVC managers develop a set of customized metrics for each investment to track difficult-to-quantify strategic returns and regularly review deal performance to inform strategy-based equity management decisions.
CORPORATE VENTURE CAPITAL

A Strategic Tool
For decades, companies across industries have pursued corporate venture capital (CVC) investments. Although commitment to equity investing tends to fluctuate along with economic cycles, overall corporate interest persists.

Propelled by heightened interest in emerging technologies and a strong economy, CVC activity has grown dramatically in recent years. The corporate share of total venture capital spending rose from 2 percent in 1994 to 15 percent by 1999, as the number of companies formally pursuing CVC also increased.

**Corporations Increasingly Pursue Venture Capital Investments**

Total Corporate Venture Investments and Corporate Share of Total Venture Investments, 1994–1999

![Graph showing total corporate venture capital investments and corporate share of total venture investments from 1994 to 1999.](image)


**Number of Companies with CVC Programs***

![Bar graph showing the number of companies with CVC programs from 1996 to 1999.](image)

* Data represents companies that have announced the establishment of a formal CVC program.

Source: Asset Alternatives, Inc; Barry, David G., “Corporate Venture Capital Soars, As Funding Hits Record $6.3 Billion,” The Corporate Venturing Report 1, no. 1 (January 2000).
Companies pursue CVC both for the strategic benefits that equity deals can provide as well as the financial gains that can supplement operating earnings. Corporate investors cite two major investing objectives: financial return on investment and a window on technology.

Financial and Strategic Objectives Underlie CVC Activity

Top Reasons for Creating Corporate Venture Groups, 1999

<table>
<thead>
<tr>
<th>Objective</th>
<th>Financial Objective</th>
<th>Strategic Objectives</th>
</tr>
</thead>
<tbody>
<tr>
<td>Return on Investment</td>
<td>56%</td>
<td></td>
</tr>
<tr>
<td>Window on Technology</td>
<td>49%</td>
<td></td>
</tr>
<tr>
<td>New Products</td>
<td></td>
<td>31%</td>
</tr>
<tr>
<td>Acquisition Opportunities</td>
<td></td>
<td>41%</td>
</tr>
<tr>
<td>Improve Manufacturing Process</td>
<td></td>
<td>40%</td>
</tr>
</tbody>
</table>

Soaring stock market valuations across the last two years are attracting corporate investors to start-ups. Some companies are adding hundreds of millions of dollars to the bottom line through asset-sale contributions to earnings.

**Strong Financial Returns Make CVC Especially Lucrative**

Value Realized by Corporations from IPOs of CVC Portfolio Companies, First Quarter, 2000*

<table>
<thead>
<tr>
<th>Company</th>
<th>Realized Value (in Millions of U.S. Dollars)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dell Computer</td>
<td>$855.5</td>
</tr>
<tr>
<td>Motorola</td>
<td>$461.0</td>
</tr>
<tr>
<td>Enron Corp.</td>
<td>$461.0</td>
</tr>
<tr>
<td>Singapore Tech. Group</td>
<td>$400.0</td>
</tr>
<tr>
<td>Microsoft</td>
<td>$368.0</td>
</tr>
<tr>
<td>Nortel Networks</td>
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</tr>
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<td>Omnicom Group</td>
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<td>Staples</td>
<td>$329.4</td>
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<tr>
<td>Amazon.com</td>
<td>$265.6</td>
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<tr>
<td>British Telecom.</td>
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<tr>
<td>Integrated Device Tech.</td>
<td>$239.0</td>
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<td>Intel Corp.</td>
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<tr>
<td>General Electric Co.</td>
<td>$210.3</td>
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<tr>
<td>CBS Corp.</td>
<td>$182.4</td>
</tr>
<tr>
<td>Texas Instruments</td>
<td>$166.5</td>
</tr>
</tbody>
</table>

* Based on the value of shares held by corporations minus the original equity investment. Calculated using SEC filings and share prices of the company as of 03/17/99. Does not include stakes that corporations acquired through spin-offs or transfers of technology or assets.


**Turbocharging Earnings Through Stock Market Windfalls**

Many of the largest companies pursuing CVC are supplementing traditional profits with venture capital earnings to an astonishing degree. Delta Airlines, for example, garnered $596 million in 1999 from unloading a share of its stake in discount Internet ticket seller Priceline.com, more than three times the $175 million Delta earned in the fourth quarter from its core air travel business.

Despite this strong financial draw, however, most companies cite strategic interests as the foremost driver of CVC activity. Financial expectations for strategic equity investments remain, but most corporate investors only require that investments earn returns in excess of the cost of capital.

Most Companies Declare CVC Chiefly a Strategic Tool

Strategic Focus of Corporate Venture Capital Programs

“We use [corporate venture capital] primarily as a strategic program…we are not trying to be a mutual fund, we are not in the business of investing for profit, we are actually trying to invest in areas that will help Intel’s basic business….Once we believe we have accomplished our goals, we don’t see a need to hang around and play the market.”

Andy Bryant
Chief Financial Officer
Intel Corporation

“We are primarily strategic investors but at the same time we are expected to produce returns that exceed our cost of capital. I think most companies that have done [venture investing] realize that you have to have both strategic and financial goals.”

Jerry Okerman
Business Development Manager
3M Company

“Our key motivation is strategic. [Not all venture] investments will be home runs.”

Alex C. Smith
Managing Director
Dell Ventures

Corporate investors pursuing strategic gains seek to enhance their understanding of technological developments that threaten existing business models and industry structures. Although CVC investments in start-ups span a range of industries, Internet-related investments predominate as incumbents strive to keep pace with rapid technological change.

### Incumbents Invest Primarily to Keep Pace with Technological Change

#### Selected Strategic Uses of Equity Investing

1. **Access Technologies to Improve Existing Operations**
   
   Companies invest in start-ups developing technologies that can improve existing business processes or increase the overall quality of a firm’s value proposition to its customers.

2. **Identify Emerging Business Models That May Threaten Incumbent Market Position**
   
   Companies place bets by investing in early-stage start-ups to understand what emerging technologies or business models have the potential to undermine existing business practices that rely on current technologies, relationships and infrastructures.

   In certain industries, the rapid pace of technological change renders internal R&D insufficient to obtain a full view of development options. Companies therefore look to the external market to source new technologies or business ideas.

3. **Outsource R&D**
   
   Companies invest in start-ups that require the investing company’s products to develop their own technologies or applications, thus increasing demand for their own technology.

4. **Drive Product Demand**

   ![Percentage of CVC Investments by Industry, 1999](chart)

   **Source:** Corporate Strategy Board research.

   Corporate investors’ focus in these three areas suggests that companies are receiving the greatest strategic benefits from start-ups that provide access to Internet-related technologies.

   **Source:** National Venture Capital Association.
A Closer Look

Equity investing for strategic returns presents significant obstacles for corporate investors. Corporate Strategy Board interviews with more than 25 companies point to three frequently cited challenges: 1) securing strategically relevant deals, 2) transferring strategic value to the corporation and 3) tracking and analyzing strategic gains.

Corporate Strategic Investors Cite Three Key Challenges

Most Frequently Cited Challenges in Managing Equity Investments for Strategic Returns

<table>
<thead>
<tr>
<th>Challenges</th>
<th>Key Obstacles</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Securing Strategically Relevant Deals</td>
<td>• <strong>Misaligned Investing Criteria</strong>—The use of investing criteria that are not linked to corporate strategy objectives may result in deals that do not support corporate goals.</td>
</tr>
<tr>
<td></td>
<td>• <strong>Inconsistent Screening</strong>—Failure to rigorously apply screening methods can result in selection of strategically irrelevant deals.</td>
</tr>
<tr>
<td>2. Transferring Strategic Value to the Corporation</td>
<td>• <strong>Unprepared Start-Ups</strong>—At early investment stages, start-ups often lack experienced leadership and capital, requiring substantial management guidance and financial support from the corporate investor.</td>
</tr>
<tr>
<td></td>
<td>• <strong>Operating Division Indifference</strong>—Business-unit focus on improving existing operations precludes interest in start-ups’ potential strategic value, complicating CVC managers’ efforts to create a foundation for value transfer.</td>
</tr>
<tr>
<td>3. Tracking and Analyzing Strategic Gains</td>
<td>• <strong>Dearth of Strategic Value Metrics</strong>—The qualitative nature of strategic objectives makes it difficult for CVC managers to identify accurate measures for tracking strategic returns.</td>
</tr>
<tr>
<td></td>
<td>• <strong>Extended Time Horizon for Returns</strong>—The long delay between initial equity investment and realization of financial and strategic returns hampers continuous monitoring of deal/portfolio progress against investing objectives, in turn delaying strategy-based equity exit decisions.</td>
</tr>
</tbody>
</table>

Source: Corporate Strategy Board research.
Drawing on lessons learned by interviewed companies, this study profiles leading practices that CVC managers can use to address corporate investing challenges. Three sets of activities support an equity investing approach designed to realize strategic returns on investment.

Managing Equity Investments for Strategic Returns

Chapter One: Screening for Optimal Deal Selection

Practice #1: Strategy-Driven Selection Criteria (p. 12)

Practice #2: Staged Investment Proposal Review (p. 16)

Propositions

- Aligns equity investments with corporate strategy
- Winnows multitude of deals to select those with greatest strategic relevance

Chapter Two: Facilitating Strategic Value Transfer

Practice #3: Strategic Value Broker (p. 22)

Propositions

- Develops the start-up to add strategic value to the corporation
- Secures involvement of the operating unit with the start-up

Chapter Three: Monitoring Strategic Returns

Practice #4: Quarterly Strategic Returns Analysis (p. 28)

Corporate Strategy Board Composite: Strategic Returns Metrics (p. 35)

Propositions

- Tracks strategic returns from equity deals
- Provides basis for strategy-based equity management decisions

Appendix: Launch Considerations for Strategic Equity Investing (p. 39)

- Consideration #1: Investing Objectives
- Consideration #2: Stage of Investment
- Consideration #3: Method of Investment
- Consideration #4: Organizational Structure

Source: Corporate Strategy Board research.
Chapter I

Screening for Optimal Deal Selection

Summary

With only one in ten start-ups likely to succeed, the corporate investor must identify ways to screen for equity deals that demonstrate the greatest potential for strategic value transfer to the corporation. Oftentimes a strategic disconnect between corporate strategy, business-unit objectives and the CVC group hampers clear identification of attractive deals. This chapter profiles two companies that employ tools to identify strategically relevant deals and screen for those deals with the greatest potential to generate strategic returns.

Practice #1: Strategy-Driven Selection Criteria

Practice #2: Staged Investment Proposal Review
Practice #1: Strategy-Driven Selection Criteria

CVC Snapshot

United Parcel Service, Inc. (UPS), with revenues of $27 billion, is the world’s largest express carrier and package delivery company as well as a leading global provider of specialized transportation and logistics services. UPS established its corporate venture capital unit, the Strategic Enterprise Fund (SEF), in 1997.

Company Description

United Parcel Service, Inc. (UPS), with revenues of $27 billion, is the world’s largest express carrier and package delivery company as well as a leading global provider of specialized transportation and logistics services. UPS established its corporate venture capital unit, the Strategic Enterprise Fund (SEF), in 1997.

Organizational Model

The Strategic Enterprise Fund (SEF) focuses on developing critical partnerships and acquiring knowledge returns from its investments in information technology companies and emerging market spaces.

The fund focuses on services, technologies or products that can reshape industries and enable UPS to provide its customers with business solutions that optimize the three flows of commerce: goods, funds and information.

In addition, the fund provides UPS with insight into new business practices to generate growth opportunities.

Investing Objectives

Major categories of strategic interest to UPS include:

- Promising Market Spaces
- New Related Business Models
- Emerging Related Technologies

Ideally, potential investment candidates in one area of strategic interest possess overlap with other areas; viable candidates are among top performers in their industry or offer a compelling business case.

Stage of Investment

UPS prefers to invest in early- or development-stage start-up companies.

Source: United Parcel Service, Inc.; Corporate Strategy Board research.
Strategy-Driven Selection Criteria

UPS considers SEF an important strategy and business development tool that enables exploration of emerging markets and technologies that may enhance UPS’s evolving business model. SEF receives an abundance of investment proposals from both external and internal sources, creating a need for disciplined investing criteria to ensure the selection of deals that are strategically relevant to UPS.

SEF establishes selection criteria to screen potential investments. To emphasize its focus on strategic returns, SEF incorporates strategic relevance as the mandatory criterion. UPS’s Corporate Strategy Group guides SEF and identifies core strategic relevance principles derived from overall UPS corporate strategy, against which SEF evaluates each investment proposal. To receive funding, a start-up must meet at least one strategic relevance principle.

SEF’s strategy-driven selection criteria ensure stronger alignment between equity investments and corporate strategy, increasing the potential for strategic benefit to UPS. In addition, by communicating its selection criteria both to business units and external candidates, SEF pre-screens proposals by discouraging the referral of strategically irrelevant deals.

Source: United Parcel Service, Inc.; Corporate Strategy Board research.
To screen investment proposals effectively, SEF has established formal guidelines for deal selection comprising five general criteria that are communicated both internally and externally. The first criterion, strategic relevance, aligns CVC investments with business-unit and corporate strategy objectives.

**Strategic Relevance Criterion Anchors Deal Screening**

--- UPS’s Strategy-Driven Selection Criteria ---

- SEF employs five selection criteria for deal approval, all of which support SEF’s investing objectives and increase the likelihood of strong deal and portfolio performance.
- The cornerstone of the deal screening process is strategic relevance, defined as the investment candidate’s alignment with at least one element of UPS’s corporate strategy.
- By rooting its selection criteria in strategic relevance, SEF maintains an investing discipline that supports UPS’s corporate strategy.

--- UPS’s Five Investing Criteria ---

<table>
<thead>
<tr>
<th>I. Strategic Relevance</th>
<th>• SEF seeks investment candidates that demonstrate strategic fit with at least one of five strategic relevance principles, without which funding is automatically declined</th>
</tr>
</thead>
<tbody>
<tr>
<td>II. Co-Investment and Early-Stage Investing</td>
<td>• SEF prefers co-investment with venture capital firms usually in the first or second round of financing due to their invaluable management and strategic planning skills for investments in early-stage companies</td>
</tr>
<tr>
<td>III. Management</td>
<td>• Investment candidates should possess a strong management team with relevant industry or technical expertise</td>
</tr>
<tr>
<td>IV. Investment Range and Location</td>
<td>• Preferred investment range is $250,000 to $2 million, with location limited to the United States and select foreign countries</td>
</tr>
<tr>
<td>V. Board Observation Rights</td>
<td>• SEF generally requires that business-unit representatives have the right to attend start-up board meetings to facilitate ongoing management interaction with portfolio companies</td>
</tr>
</tbody>
</table>

Source: United Parcel Service, Inc.; Corporate Strategy Board research.
**Key Practice Element: Strategic Relevance Principles**

- In conjunction with UPS’s Corporate Strategy Group, SEF has defined five core relevance principles that are closely tied to the firm’s overall corporate strategy. An investment candidate’s failure to satisfy at least one of the five core principles results in immediate denial of funding.
- SEF distributes strategic relevance principles internally among UPS’s business units to assist their identification of strategically relevant deals.
- By establishing strategic relevance as a condition of investment, SEF controls the quantity and quality of business plans that it evaluates and increases the likelihood that funded deals will generate strategic value for the corporation.

**Hypothetical Core Strategic Relevance Principles**

1. Drives end-consumer utilization of UPS’s services
2. Supports product or service evolution
3. Accelerates global expansion of the enterprise
4. Enhances customer relationships through service personalization
5. Spurs development of and demand for e-commerce-related business solutions


Source: United Parcel Service, Inc.; Corporate Strategy Board research.
**Practice #2: Staged Investment Proposal Review**

**CVC Snapshot**

**Novell**

<table>
<thead>
<tr>
<th>Company Description</th>
<th>Novell, Inc. is a $1.3 billion network and connectivity software company. The company formed Novell Ventures as its corporate venture capital arm in late 1997.</th>
</tr>
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</table>

**Organizational Model**

The bulk of Novell Ventures’ CVC activity focuses on direct investments in start-ups for strategic gain. Its primary objectives are the integration, utilization and consumption of Novell technologies.

Underlying these primary objectives is Novell Ventures’ mandate to accelerate the growth of the directory market, in which its product, Novell Directory Services, is a core technology. Novell Ventures invests in start-ups that require Novell products to operate or operate more effectively.

In addition, Novell Ventures makes investments as a limited partner through independent venture capital firms to gain exposure to the entrepreneurial community and to help rapid identification of investment opportunities.

**Investing Objectives**

Novell prefers to invest in early- and development-stage start-up companies.

**Stage of Investment**

Source: Novell, Inc.; Corporate Strategy Board research.
Staged Investment Proposal Review

Practice Description
A multistage deal review process enables the corporate investor to screen all proposals for funding decisions. This tool improves the identification of strategically relevant start-ups most likely to produce the greatest strategic gains for the corporation.

Practice in Brief

<table>
<thead>
<tr>
<th>Practice in Brief</th>
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<tbody>
<tr>
<td>Background</td>
</tr>
<tr>
<td>Since the program’s inception in late 1997, Novell Ventures receives funding requests from a large number of entrepreneurs, as well as referrals from Novell’s business units and its independent venture capital partners. Based on the company’s strict mandate for strategic gains and a return on investment threshold of at least 20 percent, Novell Ventures only funds approximately one percent of all proposals evaluated.</td>
</tr>
<tr>
<td>Proposal Evaluation</td>
</tr>
<tr>
<td>To more accurately assess which candidates should receive funding, Novell Ventures institutes an investment proposal review process. A pre-screening round eliminates all candidates that lack sufficient strategic relevance to Novell, after which the company further filters remaining candidates to identify the few to receive funding. For this purpose, Novell Ventures develops a quantitative strategic evaluation model to select candidates most likely to generate the greatest strategic returns for Novell.</td>
</tr>
<tr>
<td>Results</td>
</tr>
<tr>
<td>Since early 1998, Novell Ventures has invested in 20 start-ups, the vast majority of which are meeting Novell’s stated objectives and have established a commercial relationship with Novell.</td>
</tr>
</tbody>
</table>

Source: Novell, Inc.; Corporate Strategy Board research.
Novell Ventures employs an investment proposal review process to screen deals for strategic relevance and ensure that business opportunities for collaboration with the start-ups are identified prior to funding approval. The key step in the process is use of the evaluation model, which identifies the deals with the greatest potential for generating strategic returns.

Staged Review Screens High Volume of Investment Proposals

Novell’s Staged Investment Proposal Review

- Novell Ventures receives approximately 250 funding requests per quarter. To deal with the large number of proposals, the group follows a seven-step investment proposal review process to filter out approximately 99 percent of all proposals to the exceptional few that receive funding.

- Following an initial pre-screening for broad strategic relevance, Novell Ventures convenes a cross-functional Equity Review Group (ERG) on a weekly basis. ERG conducts initial deal assessment and due diligence to identify candidates with the potential for concrete business opportunities with Novell.

- ERG subjects promising candidates to a thorough evaluation using a quantitative model to determine which investment proposals best support Novell’s investing objectives.

Novell’s Investment Proposal Review Process

I. Strategic Value Pre-Screening
Novell Ventures’ team screens proposals based on their potential to accelerate directory market growth and build on Novell Directory Services technology

II. Initial Deal Assessment
ERG identifies potential business opportunities and information gaps associated with each deal

III. Due Diligence
ERG uses due diligence checklist to identify concrete business opportunities

IV. Deal Evaluation
ERG evaluates all remaining candidates across three dimensions: strategy, execution and market potential

Key Practice Element:
Strategic Evaluation Model

V. Business Opportunity Definition
ERG determines specific business opportunities for each deal and creates a time frame for achieving stated goals

VI. Final Deal Recommendation
ERG drafts a pre-closing memorandum summarizing the deal’s strategic and financial objectives

VII. Funding Approval
Investment Committee reviews each investment proposal and usually approves ERG recommendations

Source: Novell, Inc.; Corporate Strategy Board research.
Strategic Evaluation Model Pinpoints the Most Relevant Deals

Key Practice Element: Strategic Evaluation Model

- Novell’s strategic evaluation model comprises three qualitative dimensions along which each candidate is numerically evaluated: strategy, execution and market potential. To succeed, candidates must score values higher than two in each factor.

- The ERG conducts a subjective review of each deal, assigning grades from zero to five (five being the highest) based on the candidate’s ability to achieve the expected objectives of each dimension.

- By requiring candidates to achieve a minimum score, Novell Ventures narrows the list of strategically relevant proposals to those that receive funding based on expected strategic returns to the corporation.

Novell’s Three-Dimensional Strategic Evaluation Model

Successful candidates satisfy Novell’s strategic prerequisites as well as portray the ability to showcase, complement or enhance the company’s strategy of making Novell Directory Services a ubiquitous technology.

**Strategy**

**Market Potential**

Successful candidates display revenue growth potential averaging 20 to 40 percent annually as well as significant diversification potential.

**Execution**

Successful candidates demonstrate the ability to execute strategies complementary to Novell’s and conclude one or more business transactions with Novell that garner lasting internal support.

Deal Approval Grading Scale

<table>
<thead>
<tr>
<th>High</th>
<th>5</th>
<th>Deal immediately approved and acquisition considered</th>
</tr>
</thead>
<tbody>
<tr>
<td>Average Evaluation Score*</td>
<td>4</td>
<td>Deal approved</td>
</tr>
<tr>
<td></td>
<td>3</td>
<td>Deal occasionally approved</td>
</tr>
<tr>
<td></td>
<td>2</td>
<td>Deal immediately declined</td>
</tr>
<tr>
<td>Low</td>
<td>0</td>
<td></td>
</tr>
</tbody>
</table>

* Deals must achieve a minimum score of two on all three dimensions before the average is calculated.

Source: Novell, Inc.; Corporate Strategy Board research.
Chapter II
Facilitating Strategic Value Transfer

Summary
To realize strategic gains from equity investing, CVC managers must facilitate the transfer of such returns to the corporation. For seed- and early-stage corporate investors, this is a particularly challenging undertaking: They must prepare an undeveloped start-up to add value to the corporation as well as convince business units of the strategic relevance and mutual benefit of a commercial relationship. Even for companies primarily conducting less risky, later-stage investments where the start-up’s strategic relevance is more apparent and a commercial agreement usually accompanies the equity stake, the CVC manager still plays an important role in value transfer by brokering introductions and facilitating the relationship between the start-up and the business unit. This chapter profiles an early-stage CVC unit that acts as a broker to facilitate the creation and transfer of strategic value to the corporation.

Practice #3: Strategic Value Broker
**Practice #3: Strategic Value Broker**

**CVC Snapshot**

**Company Description**

Lucent Technologies Inc. is a $38 billion communications and networking technologies company. Lucent established its CVC subsidiary, Lucent Venture Partners (LVP), in early 1998.

**Organizational Model**

LVP pursues two equally weighted goals:
- Investments that are strategically relevant to Lucent Technologies (i.e., contribute to Lucent’s long-term growth goals)
- Financial returns that exceed the venture capital industry median

**Investing Objectives**

LVP prefers to invest in seed- through development-stage start-up companies.

**Stage of Investment**

Source: Lucent Venture Partners, Inc.; Corporate Strategy Board research.
# Strategic Value Broker

## Practice Description

Nurturing early-stage start-ups through their initial growth and development enables CVC managers to ascertain how and where in the corporation the start-up can provide the greatest strategic value. Furthermore, by facilitating a commercial agreement with one of the parent company’s business units, corporate investors play an important role in the transfer of strategic value to the corporation.

## Practice in Brief

### Background

In February 1998, Lucent establishes Lucent Venture Partners (LVP) as a vehicle to access external innovations at an early stage of development. LVP invests in start-ups that are creating technologies approximately two years ahead of the industry. LVP expects that at least 50 percent of all deals will deliver some strategic benefit to the parent corporation, but recognizes that the development of early-stage start-ups is unpredictable and that numerous deals may not deliver strategic gains to Lucent.

LVP’s interaction with its portfolio companies focuses on two key elements: 1) nurturing the start-up through active board participation to understand where the start-up might best align with Lucent’s overall strategy and 2) brokering business-unit interaction with the start-up by making introductions and facilitating ensuing relationships. These activities support LVP’s goal to create strategic value and enable its transfer to Lucent.

### Value Creation and Transfer

LVP achieves its investing objectives by facilitating a strategic commercial relationship with Lucent, encouraging general learning about the start-up’s market or industry space or participating in a liquidity event for financial return. LVP currently has 30 companies in its portfolio, several of which have already established a commercial relationship with a Lucent operating unit. LVP partners estimate that some investments will not contribute value to Lucent other than strong financial returns. The remaining start-ups have high potential to secure a commercial relationship with Lucent or provide some other means of contributing strategic value.

### Results

Source: Lucent Venture Partners, Inc.; Corporate Strategy Board research.
**LVP Nurtures Start-Ups Through Active Board Participation**

**Key Practice Element: Nurturing the Start-Up**

- To prepare the start-up developmentally for a commercial relationship with a Lucent operating unit, LVP requires an active board seat as a condition of investment—but does not insist on voting rights—terminating equity negotiations if the start-up requests passive board observation or denies board access. The LVP partner maintains a voice at the table to influence decisions regarding the start-up’s development.
- LVP’s actions as a board participant unconditionally support the start-up’s development even if a Lucent operating unit perceives a potential competitive threat.

---

**LVP’s Active Board Participation in Early-Stage Start-Ups**

- CEO & Entrepreneur
- Board Member
- Board Member
- Board Member
- VC Investor
- Board Member
- LVP Partner
  (typically possesses technical expertise and Lucent operating experience)

---

**LVP Goals**

- Nurture the start-up to generate the greatest opportunity for strategic value transfer
- Ensure the highest financial returns if Lucent cannot realize the strategic value
- Identify the optimum time to introduce the start-up to the Lucent operating unit

**LVP Actions**

- Provide guidance and advice to the entrepreneur when necessary
- Share lessons learned from other LVP portfolio companies
- Build a working relationship with the start-up

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**The Board Seat Imperative**

“If LVP’s partners cannot sit at the table, understand exactly what is going on and participate in the development of the start-up, we are less likely to be able to add value to Lucent’s operating units. Then, it is a financial investment and it is passive. It will not allow us to achieve our strategic objectives.”

John Hanley
Managing Partner
Lucent Venture Partners

Source: Lucent Venture Partners, Inc.; Corporate Strategy Board research.
LVP Promotes Interaction with Lucent’s Operating Units

**Key Practice Element: Brokering Interaction**

- To establish a commercial relationship with the start-up alongside an equity investment—and counter operating-unit focus on short-term performance—LVP partners must persuade operating-unit leadership of the potential long-term strategic value of a relationship with the start-up.

- LVP’s primary role is to secure the involvement of an operating unit with the start-up to realize the greatest strategic value when a commercial relationship comes to fruition. Once the parties reach a commercial agreement, a business-unit representative develops the strategic relationship.

**Case in Point: LVP’s Role in Strategic Value Transfer to Lucent’s Microelectronics Division**

1. **LVP Familiarizes Operating Unit with Recent Start-Up Investment**
   - LVP invests in the start-up stage of funding (the start-up company is nine months away from a beta product). Lucent’s Microelectronics operating unit is largely unaware of the start-up’s existence.
   - With the permission of the start-up, LVP works with Microelectronics’s leadership on an informal basis to familiarize the business unit with the start-up by providing updates on its development.

2. **LVP Facilitates an Initial Meeting Between Start-Up and Operating Unit**
   - LVP arranges an initial meeting between the start-up and Microelectronics. LVP participates in the discussion to assuage both parties’ concerns regarding competitive conflicts of interest. Acting as an intermediary, LVP helps both parties to recognize the benefits of collaboration.
   - LVP encourages the start-up and Microelectronics to collaborate informally, sharing technical information and advice throughout the following year.

3. **Microelectronics Contributes a Financing Round After Reaching Commercial Agreement**
   - Microelectronics negotiates a formal commercial agreement and contributes the entire strategic round of financing.

4. **Strategic Value Transferred, LVP Remains on the Board**
   - Lucent moves toward a memorandum of understanding regarding the mutual use of each other’s technologies.
   - LVP remains on the start-up’s board, serving as an intermediary between the start-up and Microelectronics to maintain and monitor the relationship.

Source: Lucent Venture Partners, Inc.; Corporate Strategy Board research.
Measuring strategic value from an individual equity investment proves challenging because strategic returns, unlike financial returns, are difficult to quantify. In addition, it may take a company several years to realize the strategic value either from the investment itself or from a related commercial agreement with the start-up. This chapter profiles one company that has implemented a formalized tracking process for strategic returns. In addition, the chapter includes a list of strategic metrics for equity investing based on Corporate Strategy Board research.

Practice #4: Quarterly Strategic Returns Analysis

Corporate Strategy Board Composite:
Strategic Returns Metrics
**Practice #4: Quarterly Strategic Returns Analysis**

## CVC Snapshot

**Hewlett-Packard Company** (HP), a $42 billion diversified computer products manufacturer, provides computers, imaging and printing peripherals, software and computer-related services. To fuel further growth, HP is restructuring as an Internet specialist providing Web hardware, software and support to corporate customers. HP restructured its corporate venture capital activity in 1999.

### Organizational Model

- **Corporate Center**
- **CVC**
- **Start-Up**

### Guiding Principles for CVC

- Make an equity investment only if it strengthens a concurrent commercial agreement between an HP business unit and a start-up that will create strategic value for HP
- Prioritize strategic benefits over equity returns

### Strategic Investing Objectives

- Proliferate HP products, services and solutions
- Access technologies to improve existing operations
- Identify emerging technologies that may threaten future business operations
- Identify future growth opportunities

### Stage of Investment

HP prefers to invest in early- through expansion-stage start-up companies.

Source: Hewlett-Packard Company; Corporate Strategy Board research.
Quarterly Strategic Returns Analysis

| Practice Description | Regular monitoring and analysis of strategic and financial returns to the organization alert CVC managers to investments’ performance trends. By providing more objective, quantitative input for equity-related decisions, strategic performance tracking helps investors to manage individual deals as well as the overall equity portfolio more effectively. |

---

**Background**

During the first years of HP’s venture capital activity, investments fail to meet either strategic or financial expectations. The company cites two primary reasons for these failures: 1) HP turnover results in a lack of business “ownership” and continuity of investments over time and 2) limited tracking and accountability of investments reduces ongoing support for partnership with start-ups. By 1998, growing business-unit interest in aggressive equity investing prompts HP to embark on a CVC restructuring effort.

In 1999, HP’s Corporate Development group (CD) redesigns the company’s approach to equity investing to remedy previous shortcomings. CD implements a formal tracking process requiring regular monitoring and analysis of strategic and financial returns. The process consists of two key elements: a customized tracking scorecard and strategy-led deal analysis.

Performance Tracking

Although HP has only recently implemented its tracking process, CD is encouraged by initial results. The company remains confident that rigorous tracking of individual investments’ strategic gains will prompt more proactive management of the portfolio in terms of continued support or immediate exit from equity deals based on their strategic performance.

Results

Source: Hewlett-Packard Company; Corporate Strategy Board research.
Despite HP’s decentralized structure, the Corporate Development group (CD) maintains responsibility for all equity investing activity. CD has established a formal deal management process to designate specific roles and responsibilities to the business units while retaining corporate oversight of the entire process.

**HP Divides CVC Responsibilities Among Key Constituents**

---

**HP’s Equity Investing Management Process**

- HP’s Corporate Development group oversees the company’s equity investing management process, which is designed to secure strategic investments in start-ups in conjunction with a commercial agreement.
- HP’s business-unit business development (BUBD) teams work with CD and individual owners of commercial relationships with start-ups across the process to ensure the transfer of maximum strategic value to the corporation.
- Deal tracking and deal analysis constitute two key elements of HP’s comprehensive equity investing management process. These elements enable CD to evaluate strategic and financial returns accruing to the corporation and execute strategy-led equity-related decisions.

---

**Equity Investing Responsibilities at HP**

- **HP Executive Council**
- **Business Unit (BU)**
- **Core Deal Team**
- **Business Development (BUBD) Team**
- **Corporate Development (CD)**

**BUBD Representative**
- Performs strategic gap analysis
- Identifies commercial opportunities
- Negotiates operating terms of commercial agreements
- Provides ongoing support and partnership to start-ups
- Extracts ongoing business value
- Oversees tracking of strategic metrics

**BU Relationship Owner**
- Serves as primary point of contact for commercial relationship with start-up
- Holds responsibility for relationship development
- Performs tracking of strategic returns against metrics listed on customized tracking scorecard

**CD Representative**
- Oversees all equity investment activities
- Tracks and manages the portfolio
- Maintains responsibility for financial returns and negotiations
- Retains investment objectivity
- Makes exit decisions

---

Source: Hewlett-Packard Company, Corporate Strategy Board research.
Two key activities enable HP to maximize strategic returns to the organization: deal tracking and deal analysis. Regular monitoring of individual equity investments and analysis of strategic value transferred to the organization allow CD to make informed equity management decisions, especially for deals misaligned with or failing to meet strategic objectives.

**Deal Tracking and Analysis Underpin HP’s Investment Management Process**

**HP’s Equity Investing Management Process**

**I. Deal Sourcing**
Business units (BUs) identify potential start-ups that fulfill strategic objectives of demand creation, technology access or operational efficiencies through new technologies.

**II. Deal Approval**
CD approves investments following due diligence process and BU negotiation of an associated commercial agreement.

**III. Deal Closure**
Deal team maps out strategic and financial objectives, which serve as metrics for the tracking sheet.

**IV. Deal Tracking**
Business relationship owner completes tracking sheet on a quarterly basis by evaluating development of the business relationship against strategic metrics.

**V. Deal Analysis**
BUBD team ensures accuracy of strategic tracking; CD updates financial tracking metrics and reviews each deal for strategic and financial returns.

**VI. Performance Reporting**
CD sends an investment portfolio report to HP’s Executive Council for review approximately one month after the close of each quarter.

Source: Hewlett-Packard Company; Corporate Strategy Board research.
**Scorecard Provides Comprehensive Deal Review**

**KEY PRACTICE ELEMENT: CUSTOMIZED TRACKING SCORECARD**

- The tracking scorecard provides a tailored set of metrics with which HP’s business units and CD track the strategic and financial performance of equity investments on a quarterly basis.
- The deal team convenes after the approval of each equity investment to create a customized tracking scorecard. The team defines appropriate strategic and financial metrics based on negotiation deal terms that most closely match the predetermined strategic objectives of the deal.

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**Hypothetical Customized Tracking Scorecard**

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**Tailored Equity Investment Metrics**

“HP has dozens of different product lines, many of which want to partner with other companies for different reasons and different needs. The strategic objectives for each relationship therefore vary by deal; deal teams define tracking metrics based on the terms negotiated for each agreement. Those metrics form the basis of the scorecard. In other words, it is the deal that drives the scorecard, not the scorecard that drives the deal.”

Kelly Battles
Director, Corporate Development
Hewlett-Packard Company
Deal Analysis Achieves Optimal Portfolio Management

**KEY PRACTICE ELEMENT: STRATEGY-LED DEAL ANALYSIS**

- Regular analysis of each investment allows the CD to make informed equity management decisions, based on realized strategic objectives, regarding whether to continue interaction or exit from the equity stake.

- HP continues to hold equity in a start-up until the BUBD team feels that the commercial relationship with the start-up is either no longer providing strategic benefit or can stand alone without the equity tie-in. At that time, the deal enters an exit pool that CD periodically reviews.

- Because HP prioritizes strategic benefits over equity returns, CD must ensure that all decisions concerning the equity component will not adversely affect the realization and transfer of strategic value. By restricting equity management decisions to a time when strategic returns will no longer be affected, HP efficiently manages its equity investments for optimal strategic and financial gain.

---

**HP's Decision Tree for Equity Exit**

1. **Strategic Equity Pool**
   - BUBD team analyzes strategic returns on a quarterly basis and determines business-related strategy.

2. **Equity Exit Pool**
   - CD reviews the exit pool on a quarterly basis and determines equity exit strategy.

3. **Financial Equity Pool**
   - HP’s CFO makes the final exit decision based on CD recommendations; treasury disposes of the equity.

---

Source: Hewlett-Packard Company; Corporate Strategy Board research.
Corporate Strategy Board Composite

Strategic Returns Metrics

While measuring financial returns on equity investments is relatively straightforward, many CVC managers struggle to accurately measure strategic gains. Because the dollar impact of strategic returns on a company’s revenues is not immediately apparent, it is difficult to quantify the value that equity investing generates. Companies that fail to track strategic returns often cannot make informed equity management decisions that support investing objectives.

Based on discussions with CVC managers and an extensive survey of publicly available information, the Corporate Strategy Board has compiled a list of metrics for strategic returns. In the aggregate, this compilation can assist CVC managers in measuring the total strategic value generated per dollar of equity invested.

Value of Equity Investments to the Corporation

Strategic Value Defined

In the context of equity investing, strategic value refers to those benefits gained from interaction with start-ups that allow the investing company to realize new or additional revenues separate from direct financial returns on equity invested.

The composite includes two main types of strategic metrics. The first type measures the indirect contribution of selected CVC activities (e.g., number of site visits to start-ups) to the creation of strategic value. The second type is a direct measure of strategic value generated (e.g., number of R&D contracts). CVC managers may find both types useful in assessing the overall strategic value of the company’s equity investing program.

Two Types of Strategic Metrics

Corporate investors tend to use standard financial metrics, including return on investment and internal rate of return, to track the financial valuation of the investments and financial returns on capital invested. Corporate Strategy Board research indicates that a majority of strategic investors seek financial returns that at a minimum exceed the corporation’s cost of capital.

Role of Financial Returns

Source: Corporate Strategy Board research.
Selected Metrics to Assess Strategic Returns

--- USE OF METRICS ---

The following metrics represent selected components of direct strategic value or contributors to strategic value. CVC managers determine appropriate metrics largely based on company-specific factors and strategic objectives specific to each deal. In addition, CVC managers should identify a denominator (e.g., dollar value of equity invested) for use with all metrics to achieve consistent assessment of value generated across the portfolio.

Metrics to Assess Activities That Generate Strategic Value

<table>
<thead>
<tr>
<th>Interaction with Portfolio Companies</th>
<th>Role of CVC in facilitating interaction to achieve the transfer of learning from the start-up to the corporation</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>• Number of hours of CVC or operating-unit manager direct contact with entrepreneurs</td>
</tr>
<tr>
<td></td>
<td>• Number of CVC or operating-unit manager site visits to portfolio companies</td>
</tr>
<tr>
<td></td>
<td>• Number of equity investments that include board observation rights</td>
</tr>
<tr>
<td></td>
<td>• Number of operating units working with each start-up</td>
</tr>
<tr>
<td></td>
<td>• Number of start-ups acquired</td>
</tr>
</tbody>
</table>

Source: Corporate Strategy Board research.
### Strategic Value Metrics

<table>
<thead>
<tr>
<th>R&amp;D Effectiveness</th>
<th>Role of CVC in increasing the efficiency or effectiveness of corporate R&amp;D</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>- Number of new products/technologies developed</td>
</tr>
<tr>
<td></td>
<td>- Number of modifications to existing products/technologies</td>
</tr>
<tr>
<td></td>
<td>- Number of R&amp;D contracts</td>
</tr>
<tr>
<td></td>
<td>- Number of patents</td>
</tr>
<tr>
<td></td>
<td>- Number of technology collaboration agreements</td>
</tr>
<tr>
<td></td>
<td>- Dollar value of licensing royalties</td>
</tr>
<tr>
<td></td>
<td>- Time saved in new product development</td>
</tr>
<tr>
<td></td>
<td>- Product time to market</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Efficient Supply Chain Management</th>
<th>Role of CVC in strengthening supply chain operations to increase company’s value proposition to customers</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>- Number of purchasing agreements</td>
</tr>
<tr>
<td></td>
<td>- Number of distribution agreements</td>
</tr>
<tr>
<td></td>
<td>- Number of manufacturing rights</td>
</tr>
<tr>
<td></td>
<td>- Cost savings due to shared production</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Customer Acquisition, Retention and Loyalty</th>
<th>Role of CVC in increasing company sales by more fully integrating customers into the business</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>- Number of co-marketing agreements</td>
</tr>
<tr>
<td></td>
<td>- Percentage increase in dollar value of customer purchases</td>
</tr>
<tr>
<td></td>
<td>- Change in market share of operating-unit products/services</td>
</tr>
<tr>
<td></td>
<td>- Change in market share of corporate technology standards/platforms</td>
</tr>
<tr>
<td></td>
<td>- Number of additional unique customers</td>
</tr>
<tr>
<td></td>
<td>- Percentage of repeat customers per specified time period</td>
</tr>
</tbody>
</table>

Source: Corporate Strategy Board research.
Appendix

Launch Considerations for Strategic Equity Investing

• Consideration #1: Investing Objectives
• Consideration #2: Stage of Investment
• Consideration #3: Method of Investment
• Consideration #4: Organizational Structure
The decision to commence corporate venture capital activity typically resides with decision makers at the executive level. To determine their firm’s equity investing strategy, executive decision makers must address four initial considerations: 1) investing objectives, 2) stage of investment, 3) method of investment and 4) organizational structure.

Senior Executives Must Address Four Critical CVC Launch Considerations

Key Questions for Executive Decision Makers Pursuing Strategic Equity Investing

**Consideration #1: Investing Objectives**
- Where should CVC fit into our overall business development strategy?
- What are our primary strategic objectives for CVC?
- How much weight should we give to financial returns relative to strategic returns?

**Consideration #2: Stage of Investment**
- What is our firm’s risk tolerance for CVC activity?
- Are we willing to pay a premium price to get into a deal?
- Given our investing objectives, which stage of investment is most appropriate?

**Consideration #3: Method of Investment**
- Which method of investment aligns most strongly with our strategic objectives?
- Does our level of equity investing competence suggest a preferred method of investment?

**Consideration #4: Organizational Structure**
- What organizational structure best supports our investing objectives?
- Where should CVC expertise reside in the company?
**Innovative Objectives**—Companies prioritizing strategic investing often struggle to balance the focus on strategic returns with the need to achieve a minimum financial return. Successful corporate investors prioritize a customized set of strategic objectives for both individual investments and the overall portfolio while simultaneously maintaining minimum financial thresholds for investing activity.

### Consideration #1

**Supporting Strategic Objectives with Financial Thresholds**

**Selected Strategic Investing Objectives and Financial Thresholds**

#### Strategic Objectives

- Access to existing technologies
- Window on new technologies
- Window on new business models
- Product demand creation
- New sources of R&D
- Access to new customer segments
- Potential new product marketing/manufacturing
- Venture capital education and experience
- Business relationship development
- Intrapreneurship cultivation
- Potential acquisition identification
- Acquisition funding

#### Financial Metrics and Thresholds

**Metrics**

- Return on investment
- Internal rate of return
- Cost of capital
- Return on equity
- Incremental revenue (revenue directly attributable to interaction with start-up company)

**Thresholds**

- Exceed median ROI of VC industry
- Exceed internal rate of return within company
- Exceed cost of capital

---

**Acknowledging Financial Thresholds**

“I think that companies with venture investing experience realize that you have to have both strategic and financial goals. In our case, J&J is definitely more strategically oriented, but we acknowledge the need for financial success in order to have a platform from which to work for strategic benefits.”

Brad Vale  
Vice President  
Johnson & Johnson Development Corporation

Source: Johnson & Johnson Development Corporation; Corporate Strategy Board research.
Stage of Investment—Corporate investors must determine whether to make investments in early-stage start-ups for a lower entry price but higher risk, or to invest when the start-up has matured and is available at a higher price but considerably lower risk. A company’s specific strategic objectives further influence the decision regarding the most appropriate stage of investing.

Consideration #2

Risk Tolerance and Investing Budget Jointly Determine Stage of Investment

Development Stages of a Start-Up: Risk and Cost to Venture Capital Investors*

<table>
<thead>
<tr>
<th>Development Stage</th>
<th>Time</th>
</tr>
</thead>
<tbody>
<tr>
<td>Seed Stage</td>
<td></td>
</tr>
<tr>
<td>Start-Up Stage</td>
<td></td>
</tr>
<tr>
<td>Early Stage</td>
<td></td>
</tr>
<tr>
<td>Development Stage</td>
<td></td>
</tr>
<tr>
<td>Expansion Stage</td>
<td></td>
</tr>
</tbody>
</table>

- - -

Cost to Acquire Equity

Risk to Investor


* Corporate Strategy Board illustrative.

Linking Investing Objectives to CVC Strategy

“One of Philips’s strategic objectives for CVC is to generate commercial relationships with the start-ups in which we invest. However, because Philips is also a western European company with a risk-averse culture, we will invest primarily in later-stage companies that are very close to going to market with their product or service. In other words, our investing objectives and our risk tolerance directly influence our decision to invest in more mature start-ups that are more likely to meet our strategic needs.”

Wouter Jonk
Director, Corporate Strategy, Venturing Royal Philips Electronics N.V.

Source: Royal Philips Electronics N.V.; Corporate Strategy Board research.
**Consideration #3**  
Companies face a choice of two main investing methods:
1) indirect investing through a limited partnership with a venture capital firm or
2) direct investing in start-up companies. Both approaches possess unique advantages and disadvantages with regard to strategic investing. Direct investing, however, best supports most long-term strategic goals because of the heightened level of control and closer interaction with start-up companies that the method affords.

---

**Companies’ Preferred Level of Control Determines Investing Approach**

**Analysis of Two Main Investing Methods**

<table>
<thead>
<tr>
<th>Method of Investment</th>
<th>Indirect</th>
<th>Direct</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Definition</strong></td>
<td>The corporation places funds, as a limited partner, in a professional venture capital firm. The VC invests with the combined money of all the limited partners in start-ups of the VC’s choice.</td>
<td>The corporation provides a start-up with a negotiated amount of capital in return for a percentage ownership of stock.</td>
</tr>
</tbody>
</table>
| **Benefits for the Corporate Investor** | • Likely to see positive financial returns on their investment because ROI is a venture capitalist’s primary objective  
• Expends fewer resources due to outsourcing of equity investment and management | • Maintains control of all investment decisions  
• Achieves much closer interaction with start-up companies  
• Receives all strategic and financial returns  
• Offers added value to start-ups through existing competencies |
| **Drawbacks for the Corporate Investor** | • Maintains no investment decision-making power, eliminating control over strategic relevance of deals  
• Forfeits 20 to 30 percent of returns to pay for “carried interest” fee of general partner  
• Possesses limited or no access to portfolio companies | • Competes directly with professional VCs for deals  
• Often pays premium price to invest  
• Carries greater financial risk due to prioritization of strategic objectives  
• Requires greater resources and commitment |
| **Potential Strategic Objectives** | • Window on new technologies or business models through interaction with general partner  
• Business relationship development  
• Networking in the VC community  
• VC education and experience  
• Potential acquisition identification  
• Return on investment | • Access to existing technologies  
• Window on new technologies or business models  
• Access to new market segments and customers  
• Product demand creation  
• New sources of R&D  
• Potential new product marketing/manufacturing  
• Business relationship development  
• Intrapreneurship cultivation  
• Potential acquisition identification  
• Return on investment |

Source: Corporate Strategy Board research.
Companies Declare Direct Investing More Suitable to Realize Strategic Gains

**3M, Lucent and Johnson & Johnson—Opt for Direct Investing**

“3M used to invest indirectly through limited partnerships with independent venture capital funds. More recently, however, we have shifted to making direct equity investments in start-ups because it enables us to gain access to the start-up’s strategy or technology more quickly and effectively than having to go through the portal of a professional fund. In addition, when 3M makes a direct equity investment, it is always in conjunction with a commercial agreement between one of 3M’s business units and the start-up.”

Jerry Okerman
Business Development Manager
3M Company

“Lucent Venture Partners almost exclusively does direct investments. Our one investment in an independent venture capital firm was not helping our strategic objectives because we were too far removed from the portfolio companies. We determined that a better use of our money and a better strategic connection could be made to these start-up companies if LVP made direct investments. In my opinion, however, it is critical to examine how to match execution tactics to desired strategy. For the strategy that LVP chose, direct investing is a great model, but for a different strategy it may not be.”

John Hanley
Managing Partner
Lucent Venture Partners

“There was an era about 20 years ago when a number of companies gave large sums of money to professional VCs to invest on their behalf. Although they made good money on some of the investments, they found that they did not have the operational linkages that would be useful to transfer technologies or acquire companies. Indirect investing has therefore on the whole been less satisfying for corporate groups than direct investing. Furthermore, it took us (J&J Development Corporation) a number of years to really sell the concept inside of J&J that direct equity investing was an important business development tool that could provide insights on new technologies, facilitate other business relationships and often generate a competitive return on money invested.”

Brad Vale
Vice President
Johnson & Johnson Development Corporation

Source: 3M Company; Johnson & Johnson Development Corporation; Lucent Venture Partners, Inc.; Corporate Strategy Board research.
Organizational Structure—Corporate venture capital organizational models vary widely across companies, ranging from ad hoc investing housed in the corporate center to a formalized program established as a subsidiary. The advantages and disadvantages of each model combine with a company’s specific investing objectives to determine model selection.

Strategic Objectives Strongly Influence Choice of Organizational Structure

Three CVC Organizational Structures

**Corporate Center CVC**
Corporation assigns CVC investing responsibility to an entity within the corporate center.

**Autonomous CVC Subsidiary**
Corporation creates an independent subsidiary with autonomous decision-making authority through which to pursue CVC activity.

**Dedicated VC Fund**
Corporation hires a professional VC firm to make dedicated equity investments on its behalf.

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**Corporate Center CVC: Nortel Networks Corporation**

Nortel Networks Corporation has pursued equity investing since the early 1980s. Previously managed by an independent subsidiary that failed to meet strategic expectations, Nortel currently designates CVC investing responsibility to the corporate development group. The company complements its direct investments in start-ups with indirect investments through limited partnerships with professional VC firms. Nortel’s primary objective is to invest for strategic returns in the form of access to new technologies and business models.

**Key Model Advantages**

- CVC manager participation in corporate and business-unit strategic planning sessions and product portfolio analysis enables identification of existing R&D gaps that strategically relevant equity investments can fill.
- Despite a centralized reporting structure, CVC management maintains close proximity to the company’s business units, raising their awareness of the potential value of equity investing as a business development tool. Compared to its previous independent subsidiary structure, this integration with the business units decreases CVC managers’ burden to convince them of the value of collaborating with strategically relevant start-ups.

**Key Model Disadvantage**

- Early-stage investments are more difficult to pursue through the corporate center because investment approval can be mired by business-unit skepticism and decision-making bureaucracy. Nortel overcomes these challenges by charging business-unit R&D experts with technical due diligence and by providing CVC management with a modest degree of autonomy and funding to allow rapid investment approval.

Source: Nortel Networks Corporation; Corporate Strategy Board research.
**Autonomous CVC Subsidiary: SmithKline Beecham plc**

SmithKline Beecham (SB) established an autonomous CVC subsidiary, S.R. One, Limited, in 1985. S.R. One’s primary objective is to invest for financial returns, but it limits itself to investing in seed- and early-stage start-ups that are of strategic interest to SB, defined as the potential to contribute to SB’s long-term growth.

*Key Model Advantages*

- S.R One’s ability to make autonomous funding decisions circumvents bureaucratic corporate approval processes, enabling the group to make rapid investment decisions alongside independent VC firms.
- To compete with professional VC firms for management talent, SB motivates S.R. One’s managers with “carried interest” compensation schemes commensurate with the VC community. Such incentives are easier to maintain in an autonomous subsidiary structure, which reduces corporate scrutiny on compensation equality across hierarchical levels of the company.

*Key Model Disadvantage*

- With an autonomous CVC unit, the corporate center may lack sufficient oversight to anticipate and minimize the occurrence of strategically irrelevant deals. SB addresses the challenge by giving the corporation’s senior business development executive the authority to veto any investment during the due diligence phase if the start-up’s business proposition lacks strategic relevance to SB.

**Dedicated VC Fund: Texas Instruments Inc.**

Texas Instruments (TI) hired Hambrecht & Quist Venture Associates (H&Q) in 1996 to establish and manage its dedicated corporate venture capital program, TI Ventures. TI Ventures invests in early-stage technology companies that focus on digital signal processing (DSP) software and hardware applications in markets such as communications (wireless and wireline), networking, audio, video, storage, display and IC power management.

*Key Model Advantages*

- TI relies on H&Q for deal sourcing, due diligence, equity negotiations and portfolio management, yet still maintains access to senior executives and technology experts within the start-ups. As a result, TI can extract strategic value from investments without expending significant resources other than capital outlays.
- TI is a leading producer of DSP technology. Because TI Ventures invests in start-ups that focus on this technology, the company’s use of a professional intermediary in equity deals helps to assuage start-ups’ concerns regarding TI’s intentions or potential conflicts of interest.

*Key Model Disadvantage*

- TI must relinquish a substantial portion of financial returns to pay for the “carried interest” fee of the professional VC firm, which usually amounts to approximately 20 to 30 percent of capital gains from the sale of securities to the public.

Bibliography


CORPORATE VENTURE CAPITAL