PARTNERSHIP VERSUS CORPORATION: UNTANGLING THE GOVERNANCE DILEMMA OF CORPORATE VENTURE CAPITAL

Gianfranco Gianfrate, Laura Zanetti*

Abstract

This brief research note discusses the role of organizational and governance design in a specific sector, namely the Corporate Venture Capital (CVC). This specific segment of the venture capital industry has so far proved to be at least as successful as venture capital investments carried out by "independent" or "pure" players, but corporate-sponsored initiatives tend to be more short-lived, cyclical and unstable. Unlike traditional venture capital funds, CVC established by corporations usually seek both financial returns and "strategic" benefits. We discuss the dilemma faced by corporations setting-up CVC programs in terms of governance design and ownership arrangements, showing that strategic and financial performances are unlikely to be conjointly maximized, thus leading to the inherent instability of such programs.

Keywords: corporate governance, ownership structure, organizational design, agency theory, corporate venture capital

* *Corresponding author: Gianfranco Gianfrate, Finance Department, Bocconi University, phone: +39 02.58363631, fax: +39 02.58363799; e-mail: gianfranco.gianfrate@unibocconi.it.*

1. Organizational Design in the Agency Perspective

An organization is the nexus of contracts, written and unwritten, among owners of factors of production and customers (Jensen Meckling 1976). These contracts or internal "rules of the game" specify the rights of each agent in the organization, the performance criteria on which agents are evaluated, and payoff functions they face. The contract structure combines with available production technologies and external legal constraints to determine the cost function for delivering an output with a particular form of organization (Jensen 1998).

The central contracts in any organization specify (1) the nature of residual claims[1] and (2) the allocation of the steps of the decision process among agents. These contracts distinguish organizations from one another and explain why specific organizational forms survive (Jensen 1998).

The residual claims of different organizational forms contain different restrictions. For example, stockholders of large corporations are not required to have any other role in the organization, their residual claims are alienable without restriction and in consideration of these restrictions, the residual claims allow unrestricted risk sharing among stockholders (Jensen 2000).

Agency problems arise because contracts are not costlessly written and enforced. Agency costs include the cost of structuring, monitoring and bonding a set of contracts among agents with conflicting interests. Agency costs also include the value of output lost because the costs of full enforcement of contracts exceed the benefits (Jensen Meckling 1976).

Control of agency problems in the decision process is important when the decision managers who initiate and implement important decisions are not the major residual claimants and therefore do not bear a major share of the wealth effects of their decisions. Without effective control procedures, such decision managers are more likely to take actions that deviate from the interests of residual claimants. An effective system for decision control implies, almost by definition, that the control of decisions is to some extent separate from the management of decisions. Individual decision agents can be involved in the management of some decisions and the control of others, but separation means that an individual agent does not exercise exclusive management and control rights over the same decisions (Jensen 2000).

Organizations in which important decision agents do not bear a major share of the wealth effects of their decisions include (open) corporations, (professional)

[1] An explanation of the meaning of residual claims is the following one (Jensen and Meckling 1976): "The contract structure of most organizational forms limit the risk undertaken by most agents by specifying either fixed promised payoffs or incentive payoffs tied to specific measures of performance. The residual risk – the risk of the difference between stochastic inflows of resources and promised payments to agents – is borne by those who contract for the rights to net cash flows. We call these agents the residual claimants or residual risk bearers. Moreover, the contracts of most agents contain the implicit or explicit provision that, in exchange for the specified payoff, the agent agrees that the resources ha provides can be used to satisfy the interests of residual claimants".

partnerships, financial mutuals and non-profits organizations (Jensen 2000). In this paper I'm going to focus only on corporations and partnerships.

Corporations

The common stock residual claims of corporations are unrestricted in the sense that (1) they are freely alienable, (2) they are rights in net cash flows for the life of the organization, and (3) stockholders are not required to have any other role in the organization. Corporations are more likely to take place when the technology in an activity implies economies of scale that are likely to imply organizations that are complex in the sense that valuable specific knowledge – knowledge that is expensive to transfer across agents – is widely diffused among agents. Such complexity tends to favor unrestricted common stock residual claims which allow specialization of management and delegation of decision functions to agents with valuable relevant knowledge.

Partnership

Partnerships are characterized by (1) restriction of residual claims to major decision agents, (2) periodic renegotiation of partner shares in net cash flows (flexible sharing rules), and (3) inalienable residual claims in net cash flows with horizons that are often limited to a partner's period of service in the organization.

Partnerships are usually observed in professional service activities (law, accounting, business consulting) where: (1) restricting residual claims to important decision agents helps control the agency problems caused by delegating combined decisions management and control rights with respect to cases, audits and so on to agents with relevant specific knowledge; (2) the primary asset of the activity is professional human capital; and (3) mutual monitoring and consulting among agents are important to maintain the value of human capital, which is sensitive to performance.

The aim of this paper is to evaluate the performance of different organizational designs, in a business, namely the Corporate Venture Capital (CVC), where both partnerships and corporations co-exist within.

2. Corporate Venture Capital: an Overview[2]

Venture Capitalists invest in young, high–potential companies. Through a combination of careful due diligence, intensive monitoring and direct assistance, the Venture Capitalist seeks to create companies that can eventually go public or be sold determining a return on the invested capital.

Venture Capital players can be divided into two different categories: traditional independent venture capitals organizations and organizations of venture funds sponsored by corporations. While the sole investment objective of the private independent venture capital is the return on the invested capital, the main objective of CVC programs is also strategic. In this kind of investments, the impact of possible capital gains on total corporate results is viewed as having the same (or, in some cases, a minor) importance of the potential for development of new business.

The first CVC began in the mid-1960s, about two decades after the first formal venture capital funds (Hardymon, DeNino and Salter 1983). The strategic objectives of these programs were to provide a sort of "window" on potential new business growth areas and to provide a source of potential acquisitions for entry into these new areas.

However, CVC as a means to acquire independent new ventures often hasn't worked well. Hardymon, DeNino and Salter (1983), in the first study about CVC just entitled "When Corporate Venture Capital Doesn't Work", noted that the venture capital opportunities available to a corporation are restricted by a number of factors that diminish the chance of strategic success. The main difficulty with the "window" approach is that corporate exposure to a venture proprietary technical or marketing information can be a legal problem.

Other reasons for the CVC failures identified by Hardymon, DeNino and Salter are (1) the lack of a clear mission regarding venture activity, (2) an inadequate financial commitment of the parent company, (3) the underestimation of the risk involved in venture investing, (4) the lack of patience related to the time required for new ventures to achieve success. It is clear that lack of understanding and plain interferences on the part of the parent company represented major sources of frustration in the eyes of CVC, often causing the termination of the programs.

In general, CVC activity is difficult to measure, Gompers (2002), however, estimates that the number of CVC programs increased nearly twenty fold over sixteen years and the amount of CVC investments that could be tracked amounted to nearly 8 billion dollars in 1999.

According to Tornado-Insider[3], a European venture capital magazine, in 2000 there were eighty-five European CVC programs totaling almost 2 billion Euro.

Gianfrate and Vesin (2002) accounted only five CVC programs in Italy pointing out that both the prevailing small and medium size dimension of Italian companies and the structural scarcity of high-tech corporations and industries affecting Italy, do not represent a fertile ground for expensive (both by the

[2] An excellent literature review about CVC is provided by Dushnitsky (2006).

[3] Cfr. *Corporate Venture Capital Takes Off in Europe*, Tornado-Insider, January 2001, no. 21, page 116-119.

financial and the human resources point of view) and highly innovative initiatives such the CVC programs.

Gompers and Lerner (1998) performed, probably, the most extensive CVC analysis in literature, to date. They examined a sample of over thirty thousand transactions by CVC and independent Venture Capital. They found that Corporate Venture investments in entrepreneurial firms appear at least as successful (using such measures as the probability of the portfolio firm going public) as those backed by independent venture organizations. The empirical evidence suggested, however, that corporate programs are much less stable than those of independent funds, and CVC programs frequently cease operations after only few investments (as previously pointed out also by Hardymon, DeNino and Salter (1983)).

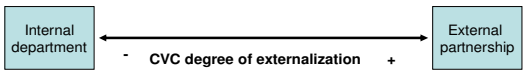
Gompers and Lerner concluded their paper suggesting that, in order to have a deeper comprehension of CVC programs, they "would need to have information on the compensation schemes and organization structures employed by these programs. While this paper has only skimmed the surface of this issue, this is a rich area for further exploration".

3. Organizational Designs for the CVC

Large companies, wanting to emulate venture capitalists, established divisions adopting several models in order to achieve their strategic and financial objectives for venture capital investments. The two main solutions emerged in the CVC industry are, however, the "internal" and the "external". At one end of the spectrum, parent companies establish corporate departments or subsidiaries allowed investing directly in start-ups. At the other extreme, parent companies provide funds for an external venture capitalist to invest. In the first case, by the operative point of view, we have the internal corporate venture, in the latter limited partnership (Gompers 2002).

- *Internal Corporate Venture*. Some parent companies create internal corporate venture groups to analyze venture capital opportunities and make investments. Problems typically arose with this strategy because it limited deal flow to those companies that wanted to be associated with that particular corporation. Entrepreneurs are limited by this structure because while they could receive excellent depth of assistance in the corporation's area of expertise, they are forced to sacrifice breadth of available resources. In addition, early stage entrepreneurs are often concerned about protecting their intellectual property and wanted to avoid alliances that could threaten their position.
- *Limited Partnership in a Venture Fund*. Existing or newly established funds give parent companies the opportunity to become passive limited partnership and make diversified investments in start-ups. In the venture capital industry, partnerships are the most common organizational structure as pointed out in the extensive analysis realized by Gompers and Lerner (1999). They found that venture partnerships have pre-determined, finite lifetimes, usually ten years, although extensions of between one and three years are often allowed. Most venture organizations raise funds by forming partnerships every two to five years. The typical venture fund makes one to two dozens investments over its life span. In a venture capital limited partnership, the venture capitalists are general partners and control the fund's activities. The typical fund has between two and ten general partners. The (corporate or financial) investors serve as limited partners. Investors can monitor the fund's progress, but cannot become involved in the fund's day-to-day management if they are to retain limited liability. Compensation is therefore the most important contractual mechanism for aligning the incentives of the venture capitalist and his investors[4].

As shown in the following figure, even if the two designs are polarized and the great part of CVC programs belongs to the extreme poles, there are also intermediate situations characterized by *ad hoc* juridical, contractual, incentive, ownership, routine configurations.



We assume that the degree of externality of a CVC is in relation with its decisional and managerial autonomy. CVC programs belonging to the "internal" pole are expected to experience significantly low independence: they must share decision-making authority with corporate management and the corporation's financial commitment is considerably more uncertain, since capital is contributed on a periodic or "deal by deal" basis.

On the other side, CVC programs organized as partnerships are expected to have far greater authority to make investment decisions and the parent company makes a far more permanent and reliable financial commitment to corporate venture activity.

[4] The limited partnership agreement explicitly specifies the terms that govern the venture capitalist's compensation over the entire ten-to-thirteen year life of the fund. It is extremely rare that these terms are renegotiated. The specified compensation has a simple form. The venture capitalist typically receives an annual fixed fee, plus variable compensation that is specified fraction of the fund's profits. The fixed portion of the specified compensation is usually between 1,5% and 3% of the committed capital or net asset value, and the variable portion is usually about 20% of the fund profits. Cfr. Gompers and Lerner (1999).

4. How Organizational Designs Affect CVC Performance

The general idea we question in this paper is whether the degree of externality/autonomy of the CVC in relation to its corporate parent is a significant determinant of effectiveness of the corporate venture activity itself.

In particular, we formulate two testable hypotheses, about the performance of different organizational design in the CVC business, applying the agency theory perspective. In this context, (1) the CVC obviously is the agent and the parent company is the principal; and (2) the agency approach classical assumption work and so (as explained in the first paragraph) agents are effort and risk avers and both principals and agents maximize their income.

So, if the degree of externality/autonomy is high, the CVC is in a partnership (or near situations), and we expect a high alignment of its objectives to the parent companies ones: both should make the maximum efforts in order to maximize the financial performance[5].

On the other side of the continuum, in the internal (or near) contingency, we expect a less strong objectives alignment. In this case, the internal CVC has no or weak incentives in maximizing the financial return, while it should tend to minimize its efforts. This means that it is expected to perform a less effective screening, choice and management of investments: we expect the internal CVC searching for satisfying solutions, just limiting to promote investments meeting the parent company approval.

Hypothesis 1: The higher the degree of externality of the CVC, the higher its financial performance

This hypothesis should hold also when (1) there exist incentives for the CVC but they are too low in respect of the (perceived) maximizing-performance efforts, and (2) when the compensation structure is not linked to the performance of the CVC program. The latter one, we expect, is a common situation because the performance of venture capital investments can generally evaluated and measured only in the medium-term.

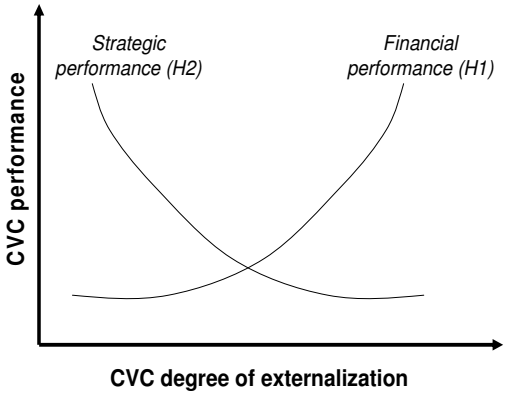
As for the CVC strategic performance[6], the inverted relation holds. We expect that internal CVC will sacrifice financial and entrepreneurial quality criteria in the choice of investments to achieve strategic fit for the parent company. The direct monitoring, control, decision-sharing and eventually the structured investment approval mechanism should be highly effective when the CVC is a corporate department or subsidiaries. On the other side of the *continuum*, a more opportunistic behavior is expected: CVC partnerships should tend to invest in start-ups maximizing their financial return with no or weak commitment in generation of strategic benefits for the parent company. In this situation, if there exists decision-sharing or approval mechanisms, the external CVC is expected to have opportunistic behavior gaining, for example, the parent company approval through a misrepresentation of the investment reality or through the accreditation of inexistent strategic benefits.

Hypothesis 2: The lower the degree of externality of the CVC, the higher its strategic performance

If the previous hypotheses hold, the parent company, establishing the design of its CVC program, faces a substantial trade-off between the strategic performance and the financial one. Formally, we can therefore synthesize this result as follows:

Proposition: If both Hyp 1 and Hyp 2 hold, then the strategic and financial performances of a CVC are unlikely to be conjointly maximized.

The proposition is showed in the graph below.



[5] Empirically, venture capital researchers commonly use two measures in order to quantifying the financial success of a venture capital investment. The fist one is the probability of going public of invested start-ups calculated on the historical portfolio of the venture capitalist. The second measure is the valuation assigned to the firm at the time of the investment: all else being equal, the higher the valuation (higher price paid per share), the lower the direct financial returns to the investor, and vice-versa.

[6] Since strategic performance is not easily quantifiable, in empirical research scholars usually use proxies or less accurate measures: for example, "degree of fit between the corporation and the portfolio firm" introduced by Gompers and Lerner (1998). They analyzed the corporate annual reports of the parent companies relatively to the period covered by the research. Hence, they denoted investments as having a strategic fit only if there was a direct relationship between line of business of the parent company and the portfolio firm.

5. Conclusion

This research note has tried to reconcile two series of scholarly evidences. On the one hand, some researchers report that ventures backed by CVC programs are at least as successful as the ones backed by independent venture capitalists, even receiving higher valuations at IPO compared to ventures funded solely by traditional VCs (Ginsberg, Hassan, and Tucci, 2003; Maula and Murray, 2001). On the other hand, Gompers and Lerner (1998) verify that CVC investment is more volatile than the general venture capital market, and that the average life span of a CVC fund is far shorter than that of independent venture capital funds.

We propose a governance design explanation for these somehow contrasting evidences. Once juridical, contractual, incentive, and ownership configurations of the CVC programs are taken into account, the "strategic" and "financial" performances which are usually expected from this kind of initiatives are unlikely to be conjointly maximized, thus leading to the inherent instability of CVC programs. Due to the relevance of CVC, and its role in fostering innovation at large, further empirical research on the governance structure of these programs should be undertaken.

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