



Viewpoint

by Jay E. Paap

The VC Opportunity In Corporate Spinoffs

Corporations around the world are reassessing their investments in new products, technologies and businesses. The companies find that in today's downsized economy with its focus on "core competencies," they can no longer afford to be as free with their development resources as they were in the recent past. In response, they are creating a generation of "orphans," -- promising, but unwanted development efforts. These are initiatives that no longer fit their newly defined strategic mission, or are developments that took a surprise turn and yielded attractive—but non-strategic—alternative business applications.

Ampersand's Link with Alcan

Ampersand Venture's well-publicized creation of a fund of 10 spin-offs from Alcan's portfolio of corporate ventures reflects a growing trend for venture capitalists to exploit the often significant technical investments made by corporations in these orphans. By creating independent venture-backed companies, the parent has the opportunity to receive a better return than it could get from a premature sale of assets and frees itself from ongoing involvement in the effort. They don't receive cash; rather, they take a minority position in the new company in return for the value of their past investments.

In the Alcan deal, the company took a position in a limited partnership managed by Ampersand, thus providing important legal protections.

The VC role is an important one and often the key to success; they contribute both capital and experience in building a venture, something rarely found in corporations.

Spin-offs also benefit the VC firm. Although no longer wanted, the entities usually have been through numerous corporate reviews, represent a significant development investment and are available at good prices since the costs were expensed.

Spin-offs are not limited to orphans. AT&T, Thermo Electron and United Technologies have set up programs to spin off strategic assets, with the hope the venture will be more entrepreneurial and at the same time attract outside investors to share in the development risks. The VC firm's role is not as critical in this case as in the orphan spin-off—but it is provided an opportunity to participate in well developed efforts holding the potential for higher than average yields.

For years VCs have looked to corporations for the talent and technology to start new firms. The newest activity, however, is different in that it involves a focused search throughout the firm for under-exploited assets. More importantly, the parent is an active and supportive participant in the search.

Spin-offs are not yet a major deal source, in part because they are not easy. Several pitfalls are worth noting. First, while the development is often well advanced, there is little

written—or even thought out—to help an investor assess the deal's value and potential. A lot of hand holding, investigating, and writing is needed before the deal can be evaluated.

Further, rarely does the development team understand the importance of cash, burn-rate, or milestones. The teams tend to focus on technology development, with little thought about the market need or competition. Last, the experience can be frustrating since the best deals are often retained by the parent, sometimes only after an outsider has shown their true potential.

This often extensive front-end work has discouraged many VC firms.

Boston Capital's Novel Approach

Boston Capital Ventures has taken a novel approach and set up a separate group to work with nascent deals of all types—corporate spin-offs as well as spin-offs from hospitals and universities. These activities can prepare them for investment and provide a rich source of early stage deals.

Consulting firms such as Data and Strategies Group and Advanced Materials Partners have set up programs to assist corporations with the initial screening and business planning, and to help them find an investor. This benefits the VC firm by providing it with focused and pre-screened deals. It can help the parent by identifying alternatives to spin-offs (e.g., joint venture or license), and often enables them to make a market for the deal. Xerox has taken the concept a step further with a \$50 million, internally managed venture fund with the sole objective of financing its spin-offs.

There is clearly potential here, and more collaboration between corporations and VCs can be expected in coming years.

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