



ALLEGIS CAPITAL SPECIAL EDITION

Sustainable Corporate Venture Capital

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CORPORATE R&D LABS ARE A DYING BREED. Their role in the world of innovation has been taken over by fleet-footed startups that are evolving faster than any large corporation could hope to match.

Between 1981 and 1999, the share of industrial R&D in the U.S. done by companies with more than 25,000 employees dropped from 70% to 40%. Over the same period, the share for companies with fewer than 1,000 employees rose from just over 4% to nearly 23%.¹ The impact of small companies on innovation is now enormous.

If the giants are to adapt and survive, they must tap into the engine of innovation that has emerged from the venture capital industry. By partnering with the appropriate VC firm, large corporations can use entrepreneurial companies as outside R&D labs and thus introduce new technologies into their DNA. It's not a simple process, but by combining the efficiency of the startup's R&D dollar with the strength of branding, distribution, and support afforded by a large corporation a new breed of company can emerge, one that will be very hard to beat.

Over the last 20 years, I've worked with more than 30 corporate investment partners in my venture business and, when I was CEO of an entrepreneurial company, established R&D relationships with huge corporate partners such as Apple, AT&T and Motorola. I've learned how to structure deals that benefit both the entrepreneur and the established company, and have seen how powerful such partnerships can be. I've also seen how they can go wrong.

1. *Survey of Industrial Research & Development, National Science Foundation, Science Resource Studies, 1991 and 1999.*

VALUATION VOLATILITY

PEOPLE THINK OF INNOVATION AS A STRAIGHT LINE, but it comes in waves: The semiconductor, the minicomputer, the microprocessor, client/server computing, and the Web all induced tsunamis of innovation. As excitement over the technology grows, so does the perceived value—and the valuations—of the startups that capitalize on the disruption. But the tide flows both ways, and the valuations of entrepreneurial companies come and go with the surges of innovation.

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Internet exuberance during the dot-com boom is a dramatic example. Money poured into Internet stocks from all corners of the investment world and corporations went along for the ride. The rules were rewritten as corporate executives were under intense pressure to invest in the Internet's promise of a revolutionary economy. Since there seemed to be no downside

to these investments, the attitude was, "You're an idiot if you don't do it." Corporate venture capital investments soared from \$1.8 billion in 1998 to \$15.9 billion in 2000, accounting for 16% of all VC invested that year.²

Then the NASDAQ corrected in a big, bad, meaningful way, and the perceived value of these investments swung to the other extreme. By 2002, everyone "knew" that IT innovation was dead. Corporate investments in entrepreneurial R&D plummeted to \$1.6 billion—a decline of \$14.3 billion in 24 months! No startup could get funding. The attitude was, "You have a cure for cancer? I don't care." Corporate executives gave word to their venture investors: "Get us out. I don't care about the write-off, just get us out."

The experience of two companies shows how harsh Wall Street can be. In the first quarter of 2000, CBS missed its Street estimate by a couple cents a share because of the declining valuation of its investment portfolio, and its stock was hammered. Less than 72 hours

2. *Pricewaterhouse Coopers/Thomson Venture Economics/National Venture Capital Association MoneyTree survey.*

later, Compaq *beat* analyst estimates by three cents a share in its earnings because of gains in its investment portfolio, but the Street pronounced it a one time deal, discounted the gain, and Compaq got no credit for it. The company had a slam dunk quarter, but it was blocked by valuation volatility.

In some Internet sectors, the valuation pendulum has swung back again to bubble proportions, this time fed primarily by corporate acquisitions and investments. Corporations are once again afraid of being left out of important trends. Ebay recently admitted it overpaid for Skype and took a write-off. Google paid \$1.2 billion for YouTube, a company that had no revenues. Microsoft invested \$240 million for 1.6% of FaceBook, valuing the company at \$15 billion. (If I were the CEO of Facebook, I'd be selling every share I possibly could right now.)

The truth is this: Most corporations don't have the patience or the shareholder permission to flow with the tides of R&D. They jump in and out of investing because they pay too much attention to short-term financial considerations, consumer trends, and the general state of the economy. If you try to time your investments to precisely match the rhythm of valuation—if you invest for strategic reasons alone—you'll always get it wrong. Venture investment requires a commitment to the long term, and a strategy that insulates you from the pressures of the pendulum.

IMPEDANCE MISMATCH

THERE'S ANOTHER PROBLEM WHEN INVESTING IN COMPANIES. The culture in a Global 1000 company is considerably different from that of a startup. I think of it as an impedance mismatch. Large corporations measure themselves by how many employees they have, their market cap, and their brand recognition. They're cautious in their approach to investing in new technologies and are resistant to change. The venture-backed entrepreneurial community is exactly the opposite. Startups take pride in being small, fast, efficient, and untethered, rushing toward an uncertain future as fast as they can. Partnership can create huge frustrations because the startup and the corporate partner operate at different speeds.

The process of combining the two cultures requires a humble acknowledgment, from both parties, of what each type of company does well, and what it does not. The attitude should not be to arrive on the scene in order to make kings of princes, but to step toward a common goal: We come to learn from each other.

PACING THE INVESTMENT RELATIONSHIP

THE KEY IS TO CREATE THE RIGHT TYPE OF RELATIONSHIP AT THE RIGHT TIME. In order to make the most of the investment dollar, corporations must ask two questions:

When should we invest, and how much?

To answer these questions and properly manage the investment risks, we consider three criteria: The amount of *leverage* a corporation can provide, the *capital commitment* that's required, and the *valuation volatility* of the investment. These factors vary as a startup grows and matures and require a different investment strategy at each stage. I describe these strategies as Discover, Leverage and Integrate. By adhering to these strategies, a corporation can develop a successful and sustainable venture investing business and avoid the volatility that can devastate a corporate market capitalization.

STRATEGY 1: DISCOVER

IN ITS VERY EARLY STAGE, A STARTUP'S PRODUCT IS MORE DREAM THAN SUBSTANCE. The risk to the entrepreneurs and their investors is inherent in the process of innovation. The corporation doesn't have much leverage to offer—the entrepreneur just needs cash in order to turn the dream into reality. The valuation volatility of the startup is high as it faces an uncertain future, but the capital commitment required is low.

At this stage, the corporate venture arm should consider investing in the startup through a partnership with an established VC firm that has developed the expertise to manage the risk. By becoming a limited partner in a venture fund, the corporation gets in on early investments, makes minimal capital commitments, and mitigates high volatility by spreading it among 20 other limited partners. The corporation can take advantage of the historical rate of return enjoyed by VC firms and receives a call option on the future, a placeholder for a direct investment in a promising startup.

With this approach, the corporation can cast a wide net and act as a voyeur, keeping an eye on new developments. It's the most likely way to find new technologies that could end up being of interest—especially that new thing that comes out of left field that the established corporation hadn't anticipated.

The important thing is to choose the right venture firms to work with. Most VC firms are happy to take your money, but are they good to work with? They should have an investment focus that's complementary to the needs of the corporation. The firm should also have a history of successful collaborations with corporations. It's essential that you check for references with other corporate limited partners of the firm before investing.

STRATEGY 2: LEVERAGE

AS THE STARTUP MATURES, THE RISK SHIFTS FROM INNOVATION TO BRINGING A PRODUCT TO MARKET. At this stage, all three of our criteria for evaluating the worth of an investment—corporate leverage, capital commitment and valuation volatility—are moderate.

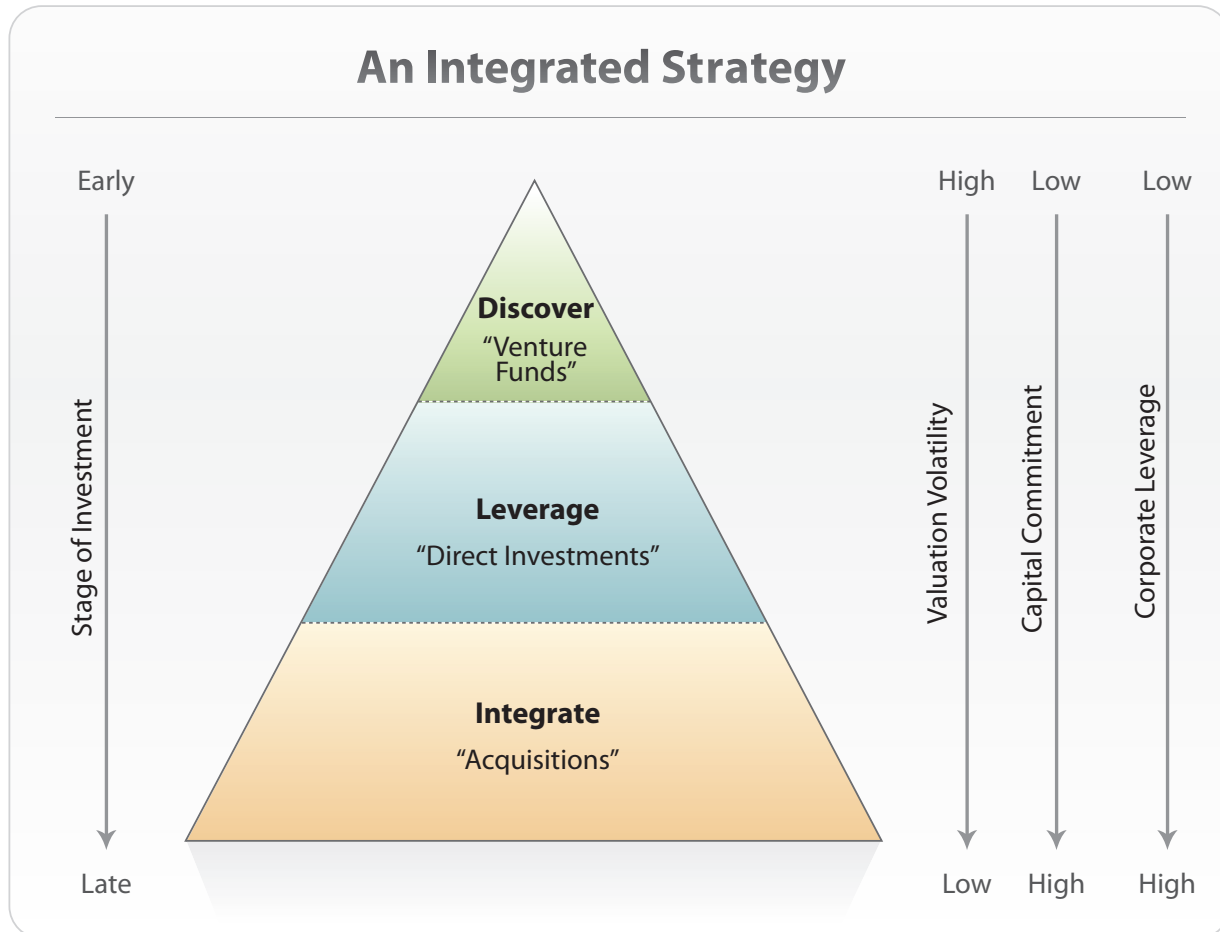
As the company moves from pure research to product and sales execution, a corporate investor can provide more than simple cash. It has some leverage to offer. It can help explain market dynamics, how to introduce the product to the market, how to scale. It may be able to provide manufacturing or distribution channels.

This stage requires a little more commitment, both in capital and culture. The corporation should consider a direct investment in the startup that will allow partici-

she will make sure that the startup is operationally relevant to the corporation. A corporate venture fund that answers to the treasurer isn't in a position to do that.

STRATEGY 3: INTEGRATE

WHEN AN ENTREPRENEURIAL COMPANY PROVES IT HAS A GOOD PRODUCT WITH STRONG DEMAND, THE RISK SHIFTS TO EXECUTION. The startup needs to scale up operations and establish a strong market position. It's



pation in the creation of value in the younger company. This will create an opportunity for the two organizations to get to know each other better, and for the large company to watch the small one develop. An executive from the investing company may join the board of the entrepreneurial company. Together, they can develop a shared strategic vision. By aligning interests and making an investment, the corporation can start to create a more reciprocal relationship, lessen the cultural conflict between the two companies—and keep competitors from adopting the new technology first.

The corporation must begin to act more like a professional venture firm and develop rigorous analytics to track the progress of the investment. It should tie the startup to a line of business at the corporation and start thinking about how to transfer value to the operating unit of the corporation. If the general manager of the business unit is willing to commit the resources, he or

at this point that the corporation has the most leverage to offer. If the startup's product appears to be something that could play a crucial strategic role in the larger company's market, then it's time to consider buying the startup outright.

The fundamentals are right. The capital commitment is higher because the company is further along, but the corporate leverage is also high and the valuation volatility is low, making it a much safer investment. If the startup is acquired before it spends millions of dollars scaling up manufacturing and building a sales and marketing organization, the corporation's team can take over these functions, thus avoiding unnecessary duplication and saving both companies money.

By this stage, the relationship will have evolved to a point where the strategic importance of the young company is understood and accepted by the corporation.

One of our portfolio companies, IronPort Systems, is an example. Cisco Systems could have bought the company a couple years ago, but it watched and waited—and became a customer first. After IronPort had proved its worth, after it had shown what its product could do and had begun to scale, it became a less risky investment. When Cisco bought the company last year, they were able to give IronPort a huge boost by selling the product through the corporate channel. In 2006, IronPort had revenues of about \$82 million, with bookings of about \$140 million. In 2008, with Cisco's help, it will do \$250 million in revenues. By 2010, IronPort could be a billion dollar business and the \$830 million that Cisco paid will be seen as a huge benefit to both companies.

In an acquisition such as this it's important to integrate the team into the corporation and hold onto the people. The acquiring company needs the M&A expertise to create a clear process for absorbing the new company while insulating the startup from too corporate bureaucracy. The most liberal of the administrative managers should be the one working alongside the entrepreneurs.

During this transition period, there is time to normalize the financial reporting, to develop a hybrid culture, and to ensure that the entrepreneurs who created the company are around long enough to help out. Eventually, the more entrepreneurial of the employees will leave to start other companies, but many will have become comfortable with the operations and stability of the large corporation and will stay. The entrepreneurial company will then have become fully integrated into the corporation.

DEVELOP A CORE COMPETENCY

IN ORDER TO MAKE SOUND INVESTMENT DECISIONS, CORPORATIONS NEED TO DEVELOP A CORE COMPETENCY IN VENTURE INVESTING. They need to develop professional and stable investment arms that aren't measured against the vagaries of the market.

Venture investing is a business of relationships. Relationships and experience take time to develop and are maintained at the individual level. When a corporation jumps in and out of the venture investing business, the relationships with entrepreneurs and the institutional memory of the venture team is lost.

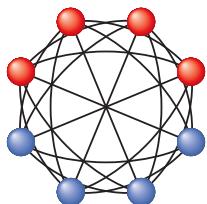
Corporations should not think of this as merely a side business that can be assembled and dismantled as needed. The venture arm of a corporation should be part of the career path, one where the best performers know it can give them a shot at the CEO's job. When that happens, the skill set will spread through the corporation and create a vibrant company with the ability to tap into some of the most innovative research being conducted in any industry.

The time to develop this core competency is now. Industries are at an inflection point. The demands of globalization, rapid innovation, and the disruptive nature of the Internet make it critical.

By developing investment expertise, corporations need not become extinct. They can gain a strategic advantage that will ensure not only their survival, but their ability to thrive, whatever the changing global climate throws their way. ■

BOB ACKERMAN IN FORBES MIDAS LIST

As previously reported, our Managing Director Pete Bodine made the Forbes Midas List for the past two years. This time, for 2008, it's Bob Ackerman's turn. Bob is a co-founder and Managing Director of Allegis and, in all likelihood, his inclusion in the list has something to do with last year's billion dollar exits. Bob represented Allegis Capital on the Board of Directors of both successful exits, IronPort and LGC Wireless. IronPort represents skillfully executed capital accumulation while LGC Wireless shows how patience in building and guiding a company pays off—sometimes.



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