

# VIEWPOINT

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## MAKING STRATEGIC INVESTMENT WORK AS PART OF YOUR FINANCING STRATEGY

By Peter Alternative & Ionut Zeche

*There's good news on the corporate venture front. Strategic investment has stabilized after plummeting from the lofty peak it reached in 2000. Now, with earnings under control, many corporations are turning outward, eager to drive growth through strategic investments.*

*Corporate venture groups are staffing up, with 3M and Siemens reporting a desire to become more like Cisco and Intel, perennial leaders in strategic investing. SAP Ventures tells us they are on track to close out '05 at double last year's pace. SAP Ventures Investment Manager Jennifer Scholze expects the higher level of activity to continue in '06.*

So with corporate venture money back on the table and likely to increase over the next few years, the question for emerging technology companies naturally becomes this: Is it time to take a fresh look at adding strategic investment to your financing strategy?

### WHY THIS MATTERS:

- Opportunities are growing for emerging technology firms to attract corporate venture money.
- The right corporate investment can add leverage to your business model while addressing consolidation of sales channels.
- Understanding how these investments differ from those of venture capital firms will help you to craft a smart deal and build a successful, long-term relationship.

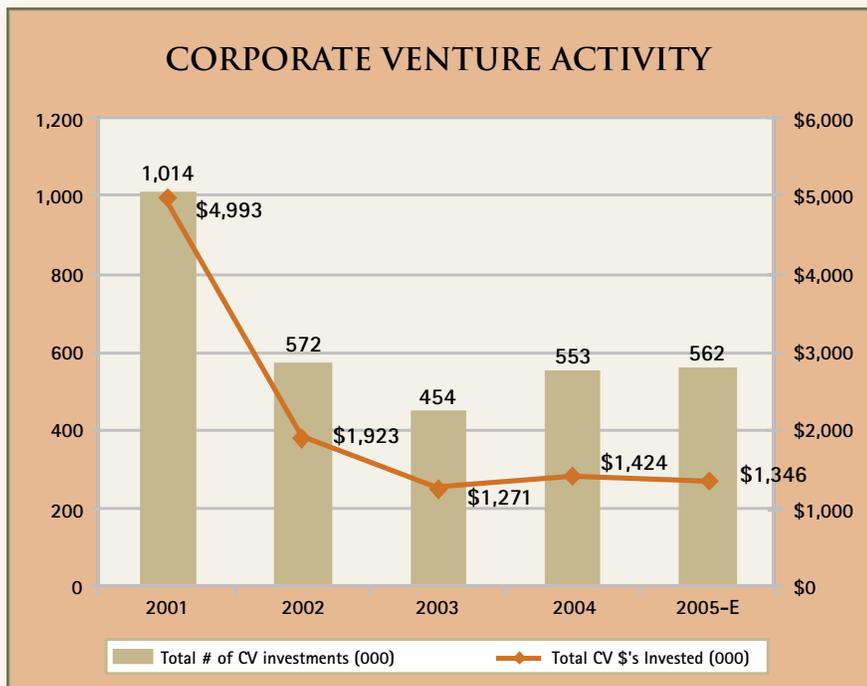
### CORPORATE VENTURE INVESTING MATURES

Some CEOs may hesitate to answer an enthusiastic yes to that question based on previous experiences with strategic investing, or because of horror stories they've heard from other firms that took in corporate venture money during the roaring 1990s. But many corporate venture groups have gone through a maturing process and have eliminated the mistakes of the past. With this growing maturity, they are:

- Doing a better job of balancing strategic and financial objectives.
- Acting more like professional investors, as their experience and capabilities grow.
- Offering deal terms that are less onerous and that don't handcuff the emerging company.
- Less likely to bump up valuations to unrealistic levels.

This is not to say that executives don't need to do thorough due diligence before entering into a corporate venture deal. It just means that the problems that plagued some parts of this sector in the not-too-distant past are less prevalent now.

## CORPORATE VENTURE ACTIVITY



Source: PricewaterhouseCoopers/Thomson Venture Economics/ National Venture Capital Association MoneyTree (TM) Survey

"Anything you can do to show greater viability helps," agrees Jim Matheson, a general partner who focuses on information technology at Flagship Ventures, a Boston-based venture firm. "But the partnership has to make sense," he stresses. "First and foremost you have to really understand deeply the pros and cons of a strategic investment and of a specific investor."

- **Product-integration:** One of the strongest reasons for taking in corporate investment dollars arises in instances where you can clearly add value to the partner's existing product set and install base. In essence, this investment is partner-funded R&D.
- **Advisory:** Along with a flow of corporate investment dollars should come domain expertise and a new and different—and therefore valuable—perspective on industry and technology issues. Corporate investors should also bring valuable insights into how best to position your company to other strategic players for exit.

## WHY CONSIDER STRATEGIC INVESTMENT

Many solid reasons exist for considering corporate venture monies as part of your financing strategy. These motivations can be segmented into five general areas:

- **Channel:** If your go-to-market strategy relies heavily on penetrating specific channels, joining forces with a more established corporation can be the most expeditious way to drive growth. Likewise, if you're operating in a channel that is very noisy, a strategic investment from a larger channel player is a viable way to cut through the chatter.
- **Geographic market:** The potential for emerging markets such as India and China to play a key role in any technology firm's success is huge. The straightest route into these markets may well be through taking in investment dollars from corporations that are already making inroads overseas.
- **Credibility:** One lingering piece of fallout from the tech bubble bursting is that more discerning IT buyers screen for vendor viability. Having an established corporate investor is a fast track to being viewed as a credible player regardless of your size or operating history.

"The credibility a strategic partner brings is enormous," said Darren Maynard, Chief Operating Officer of Nextlinx, which took in both VC and strategic money. "Telling customers that a strategic partner has chosen to invest in you is an endorsement that you can never establish in any other way. Also, you can use executives in the partnering company to provide references that have a lot of clout."

## DOING YOUR DUE DILIGENCE

If any of these motivations strikes a chord with you, then one of your first steps should be to carefully think through what you will need to know to choose wisely among potential corporate investors. Having the answers to these critical due diligence questions will help you increase the probability of building and maintaining a successful relationship with your corporate investor partner:

**What motivates the partner?** What is its investment objective and how does your firm fit in with that? Just as you need to thoroughly understand your own reasons for entering into a deal, you also need to know why the folks on the other side of the table are interested in backing your organization.

Getting these issues out on the table at the outset is critical. "The more clarity there is around expectations, the better," stressed Izhhar Armony, a partner at Charles River Ventures, a VC firm where he focuses on enterprise software and services. "It's good for a marriage; it's good for anything. It's always the thing that you don't say but you hope will happen that hurts you in the end."

Key areas to explore regarding motivation include whether the potential investor has made other investments in your space or whether your firm is operating in a white space on which the investor is anxious to capitalize. If it has already invested significant dollars in a market space, it will be more wed to a particular strategic direction. You need to know if this direction is consistent with your view; if it's not, it might limit the viability of the relationship.

One way to explore whether the potential partner's investment objectives and business expectations are a good fit for your company is to identify explicit relationship milestones, timelines, clearly delineated responsibilities and deliverables.

A red flag to a potential mismatch in motivations arises when a potential investor puts forth onerous deal terms that will limit your operational freedom. Be wary of requests for exclusivity, right of first refusal for downstream acquisitions, and veto powers.

Along these same lines, ask questions about who will own the intellectual property that arises out of the relationship. More experienced and savvy corporate venture professionals recognize the importance of such questions and can assure you that a Chinese wall will be in place to prevent cross contamination of intellectual property.

Another area of motivation to look into involves the corporate sales force. When the strategy involves having the investor's team sell the new product or service into their customer base, the incentives for making that happen must be made clear. Many a strategic partnership has failed because the corporate sales force never really understood the new product or service, how it fit their customer base or how they would benefit by making the sale.

One strategy for thoroughly teasing out a potential corporate investor's motivations is to enter into a business alliance before agreeing to an actual financing deal. Such an arrangement gives both sides a chance to get to know each other and to determine whether a stronger, longer-term relationship involving a strategic investment might have merit.

**Who is driving the relationship on the investor's side?** If the corporation you're dealing with has an autonomous corporate venture group, you're going to want to get to know the individual from that group who you'll be dealing with, along with anyone on the operational side of the company who will be influential in making the relationship work once it's in place. Make sure the motivations and expectations articulated by both the investment professional and operational sponsor reconcile.

Dealing with a separate CV group tends to have advantages. But, of course, not all CV groups are created equal. A long-established CV group with a proven track record will be easier to evaluate than a newer cohort. It also may have more internal power to influence its corporate parent than a newly formed investment group.

With regard to the specific individuals you're negotiating with, look at how long they've been in their positions and what their experience is with respect to boards of director positions or advisory functions. Also be aware that turnover is frequent in such corporate venture positions, so inquire about what would happen if the person you're dealing with leaves.

Similarly, look at whether the operational people you'll be working with understand your industry and technology, and where they reside within the organization. A positive answer will have significant implications with respect to their ability to sell your technology and the broader business opportunity to colleagues as the relationship goes forward.

"If the person who enters into the agreement is not functionally skilled, it causes problems," said Nextlin's

Maynard. "In our case, a senior person at our strategic partner had limited understanding of what we did other than he knew he needed us from a strategic perspective. So when we entered into the agreement, he didn't understand what he was buying."

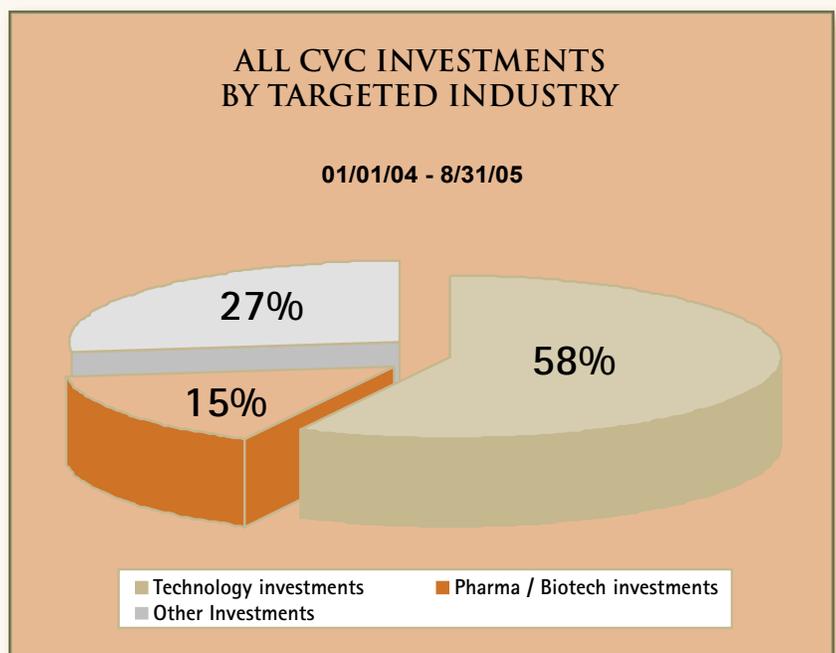
Potential culture clashes are also something you'll want to explore. Culture differences can be significant between emerging companies and long-established corporations. The CEO of a company that took money both from venture capital firms and from a strategic partner told us, "The strategic partner couldn't believe we were talking about having stock option plans for all employees and that this pool would be 20 percent. The cultures were just so different. Conversely, the venture guys wanted us to incent employees to make the business successful."

## WHO, WHEN AND UNDER WHAT CONDITIONS

Sizing up your potential corporate venture partner is critical, but who is getting investment, when is the best time to get it, and under what conditions strategic capital makes sense are questions of equal importance.

**Who's getting corporate funding?** As the accompanying pie chart illustrates, the two areas receiving the lion's share of investment dollars include technology and pharmaceuticals/life sciences. The definition of technology includes software and hardware products, Internet related technologies, enabling technologies for the communications market, and wireless technologies supporting the health care industry. If your company operates in one of these broad market segments, the availability of corporate venture capital is significantly better than in recent years.

**What's the right timing for a corporate investment?** The people we interviewed all agreed that it is better to take in corporate venture money in later stages such as B and C rounds.



Source: Ernst & Young

*"The mistake we made was thinking we got much higher value by going strategic. But it's a meaningless value because the strategic partner is not looking for financial return."*

— Nextlinx's Maynard

Why? Because, by then, your business model is more fully formed. This should not only make your organization more attractive to corporate venture groups but also should make it less likely that they will use their investment as leverage to push your business strategy in directions that benefit them but may not be in your company's best long-term interests.

#### **Are corporate venture groups suited to be your lead investor?**

The consensus on this seems to be no. A lead investor should be there for the long term and through up and down markets.

The dangers with having a corporation as the lead investor are twofold: First, its investment is bound to be only a small drop in their financial bucket, so whether they'll have an interest in sticking it out if the road gets rocky is questionable. Second, if a corporation changes strategic directions, you may suddenly be left out in the cold as their investment in your firm's future suddenly becomes irrelevant to the investor's own future.

#### **Is it preferable for your strategic investment partner to sit on your board of directors or serve in an advisory role?**

Giving a strategic investor a board seat may exacerbate potential conflicts of interest and may allow it to exert too much control over your business's future direction. This is especially true if the strategic investor is also going to be your customer.

Experienced CV professionals understand why accepting an advisory role might be better for all concerned. If you find yourself being pressured to give the investor a board seat, this may be a tip-off that you're not dealing with an organization that has enough experience in corporate venture to make the deal work for you.

## NEGOTIATION TRAPS TO AVOID

If you decide that taking in strategic money makes sense for your organization, how do you avoid some of the common negotiation pitfalls that prevent such deals from being successful? Here are three guidelines that should help:

- **Go into negotiations with realistic expectations.** Many entrepreneurs falsely assume that a strategic investment will instantly bump up their company's valuation. "The mistake we made," said Nextlinx's Maynard, "was thinking we got much higher value by going strategic. But it's a meaningless value because the strategic partner is not looking for financial return."

Also, Mirus' research shows that less than 10 percent of strategic investments end in acquisitions. So don't assume that this investment is going to be the start of a creeping acquisition that will provide your exit strategy. In the vast majority of cases, that does not happen.

"I think acquisition is one of the false expectations that entrepreneurs have when going into strategic partnerships," said Armony of Charles River Ventures. "I recommend looking for shorter term, more immediate gains such as channel distribution, OEM and other similar straight-forward benefits."

- **Get operational/functional buy-in before starting to draw deal terms.** Don't start getting into the legal specifics of a deal before each side thoroughly understands the other side's business and investment objectives. Lawyers should be brought into the negotiations only after clear agreement has been reached with your operational or functional counterparts. Once you thoroughly understand each other's various objectives, it also becomes easier and often quicker to negotiate a good deal.

A final thought we have yet to mention in our "corporate venture" roadmap is that having the support of existing investors is critical. With the backing of current investors and by performing the thorough due diligence we've outlined above, your company can access a powerful financing vehicle to remove barriers to growth and improve corporate leverage.

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