Corporate Innovation Capital: An Alternative Investment Vehicle to Traditional Venture Capital

By Ken Singer

Abstract

In this paper, the author enumerates and analyzes a series of structural challenges and problems in the current standard Venture Capital (VC) investment model. The paper further studies the implications and negative impacts of these issues for most participants in the VC market. Acknowledging the ongoing importance of "venture-style" investment returns for these market participants, the study identifies a promising emerging alternative for indirect (i.e. Limited Partner) investors. The study concludes that the Corporate Innovation Capital (CIC) model can solve many, or all, of the existing VC-market's problems for these investors.

Introduction

Since the 2000's, the market has shed new light on the venture industry's economics; from the flaws of growth-at-all-costs to massive bankruptcies (see WeWork, Convoy, Hyperloop One, Zume Pizza, Olive AI, and others), these flaws show in both "good" and "bad" broader economic conditions. At the conclusion of each economic cycle, concerns invariably arise regarding the vitality and sustainability of the venture industry. The majority of startups do not proceed to an initial public offering (IPO), with many quietly ceasing operations or deciding to remain private and thus subject to valuation write-downs. Venture firms that fail to deliver returns encounter challenges securing subsequent fund raises, which directly impacts their assets under management fee structure, while the select few at the apex continue to capitalize on their rare unicorn successes.

The fixation on unicorns by VCs arises from their necessity to fulfill their investment model. Without a 50x winner, delivering the promised returns becomes infeasible. If this sounds like gambling, there is a good case to be made that it is. The prevailing question pertains to whether this model is fundamentally flawed.

According to Carta, the number of startups shutting down in 2023 has set record numbers by a large margin (thus finding a Unicorn for portfolio performance is even more difficult), and is a trend that has been accelerating over the last four years. Even the number of VC firms themselves decreased dramatically. According to Pitchbook, there were 7,439 US VC investors that did two or more deals between Q1 and Q3 of 2021 – that number was only 4,354 in 2023, a decline of over 40%.

Further, according to Crunchbase News, in just the first quarter of 2023 alone, global funding of venture companies dropped 44%-54% in every funding stage.

Too Much Money, Not Enough Unicorns

A collapsing startup market is often blamed on the perception that excess capital pursuing too few promising ventures lead investors to fund unsound or underdeveloped startups. In an effort to deploy all of their capital (sometimes in the billions), VCs seek riskier investments as the most promising startups are oversubscribed or may be too "expensive." Only the elite VC firms, with a multi-cycle track record, consistently achieve favorable returns in this environment. Venture capital has always entailed inherent risk, but in recent times, it has increasingly assumed a speculative nature. More money than ever has flowed into venture as the investment class has matured and gained popularity. Even the most risk-adverse family offices and eleemosynary entities have become LPs. However, there are only a handful of unicorn exits in every cycle — a successful venture firm may see only one unicorn in any given fund. Investment funds now place bets on numerous venture firms, hoping that one will produce a billion-dollar unicorn. This dynamic fosters a winner-takes-all paradigm, benefiting only the top VC firms with access to premier opportunities. Not surprisingly, the dynamic cascades down to the LP level, where exclusive access to top VCs is

confined to larger funds and assertive fund managers. This **venture cascade effect** produces uneven risk profiles — larger funds have lower venture risk by virtue of their access. All others are playing roulette.

As we navigate the current economic cycle, intensified competition for limited high-quality opportunities necessitates LPs to explore alternative investment avenues within their alternative asset portfolios.

A Recurring Call for a New Venture Paradigm

At the culmination of the previous startup hype cycle in the early 2010's, the clear inadequacies of the conventional venture model prompted calls for innovation. This gave rise to the "accelerator" model championed by entities such as Y Combinator (YC) and Alchemist. The architects of the accelerator model recognized a widening gap between startups and VCs. Many promising startups lacked the polish and access required to secure the best VC partnerships. The surge in tech startups left VCs with limited resources to identify and vet superior companies. Accelerators functioned as intermediaries, nurturing promising startups and bridging the gap to venture financing. While this model initially appeared effective in helping VCs identify promising investments, the recent venture market downturn revealed that accelerators are not immune to the **venture cascade effect** phenomenon. There are a finite number of unicorns born each year, and accelerators have not been able to increase that number sufficiently to satisfy the growing venture community.

Consequently, a new evolution of the accelerator model has emerged: the **venture studio**. Not a wholly new idea, the venture studio is a reconceptualization of Bill Gross's Idealab. The concept is built on the belief that good startups can be seeded, not just discovered in the wild. Several successful entrepreneurs have opened up venture studios around the latest technology trends like AI or blockchain, giving 2nd time founders $100k+, office space, and a year of development time to incubate a fundable product idea. The most promising teams enter accelerators and attempt to raise venture capital. Although not a novel concept, recent iterations have seen widespread adoption due to reduced capital requirements and an abundance of seasoned entrepreneurs. But these are just minor step changes to the current venture

model that do not address the venture cascade effect for investors. There will never be enough unicorns.

Beyond the Unicorn: Turning to the Overlooked and Undervalued

New technology typically enters the market through two main avenues. First, the conventional startup journey commences with founders ideating and bootstrapping, then securing seed or angel funding to develop their product. Subsequently, they seek capital for expansion, often turning to traditional venture capital, culminating in a liquidity event such as acquisition, private equity investment, or an IPO.

The second approach involves corporate R&D departments within large enterprises. These corporations reinvest profits into developing intellectual property and new products. A minority of these products achieve blockbuster status, while many never reach the market due to changing market dynamics, shifts in corporate strategy, or internal factors that may have nothing to do with the underlying quality of the asset.

Thus, corporations have evolved two main methods by which they seek alpha vis-à-vis startups: Corporate Venture and Corporate Studios (a term not regularly used in the diaspora, but appropriate here as a direct analogue to Venture Studios).

Corporate venture is almost as old as corporations themselves, but the moniker was adopted when formal budgets and business units were created to identify and fund strategically-valuable businesses – often with the aim for later acquisition or important supply chain considerations. Corporate venture has nearly all the same characteristics, risks, and rewards as the standard venture model, but tacks on complexity if the exit strategy involves a merger or acquisition.

Corporate studios are increasingly common and emerged alongside the accelerator and venture studio models, in many ways as a reaction by Wall Street to capture the alpha that startups-gone-public like Meta, Google, and Amazon were experiencing.

But with few exceptions, both corporate venture and corporate studios are hamstrung from the start with ineffective leadership and corporate inertia. Leaders for corporate

venture/studios tend to be sourced from the corporate development team and are often financial professionals without startup operating experience. Additionally, the corporation's lack of self-awareness coupled with the traditional risk aversion bias toward sustaining cash-generating business units, means that successfully identifying new assets and establishing an independent growth trajectory while still in the confines of the corporation is a recipe for failure.

Finally, taking venture-style risks outside of the corporate charter are abhorrent to Wall Street expectations. Imagine a defense company starting an energy business unit; this would be seen as a distraction outside of core competencies that traders would not understand and would likely punish.

A New Model for Alternative Investment

A promising new model has emerged for introducing new innovative technologies into the marketplace: **corporate innovation capital** (CIC). This model leverages the tens of billions of dollars spent on research & development (R&D) within multinational corporations (MNC), applying entrepreneurial startup methods in a repeatable process to spin out assets into large commercial markets, with freedom to launch these products into the most promising orthogonal markets that may be outside of the original MNC's charter or focus.

By targeting acquisition of products within the MNC's that are proven at least to pilot or prototype stage, CIC NewCos are frequently able to achieve first revenue and cashflow at speed, reducing the long-term risks and potential dilutions in equity over time.

In addition, corporate innovation capitalists can leverage complementary technologies (aka "bolt-ons") sourced from other global companies to add value and fortify the barrier to entry for each entity. So, unlike a VC firm that invests in 20 to 30 AI companies, a CIC may assemble promising tech from multiple Multi-National Companies (MNC's) to form one entity to accelerate the go-to-market by filling gaps in the product portfolio, further lowering the risk profile and making more efficient use of capital.

These ingredients allow CIC investors to achieve better returns on a smaller risk pool than traditional VC and PE markets where a portfolio company's unicorn status is required to earn suitable overall fund returns.

How They Work

Corporate innovation capital firms typically own a majority share of each portfolio company (NewCo) upon inception; in other words, the CIC is the founder. This structure is superior for both the MNC and the CIC investor.

From the MNC perspective, products or even small business units that would not achieve full potential within the MNC are given a new life with monetization potential to the MNC, especially if spinouts by the CIC are done on a repeatable basis. The minority stake the MNC holds allows them to experiment with this new model without public company disclosure requirements that may otherwise curtail innovation.

CIC differentiates from VC and PE in the alternative asset class by materially reducing the risk for investors. While VC fund investors expect the fund to acquire minority stakes of NewCos from those company founders, CIC investors can expect the CIC to own a majority stake of each NewCo upon inception. The impact of the equity position is essentially inverting the numbers relative to VC and enables the investor in a CIC to earn superior potential returns to VC and PE investments without the need for the elusive single unicorn exit.

This approach uniquely conveys founder economics to passive investors, offering relatively larger ownership stakes in a portfolio of substantially risk-reduced technologies.

Summary of the Operational Elements of the Corporate Innovation Capital Model

To access de-risked innovative technology assets and make them accessible to investors seeking an alternative asset class to solve the problems previously described,

a CIC operator needs to execute the following practices on a repeatable and recurring basis:

- Build and maintain C-Suite relationships with major corporations as a trusted partner in creating win-win outcomes.
- Access these partner companies' intellectual property repositories in search of commercialization candidates.
- Identify fully-developed and validated technologies within the company that have unrealized potential. [Note: in many cases these IP assets will already have been written down or written off by the corporations.]
- Apply rigorous due diligence and business planning to assess candidates for commercial potential and dual/multi-use applicability.
- Negotiate licensing or equity agreements with the MNC.
- Assemble a management team of industry veteran entrepreneurs with a proven track record in selling similar technology within the respective sector to run the NewCo based on the validated and de-risked IP.

Advantages of the Corporate Innovation Capital Model over Traditional VC

1. **Risk-Reward Profile:** CIC presents a lower technology risk profile while retaining the potential for moderate to high returns. For a VC fund and its LPs to be successful, one or two of the 15-20 portfolio companies must return billions. In an average CIC model, highly de-risked assets are launched into markets with more achievable $100M+ exit expectations, providing investors with the alpha they desire.

2. **Proprietary Access to Mature Technology:** CIC's enjoy unique access to assets that are mature yet may have massive unrealized potential, and are frequently able to acquire those assets without a competitive bidding process. The CIC investors that own the NewCo have access to participate in future growth rounds that are not available elsewhere.

3. **Cost-Effective Technology Acquisition:** Most target corporations are amenable to success-based IP licensing agreements or equity participation in NewCo (in lieu of simply writing off the R&D expense), which reduces the overall cost of technology acquisition. Furthermore, these assets have enjoyed significant (often tens of millions of dollars) non-dilutive, pre-investment capital infusion.

4. **Radically Favorable Equity Positioning:** The CIC portfolio is majority owned by the CIC from inception, essentially flipping the script from typical VC or PE economics. By providing an investment opportunity with founder equity shares at the earliest valuation stage, CIC can return sustainable, long-term value to investors.

5. **Flexible Monetization Horizon:** While time-horizon funds have their own purposes, the CIC Model focuses on value optimization with interim distribution potential. This means that decisions about how to maximize enterprise value can be made without artificial constraints of timing (especially prevalent in the later years of a venture fund).

An Early Example of Corporate Innovation Capital in Practice

The Catalyze Partners team out of Dallas, Texas has had success pioneering the approach to corporate innovation capital. Developing their model since 2014, Catalyze Partners has assembled a team of senior executives with diverse industry experience and has built trusted relationships in some of the world's largest corporations (Lockheed Martin, IBM, General Electric, Textron, Boeing, Boston Consulting Group, etc.). These relationships in turn have enabled Catalyze Partners to begin piloting the CIC Model with promising early results.

Catalyze Partners has generated initial proof-points that the CIC model can be compelling to MNC's, having successfully executed numerous transactions feeding IP into three NewCo's to date. This CIC firm has also attracted significant capital from family office investors who have recognized the value of the exclusive access to pre-

invested intellectual property and the potential economics of the CIC's majority ownership stake in each portfolio company.

Conclusion

In conclusion, the landscape of venture capital is evolving, prompting investors to contemplate alternative asset investment opportunities. Corporate innovation capital (CIC) emerges as a pragmatic solution as a new asset class, offering reduced risk exposure, unique access to mature technology, founder level economics, and professional management from the outset. This innovative approach challenges conventional venture capital paradigms, offering investors an enticing alternative in their pursuit of robust portfolio performance.

About the Author

Ken Singer is a former startup founder and current Managing Director at the Sutardja Center for Entrepreneurship and Technology at UC Berkeley. Having mentored or advised hundreds of companies from early stage to public corporations, he has witnessed several Silicon Valley hype cycles. Through his work with numerous acceleration programs, he has observed a recent trend in the startup market that raises new questions and renewed concern about the traditional VC funding process for emerging tech firms. In searching for alternative pathways for technologies to enter the marketplace, he has identified a promising new model for technology venture creation.