The downside of a corporate VC fund

Otherwise sagacious chief executives saw nothing but riches when they formed in-house venture capital funds with unprecedented amounts of money. When all is said and done, most corporations will rue that move. **BY HARRY EDELSON**

THE SIREN SONG of venture capital successes in the mid-1990s attracted a slew of corporations to the venture capital field in search of easy profits, a window on technology, and corporate synergy. Corporate operating capital was funneled into in-house venture capital arms at unprecedented rates in the past two years. The avalanche of funding by corporations into venture capital was precipitated by the enormous venture capital returns of recent years. Unfortunately, most corporations started their VC operations at the worst possible time. Moreover, an in-house corporate VC fund is rarely a good idea.

The Nasdaq Composite Index rose every year from 1995 to 1999, fueling enthusiasm for initial public offerings and creating great wealth for investors in venture capital. For five consecutive years beginning in 1995, the Index rose a minimum of 20% annually, culminating in an 85.6% increase in 1999 alone (a 130% increase to March 10, 2000, the date the Nasdaq Composite Index closed at an all time high). Emerging companies with little or no revenues (Cerent, Chromatis, Xros, Arrowpoint) were being acquired for billions of dollars by companies whose stocks were selling at exorbitant multiples of revenues, much less earnings. In early 2000, the Merrill Lynch Internet Index sold at more than 50 times revenues, not earnings.

Wall Street inflated the bubble, which would eventually burst, by launching more IPOs and raising more capital than ever before in history. Otherwise sagacious corporate chieftains saw nothing but riches in early stage investments and formed in-house VC funds with unprecedented amounts of capital. In 1999 alone, more than 50 corporations provided a minimum of $100 million each to new in-house VC arms. At least three companies committed to $1 billion funds (Accenture, EDS, and Intel). According to figures provided by Venture Economics, the reliable source of statistics for the venture capital industry, corporate venture capital activity stayed in a cyclical range of $85-542 million annually from 1980 until 1996 before escalating to $1.1 billion in 1997, $1.6 billion in 1998, $8.6 billion in 1999, and $16.5 billion in 2000. Despite warnings by some Wall Street pundits (and even a number of speeches by yours truly), the lemming's march towards financial immolation gathered steam in early 2000.

In March 2000, the bubble of excess valuation began to burst, eventually leading to a thunderous collapse, spreading destruction in its wake. The closing Nasdaq Composite Index peaked on March 10, 2000, at 5,048.42 before declining 63.5% to 1840.29 a little more than one year later on March 30, 2001. It has risen only modestly since. Do not be mislead by the difference between a series of annual gains of 20%-plus culmi-

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nating in a 100%-plus gain and a subsequent loss of 63.5%. Look at it this way, a 100% loss wipes out everything; all of the gains ever made and even the base. A loss of 63.5% is pretty devastating. It brings us back to the levels of 1998. Internet and related telecommunication stocks, the investment preference of most VC firms, declined even more sharply. Stalwarts such as Priceline, Amazon, Yahoo, Inktomi, Ariba, Corvis, and Akamai Technologies declined 90% or more from their highs. Scores of emerging Internet companies such as eToys, Homegrocer, Beyond.com, Drugstore.com, Ventro, and WebVan rose to ridiculous valuations and then declared bankruptcy or their stocks subsequently sold for pennies per share or were acquired for almost nothing. Before long, almost all major telecommunication stocks fell more than 50%, including Lucent, Cisco Systems, AT&T, Motorola, and JDS Uniphase. Much of the damage devastated subsections of the telecommunications industry such as CLECs, ISPs, and international carriers, e.g., Northpoint, Winstar, PSINet, and Global TeleSystems.

While there are many great corporations and many great VC firms, there are few great corporate in-house VC funds.

Some VC firms were smart enough to take profits and make distributions. Few corporate VC funds did this. A comparison of the trends in the Nasdaq, IPOs, and corporate venture funding shows that the great majority of corporations selected the worst time to initiate their in-house VC funds. All three indicators peaked at the same time but corporate venturing virtually exploded compared to the Nasdaq and the number of IPOs. Corporate VC funds quadrupled from 1996 to 1999 and their invested capital grew an astonishing 691% in 1999 alone, just before the absolute peak in the market. Although there was a precipitous decline in the Nasdaq Index since March 10, 2000, and in the number of IPOs since May 1, 2000, corporate VC spending continued at a high level in 2000 because commitments once made are difficult to extinguish.

While there are many great corporations and many great VC firms, there are few great corporate in-house VC funds. When times are bad and corporations are losing money in their VC operations, the old adage about being in the business for strategic reasons and not to make money is often used. If losses and problems mount, the old adage goes out the window and the VC operation is closed down.

What corporations do not fully comprehend is that in-house VC funds are fraught with problems and should rarely be started, regardless of timing. Here is why.

Predictions

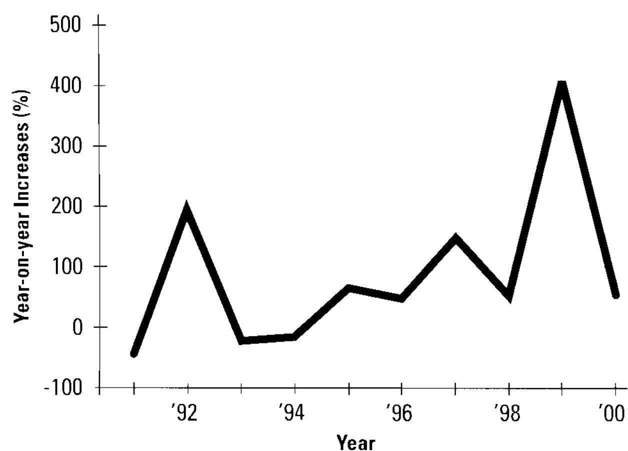
1. Lawsuits against corporations because of VC investments will proliferate.

2. The best people at in-house VC arms will leave in droves to work for independent VC firms.

3. Cooperation between division heads and the in-house VCs will deteriorate.

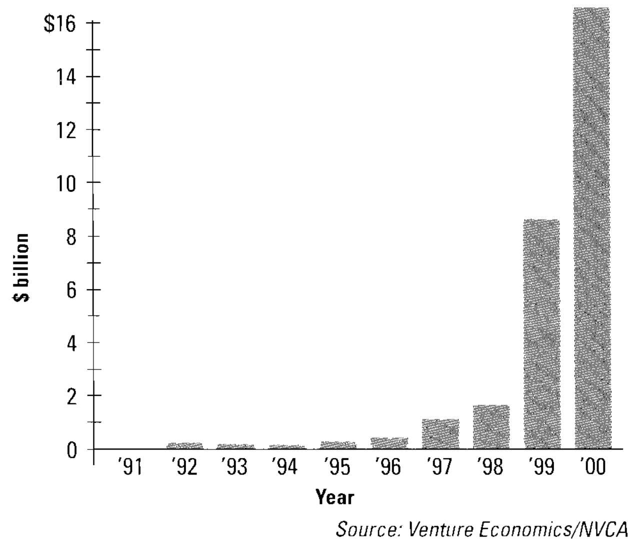
4. Top management will spend valuable time on

Year-on-year growth rates of corporate VC funds U.S. venture investments



Source: Venture Economics/NVCA

Corporate venture investing



Source: Venture Economics/NVCA

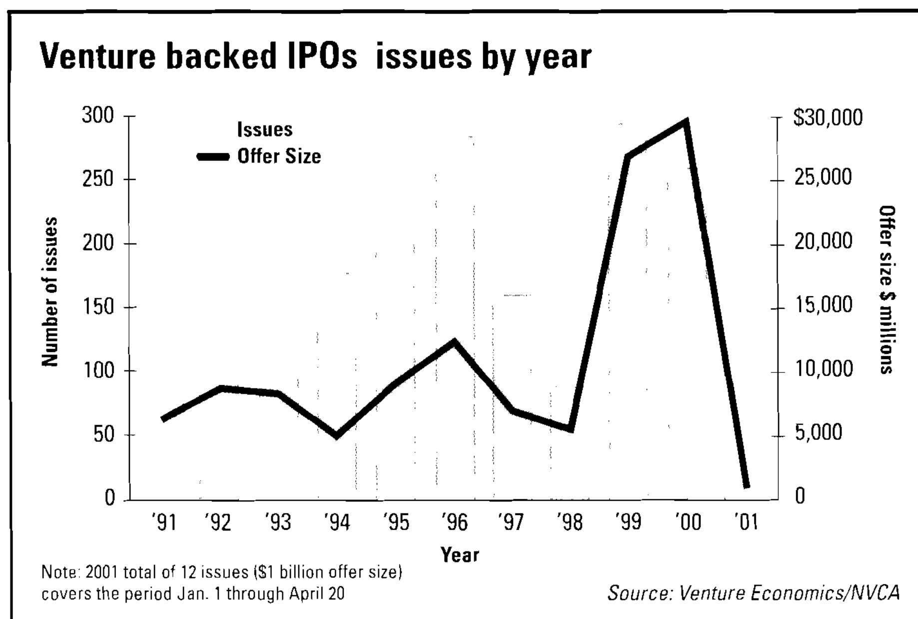
problems stemming from small investments in tiny companies.

5. Corporations will abandon their VC efforts in favor of traditional corporate development activities.

Let us look at the predictions in some detail, taking them in order.

Lawsuits

We live in a litigious society. Corporations have deep pockets which makes them primary targets for lawsuits. When a company invests through an independent VC firm, it is insulated from lawsuits because it is either a Limited Partner or part of an LLP. But, when corporations invest in private companies and take an active role, lawsuits can follow. Moreover, if a board seat is involved, or even observer rights, the company and its appointed director or observer can be sued for any number of reasons related to fiduciary responsibilities.



Corporate VCs invest strategically; therefore, investments are made in potential suppliers and customers, and in new technologies. All three of these investment targets can find reasons to initiate lawsuits. Suppliers can sue because they assumed a supply arrangement that never materialized or that ended early. Potential customers can sue because product was sold to competitors instead of them. Companies with innovative technologies can sue because their secrets were allegedly stolen and incorporated into competitive products. Moreover, any company can sue because it did not receive anticipated funding or for any number of plausible reasons. You get the idea — lawsuits are a dime a dozen, and many corporations choose to settle the claims rather than going through the time and expense of the legal process.

Staffing

Most companies choose insiders to manage and staff their VC activities. A corollary is that there is little or no venture capital know-how, only experience in corporate development, mostly involving large deals. This is not the same as dealing with small companies and inexperienced, unproven management.

Little attention is paid to the burden on the in-house legal department which will soon be consumed with activity even if outside law firms are used for all transactions.

Once the staff is in place, the fun really begins. If the staff is compensated somewhat comparable to their previous positions, and they are astute investors or get lucky with investments because of fortunate timing, they will leave for independent VC firms and a piece of the action. GE Capital lost a relatively large percentage of its staff in this manner. If the staff is compensated with a carried interest similar to partners at independent VC firms, jealousy will erupt within the corporation and lead to divisiveness.

Corporate infighting

The approval of a VC investment by a department head is de rigueur in most corporations. It often happens that the corporate VC group has what they consider to be a great investment opportunity but cannot find the necessary sponsor. Many potential sponsors have their hands full with current operations and do not want to be bothered with a new and possibly competing technology no matter how promising. After a few years of missed opportunities the in-house VCs become discouraged and disparage management. In down years, department heads become disenchanted when they take hits on their budget from failing VC investments. Before long, they scorn venture capital.

All of the problems with in-house venture capital are amplified by poor timing. Historically, corporations discover venture capital at the top of the cycle. A year or two of profits usually ensue followed by many years of distress. Analysis of the current cycle proves the point. According to PricewaterhouseCoopers, in 1995, 65 corporations had VC activity totaling $94 million. Four years later, there were 937 corporations with VC activity totaling $7.9 billion.

Top management distraction

It is easy to start a corporate VC activity, but hard to disengage. Most companies are relatively pure plays before they get involved with venture capital. Companies such as Intel, which has made 400 or so VC investments, are becoming conglomerates, spreading themselves thin, exposing themselves to problems and lawsuits, and burdening top management not with one company but with many. Intel's investments are strategic but cover a wide swath. Some of their investments have yielded huge returns but will inevitably be followed by huge losses and writeoffs. Independent VCs distribute holdings and are finished with them. Corporations usually retain their holdings for too long because it is not comfortable to sell the stocks of "strategic partners." Distributions to shareowners are difficult.

Wall Street favors pure plays, predictability of earnings, and steady growth. Heavy VC activity can give Wall Street fits. Look at what happened to Safeguard Scientifics, CMGI, Internet Capital Group, Softbank, and hundreds of other companies which thought they could do everything.

Small companies have enormous appetites for capital. Many VCs reserve three times the amount of their original investment for later rounds. It is not uncommon for companies to have numerous rounds of investments — e.g., Preferred A through G. Is top management aware of a perceived obligation to continue the funding process, especially for strategic partners? This takes money away from R&D and corporate development, not to mention operations. Meanwhile, portfolio companies cannot understand how large multinational corporations can refuse to continue funding them. What will happen at Intel when many of their 400 portfolio companies say "send us more money or we will have to cease operations"?

Abandonment

That the majority of corporations will shut down their in-house VC activities is not a bold prediction. It is thoroughly proven by history. Almost all the corporate VC activities of the 1960s, '70s and '80s are gone. It stands to reason that the corporate funds of the 1990s will disappear in the 2000s.

In the recession of the mid 1970s, there were hardly any IPOs for five years. Periodically, a lack of IPOs has plagued the VC industry. If there are no IPOs for even one or two years now, many corporate portfolio companies will cease to operate if they cannot obtain substantial additional funding from existing investors. In times like these, new investors are difficult to attract because they are hard pressed to fund even their own deals.

Top management is often replaced during economic downturns. Very often, incoming management has a different view of venture capital than their predecessors. One of the first acts of the new CEO is to get rid of problems — and that can mean the venture capital operation.

Secret of longevity

When all is said and done, most corporations will rue the day they followed the siren song of venture capital riches. History backs up that statement. Hundreds of corporations have folded their VC efforts after early successes and long-term failures (Exxon, Xerox, and Gulf & Western come readily to mind). Longevity has been achieved almost exclusively by financial firms whose business is investments, such as J.P. Morgan Chase, Warburg Pincus, and CSFB Sprout Group.

An alternative to in-house VC arms

Most venture capital firms manage the money of pension funds along with the money of foundations and wealthy individuals. Pension funds operate under the strict rules of ERISA. There are a handful of VC firms that manage corporate rather than ERISA money. Those firms have two goals rather than one: assist the limited partners, and earn a good rate of return.

A corporation that invests in a strategic fund obtains many of the benefits of an in-house operation and few of the problems (superior benefit is in **bold** type):

External versus Internal Funds

	External	**Internal**
Strategic Value	Diluted	**Focused**
Management	**Seasoned**	Unproven
Legal Exposure	**Low**	High
Financial Results	**Strong**	Good
Relationships	**Varied**	Parochial
Liquidity/Exit	**Easy**	Hard
Conflicts of Interest	**None**	Many

Strategic funds are run by managers with extensive corporate experience and good VC track records. They work closely with counterparts at corporations to identify interesting solutions, provide advice, and introduce new technologies and contacts. Obviously, they do not know the companies that are investors as well as management does, but an external viewpoint is helpful in many situations.

Usually, many corporations become partners in the same fund. This can be beneficial. Often, corporate partners are exposed to interesting viewpoints and knowledge. The general partner makes investments in companies that may not be of interest to all corporate partners but each corporation invests only a portion of the total capital and pays a proportionate share of expenses. Finally, it is surprising how often investments "outside the box" are of interest later on.

— Harry Edelson

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