

Rediscovered, Redefined

Corporate Private Equity

Corporate private equity investment is resurging. And why not? It can help you grow your company better, cheaper and faster.

Since the mid-1990s, Intel Corporation has invested more than \$2 billion in over 200 companies, usually in the early stages of development. Its investments are relatively small, on the order of \$1 million to \$2 million in each company. Private venture capital funds with as much money to deploy as Intel probably wouldn't consider investments of that size. But Intel's strategy is to invest not only for financial return, but perhaps more importantly for strategic reasons.

Intel's private equity investment program is headed by Leslie Vadasz, an Intel senior vice president, director of corporate business development and member of Intel's board of directors. He was the third employee at Intel, back in the late 1960s, and has been a major contributor to the company's extraordinary growth. Vadasz's mission is clear, given Intel's position as a dominant supplier of semiconductors: Feed the demand for increasingly powerful microprocessors.

To accomplish this objective, Intel can't just produce faster chips; it also must ensure development of applications that will continue to demand more powerful microprocessors. As a result, Intel has invested in everything from content developers to bandwidth expanders to facilitators of e-commerce. Any company that will

help to feed its core mission is a potential investment target.

Powerful Wave

Like Intel, many corporations over the past 25 years have created wholly owned or affiliated venture capital funds. Typically these funds are organized for strategic purposes, but are expected to deliver financial returns at least commensurate with average historic returns on shareholder equity. Since they often have the latitude to invest in a range of transactions, the term "venture capital" is giving way to the broader notion of private equity.

This concept is now central to many companies' growth strategies. Why? There are several factors: the phenomenal growth and financial success of the private venture capital industry, corporate outsourcing and spin-offs; the rationalization of R&D portfolios; changes in relationships with suppliers; and most significantly, the upsurge in entrepreneurial culture. And corporations have helped venture capital activity to surge by making substantial investments in venture capital funds, increasing the level of direct investment in private equity transactions and, in some cases, forming their own strategic venture capital subsidiaries.

**By Stephen M. Sammut,
Robert J. Borghese
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Today's boom is the latest resurgence in a recurring cycle of rise and decline in this type of investment, roughly in synch with the stock market. Prof. Josh Lerner of Harvard Business School divided these cycles into three distinct waves. The first began in the late 1960s and early 1970s, when more than a quarter of the *Fortune* 500 initiated CPE programs to capitalize on opportunities similar to those identified by some of the early venture capital funds. One such fund was ARD, which acquired 77 percent of Digital Equipment Corporation (DEC) in 1957 for just under \$70,000. ARD realized an enormous return after DEC

went public and became a multibillion-dollar manufacturer of minicomputers. Few CPE programs replicated the results of these early funds during the first wave, which crested in 1973 when the market for new public offerings (the preferred exit strategy for venture capital investments) evaporated. The second wave began in the early 1980s as the market for IPOs re-emerged, but ended abruptly with the stock market crash in October 1987. The third wave – the one we're riding now – began in the mid-1990s, driven by a powerful stock market with a seemingly insatiable appetite for IPOs.

Flies in the Ointment

The failure of CPE programs during the first two waves can be attributed not only to the evaporation of the IPO market, but also to certain structural flaws in the programs themselves. One major fault has been the absence of well-conceived, clearly articulated objectives. The programs were often charged with two distinct missions: to identify and invest in emerging technologies that complemented the business of the corporate parent, and to achieve returns on investment that would meet or exceed the return on shareholders' equity being generated by the corporate parent. These two mis-



Form Follows Function

Since structure is a determinant of success, what factors should shape a corporate private equity program? Perhaps the key consideration is that, regardless of whether the program is established as a "pure" financial or strategic play, or as an integrated business unit, the optimal framework must be driven by, and will vary in accordance with, its full range of objectives.

If, for example, the program is expected to achieve returns commensurate with other business units, and at the same time facilitate strategic opportunities for operating units, the following considerations are critical:

Mission

- ◆ How precise are the strategic goals? Must the investment be made in a company whose technology is an exact and immediate fit, or is the posture of the parent corporation more patient?
- ◆ If the fit is immediate, how will equity participation be coupled with an operational relationship? Will the price paid for equity encompass technology or product rights? If so, how does that affect the portfolio company? The accounting treatment of the portfolio company? The rate of return?

Environmental Factors

- ◆ How do independent venture capitalists generally operate within the industry of which this corporation is a part?
- ◆ What's the historic role of corporate investment in portfolio companies in this industry?
- ◆ What are the historic liquidity events in the industry? IPO? Acquisition? How does the presence of a corporate investor affect that mode?

Operational Factors

- ◆ How will deal flow be generated?
- ◆ What will be the typical style and level of due diligence? The pace of negotiations?

The time between investment and liquidity?

Governance Factors

- ◆ What level of participation in governance does the portfolio company expect? How have independent venture capitalists accommodated this expectation?
- ◆ If the posture is that the operational relationships should be at "arm's length" from the equity investment, how will the due diligence be coordinated? Where will the investment decision lie? Will negotiations be teamed, or managed separately?

Compensation Factors

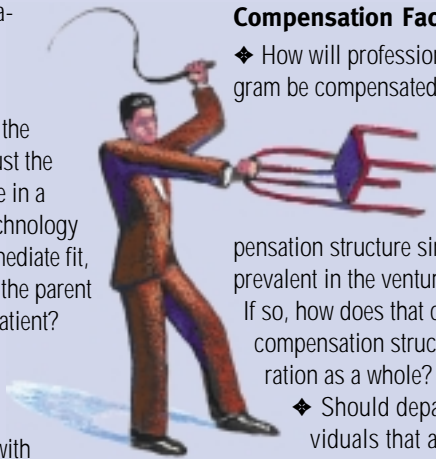
- ◆ How will professionals in the program be compensated? On returns only? On strategic benefits? Or on some combination?
- ◆ Is the compensation structure similar to those prevalent in the venture capital industry? If so, how does that compare with the compensation structure in the corporation as a whole?
- ◆ Should departments or individuals that aren't part of the private equity program, but which add value through due diligence or other contributions, participate in the compensation?
- ◆ Should employees rotate through the program as part of their professional development? If so, how does that rotation affect compensation?

Measuring Success

- ◆ If strategic relationship is separate from the equity investment, are outcomes measured separately, or are they still linked? On what basis? With what metrics?

Integrating the Considerations

- ◆ How do you reconcile these variables to achieve an appropriate structure, with realistic and achievable performance expectations and measurable outcomes? ⇄



sions were, in many cases, incompatible, and often contributed to the programs' perceived failure.

A second major flaw was the lack of a firm corporate commitment. Sometimes these programs were considered peripheral to the corporation's core mission, so the most talented managers weren't always recruited to head them. Or corporate reorganizations and changes in senior management led to the elimination of the programs, as they were perceived to be pet projects of prior management. Or senior management would curtail them during lean years to maintain earnings.

And third, these programs failed to design and offer compensation packages to attract and retain top venture fund managers. Corporations have traditionally been reluctant to tie managers' compensation to the performance of the program in the same way private venture fund managers are compensated through their "carried interest." Few senior managers were willing or able to expend the political capital necessary to lobby for a compensation package that differed radically from the standard package the corporation offered.

Type and Match

Despite the experience of the first two waves, there's still a lack of understanding about how the structural aspects of a CPE program affect its success. This relationship is founded in large part on how well the mission of the program is conceived and articulated. CPE programs can be subdivided into three distinct types based on their stated mission. Each has its own driver, difficulties and basis for measuring success.

Type 1: The Financial Play. In programs where the mission is stated in financial terms, the focus is on achieving baseline rates of return on private equity investments. This type of program is driven by the CFO's office, either as a treasury function or as an alternative investment for the corporation's pension fund. It participates in the venture capital market typically by making passive investments in private venture capital funds. These funds

have a long-term investment horizon, and their liquidity is a function of the fund's investment strategy.

If the investment is made out of operating funds, a number of factors – from the tangible costs of equity and debt to the intangible opportunity costs of otherwise occupied capital – make measuring returns difficult. By contrast, investments made on behalf of the pension fund have a built-in standard for measuring success: The investment can be compared to investments in other asset classes over the same time horizon.

Type 2: The Strategic Play. Where the mission is an extension of corporate strategy, the driver is the expectation that the corporation will derive strategic benefits that outweigh the investment cost. Taken to its extreme, this approach is tantamount to outsourcing the corporate research and development function. No attempt is made to capitalize the investment, and the cash used to finance it is expensed as it flows into the portfolio company. This approach is often managed by a research and development unit or by the corporate development office, with the CFO's office in a supporting role. It's predicated on two assumptions: that the management of the portfolio company can deliver on plan, and that the rights to the intended assets are properly secured by the corporation.

Measuring success depends entirely on how expectations are set at the time of the investment and how those expectations are managed over its life. While no corporation anticipates financial losses on its investments, the reality is that new strategic opportunities sometimes justify sub-par returns.

Type 3: The Program as Business Unit. Where the mission centers on developing the program as a business unit of the corporation, the focus is on

combining a level of financial accountability with a strategic goal. This is ideal for many corporations, because it's built around disciplined and well-articulated financial principles, but is essentially strategy-

driven. These programs are expected to achieve baseline financial returns (e.g., average return on shareholder's equity), which are further supplemented by specific, definable strategic benefits. Of course,

when the CPE program is structured as a business unit, it's necessarily subject to all the planning and consensus building that surround other business units in the organization.

Most corporations that have initiated or continued their CPE programs in this "third wave" have done so for both financial and strategic objectives. The degree to which the program is oriented toward either of these goals often reflects where the program fits into the corporation's mission. Intel's program is a shining example. It successfully integrates financial and strategic objectives and avoids many hazards.

Intel's Payoff

Two recent Intel investments, Inktomi (a developer of web-search technolo-

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gy) and eToys (an online toy retailer), illustrate the diversity of target companies and the potential financial and strategic payoffs Intel seeks from its private equity investment program. In both cases, Intel put in money alongside traditional venture capitalists and other strategic investors. This is a common approach for Intel, as it doesn't want to be in the "business of managing other people's businesses." Sometimes it will request observation rights at board meetings, but rarely will it exercise voting power. In reality, however, like many other strategic investors, Intel still has extensive influence over its portfolio companies, as the leverage of being affiliated with Intel can often make or break a company in the marketplace.

Intel's investments in Inktomi and eToys were both modest – under a few million dollars each. Each company has achieved a market capitalization in the \$5-billion range less than two years post-IPO. Intel's holdings in each are worth about \$100 million. And these investments have achieved the financial and strategic objectives Intel sought.

Thus, the successful corporate equity programs of Intel and others make it possible to believe that this round of investment may be a sea change, rather than just another wave. ◊

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Why Private Equity?

Corporate private equity programs appeal to corporations because they offer:

- ◆ A means of identifying and partnering with companies whose products and technologies might play important roles in the development of the corporation's business;
- ◆ An inside perspective on possible acquisition targets;

- ◆ An opportunity to outsource product design and development cost-efficiently;
- ◆ The prospect of creating reliable suppliers of materials and components, and of outsourcing selected operations;
- ◆ Access to new and emerging technologies; and
- ◆ A means of realizing value from internal R&D programs that are no longer relevant to the corporation's core mission. ◊