

# **CORPORATE VENTURE CAPITAL AND INNOVATION**

**L. Gregory Henley**, University of South Florida  
4202 East Fowler Ave., BSN 3403, Tampa, FL 33620-5500  
813-994-0229, ghenley@coba.usf.edu

## **ABSTRACT**

This article examines the strategic fit between large investing firms and the small companies they invest in. Investigation of corporate venture capital indicates that small companies having a low degree of strategic fit with the investing firm receive funding just as frequently as those that are closely aligned. This is revealing because few CEO's would consider acquiring another large firm that did not share a perceived high degree of strategic fit with the focal firm's core business. Even more enlightening is that the majority of minority investments are in small companies that are vertically related to the investing firm.

## **EXECUTIVE SUMMARY**

To remain competitive, firms must continually innovate. Yet, some large firms are risk-averse, reluctant to create change and might suffer from a "liability of largeness" that hampers their ability to produce radical innovations. This liability of largeness can result from: (1) success, (2) rejection of change, (3) agency issues and (4) lack of appropriate resources. As a result, small companies frequently bring new, innovative products to market more effectively than large firms. Nevertheless, a great deal of innovation occurs when large firms and small companies partner with one another. The purpose of this paper is to introduce an underutilized strategic vehicle – the minority investment - that corporate strategists can add to their arsenal that already includes acquisition, internal ventures, joint ventures, etc. Used strategically rather than to generate quick financial returns as a traditional venture capitalist might, the large firm can capitalize on the innovative ability of small companies. Minority investments will tend to require fewer resources than the other growth vehicles and provide greater strategic flexibility. The small company can provide innovative technologies, products, markets, entrepreneurial talent, etc. that may otherwise be unavailable to the large firm and which can be a major source for additional competencies to more effectively compete. Investments in promising ventures can be made at a low cost and if the small company develops and both parties agree, the large firm may increase its investment. On the other hand, if the anticipated benefits of the minority investment are not realized, the loss, in terms of funding, time, coordination, etc. are minimal.

## **INTRODUCTION**

To remain competitive, firms must continually innovate. Firms have responded by undertaking corporate entrepreneurship involving (1) creating new businesses within the existing business and/or (2) transforming existing businesses through strategic renewal (Guth and Ginsberg, 1990) that alters business resource patterns (Stopford and Baden-Fuller, 1994). Internal or corporate venturing has received the majority of corporate entrepreneurship attention, both in academic research and in managerial actions (Biggadike, 1979, Burgelman, 1983; Venkataraman et al., 1992). Yet, new ventures may be more effective when started outside the firm than inside (Fast

and Pratt, 1981; Weiss, 1981). In addition, some large firms are risk-averse, reluctant to create change and might suffer from a “liability of largeness” that hampers their ability to produce radical innovations. As a result, large firms may benefit from extending their boundaries by partnering with and investing in small entrepreneurial companies. The purpose of this paper is to introduce an underutilized strategic vehicle – the minority investment - that corporate strategists can add to their arsenal that already includes acquisition, internal ventures, joint ventures, etc. Used strategically rather than to generate quick financial returns as a traditional venture capitalist might, the large firm can capitalize on the innovative ability of small companies. This paper explores corporate venture capital which entails large firms taking minority equity stakes in smaller, entrepreneurial companies that may identify opportunities, develop products and implement new technologies more quickly than the large firm.

### **THE LIABILITY OF LARGENESS AND CORPORATE VENTURE CAPITAL**

Many firms have previously been successful innovators, but once they become successful, they become risk-averse as exploration for new opportunities becomes a secondary goal to exploiting their existing resources causing them to lose their innovative habits (March, 1991). For example, with the emergence of digital photography, Kodak must reposition assets that once created a competitive advantage. Some of the reasons for a liability of largeness include: (1) success that breeds complacency (Bourgeois, II et al., 1999), (2) rejection of change that accompanies innovation, (3) agency issues as agents that have no opportunity to share in the entrepreneurial profits that principals seek are risk averse when they must bear the uncertainty of entrepreneurial activities while only receiving normal returns (Jones and Butler, 1992) and (4) lack of appropriate resources due to the dispersion of sources and capacities needed to commercialize innovation (Teece, 1992) or the rejection of proposals that couldn't overcome internal competition with the existing business for the firm's resources (McGrath and Dubini, 1999).

In sum, the liability of largeness occurs when a firm reaches a certain size and it changes from an organization that had entrepreneurial characteristics and sought opportunity to one that emphasizes bureaucratic policies and procedures to protect existing resources and handle recurring issues (Hardymon, et al., 1983; Hannan and Freeman, 1984; Sykes and Block, 1989).

Firms must often look outside their boundaries when a liability of largeness impedes radical innovation within the firm. Engaging in corporate venture capital by investing in a portfolio of smaller, entrepreneurial companies may help the large firm explore areas that the core business has difficulty entering. The minority investment and, perhaps, subsequent step-up investments, will give the large firm a “seat at the table” that can give it more influence than a non-equity partner, but without dulling the incentive of the small company's entrepreneurs.

Minority investments are not a new phenomenon and, in fact, investments in smaller companies have existed since before the traditional venture capital industry began (Chandler, 1962). Some of the benefits of corporate venture capital for large firms and small companies are listed in Table 1.

TABLE 1  
Potential Benefits of Corporate Venture Capital

| <u>To the Large Firm</u>                             | <u>To the Small Company</u>                                               |
|------------------------------------------------------|---------------------------------------------------------------------------|
| Access to New Technology, Products or Markets        | Receive Greater External Recognition and Credibility                      |
| Extension of Internal R&D                            | Access to Distribution Channels                                           |
| Provide Support for Fledgling Suppliers              | More Flexible Financing                                                   |
| Low Cost Exploration Outside Area of Core Competence | Can Fill Competency Gaps (e.g., product development, sales and marketing) |
| Entry into New Industry                              | Potential Exit Vehicle via Acquisition                                    |

Investing in smaller companies that have completely different resource strengths can be valuable. I argue that corporate venture capital can help large firms manage the risks and uncertainties associated with growth and innovation when used as part of a well-crafted strategy. Yet, corporate strategists have a number of modes of investment to choose from to achieve growth and innovation. Investing in small companies should be considered, not to generate quick financial returns as a traditional venture capitalist might, but as part of an arsenal that includes internal expansion, internal ventures and acquisitions. Compared to the alternatives, minority investments often have advantages in terms of (1) resource commitment (2) strategic flexibility, and (3) development/acquisition of new competencies.

Minority investments tend to require fewer resources than other growth vehicles and provide greater strategic flexibility. Investments in promising ventures can be made at a low cost and if the small company develops and both parties agree, the large firm may increase its investment. On the other hand, in the event the anticipated benefits of the minority investment are not realized or the small company's technology becomes obsolete, the loss, in terms of funding, time, coordination, etc. are minimal. The large firm also has the opportunity to acquire new competencies. Importantly, they may be advantageous when the formal control often associated with the other modes would stifle entrepreneurial creativity (McKinsey and Company, 1997). Two techniques that may be useful in corporate venture capital programs to help firms cope with risk are a "spider's web" and a real options approach.

### **Spider's Web**

Investing firms can act as the "hub of a wheel" and diversify by not betting everything on a single partner. This is effective in highly uncertain environments and can spread risk until a dominant firm, technology or product emerges (Harrigan, 1985).

## Real Option

Instead of making upfront investments in risky projects that can result in huge losses, a real option approach allows the firm to invest smaller amounts in many initiatives (McGrath, 1999). Purchasing an option requires an initial investment that gives the firm the right, but not the obligation, to make additional investments that will be made only after more information is obtained (which reduces risk and uncertainty). This approach also allows firms to invest in projects that may not have a significant immediate impact, but have the potential to improve the firm's future opportunities (Kogut and Kulatilaka, 1994; McGrath, 1997).

## DATA COLLECTION AND ANALYSIS

Information for this study was collected during 2000 and 2001 via 45 surveys yielding 89 small company investments in 15 industries. They were supplemented by interviews with 72 managers that included 28 who did not fill out surveys. The managers had titles such as SVP of Corporate Development, Business Development Manager, and Director of Corporate Development. This approach was designed to balance the richness of information found in case studies with the breadth of large-scale examinations.

Relatedness is a proxy for strategic fit and refers to the extent that businesses share a common expertise, market or resource. Firms can be related based upon various factors, including the type of technology utilized, their manufacturing processes, distribution systems and the markets they serve (Rumelt, 1986). Patterns and characteristics between the large firm and its small company investment were examined to discover whether the investment was made to augment existing technology or markets (i.e., related to the large firm) or to pursue new markets or technology (i.e., unrelated). Vertically related is a third trait as small companies have been found to buy from or sell to the large firm. The data collected revealed the following taxonomy.

TABLE 2  
Minority Investments by Type of Relatedness

|                        | Related | Unrelated | Total |
|------------------------|---------|-----------|-------|
| Vertically Related     | 27%     | 32%       | 59%   |
| Not Vertically Related | 23%     | 18%       | 41%   |
| Total                  | 50%     | 50%       | 100%  |

Investigation of strategic fit indicates that small companies having a low degree of strategic fit with the investing firm receive funding just as frequently as those that are closely aligned. This is revealing because few CEO's would consider acquiring another large firm that did not share a perceived high degree of strategic fit with the focal firm's core business. Even more enlightening is that the majority of minority investments are in small companies that have a vertical (i.e., a buyer or seller) relationship with the investing firm.

## DISCUSSION

### **Investments in Vertically Related Small Companies**

Vertical strategies are critical for firms that need a steady supply of raw materials and a market for their goods. Although a firm may control various supply and distribution entities, a range of ownership arrangements from no ownership to full ownership may be utilized to control risks. Minority investments allow investing firms to limit their asset exposure and risk while retaining the flexibility that is important when the technology or market is in its emerging stage and/or is changing rapidly. This allows the large firm to transfer some of the risk of vertical integration to the small company (Harrigan, 1983).

Minority investments also have the advantages of increasing the large firm's bargaining power. Bargaining power is the ability to affect the supplier's prices, terms, product characteristics, etc. (Harrigan, 1983). Minority investors often have a "preferred seat at the table" and, often, board representation making it more difficult to deny the investor access to a resource. Alternatively, when large firms sell their products to the small company, pressure can be exerted to insure that those products are purchased or may be a condition of the investment.

### **Investments in Unrelated Small Companies**

Unrelated small companies – those that have a low degree of strategic fit with the investing firm – comprise a significant number of minority investments in the data collected. Many of the managers interviewed expressed that investments in small companies are made only when the large firm cannot or does not want to develop the technology that the small company has or is developing. The technology must be adjacent, complementary, and/or able to be applied to an existing product. Stated one manager, there's "not much use in doing exactly what they do." Several managers want small companies that can fill "gaps" in their technology. Investing firms are attracted to unrelated small companies because small companies can develop technologies faster, better and/or cheaper than large firms.

Unrelated small companies are also utilized to gain insight into new technologies that have the potential to provide a competitive advantage. One example is of an investing firm that targets Internet-related small companies to bring together capabilities that can transform the firm such as with business-to-business e-commerce. Internet firms are used to streamline logistics and more efficiently interact with customers and settle financial transactions. Such a strategy can be realized in partnership with other firms in the same industry and the firm has made an investment in at least one small company along with industry competitors.

Unrelated small companies can also help a larger firm explore and gain familiarity in new areas before investing more money in them. In this case, investments will be made when the firm doesn't want to make a bet with its own research and development, but wants a "foot in the door" for new technology that can help alter the firm. Yet another manager described that, his firm made an "investment in a company with a technology entirely unrelated to our core business but one that we can use in changing our core business."

## **Investments in Related Small Companies**

Large firms also invest in related small companies. Cisco started out specializing in routing devices that direct traffic over the Internet and invests to stay at the forefront of its industry. Its minority investment in Cerent Corporation allowed it to stay abreast of a related, but more advanced router than the networks developed by Cisco. Subsequent to making the minority investment, Cisco acquired Cerent (Thurm, 1999). Cisco Systems often invests in small companies to respond to a rapidly evolving industry, to keep key technology away from competitors and to internalize and control the technology.

Alternatively, firms that are not industry leaders can invest in related small companies to help close the gap between themselves and the industry leader or to help develop a critical technology, product or market faster than they could do it on their own. For example, Rite Aid's investment in Drugstore.com allowed it to establish on-line distribution faster than it would have had it tried to develop an Internet site on its own.

Investments in related small companies will be made (1) in anticipation of a vertical relationship, (2) to learn about a related, but more advanced technology and (3) when similar markets are served and the small company has complimentary technology or products.

## **Pitfalls of Corporate Venture Capital**

Corporate venture capital programs often do not succeed when investing firms attempt to replicate venture capital firms and emphasize financial return at the expense of strategic benefits. In fact, Apple Computer disbanded its corporate venture capital program because it did not provide synergistic benefits despite achieving returns of 90% over five years (Brody and D. Ehrlich, 1998). In addition, many large firms fail to articulate clear strategic objectives. Should the small company have a close strategic fit to the large firm or is exposure to new technologies more important? Is a subsequent acquisition important? Even programs with a comprehensible strategy may suffer from a change in management regimes that dismantle the program, or the firm may not successfully integrate benefits into the business.

## **So What?**

Investments made for financial return only and without a strategic orientation miss the point: (1) small companies provide a significant amount of innovation as they often recognize and respond to opportunities quicker, make faster decisions and have fewer mobility barriers than large firms, and (2) a significant amount of innovation is created by large firms working together with small companies as each has something the other wants.

Some of the benefits of corporate venture capital include allowing investing firms to (1) gain access to and explore opportunity spaces that their core business may not be able to, (2) stay at the forefront of innovation with an option on future opportunity, (3) influence the small company's technology development or (4) simply to increase their bargaining power.

Minority investments may represent a middle ground between virtual and fully integrated organizations for bringing innovation into the large firm. With the minority investment, an integrated large firm is not saddled with all of the risks of innovation. Yet, it may impact the innovation being developed by the small company so that it may ultimately help improve the large firm's product or process. The small company may benefit from the minority investment because it can develop not only the product, service or technology for the investing firm, but also, products, services and technology that may be somewhat different and which may diverge from the large firm's interests later.

## CONCLUSION

Few firms will invest in a small company with the expectation of losing their investment. But, well-placed investments can provide strategic benefits by forging a partnership that allows the large firm to capitalize on the innovative ability of a small company. For corporate strategists concerned about improving their firm's innovativeness, investing in smaller companies must be considered. However, rather than follow the cycles of the venture capital industry, developing a strategy with objectives and goals that fit their needs can pay off handsomely.

Corporate venture capital should not be perceived as simply a financial activity. Along with acquisition, joint ventures and internal ventures, minority investments can be a strategic tool that can help augment a large firm's growth and competitive position. It can be particularly helpful in managing the risks and uncertainties inherent with innovation.

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