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Minority investments: How to use corporate venturing for strategic gain

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Corporate venturing – acquiring minority stakes in smaller, often high-growth or disruptive enterprises – can be a very effective tool for large, established companies looking to accelerate the digital transformation of their businesses, access new technologies and strengthen their innovation capabilities. However, negotiating these transactions requires a different approach and, in particular, a clear understanding of what potential targets are likely to expect of would-be investors and the long-term strategic rationale for making the investment.

Just a few years ago, it was relatively unusual for large corporates to acquire minority stakes in start-ups. Typically the preserve of venture capital funds, the lack of control and relative risk in such investments were not attractive to established corporations. How quickly things can change. As big companies realise that they have much to gain from the vibrant universe of start-ups, such corporate venturing is becoming a popular boardroom topic.

Why is this the case? Because making a relatively small investment in a dynamic start-up can provide invaluable insight into disruptive business models and technologies, access to the talent behind them, rights to their intellectual property and can even be preparation for an acquisition. For the start-up, the large corporate can provide not just much-needed capital, but also the expertise and credibility to help scale its business.

Corporate venturing represents a shift in motivation for large companies as they adapt to today's mounting business challenges. Established companies are seeking to collaborate with start-ups harnessing fast-evolving digital technology, judging that the best way to innovate is to learn from, and build with, these new entrants to the market.

Achieving these goals requires a corresponding shift in mindset when it comes to planning, negotiating and executing transactions. What works when acquiring control of a substantial business is not necessarily appropriate when making a minority investment in an early-stage enterprise.

Potential benefits and risks

Whether the large corporate is making the minority investment to help facilitate the digitalisation of its own business or for a broader range of purposes, corporate venturing carries a range of possible benefits. These include access to some of the best talent, the possibility of a high return on investment, access to intellectual property (IP), the opportunity to stimulate demand for the investor's own products, and gaining new insights from disruptive businesses. At the same time, while the risk of failure in an investee company may be somewhat increased, the financial risk to the investor is relatively low. By the standards of large corporates, these are typically small investments that allow them to test a wide range of new businesses and products.

Furthermore, corporate venturing is flexible. The corporate can decide how close a relationship it wants with the new business. Investors can elect to play an active role in the development of the company, including holding board seats or entering into collaboration or R&D agreements, or it can adopt a more passive position, content to allow the company to develop at its own pace.

This flexibility extends to the investor's ability to exit from the company, with a number of mechanics often making their way into the final investment agreements. These options range from traditional drag rights and an ability to sell to third parties, through to rights of the investor to acquire a controlling stake in the start-up's equity or to take ownership of its IP. An investor concerned about the need to disengage from the start-up quickly (for example, if there is a risk that behaviour by the start-up might cause reputational damage) may also require an ability to put its stake in the company up for sale for a de minimis sum and walk away from the investment altogether.

A different type of deal

For corporates making minority investments in young businesses, what are the issues to consider? By nature, these investments may be quite different from anything that they have done before. Start-ups tend to have dynamic cultures with little in the way of traditional corporate structure, and the large company will have significantly reduced control over the day-to-day running of the business.

At the outset, the large company must decide why it is buying the stake. What is the motivation and strategic rationale? Is it to help digitise its business? Is it an option for a future acquisition? Is it to try to understand the market better and have access to the key people? Does it want access to new intellectual property? The answers to these questions will affect the approach to the negotiations and should therefore be considered as early as possible (ideally before drafting a term sheet).

If making the investment ahead of a possible acquisition, consideration of a right of first refusal when the shares come up for sale may be a key driver. If development and acquisition of intellectual property is a key concern, then a licensing agreement or a right of first look in respect of the IP may be the greater priority. If the investment is intended to give rise to new products or R&D within the investor's group, a collaboration agreement and questions of exclusivity may need to be considered.

Turning to due diligence, young companies generally have less information to review. Deals tend to be done faster without the lengthy, comprehensive diligence exercises which are typical of traditional M&A. Investors should seek to have a sharp focus on the details that really matter which, in the case of IP-rich or tech-focused start-ups, will often consist of issues relating to employment, intellectual property and, in some sectors, regulatory matters. Do the key employees have proper contracts that tie them to the company and prevent them from working for other companies? Does the company own its intellectual property and do any other companies have rights to it? If it is in a regulated industry such as financial services, it is essential to be sure that the start-up understands its regulatory obligations. A failure to understand or follow the relevant law and regulations on the part of a start-up could not only lead to a significant loss of value but also major reputational damage for its investors.

In mature markets, venture investments are generally made on broadly standardised terms which are amended to reflect any unique aspects of the relevant transaction. Ideally, any such amendments are kept to a minimum. In the UK, these terms are published by the British Venture Capital Association; in the USA, they are published by by the National Venture Capital Association. Standardisation in this area means that transactions can be executed quickly and efficiently, with parties focused on key terms such as economics and governance.

While there are undoubted benefits to standardisation, acclimatising to a minority relationship and the terms which govern it may take time for the strategic investor. A thorough understanding of the market-standard terms and consideration of 'red-lines' which will be requested from each target (for example, a board seat, restricting the target from working with competitors, or particular veto rights) often pays dividends and allows for smoother and more focused negotiations. Similarly, understanding and developing a 'house position' on these key areas can be a very profitable strategy, providing certainty for stakeholders within the investor and a clear roadmap for the deal team.

Being an attractive investor

Taking the wrong approach to a transaction can spark a culture clash and disrupt or, worse, end negotiations. Start-ups move quickly, frequently place a premium on the protection of their culture (a culture which may well be very different from that of the investor), and focus on key commercial issues. From a practical perspective, a fundraising can take up a significant amount of management time in the start-up, and steps taken to make the process as efficient as possible will be likely to be attractive.

In the fluid and sometimes volatile environment of 2021, how can a corporate capture the attention of the target and appear to be a culturally compatible and attractive investor? In part, that comes down to taking a pragmatic approach to the transaction. As noted above, if a corporate is planning to make a series of minority investments, it is worth preparing a standard house term sheet to use in these deals that is practical but includes any red lines or non-negotiable points. Similarly, developing a more streamlined due diligence process which focuses on the points which matter most will go some way to signalling that the investor not only understands the target but wants to spend time on business-critical issues and, ultimately, to be a good partner.

Understanding the corporate's value to the start-up is also important. Large companies offer start-ups huge value in terms of the expertise, connections, brand recognition and understanding of regulations that can speed their progress. Being able to identify these benefits to the management of the target is often a vital aspect of the early stages of successful negotiations.

An eye on the future

As the start-up universe flourishes, fostered by the rapid evolution of digital technologies, so there are suddenly thousands of young companies around the world seeking to disrupt established markets and challenge profitable businesses. The corresponding increase in corporate venturing is an understandable response – providing a flexible and often powerful means for established players to respond to the challenge posed by these new entrants.

Measuring return on investment for these strategic investments is rarely purely a question of finance. As we have seen, there are myriad reasons a corporate player may wish to begin or expand its programme of minority investing and each of these reasons will have an impact on not only the targets sought by the investor but also the terms it seeks in negotiations from day one. It is for this reason that a thorough understanding of the long-term strategic rationale for making the investment – an eye on the future – is so critical from the outset.

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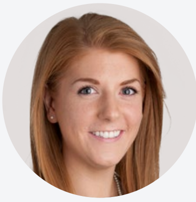

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