THE COMMERCIALIZATION CHALLENGE:
Lessons from Venture Capital

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One of the most pressing needs confronting organizations of all sizes is the commercialization of new products and services. The rate of change in technology, customer expectations, and competitive capabilities makes it imperative that firms better manage the process by which ideas are converted into sales.

For the past several decades, the venture capital industry has made the profitable commercialization of new businesses their sole objective. Although financial returns from venture capital funds have been down in recent years, their ability to successfully build new enterprises has remained high – with over half of all companies financed by venture capitalists reaching a point where they went public or were acquired by a major corporation.

There are lessons to be learned from the way venture capitalists build businesses. These lessons can be applied to improve the success rate – and financial return – of the venturing-like efforts pursued by corporations, i.e., the commercialization of new products and services, and the application of new design, material, or process technologies to enhance their competitive position. The table below summarizes how venture capitalists approach commercialization. In the sections that follow the implications for corporations are explored.

KEYS TO VENTURE CAPITAL SUCCESS

- **CLARITY OF PURPOSE AMONG ALL PARTNERS**
- **CAREFUL AND RAPID SCREENING OF OPPORTUNITIES**
- **VALUE ADDED INVOLVEMENT BY SENIOR MANAGERS**
- **INCENTIVES FOR ENTREPRENEURS**
- **PORTFOLIO APPROACH**
- **EARLY WEEDING OF TROUBLESOME VENTURES**
- **LONG TIME HORIZON FOR PROMISING VENTURES**
- **EARLY IDENTIFICATION OF AN EXIT STRATEGY**

Clarity of Purpose

Venture capitalists have one objective: to provide a significant financial return to their investors through the creation of a new business. As many managers of venture capital-backed enterprises will tell you, venture capitalists can be ruthless in pursuing that goal – changing managers, technologies, or markets – whatever will help build the company. Their particular goal is not as important as the fact it is clearly defined, agreed upon by all the key players, and actually used to guide their actions. Corporations need to balance this single minded drive to venture success with other legitimate goals, e.g., to protect their markets and core technologies, provide a stable work environment, and meet the needs of complementary business units. However, to the extent a company can develop a clear, unambiguous statement of objectives to guide their ventures, they will find it much easier to select opportunities, manage developments, and evaluate success.

One problem of not having goal consensus was highlighted a few years ago by a major electronics firm that had tried using strategic alliances to help grow their business. After five attempts everyone concluded "most" of their alliances were failures and they abandoned their effort. On closer examination, it was not clear the venture program was a failure.

When asked the objective of the alliance program, senior managers provided different, but consistent responses. The R&D Director wanted to develop technology capabilities faster and cheaper than they could on their own, but that had occurred in only two of five cases. The Marketing Vice President wanted to introduce new products faster, but that had occurred in only two cases. The Chief Financial Officer wanted to realize financial gain from the equity stakes in their alliance partners. Although the overall portfolio of five showed a respectable capital gain, only two of the investments did well on their own. The Personnel Director was looking to improve the internal and external image of the firm as more entrepreneurial, to help in recruitment and retention. While there was a general feeling of an "enhanced culture," there were no hard numbers to support this view. In the end, each manager

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concluded that "most" of the investments were failures.

In reality, each of the five initiatives had been a success on at least one of the measures. Few deals can satisfy the needs of all possible constituencies, and attempts to do so usually lead to disappointment. Had the managers developed consensus before each deal about its primary objectives, it is possible that each would have been viewed a success. More importantly, the firm could have focused its efforts on one or two targets.

Screening

The typical venture capital firm reviews 400 to 500 business plans per year. Most are completed within one to two weeks of receipt! The vast majority – often over 80% – are rejected on the first review, and 80% of those surviving that screen are rejected after a few phone calls or an on-site visit with the would-be entrepreneurs. This is not to mean that screening is taken lightly: market impact, technology leverage, and the soundness of the management team are all examined. For the 4 to 5% that survive the first two cuts, the screening – or due diligence – is very detailed, often involving dozens of calls, half a dozen on-site visits, and the preparation of extensive supporting market and technology studies.

One reason venture capitalists can process deals quickly is that they tend to spend most of their time evaluating deals that have promise, and relatively little effort on those that appear to be weak. They know they are passing up good deals that would be found if they studied all in depth, to confirm that a "reject" was really deficient. They realize, however, that time is limited, and time spent on confirming rejects is time unavailable to make sure that selected deals are sound. When compared to the venture capital experience, corporations usually spend significantly more time on examining bad ideas and less time on examining good ones. Understanding the reason for this disparity provides clues on how to increase the efficiency of corporate venturing.

The key factor seems to be in the focus of the due diligence. The venture capital partnership spends its time justifying why a prospect should be selected, not in explaining why it should be rejected. The corporation tends to focus more on the rejects for two reasons. First is the belief that anyone submitting an idea deserves a detailed explanation of why their idea was rejected. Second, there is often a fear among managers that they will be criticized for missing a winner. The problem with this logic is that few firms have the time or resources to fully justify every rejection. The result is that there are insufficient resources to review worthwhile projects in the time needed to remain competitive, and the depth needed to ensure effective use of limited development resources.

In short, corporations should focus on selecting winners, not on explaining losers. The selection process would not only run faster, but the quality of the ventures actually pursued would likely be much greater. True, corporations need to look at rejects a little more carefully than does a venture capitalist to determine the impact if a rejected winner is commercialized by a competitor. However, this can be overdone. The key to long term success is to have a good portfolio, not necessarily the only portfolio.

Unfortunately, this screening approach requires a greater pool of ideas than corporations typically have available. As with venture capitalists, innovative companies spend a lot of time actively seeking investment opportunities – screening is a proactive, not reactive process. As noted above, many corporations believe that detailed rejection analyses are needed to encourage ideas. This is not the case. Rapid feedback and well-publicized support of a few winners will keep ideas coming in. If anyone doubts this, a quick visit to the slot machines in Las Vegas will provide a quick reminder of the power of an intermittent reinforcement schedule.

Venture capitalists don't just look at the "hard" facts, the human side is also important. There needs to be a champion, and a supporting team that has – or is willing to accept – expertise in marketing, technology, and finance. Perhaps most important, there needs to be good chemistry between the project leader and the sponsor (in the venture capital situation, the lead General Partner). New ventures – whether in large corporations or a venture capital portfolio – require hand-holding and support from senior managers. A good idea is not enough to sustain this relationship – and good interpersonal chemistry is often the deciding factor in the ultimate success of the venture.

Value-Added Involvement

The third component is this senior level, value-added involvement in the guidance of the project. Most venture capitalists sit on boards, hand-pick company

managers, and interact weekly to monitor progress against project milestones. They are there to provide help – both financial and advisory – when problems arise. Successful new developments in industry have a similar profile.

A look at the Japanese VCR industry shows the importance of senior level champions. The leaders of Sony and Matsushita were personally involved in their projects at all stages, keeping the home VCR development alive and on track. Their attention gave the development focus and the ability to weather the setbacks that inevitably befall major new developments. Often, corporate executives focus only on the larger segments of their business, waiting until a development is "big enough" to warrant their attention. They need to recognize that a project may never become "big enough" without their attention, and that long term success requires attention to potential – not just current – business impact.

Incentives

New developments entail risk on the part of those involved – to their finances, careers and reputations. Venture capitalists recognize these risks and provide rewards that encourage entrepreneurial managers to accept those risks. Most well known is the opportunity for personal gain through an equity position in the firm. Such tactics in industry are often impossible, and schemes such as shadow-stock have had mixed results.

Fortunately, there are other incentives that venture capitalists rely on to motivate their entrepreneurs. Independence and identification with the project are strong motivators. True, the venture capitalist provides general guidance and is always in the background, but the managers of the venture capital-backed firm enjoy significant autonomy over day-to-day operations.

Another incentive is the close linking of achieving results with continued support. Instead of an annual budgeting and planning process, most venture capital backed-firms are funded on a milestone basis. Support is provided to accomplish a set of development objectives, and further support is contingent on meeting the milestones within specific time and cost projections. The extra effort often associated with entrepreneurial activities is not just a function of greed and commitment (both important), but also to survival.

There are also incentives for the venture partners to kill losers as soon as possible. Their incentive for doing so is the opportunity cost of the limited money available in the fund backing the portfolio; every dollar wasted on a weak investment reduces the potential of backing a big winner. Few corporations give incentives for the timely cancellation of troubled developments, e.g., a bonus for killing a project ahead of a scheduled review. Normally incentives work the other way, a bonus for success and nothing less. This encourages project leaders to try convincing themselves and upper management that success is "just around the corner" to keep a project – and their bonus – alive. Incentives should encourage making good decisions – not just project success.

Portfolio Approach

Venture capitalists are measured by the success of their portfolio of investments, not the success of a single entrepreneurial effort. This recognizes the inherent riskiness of new developments and the unpredictable nature of customer or regulatory demands, the development of new technologies, and the entrance – or retreat – of competitors. You cannot avoid risk, but you can use a portfolio to minimize its impact.

Corporations have less flexibility in developing a portfolio, but some important steps can be taken to apply the logic behind a portfolio. When faced with high risk development options, parallel development of alternative technologies or the use of alternative development approaches can help reduce risk. In the 1980s, IBM faced a narrow window in which to introduce a new memory chip. They had two competing approaches, one using an old technology that might not reach the new performance demands, and the other a new technology with unproven capabilities. IBM pursued each with separate internal efforts, plus entered into a strategic alliance to provide backup for the new technology in which they had limited experience. Two of the three programs were successful; more importantly, IBM had the component ready when needed.

Companies have also found it useful to track the success of their ventures, whether internal or external, as part of a single corporate development portfolio. This allows them to measure success on a broader base. It also reduces the tendency of business units to kill innovative development projects when faced with the prospect of taking a bottom line hit for a venture that falls short of its

goals. Only at a corporate level is there usually sufficient diversity and breadth to form a true portfolio.

Early Weeding, Long Time Horizon

The next two are separate but related concepts. Important to the success of a venture is the patience to stay with the development over the time needed to design, test, scale up and commercialize a novel technology or market concept. This patience is relatively easy in a venture capital fund since the partners usually have ten years to provide a return to their investors. In corporations it is often necessary to set up separate groups, or separate funding categories to protect the venture from the often necessary short term focus of the business units.

A long time horizon does not mean that venture capitalists stay with all their investments to the end. They constantly review their portfolio and weed out losers as soon as their prospects for long term gain are significantly reduced. There is a difference between being stubborn and being patient, and this is a skill required in building new ventures.

Exit Strategies

From the day of the first review, the venture capitalist starts thinking about how they will get out of the investment, usually through a public offering or an acquisition. The backgrounds of the people they recruit, the infrastructure they build, the breadth and character of the technology and product base – these are but a few of the early decisions that depend in large part on the long-term exit strategy.

Corporations also need to look at the exit strategy for each new venture – will it be a new division, a new product line in an existing division, a wholly owned subsidiary, a joint venture or merger candidate? If there is to be an internal transfer from an advanced development group to a line business, early interaction with the future "owner" is critical if the "not invented here" syndrome is to be avoided. The eventual transition can be made easier if there is an early effort to reconcile manufacturing, sales, service, planning and control procedures, or to anticipate changes needed in the future technical and managerial infrastructure of the acquiring business unit. Corporations who wait until the venture is near the end of its development to begin the transfer process are rarely able to realize the full potential of the development.

The consequences of possible failure also need to be addressed. How will value be extracted, by whom, and under what circumstances? What will become of the people, the patents, the equipment? It is no longer financially acceptable to just write off unsuccessful ventures, the stakes are often too high. Increasingly, corporations are looking to spin-off, sell, license out, or create a joint venture to realize a return on past development expenses. Having such alternative exit strategies not only reduces the financial downside of investing in high risk areas, but can stimulate innovative individuals to take more personal risk. This is particularly true when the development team has an opportunity to commercialize their work as entrepreneurs in their own start up venture independent of the parent. Recent equity spin-offs by Thermo Electron, United Technologies, Xerox, AT&T, and Alcan, indicate the growing popularity of such schemes.

Conclusions

The needs, resources, and pressures on venture capitalists are different in important ways from the forces working on corporate executives. The above guidelines for managing ventures are easier to follow when decisions are made solely by a handful of partners, there is a single unambiguous goal, there are few competitive pressures, and there is an unusually long time in which to find, build, and profit from their investments.

Despite the differences, the techniques used by venture capitalists can serve as a framework for approaching the corporate situation. There are lessons to be learned from how venture capitalists work. If corporations apply the underlying principals identified above they can improve their odds of remaining competitive through the responsible backing of a portfolio of entrepreneurial commercialization efforts.

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