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Corporate Venture Capital & the Returns to Established Firms when Acquiring Startups

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Why do established firms invest in start-ups?

- **Financial Motives**

- ~ “Place good bets” due to knowledge of technology & markets
 - Across industries, 1983-94 (Gompers & Lerner, 1999)
 - 325 IT start-ups, IPOs 1998-99 (Maula & Murray, 2001)
 - 301 Biotech start-ups, 1978-91 (Stuart et al., 1999)

- **Strategic Motives**

- ~ Gain “window” on emerging technologies (Dushnitsky & Lenox, 2005; Dushnitsky & Shaver, 2007; Wadhwa & Kotha, 2006)
- ~ Facilitate development of firms offering complementary products or services (Chesbrough, 2000,2002)
- ~ Identify and monitor potential acquisition targets (Maula and Murray, 2001; Dyer et al. 2004)

CVC & Acquisition Performance

- Core Arguments:
 - ~ CVC investing confers informational advantages to acquirers in takeover markets for startups by:
 - Increasing awareness of acquisition opportunities
 - Improving ability to estimate “value”
- What we find:
 - ~ CVC increases the returns to acquisitions of technology startups, but it:
 - Depreciates very quickly
 - Involves significant portfolio effects
 - Depends on balancing internal / external investment
 - And is subject to organizational challenges (organizational structure, escalation of commitment)

Paper #1: On Complementarities w/in IT Sector (working paper)

- Based on 500+ acquisitions made by 200+ acquirers (1987-2003)
 - Firms actively engaged in CVC earn 1.6% higher returns when acquiring startups than otherwise predicted
 - Not explained by unobserved heterogeneity among acquirers, acquisition experience, selection, or “boom period” effects
- As predicted, I also find that...
 - ~ the informational advantages depreciate quickly
 - CVC investors are not better acquirers overall
 - Only investments in current & prior years seem to matter
 - ~ Portfolio size matters
 - Few benefits for “dabblers”
 - Otherwise, diminishing returns

Paper #2: On the Balance Between Internal & External R&D Investments (*Org Science*, forthcoming)

- “Learning to Acquire Technology Startups: The Role of Corporate Venture Capital”
- We predict:
 - A curvilinear (inverted-U) relationship between the share of R&D dollars devoted to CVC activities and the firms’ startup acquisition performance.
 - That firms with more stable CVC programs will earn higher returns when acquiring startups than firms with more sporadic investment patterns.
- ~ We find (IT acquirers, CVC investors):
 - For firms in our sample, the effects are diminishing and hit a tipping point at roughly 15% of total R&D spending.
 - Stability matters

Paper #3: On organizational challenges (under review)

- "The Returns to Corporate Venture Capitalists when Acquiring Portfolio Companies: An Overpayment Puzzle"¹
 - ~ Corporate investors can risk becoming "too close" to their portfolio firms
 - We find that CVC investors more likely to overpay when acquiring portfolio companies, possibly due to overconfidence biases
 - ~ Investing through a dedicated unit (e.g. "Intel Capital", "Dell Ventures", "EDS Ventures") seems to mitigate against that risk
 - Moreover, firms with dedicated units less likely to re-invest in startups that ultimately fail

¹ An earlier version of this paper was titled "Try before they buy: Corporate venture capital and the acquisition of portfolio companies"

For Paper 3: Alternate explanations tested

- Could be that corporate investors are “dumb” money (poor investors / acquirers)
 - ~ CVC-investments perform as well as VC’s (w/ IPO)
 - ~ Sample firms’ non-CVC acquisitions are successful
- Could be a “lemons effect”
 - ~ Then we would expect them to discover this as they work with the startup
 - ~ Consequently, (1) don’t acquire, or (2) pay a lower price
- Could be “disappointment” that target won’t have an IPO
 - ~ Should see (+) at investment stage, (-) at acquisition
 - ~ Other corp investors (who didn’t acquire) should have negative reaction too
- Could be a “falling in love” &/or escalation of commitment-type story (most consistent with our results)

Remaining Questions

- Are the gains we observe due to better information or preferential access to promising candidates for acquisition?
- How does the information gained through CVC investing transfer from individual to org level?
- What is it, specifically, that acquirers are learning?
- Is the rapid obsolescence in Paper #1 due to short technology life cycles?
 - ~ Is it exacerbated by high turnover of CVC managers?
- How do alternative reward systems and/or organizational structures alter the behavior of CVC managers?