VENTURE CAPITAL AND CORPORATE GOVERNANCE

OVERVIEW

- What is venture capital?

  -Venture capital funds

  -Corporate venture capital
- Research findings on venture capital funds
- Research findings corporate venture capital
- Case companies
- Conclusions

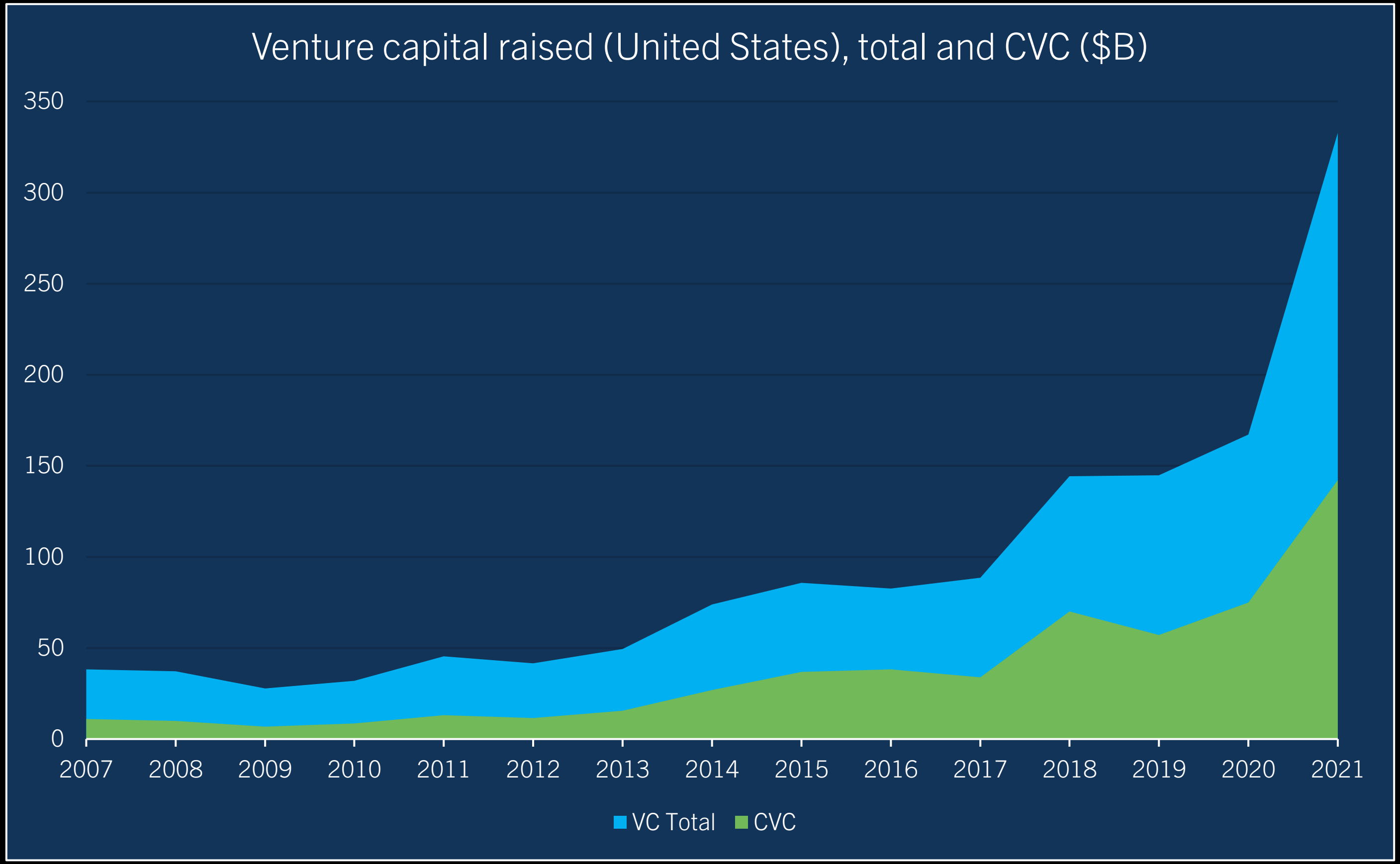
WHAT IS VENTURE CAPITAL?

- Venture capital funds

  -Financial objectives

- Corporate venture capitals

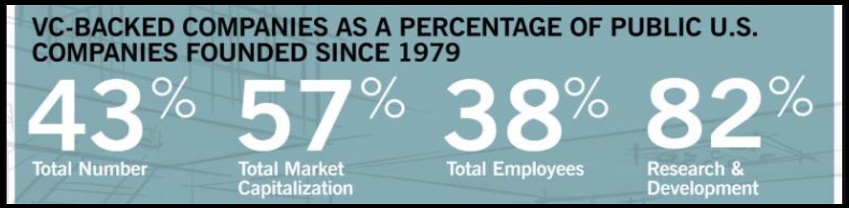
  -Strategic and financial objectives



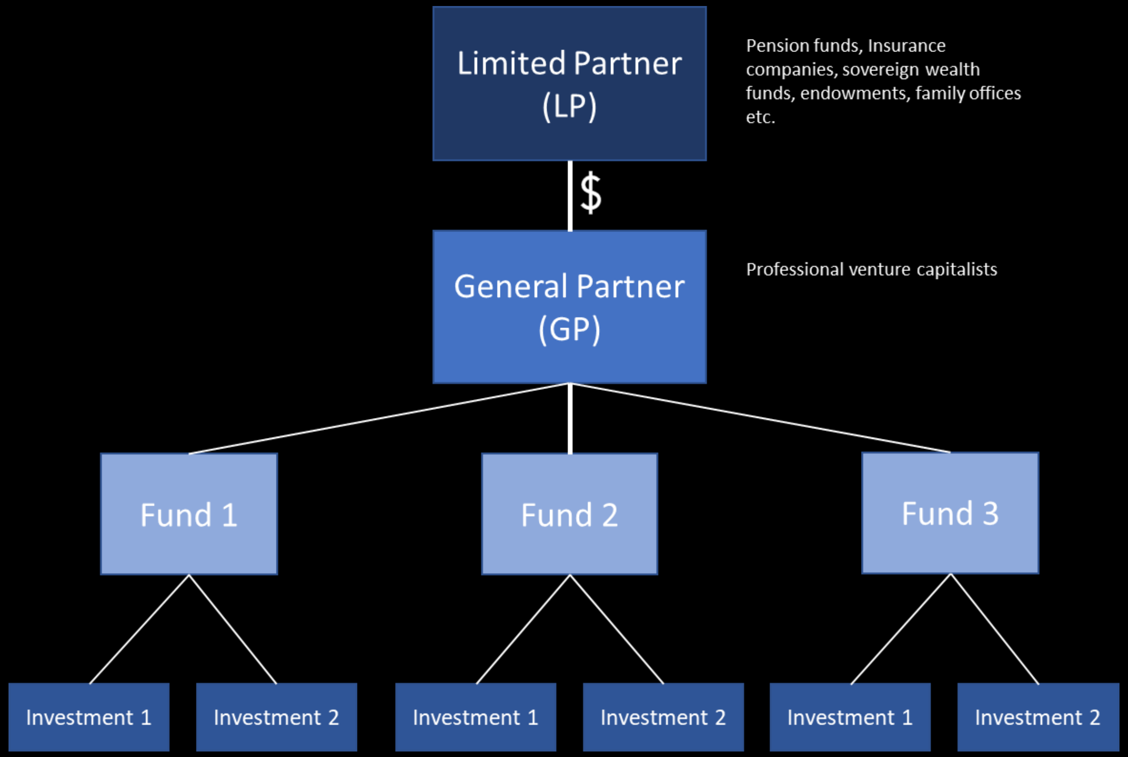
Data from: Yearbook 2022, National Venture Capital Association

VENTURE CAPITAL FUNDS

- Traditional external venture capital works through a fund structure
- Funds might have particular focus areas (industries, sectors, business models…)
- Often provide additional value to investments through day-to-day management, strategy development, networks and connections
- Argued to have an essential role in economic development[1] through enabling the development and commercialization of risky emerging technologies and ideas that otherwise would not be conceived



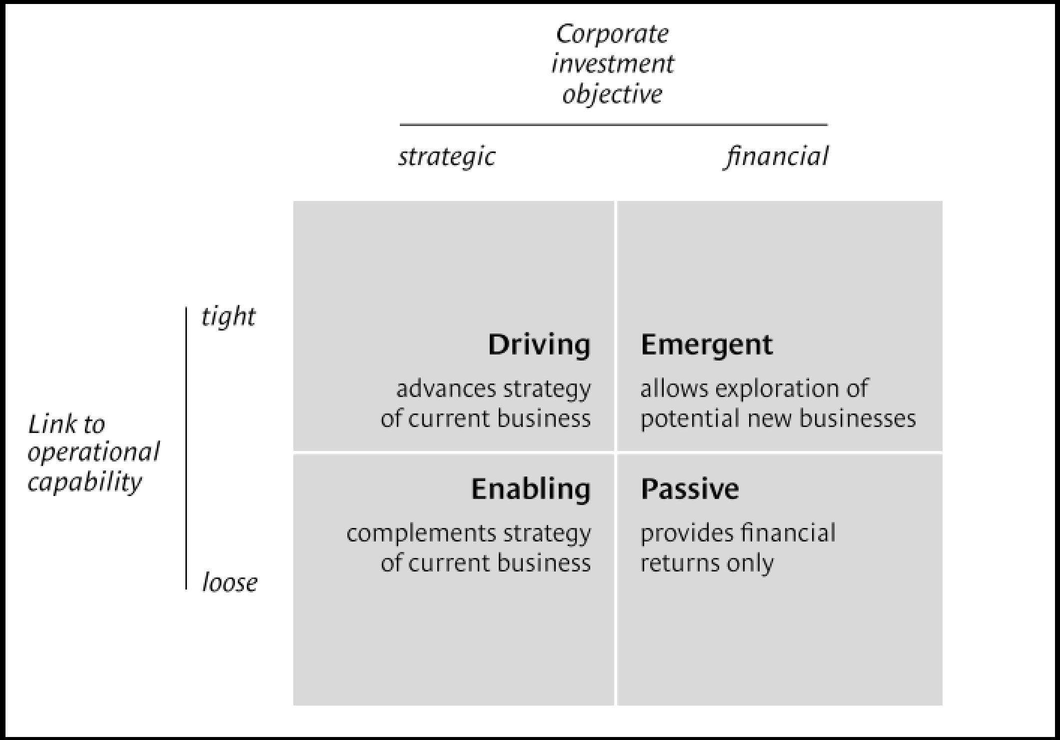
Picture from Sterbulaev & Gornall (2015), Stanford Graduate School of Business



1: Samila and Sorenson (2011)

CORPORATE VENTURE CAPITAL

- Corporations can invest in outside firms to achieve strategic and financial goals
- Innovative companies such as Intel, Microsoft and Alphabet (Google) often have their own CVC arms
- Traditional VC funds and CVC adds value to their portfolio firms in different ways; "enterprise nurturing" vs "commerce building" (Maula et al. 2005)
- A framework (Chesbrough, 2002) for categorizing CVC investments based on investment objectives and links to operational capabilities
- Non-financial objectives are the key difference when compared to normal VC-funds



Picture from Chessbrough (2002)

CORPORATE GOVERNANCE FACTORS AND VENTURE CAPITAL 1/2

- Contracts are the main explicit form of governance in the investor-venture relationship
- Contracts allow VCs to separately allocate cash flow rights, voting rights, board rights, liquidation rights…

1 Cash flow rights -> Vesting clauses in compensation contracts (performance and/or time)

2 Voting rights -> Ability to enact decision-making, often through majority share of total votes (VC voting rights more common in earlier stage investment rounds)

3 Board rights -> share of board seats in a venture's BoD (VC board rights generally stronger in later stage investments)

4 Liquidation rights -> VCs redraft SHA to grant them priority shares (paid first in case of liquidation)

① VCs controlled **~50%** of cash flows

② VCs held majority voting rights in **56%**

③ VCs had majority board seats in **26%**

④ VCs had senior liquidation rights in **98%**

Source: Kaplan and Strömberg (2003)

CORPORATE GOVERNANCE FACTORS AND VENTURE CAPITAL 2/2

- VCs take both intervening and supporting actions unto their investments. Before and during the investment
- In a sample analyzed by Kaplan and Strömberg (2004), more than half of VCs expect to **play a role in recruiting management** (likelihood increases as VC control increases)
- Over one-third of VCs expect to **provide value-add services**: strategic advice, customer introductions etc. (likelihood increases as VC equity stake increases)

- Previously discussed internal risks -> Contract theory has **clear predictions** for
- **External risks** on the other hand -> Contract theory has **ambiguous predictions** for

Holmström (1979): when risks are external and not controllable by entrepreneur -> performance contingent pay less desirable for entrepreneur

Prendergast (2002): performance contingent pay should increase as external uncertainty makes monitoring more difficult

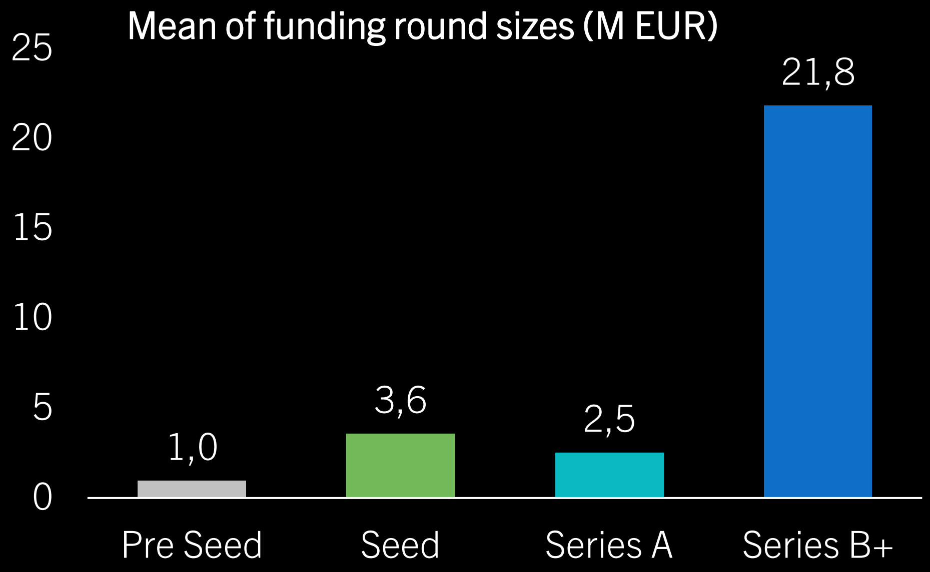
Conclusion: Literature provides links between governance practices and VC investment/firm characteristics

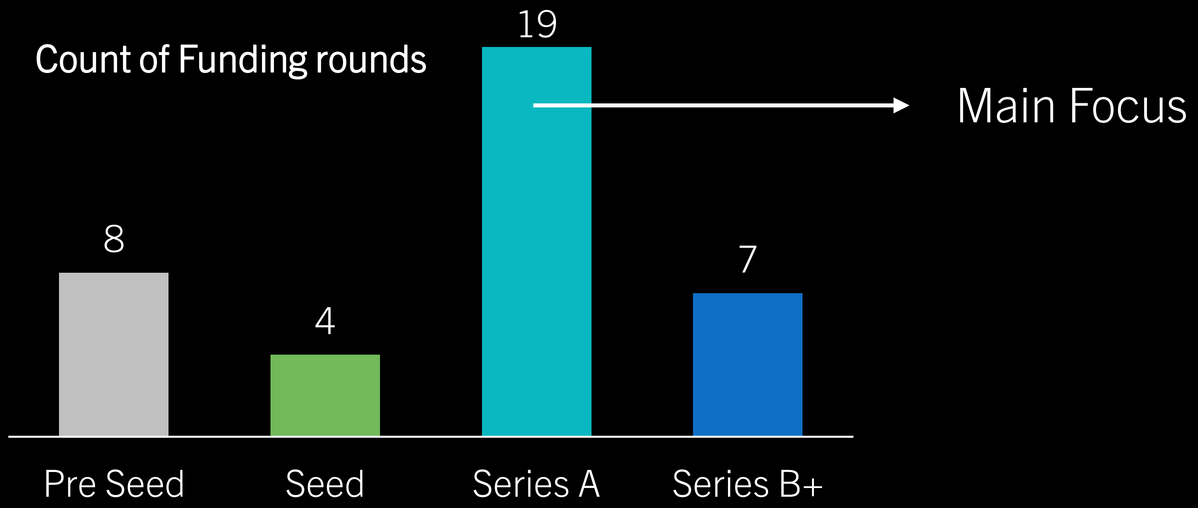
Source(s): Kaplan and Strömberg (2004), Holmström (1979, Prendergast (2002)

CORPORATE GOVERNANCE FACTORS AND CORPORATE VENTURE CAPITAL

- Anokhin et al. (2016) studied how various corporate governance factors correlate with CVC activity
- CVC activity intensity was measured by the number of distinct ventures supported
- Number of factors were hypothesized to correlate (positively or negatively) with CVC activity, the following factors were correlated:
  -**Ratio of board members with multiple mandates** (positive)
  -**CEO duality** (negative)
  -**Institutional ownership** (negative)
  -**Board equity ownership** only when combined with high risk tolerance in CVC investments (positive)
- Conclusion: CG affects CVC activities? Possibly, problem of interpretation (recall Hermalin & Weisbach, 2003)

CASE COMPANY #1 (MAKI VC) 1/2





MAKI.VC

Assets Managed: 180 M

Ticket Size: 200k – 3M

Speciality:
Deep Tech & Brand-drivenness

"Maki.vc is venture capital fund founded to fuel the most lunatic visions, to back the most audacious founding teams and defend disputed ideas." - Maki.vc

"We vow to be the VC company that's always on the founder's side – because we know that entrepreneurship is hard, and it becomes impossible without the right support network. " - Maki.vc

CASE COMPANY #1 (MAKI VC) 2/2

- Maki's brand-driven approach, accompanied with the focus on deep technology, gives Maki and its portfolio companies important advantages in differentiation and market disruption capabilities
- Portfolio companies gain proficient tools for brand growth
  Maki gets wide access to the portfolio Company, via a larger ownership and Board seats within the company to utilize their brand expertise

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- Findings of Kaplan and Strömberg (2003) can be seen in Maki VC, especially in the financial contracts and liquidation perspectives
- SHA terms are negotiated to include vesting terms aimed for core team and Founders
- Liquidation terms are redrafted to benefit VC's and to ensure liquidation in different exit scenarios
- Specific SHA terms, board-management dynamics and funding round details are not available for the public, which makes it challenging to determine VC-firm specific terms and details.

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CASE COMPANY #2 (BAYER)

leaps - The strategic impact investment unit of Bayer

Facts & Figures

- Established in 2015
- Invested >1.5bn USD with plans to continue at a similar pace and volume
- Portfolio: >50 start-ups in health and nutrition
- Specializes in early-stage life sciences
- Role within Bayer:
  - Operates across all divisions
  - Complements internal R&D function
  - Aim to encourage divisions to embark on upcoming technologies (Cell & Gene therapy etc.)

Approach

- Mission: Invest in breakthrough technologies and disruptive business models
- Uses minority equity to found new and invest in existing businesses
- Facilitates and supports invested start-ups in a process of “active incubation”: experienced team members actively engage in the young companies’ development
- Enables the exchange of proprietary assets: sharing own patents or providing access to Bayer network’s technical capabilities and expertise
- Maintains autonomy with respect to decision-making in the invested companies

CASE COMPANY #2 (BAYER)

leaps - Reflecting Anokhin et al. (2016) findings of corporate governance factors on CVC

Past literature findings

1 The **ratio of board members** holding multiple mandates has a **positive relationship** to the firms' CVC activity

Insights into Governance System at Bayer

- **14/20** board members of the supervisory board hold memberships in that of other corporations

- Considering 50+ investments and over 1.5bn USD invested since the founding year 2015 is high CVC activity, this finding holds true. However, this observation is highly subject to spurious correlations.
- That is, for example, do board members having multiple mandates lead to higher CVC activities, or does Bayer with an aim to drive high CVC activities tend to nominate board members with multiple mandates for some reason?

2 Board equity ownership when combined with high tolerance for risky investments has a **positive relationship** to the firms' CVC activity

- New Share Ownership Guidelines:
  - Outside board members: Increased to 100% of base salary (75%)

- As Leap is focusing on seed- or early-stage interests, the investments made can be considered risky, especially when Leaps' ventures entails high risk of technological failures.
- The increase in share ownership for outside board members indicates the intention to motivate the engaged board to seek out new technology breakthroughs.

CONCLUSION

- Our examined literature finds certain correlations between governance factors in VC and CVC and their venture capital activities
- The case companies exhibit these links largely as expected, with some caveats (market or company specific)

- **Potential future research:** what kind of venture fund characteristics moderate fund activity, and how? See Anokhin et. al. (2016) done on CVC
- **Limitations**: focused on select key studies instead of an exhaustive meta-analysis. Scope of discussion limited to select topics brought up by the literature rather than touching on everything.

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