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Startups: Will Your Corporate VC Ditch You Too Soon?

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While CVCs may provide capital now, they sometimes end their commitment abruptly, spooking your other investors. It pays to research their track records.

For many ventures, receiving outside investment is an important step that can help the company grow and thrive over time. Some investments come from individual "angel" investors, whereas others come from venture capital firms that specialize in startup investing. But venture capital firms differ in how they operate. Whereas most invest funds that are raised from assorted investors, some venture capital firms are run by established corporations that want to make their own investments in startups. These are what constitute "corporate venture capital" investor firms.

Corporate venture capital (CVC) involves established firms purchasing an equity stake in startup firms. Through this minor ownership stake, the corporate investor is able to observe and access what is happening at the startup and learn about new technologies or business models that may be relevant for their future business development efforts. Not surprisingly, companies increasingly use CVC as one of their corporate entrepreneurship tools, looking externally to help complement their own ideas. In exchange, startups use these relationships with established companies not only to gain financial capital, but also to benefit from endorsement and complementary resources that incumbent firms can provide.

CVC is often discussed as a low-commitment, easily reversable "option" for companies to explore entrepreneurial opportunities. Researchers have found that lower commitment and arm's length exploration confers many benefits to the company investing in the startup. The company can adjust focus and easily walk away from these innovation pathways if they deem them to be not a good fit. This certainly makes sense: by avoiding hiring personnel or acquiring assets in house, companies maintain flexibility and avoid significant costs. In essence, they outsource some of their corporate entrepreneurship efforts. Because their only official link is their investment and their operation is less integrated with that of their investees, they can stop investing at any time if their strategy changes.

However, this overlooks the key point that the CVC's freedom to stop investing affects both the startup and its other independent venture capitalists. Even if an established company invests only money in the startup, its very involvement creates an endorsement effect that makes the startup desirable to other investors. If the CVC stops investing, the startup will lose that endorsement effect that made it such an attractive investment. Indeed, others may wonder why the CVC abandoned its investment in the startup and hesitate to invest in the startup.

The major shock to the startup's resource base that results from these actions by the CVC investor is dangerous for firms in their early stages. Moreover, independent venture capitalists may have chosen to join, and price their ownership in the startup, assuming the CVC's continued support into the future. These realities suggest that startups looking for funding also examine a potential CVC investor's past investment pattern as they weigh whether accepting CVC involvement will be helpful or hurtful to their ultimate development. With this background in mind, we sought to understand how a CVC's past behavior, specifically by not abandoning investment syndicates prematurely, was a desirable attribute among CVCs, and whether it would open up future investment opportunities. Indeed, receiving investments from strongly committed CVCs would provide much needed comfort for startups that already face considerable uncertainty, prompting them to also consider the commitment level of CVCs in prior relationships.

Our research confirms that startups and other syndicate investors such as traditional venture capitalists tend to avoid co-investing with CVCs whose past behavior was uncommitted or capricious. When a CVC demonstrates a commitment to its portfolio startups and co-investors through repeated investment rounds, no matter what's happening at its corporate parent, it improves its reputation and its chance of being included in future investment syndicates. This reputational benefit is even stronger when the CVC's parent is pursuing its own internal opportunities for patented innovations, which could potentially take resources away from commitment to CVC activities. Second, the reputational benefit was also more valuable when the CVC parent had abundant financial resources. In essence, the startup's other investors would be concerned that incumbent firms were only investing through CVCs because they had money to experiment, but could withdraw if the financial situation worsened. In these instances, a past history of commitment helps to alleviate concerns that such a pullback will occur.

What We Studied

This study was primarily investigated using secondary data provided by the SDC VentureXpert database, which contains information on startups, venture capitalists, investment banks, and other stakeholders to triangulate information about fundraising events. Our sample looks at syndicated fundraising rounds by US-based startups between 1995 to 2010. In total, we followed 3,109 startups, across 10,406 funding rounds. We then identified 183 CVC investors that had public corporate parents that were actively investing during the same period. The outcome variable of interest was the probability that a specific CVC was included in the observed investment syndicate. Our independent variable was straightforward: We looked at CVCs' investment histories through the year prior to a focal investment round. We then computed the percentage of investment syndicates that the CVC remained committed to through the investment process -- i.e., where it did not end the relationship with the startup unless all of the other investors did as well. We then used US Patent and Trademark Office patent data and CVC parent financial data to determine the impacts of internal R&D and the company's financial wealth.

To supplement our research, and as a reality check, we also talked with 12 independent VCs and 15 CVCs. This gave us better context and additional support for our theorizing.

What We Found

Our research confirmed our theory that a CVC's past history or commitment was valued by other co-investors. We also looked at how these reputational assets interact with other known drivers of CVC linkages, such as the corporate parent's financial health and resources. While CVCs are more attractive to others in the syndicate if the parent company has abundant financial and technology resources, this halo will dim if the company has abandoned its CVC investments capriciously in the past. In essence, those resource endowments are only valuable to a corporate investor's collaborators (startups and other investors) if the corporate investor show its willingness to stay committed to the relationship throughout the life of the engagement. Moreover, these same attractive attributes and resource endowments may be the very reason a corporate investor chooses to end its relationship, for example because a corporate investor has its own promising technology or product.

Taken together, our study provides insights into how startups and other co-investors reconcile these competing forces when assessing a co-investor's attractiveness.

Takeaways

We've discovered some new insights that can help startups make sense of the financing options available to them. Specifically, our study suggests that they should not assess corporate partners on the basis of resource endowments alone, such as availability of funds or technological capabilities in the shape of patent portfolios. Of additional importance is the CVC's past record in terms of staying committed to a relationship despite other factors.

From this perspective, it is important that startups do due diligence about CVC investors, and not immediately accept investment from such investors, as tempting as it may be. Additionally, startups also need to be "clued" into networks that share knowledge and historical information about CVC investments. This also points to an overlooked value adding role that traditional venture

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capitalists bring to their relationship with startups. Specifically, these investors may have firsthand experience with specific CVCs and can steer entrepreneurs away from those that are most likely to abandon their investments. Relatedly, even when lacking direct experience, the social networks of traditional venture capitalists can help gather necessary information about CVCs that entrepreneurs would be unable to obtain on their own.

Another key practical implication of our research is that corporations need to understand that CVC is different from traditional internal R&D or alliancing with other well-established organizations. The parties that they work with are in much more vulnerable situations, and the startup often pays a heavy cost if the relationship terminates. At the same time, independent venture capitalists are important intermediaries with their own values and institutionalized norms; corporations need to “behave the right way” in their space if they wish to have access to promising startups. Our findings suggest that companies that were able to continue providing resources to their CVC units and portfolio firms, despite having ample internal opportunities, were at a strategic advantage when competing with other CVCs to invest in a startup. At the end of the day, CVC is only a useful corporate entrepreneurship tool if those links to startups are able to materialize, so it is imperative to understand what makes you an attractive investor.

Explore the Research

The value of a reputation for sustaining commitment in interfirm relationships: The inclusion of corporate venture capitalists in investment syndicates. (https://www.sciencedirect.com/science/article/abs/pii/S0883902624000132) Journal of Business Venturing, May 2024

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