CORPORATE VENTURING IN THE UK

JAMES MAWSON

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Contents

The RSA and enterprise

The RSA's full name is The Royal Society for the Encouragement of Arts, Manufactures and Commerce. Since its foundation in 1754, the Society has fulfilled the mission encapsulated in its name by offering financial incentives for business innovation, showcasing new technologies transforming the commercial world and helping to rethink the way business is done. The RSA is drawing on this history by launching new strands of work designed to stimulate and support entrepreneurial initiative in the UK and around the world. Given the scale of the economic challenge we face, there could be no better time to undertake such work.

As part of this initiative, the RSA will publish a series of papers that aim to understand how business investment can be encouraged to start flowing again and, equally importantly, how it can be directed to the most innovative and productive companies. This is the first of those papers.

About the author

James Mawson was editor of *Private Equity News*, part of Dow Jones and *The Wall Street Journal* in London, for nearly four years until May 2010 when he launched *Global Corporate Venturing* as an independent title from his own publishing company. This was followed by the launch of a second publication, *Global University Venturing*, in January 2012.

James has also freelanced for a host of national and trade media titles, including the BBC, *Financial Times*, *Economist*, *Independent on Sunday*, *Sunday Express* and Dow Jones Newswires; provided research for Nick Davies's book, *Flat Earth News*; was a foreign correspondent in central and eastern Europe; and was international editor for *FT Business*.

Executive summary

Corporate venturing has a troubled record. In previous waves, investment from corporates in third party firms has tended to expand considerably towards the end of the economic cycle. Most recently, many corporations invested late in the technology bubble of the 1990s and then retreated from their venture capital initiatives after the dot.com bust.

However, corporate venturing is once again on the rise and attracting the interest of policymakers as it becomes clear that those companies which did not sell off or dissolve their venture capital units are out-performing companies without a minority investment strategy. More importantly, corporations are aware that an opportunity now exists to start investment at the beginning of the business cycle rather than the end.

Some have also observed that corporations have learned the lessons of the past and are now establishing and running their venture units in a new way, hiring a mixed team of experienced venture capitalists to work alongside business managers and entrepreneurs while ensuring senior buy-in within the corporation.

Corporate venturing is showing itself to be an effective way of channelling foreign investment into the country

Despite this, the current state of corporate venturing in the UK is mixed. Corporate venturing is showing itself to be an effective way of channelling foreign investment into the country and as an approach which offers greater diversity and longer timeframes for investments than the ailing conventional venture capital sector. However, the scale of corporate venturing in the UK remains modest. Few deals reach the scale judged to be the most efficient size for venture capital.

The key barriers seem to be access to suitable and high volume deal-flow. Some corporations also worry that the regulatory framework may not be as friendly, and the UK government not as proactive, in its support for corporate venturing as overseas. It may be that these concerns are as much about perception as reality since other investors do feel the UK has much to offer in terms of high potential entrepreneurs and a regulatory environment which is, at least, equivalent to other countries. It seems that challenging perceptions is important but getting strong-deal flow in the right sectors and creating as friendly a regulatory environment for investors as possible will be vital to attract corporate venturing to the UK.

There are a number of measures policymakers could consider as ways of strengthening the ecosystem to encourage and support corporate venturing:

Venture connectivity

- The government should establish a forum designed to encourage UK-based executives to consider starting or expanding their venturing programmes. The forum could undertake a number of roles including: presenting investor analyses and working with stock exchanges so the potential of companies with successful venturing programmes is understood and recognised; looking at gaps in the corporate venturing ecosystem and understanding how they could be filled; mentoring portfolio company executives and investors; and exploring how the government can create connections between smaller companies looking for investment and corporate venturing units

Co-investment

- The European Commission is considering establishing an innovative co-investment scheme to aggregate medium-sized corporations interested in a specific sector. Developing a similar approach in the UK could offer firms a relatively easy entry into venturing without having to set up a fund of funds to cater for all parties across multiple sectors. The natural mechanism in the UK to allow such a development is a variation of the existing Enterprise Capital Fund.

Fiscal incentives

A series of fiscal measures could be taken to incentivise and remove barriers to corporate venturing.

- An accelerated 'qualifying venture investment allowance' for corporations would reward or recompense risk-taking by corporations in UK ventures.
- The government could also seek to encourage 'serial venturing' by changing the capital gains rules so that disposal could be deferred if profits are reinvested in further qualifying corporate venturing.
- For overseas companies investing in UK-based risk assets there could be a structure to allow them to use offshore cash with little UK taxation and the ability to repatriate the money if the investee sets up a subsidiary in the UK.
- Corporate venturing could also be put on the same tax level as independent venture capital funds.
- To encourage corporations to be limited partners in independent venture capital funds, corporate limited partners could be as tax exempt as pension funds and investments and could be classed as outsourced R&D because of the length of time from commitment to potential returns.
- There is also a strong argument for restarting the Corporate Venturing Scheme, wound up by the last government, while allowing a higher proportion of relief against corporation tax than that scheme provided and for increasing the size of a qualifying target company from £7 million to £25 million.

Introduction

Recent years have seen an increase in corporate venturing. This has been preceded by waves of activity in the 1960s, 1970s, 1980s and 1990s; which saw increases in corporations starting or massively increasing their minority investments in third parties at the end of the economic cycle. This pattern is not surprising. Venture capital as an asset class is pro-cyclical; more money is invested as the economic cycle reaches the latest stages of most rapid growth before the downturn and potential recession causes deal-making to plummet.

Historically, corporations have been even more pro-cyclical than their independent venture capital peers; the latter have the cushion of 'blind pool', 10-year life funds which give them more flexibility about when to make investments. Corporations, however, often fund their venture investments from the balance sheet with allocations made each year.

Governments have often encouraged this pro-cyclicality by offering tax breaks or regulation changes at the tail end of the cycle to try to pull in the final, uncertain stragglers. This included the UK's Labour administration, which introduced the Corporate Venturing Scheme in the 2000 Budget.

The tendency to pro-cyclical investment and the losses endured during the dot.com bust mean most corporations have retreated from corporate venturing and shut or spun off their incubators and investment teams, selling their limited partnership commitments to venture capital funds.

However, the idea of corporate venturing has remained alive and more recently has attracted the interest of policymakers. Countries, including France, Germany, Israel and the US, have begun to develop a coherent policy package with the aim of encouraging corporate venturing, including new funds to support start-ups.

This is partly because those corporations that retained and refined their venturing policies after the dot.com bust have outperformed their non-corporate venturing peers by most important metrics, according to research by London Business School associate professor Gary Dushnitsky.[1] This out-performance and its causes have started to be noticed and rivals have set up new venturing programmes or started afresh with more specific goals and more qualified teams.

In addition, the financial crisis that began in summer 2007 has forced governments, companies and individuals to re-evaluate their reliance on debt to leverage returns over the past 100 years. This in turn has led them to look at the role that innovation can play in boosting the equity part of their balance sheets through finding new sources of revenues or cutting costs to increase margins or profitability.

According to the newswire Bloomberg, corporations remain well capitalised with $1.5 trillion of cash sitting on the biggest European companies' balance sheets and a further $2 trillion on those of their US peers.[2] They have the means and desire to turn to corporate venturing as part of a more open model for developing innovation. By contrast, the pool of alternative long-term institutional investors funding venture capital firms set up after 1945 has started to collapse with the retirement of the baby boomer generation and the systemic failings in the broader financial services industry to allocate capital effectively, favouring instead the generation of profit through fees.

In addition, the consequences of having about 3 billion people – effectively the BRICs (Brazil, Russia, India and China) – join the broadly capitalist economy with few restrictions on capital controls has opened up near exponential opportunities to find entrepreneurs with disruptive ideas or business models. This has created competitive pressures unseen since before the First World War.

Finally, the number of potential and actual entrepreneurs is accelerating as the cost of basic technology in a number of industries is falling rapidly, leaving the challenge one of scaling up and distribution through corporations' established sales and marketing efforts.

Given the problems encountered during previous waves of corporate venturing, it is inevitably risky to suggest that this time it is different but it seems that, under current circumstances, it may be justified. For the first time, corporate venturing has started to gain traction both for companies and entrepreneurs at the start of the economic cycle. For governments, implementing the right policies now could prove critical to boosting their employment rates and gross domestic product, and in gaining competitive advantage.

Cadbury's likes taste of success

The chance to take your ideas into the mainstream and encourage fairer practices is one of the ways whereby the partnership between large, established corporations and nascent businesses can be aided through corporate venturing.

For organic chocolate maker Green & Black's (G&B), whose Maya Gold chocolate was the first Fairtrade product to go on sale in the UK in 1994, that chance came in 2002 when the UK's largest chocolate maker, then called Cadbury Schweppes before its acquisition by Kraft Foods, acquired 5 per cent. Three years later, Cadbury bought G&B outright.

While some at the time of the 2005 acquisition worried Cadbury would reverse G&B's organic and ethical stance on buying chocolate from Belize farmers at a set amount, Cadbury later rolled out the Fairtrade logo across its broader range of chocolate. This was a turnabout, as even the year before Cadbury had repeated its opposition to the principle of fixing the prices it paid to cocoa farmers.

The record of corporate venturing

an estimated 350 corporate venturers invested

$16 billion

in 2000 in the US

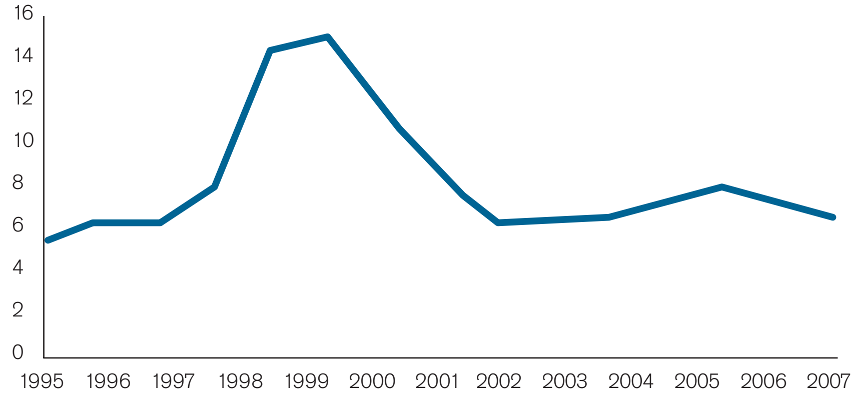
The history of corporate venturing, as with venture capital more broadly, is dominated by the US and there are few data points on the global perspective until the last decade. In the 1960s and early 1970s, a quarter of Fortune 500 firms had a corporate venturing programme, with industrial groups 3M and DuPont, in particular, popularising corporate venturing from the late 1960s onwards. These programmes were largely wound down in 1974 and 1975 due to the oil shock and ensuing recession.

The second wave began in the early 1980s after the US and UK economies emerged from 1970s stagflation and the early impact of Reagan and Thatcher tax and monetary policy. This wave was fuelled by the growth of the computer and electronics sectors, peaked in about 1985 – with 100 corporate venturers investing just under $1 billion – and came to an end in the late 1980s, again because of recession.

The third wave began during the 1990s technology boom, in particular after the internet services provider Netscape was floated on the market in 1995. It peaked in 2000 before falling steeply to the middle of the past decade. This wave was driven by a combination of new technologies – internet, microprocessors, telecommunications and biotechnology – and a bubble economy that made it seemingly possible to make quick returns by investing in new technologies.

As a result, from relatively low beginnings in the early 1990s, an estimated 350 corporate venturers invested $16 billion in 2000 in the US – 500 invested more than $22 billion globally – making up about 16 per cent of all venture capital investment that year (see Figure 1). The dot.com implosion in 2001 wiped out previously booked earnings and many investments, causing corporate venturers rapidly to retreat. By the first half of 2007 in the US, corporate venturers invested only $1.3 billion: 8 per cent of total venture capital invested.

Figure 1: The share of US venture capital dollars accounted for by corporate venture capitalists, 1995–2009 (see appendix for further figures)



Source: Created by BusinessWeek from data collected by the PricewaterhouseCoopers/ National Venture Capital Association MoneyTree Report and Thomson Reuters.

In the UK and Europe, corporate venturing has tended to follow the US experience. Professor Julian Birkinshaw has estimated that just before the dot.com implosion three-quarters of FTSE 100 firms had a corporate venturing unit.[3]

A European Commission survey published in 2000, estimated direct corporate investments totalling €1.2 billion per year by about 84 companies.[4] This money went to about 500 companies between 1995 and 1999 and represented 10 per cent of total European venture capital and 40 per cent of early-stage investing. However, by 2006 the European Private Equity and Venture Capital Association (EVCA) found that only €322 million was invested by corporations in about 175 deals.

Some have argued that corporate venturing's decline after the dot.com boom may not be simply a cyclical effect but also relates to inherent weaknesses in the corporate venturing model. Birkinshaw, writing with Andrew Campbell from Ashridge, has argued: "Almost all units set up to create new opportunities for a company fail to develop any significant new businesses."[5] Birkinshaw and Campbell identified three main reasons: early-stage venturing is very hard to do successfully; corporate venturers have no particular advantage over independent venture capitalists; and the new ventures that do start up within a corporate venturing unit often attract little attention or commitment from the core of the company.

As a result, Birkinshaw concluded:

> "These obstacles to corporate venturing appear to be insurmountable. In our research, we could find no examples of new legs being developed from a venturing unit that passed the test of being 'significant, permanent new businesses', meaning they are profitable, are part of the parent company's portfolio and amount to 20 per cent of sales or $1 billion in value. Even when the research was extended back to venturing units set up in the 1970s or 1980s, none of them spawned a new business that passed our signifi-

cance and permanence tests. Corporate venturing units do not, it appears, deliver growth."

And yet corporate venturing is on the rise again. Last year, more than 550 corporate venturing units from around the world agreed more than 1,100 deals, including exits, as part of broader consortia investing over $26 billion.[6] It appears that the lessons of the past have been taken on by the survivors of the dot.com bubble and new entrants through hiring a mixed team of experienced venture capitalists to work alongside business managers and entrepreneurs while ensuring senior buy-in. Dushnitsky's work at the London Business School over the past decade shows how the average life of a corporate venturing unit now surpasses the average chief executive's job tenure and that venturing units often have advisory boards made up of senior representatives of business units and report to the executive board.[7]

Dushnitsky argued that companies with corporate venturing units outperform peers without a minority investment strategy; both by a company's market-to-book-value ratio and its innovation capacity, as judged by patents. He found that between 1987 and 2009, 602 of a sampled 5,313 corporations engaged in venturing and concluded: "Companies with corporate venturing units outperform peers in similar fields judged by patenting output and using a market-to-book-value ratio."[8] Indeed, over the past decade there have been a number of examples where companies, such as Nestlé, Intel and Cisco, have effectively created large business lines through their minority investment strategies.

The state of corporate venturing in the UK

The UK also appears to be doing well with regard to the number of corporate venturing units present in the country when compared to economies of a similar size

Data and information provider Global Corporate Venturing tracks 37 UK-based corporations with a venturing programme.[9] In 2011 this included four launches of new corporate venturing units – advertising firm BBH, industrial group Marshall, financial services firm Icap and media group BBC. Established corporate venturing unit SR One, from drugs company GlaxoSmithKline, also set up a dedicated UK fund.

Of the 55 corporate venturing deals in the UK last year (excluding four trade exits, one flotation and one merger and acquisition)16 were in the healthcare sector, followed in order of popularity by IT, media, services and clean-tech.[10] Although more than a third of deals were for portfolio companies at undisclosed stages of development, 13 of those that did reveal their maturity were in the seed or series A round. This is notable because the European Venture Capital Association says there are fewer than five venture capital (VC) firms operating at this stage across the whole of Europe. This means corporate venturing units can be complementary to the entrepreneurial ecosystem by going into areas from which VCs appear to be shying away.

In addition, Global Corporate Venturing tracks 24 corporate venturing units sponsored by foreign corporations with staff in the UK. These foreign corporations cover the main sectors from health, industrial and financial services, to media and technology, reflecting the breadth of the UK's economy.

Of the 61 investments and exits in the UK last year, 38 involved a corporate venturing unit with overseas parent as part of the deal syndicate.[11] As such, corporate venturing has become an important way for foreign direct investment to arrive in the UK and a significant way for venture-backed companies to find an overseas buyer. Last year, for example, South Korea-based Samsung acquired venture-backed technology company Liquavista for about £32 million ($50 million) after Samsung had established a European corporate venturing office in the UK.

The UK also appears to be doing well with regard to the number of corporate venturing units present in the country when compared to economies of a similar size. So while the UK has 37 active corporate venturing units from local parents, Germany has 31, France has 29 and Italy eight, according to Global Corporate Venturing's data. There are slightly more deals done in Germany than France (from local and overseas-based corporate venturing units) with 39 and 14 completed last year in the two countries, respectively, and none in Italy. The UK is well in the lead in this regard with 55 deals completed last year.

It is important that these signs of corporate venturing success in the UK continue not least because conventional venture capital is looking less than healthy in the UK. There were 314 venture capital deals in the UK last year, with $1.6 billion invested. This was down 32 per cent from 2010. Private equity firms made up the majority of deal-flow, involved in 235 deals worth an aggregate $1 billion, down 41 per cent from 2010 figures.[12] The UK still leads European venture capital,[13] however, it is being rapidly overtaken by other, emerging markets, such as China, which poured $9 billion into 976 deals last year; up 50 per cent and 16 per cent by value and volume respectively.

Business Insider looked at internet companies expected to be worth more than $1 billion in 2011. Only one UK venture capital fund has backed more than one of the top 24 deals, even though five of them have UK roots.[14] By comparison, US-based venture capital funds have backed twelve between them. Switzerland-based funds have backed seven, Russia's DST two and France's Idinvest two.

By being drawn from all sectors of the economy and with often strategic rather than purely financial reasons for investing, corporate venturing units can diversify their venture investment from a narrow focus on certain sectors and those companies only able to offer returns over the shortest time period.

Rahu finds right chemistry for Unilever

The hardest area for corporate venturing to help its parent with is regarded as the spin-out and successful development of intellectual property. The achievement, therefore, of Anglo-Dutch-listed consumer goods conglomerate Unilever in selling one of its corporate venturing unit's portfolio companies to OM Group, a New York-listed coatings provider, is impressive.

OM bought Rahu Catalytics, which provides materials for environmentally friendly coatings, composites and inks, from Unilever Ventures (UV) and the company's management. A source close to the deal said the price tag was about £35m ($50m).

Rahu was founded in early 2006 as a spin-out from Unilever Ventures, which incubates ideas and takes minority equity stakes in UK entrepreneurs and is managed by co-founders Paul Smith and Dermott Hill. John Coombs, managing director of UV and non-executive chairman of Rahu, said: "It has been a very successful spin-out for us of [intellectual property] developed in the Unilever [research and development] labs originally for washing powder."

Since early 2009, Rahu has operated under an exclusive commercial agreement with OM Group with regards to its Borchi Oxy-Coat product line.

What do corporate venturers think of the UK?

While these developments are encouraging, interviews conducted with some leading corporate venturers for this paper suggest that the UK's position is far from secure and has yet to operate at its full potential.

For indications of how fragile the UK's place as a venture and innovation hub is, the warning from one London-based head of a US-listed corporation's venturing unit (who wanted to remain anonymous) was salutary. The venture head stated his unit was moving to Paris as "France has more innovation and now has critical mass and deal-flow" compared with a decade earlier. His company had set up its corporate venturing in the UK because it had facilities in Britain which was then the undisputed hub of venture capital but times had changed.

Unfortunately, such stories are not rare. Since 2000, a number of other corporations have closed their UK corporate venturing bases. This includes medical company Johnson & Johnson and publisher International Data Group (IDG). As Patrick McGovern, founder of IDG, which manages $6.8 billion in corporate venturing assets, said:

> "In 2000, IDG Ventures did have a fund and operating team of general partners in the UK. Unfortunately, we found that the expected [return on investment] of the fund, which was higher than average for venture funds based in the UK, was not as high as the returns we were receiving from our venture funds in the US and Asia. We decided to sell the venture team and its operations to a prominent private equity fund in the UK."[15]

Attracting new corporate venturing units to the UK may also be challenging. While Georg Schwegler, managing director of Deutsche Telekom's T-Venture unit, disputes the claim that there is a lack of deal-flow in the UK, he has no plans to establish a unit in Britain. He stated:

> "On the portfolio side, UK law gives us lots of burdens when it comes to statutes and shareholder agreements. Closing local contracts is expensive."

The global competition to attract corporate venturing is intensifying. Advisers to the US, Israeli and German governments are now actively looking at changing their policies to encourage corporate venturing. In particular, France has seen some of the most interesting developments. Broadly, its national policy until the late 1990s was about creating ‘national champions’ out of large enterprises and later trying to use tax incentives to encourage angel and venture funding for entrepreneurs. Most recently, there have been efforts to bring large corporations together into venture funds to support specific parts of the French economy and complement its tax breaks for angel investors.

In the past year, these funds have included telecoms group France Télécom-Orange and communications company Publicis Groupe jointly committing €150 million to a venture fund to back entrepreneurs setting up digital companies in France and the European Union. In addition, state-owned rail company SNCF, oil major Total, France Télécom-Orange and car maker PSA Peugeot Citroën founded Ecomobilité Ventures to invest €30 million ($40 million) in sustainable transport start-ups. Meanwhile, Aster Capital, a France-based venture capital firm formed by the merger of the corporate venturing units of engineering companies Alstom and Schneider Electric, had its size and reach enhanced when it was joined by the chemicals company Rhodia.

As Martin Kelly, a partner of computer group IBM’s corporate venturing unit and part of the Innovation Fund Ireland’s board, stated:

The global competition to attract corporate venturing is intensifying

> “The most important considerations are availability of opportunities, not tax breaks. So, for me, it is about access to great deal-flow – teams, intellectual property and so on – and an active community – start-ups, corporates, legal, media and so on. I also think in terms of cities not countries. So the question for me is more London versus Dublin versus Berlin versus New York than UK versus Ireland. I think we will see more alignment around specific themes for innovation and so it is important that cities pick those sectors and themes where they have a potential to capture a unique global position.”[16]

This is precisely the aim of the French approach.

This fits with the rationale behind new corporate venturing units’ location decisions. One group said as its focus was material science and technology, it made a decision to locate in the heart of Silicon Valley, California, although it had a UK-based parent. The unit head, who wanted to remain anonymous, said:

> “We recognised there would be a critical mass of resources and expertise in this area uniquely suited to our requirements for partnering and other relevant resources. We did not look at this on a country basis, such as the US versus the UK. Rather we specifically chose Silicon Valley.”

Despite these challenges, the UK still has strengths to which the right policy framework could play. Peter Cowley, head of Cambridge-based industrials company Marshall’s corporate angel fund, Martlet, said for this paper:

> “In my view – having spent five years in Germany, albeit a while ago – the UK is up with the US in terms of commercial innovative mindset and support structures. London is crucially important: its size, its educational establishments, the UK being in the top 20 of countries worldwide (by some measures), the professional and altruistic support infrastructure. In a word, London has maturity.”[17]

Martin Grieve, head of consumer goods company Unilever's corporate venturing unit, added:

> "The UK is a good place as it has a strong VC community, you can find a large population of skilled entrepreneurial people and the governance and regulation are at US standards."[18]

Jon Lauckner, head of car maker General Motors' ventures unit said:

> "GM, through our Vauxhall operations has a presence in the UK, so it made sense to have Jerneja (investment manager Jerneja Loncar) work from Milbrook. We decided to make the move last year to get better access on the start-up and VC activity in the UK and provide access to other major European markets. Time and distance are key advantages as compared with doing this remotely from the US."[19]

Mike Brown, a partner in US-based media company AOL's venturing unit, which has hired a UK-based senior adviser to help the fund build a presence in EU, said:

> "As a US fund with a global mandate and parent company that has interests in Europe, we felt the UK was the best area of expansion for us. Having been to many emerging countries, we felt the proximity [to the US, Middle East, India and China], ecosystem and entrepreneurial talent and quality was best in class relative to where we want to take AOL Ventures."[20]

So the UK has a particular USP as a route into Europe and other markets. Georg Shwegler of Deutsche Telekom's T-Venture agreed but sounded a note of caution: "The UK is typically a good cornerstone for companies if they intend to go to Europe. However, we feel this is changing and in the mid-term perspective continental sales people are inevitable."[21]

Investors clearly have a mixed view of the UK as a location to grow corporate venturing. Some feel indigenous entrepreneurial talent, the vibrant London economy and access to Europe and the wider world make the UK highly attractive. Others are far more sceptical.

This ambivalent perspective is reflected in a study by Switzerland-based venture capitalist Verve Capital Partners' study of the perceived attractiveness of a country for venture capital firms which shows the UK performs relatively poorly.[22] Although the UK and Ireland have about \$39 of venture capital invested per person – this is above the European average of \$35 – Verve concluded that this was: "notably lower than their attractiveness rating would suggest."

In a similar vein, a study by Steffen Wagner and Lucas Laib added: "The UK is commonly perceived to be one of the leading VC spots in Europe [but] this counter-intuitive finding might have to do with their centralistic economies focused on its large capitals. While especially London remains a leading VC breeding ground, peripheral regions and populations deflate the actual figures of VC spent per capita. There have been attempts to artificially create start-up hubs in the periphery, but more time might be needed for these initiatives to bear fruit."[23]

If corporate venturing is to deliver the growth and jobs in the UK which it could then clearly this ambivalence must be addressed. Getting strong deal-flow in the right sectors is crucial as is creating a friendly environment for investors when other countries, such as France, are already vigorously pursuing programmes designed to encourage corporate venturing in their own economies. Otherwise the risk will be that reality comes to match the more negative perceptions expressed above.

Amazon gives strong reviews to Lovefilm

When Nasdaq-listed online retailer Amazon bought out the remainder of the shares in UK-based movie rental company Lovefilm for an undisclosed amount in January last year, the companies said there would be developments but no immediate change to the logo or service terms.

Since then, Lovefilm has continued to expand from a film rental service by post towards an internet-streaming media distributor with more than two million members of its Lovefilm Instant service. In January this year, Lovefilm said it was working with global electronics company LG to bring Lovefilm's video streaming service to the Korean chaebol's smart TV platform. Lovefilm has also signed up distribution deals with a number of major content producers, such as Disney, ITV and BBC Worldwide, and expanded into Germany.

For Amazon, the continued growth and maintenance of Lovefilm's senior management represents a successful integration aided by the close working relationship formed between the two companies through owning equity. It also represents a turnaround from its previous effort to expand in Europe's film rental market.

At the time of the acquisition, Greg Greeley, Amazon's vice-president of European retail, said: "Lovefilm and Amazon have enjoyed a strong working relationship since Lovefilm acquired Amazon Europe's DVD rental business in 2008, and we look forward to a productive and innovative future."

News provider Wall Street Journal said Amazon valued Lovefilm at about $320m but the cost was offset by its 42 per cent holding. While Amazon reduced its cost of acquisition through its corporate venturing share ownership, for Lovefilm's others investors, including venture capital firms Index Ventures, DFJ Esprit and Balderton Capital, which came together after the 2006 merger of Video Island and Screen Select and rebranding as Lovefilm, the exit was one of the largest of the year.

Creating the right policy environment for corporate venturing

There are a number of measures policymakers could consider as ways of strengthening the ecosystem to encourage and support corporate venturing without having unintended consequences or trying to predict future winners. These measures have been divided below into three broad areas: venture connectivity, co-investment and fiscal incentives. The challenge for all the recommendations will be further work to devise effective ways to measure progress and efficacy without creating cost or operational barriers. Modelling for unintended consequences and cost/benefits will also be required.

In terms of order of priority, measures to aid venture connectivity will help develop the demand and capital supply-side conditions which, if effective, could then create the policy space and justification for the proposed co-investment approaches and the fiscal reforms.

Venture connectivity

The European Union's 2000 report on corporate venturing identified opposition within corporations as a key barrier to establishing corporate venturing units. As the report stated:

> The most common reason for a corporation not to engage in corporate venture capital is an unwillingness to divert management time from core activities, linked with the feeling that it is irrelevant or not strategically useful.

In addition, a 1999 Confederation of British Industry (CBI) report argued that peer pressure and education could help encourage greater corporate venturing through initiatives designed to produce publications, mentoring, networking or personnel transfer across industries along with practical support to entrepreneurs through affordable expert advice, perhaps part subsidised.[24] Such an approach would also help challenge some of the negative perceptions corporate decision makers have of the UK environment.

It would be beneficial, therefore, for the government to establish a forum designed to encourage UK-based executives to consider starting or expanding their venturing programmes. This forum should also be part of an advisory board structure on venture capital for government – as used in Australia through work developed by the Bell Mason

Group – so corporate venturing is part of the discussion on the wider venture ecosystem.

The forum could undertake a number of roles including:

- Presenting investor analyses and working with stock exchanges so the potential of companies with successful venturing programmes is understood and recognised.
- Looking at gaps in the corporate venturing ecosystem and understanding how they could be filled.
- Mentoring portfolio company executives and investors.
- Exploring how the government can create connections between smaller companies looking for investment and corporate venturing units. It is notable, for example, that the government is a potential source of rich market intelligence resulting from its extensive procurement activity.

Co-investment

A 2009 study found government-backed funds had created

1,407

jobs in total

The European Commission, via the European Investment Fund and other planned mechanisms being created as part of its 2014 Innovation Plan, is considering how to help corporate venturing. This includes an innovative co-investment scheme to aggregate medium-sized corporations interested in a specific sector. Developing a similar approach in the UK could offer firms a relatively easy entry into venturing without having to set up a fund of funds to cater for all parties across multiple sectors. The natural mechanism in the UK to allow such a development is a variation of the existing Enterprise Capital Fund.

In a similar vein, it is noteworthy that Wales and Northern Ireland have introduced policies that mean that up to 75 per cent of venture money is matched with public funds. This has encouraged corporate venturing units to invest in those regions.

The challenge of any co-investment model backed by public funds will be to ensure high performance. For example, it is notable that regional venture funds supported by the state have tended to underperform on returns. A 2009 study found government-backed funds had created 1,407 jobs in total, giving an average of just 1.8 jobs per company backed between 1995 and 2008. The increase in profits at these firms was also found to be 'modest'. The report also argued that regional funds have a limited impact on start-ups.[25]

Fiscal incentives

The EU report also concluded that the main obstacle to increased corporate venturing are levels of taxation. In particular, the report claimed that the rates of capital gains tax and complicated tax regimes discouraged equity investment.[26] A series of measures could be taken to incentivise and remove barriers to corporate venturing.

- An accelerated 'qualifying venture investment allowance' for corporations – 100 per cent in the first year – which can be thought of as analogous to the old accelerated capital allowances but for a world where physical capital matters less, would reward or recompense risk-taking by corporations in UK ventures. If the ownership of those assets was ultimately not in the UK then if a programme of investments overall generated positive returns on realisation, the realisation would in effect repatriate funds.

- The government could also seek to encourage 'serial venturing' by changing the capital gains rules so that disposal could be deferred if profits are reinvested in further qualifying corporate venturing. For the balance of any losses incurred, either through sale or winding up, there may also need to be a relief made available.
- For overseas companies investing in UK-based risk assets there could be a structure to allow them to use offshore cash with little UK taxation and the ability to repatriate the money if the investee sets up a subsidiary in the UK. The challenge with this policy is it is contrary to the direction of travel by HM Treasury that is trying to make inward investing more equal with UK-based investors.
- Corporate venturing could also be put on the same tax level as independent venture capital funds. As one head of corporate venturing said: "We are in competition internally over use of cash so anything that makes us more efficient is good."
- To encourage corporations to be limited partners in independent venture capital funds, corporate limited partners could be as tax exempt as pension funds and investments and could be classed as outsourced R&D because of the length of time from commitment to potential returns.
- As was mentioned previously, attempts to incentivise corporate venturing were made by the UK in 2000 with its Corporate Venturing Scheme (CVS). This was poorly timed, as corporations were looking to shut rather than open schemes coinciding, as it did, with the end of the economic cycle.

According to HM Revenue & Customs (HMRC), 74 companies were raising £18 million from 256 investing companies using the CVS in its first year of operation. The amount fell gradually to a nadir of £8 million in 2006–07, before climbing in its final three years both by aggregate value and volume of investor companies before the scheme was wound up. The number of investee companies held broadly steady. During its 10 years of operation £132 million was invested in just fewer than 600 small companies. A parliamentary select committee inquiry welcomed the overall direction of the legislation but criticised the scheme for having "a lot of very fiddly little restrictions".

The CVS scheme allowed: investment relief against corporation tax of 20 per cent of the amount subscribed for full-risk ordinary shares; deferral relief from tax when the shares were sold and the funds reinvested; and relief against income if shares were sold at a loss. The shares would have to be held for at least three years to gain full tax credit.

Given the context set out above, there is a strong argument for restarting the CVS and allowing a higher proportion of relief against corporation tax – between 30 per cent and 50 per cent – and for increasing the size of a qualifying target company from £7 million to £25 million as that reflects the usual upper limit of an investment in a deal from an average-sized venture fund. It will, of course, be necessary to ensure that any such scheme is not burdened by the restrictions identified by the select committee. As the government is currently operating in a period of severe fiscal constraint, the introduction of such a scheme would only be likely when it was clear that less expensive measures such as encouraging venture connectivity and co-investment had created enough of a momentum behind corporate venturing to ensure that the CVS was both cost effective and beneficial to the wider economy.

Corporate venturing has a clear role to play in growing parent firms, start-ups and medium sized enterprises. It can encourage inward investment, boost jobs and, ultimately, GDP. US companies, such as Intel Capital and International Data Group, have created multi-billion dollar asset management units able to invest around the world and help their core businesses and entrepreneurs.

However, a growth in corporate venturing will not happen in the UK by accident. The UK needs to provide the right conditions to encourage talented investors and entrepreneurs and larger business to come to the UK as a welcoming shore where value can be added and exported across the globe. In designing and balancing new fiscal and regulatory rules, we must create a playing field on which corporate venturing can compete and win .

Endnotes

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Projects

8 John Adam Street
London WC2N 6EZ
+44 (0)20 7930 5115

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