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The strategic use of corporate venture financing for securing demand

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Abstract

This paper focuses on the strategic role of corporate venture financing carried out by a corporation (a headquarter). When the headquarter finances a venture through its corporate venture-financing arm, it can increase the complementarity between products of the venture and the headquarter. The effect of having an increase in complementarity is a softening of ex post product market competition with rival products. Hence, in deciding whether to finance the venture, the headquarter faces a trade-off between, on the one hand, being more aggressive ex post in the product market, and, on the other hand, using venture financing to soften ex post competition with substitute products.
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1. Introduction

Large corporations often establish corporate venture funds to finance start-up firms. Gompers and Lerner (1998) show that already during the late 1960s and early 1970s, more than 25% of the Fortune 500 firms established corporate venture funds. Currently, over 900 VC funds included in the large Venture Economics database (from Thomson Financial) are corporate subsidiaries, which represents 15–20% of all US VC funds. In Europe, about 11% of the funds raised in 2000 came from corporate investors (EVCA, 2001).

There are several reasons underlying the use of corporate venture financing.[1] One reason is that it enhances flexibility for a headquarter (HQ) backing the corporate venture capital fund, by allowing HQ to focus on the core business rather than on other secondary issues (out-sourcing of R&D activities). It also allows corporations to respond more rapidly to investment opportunities. Furthermore, the use of such a financing scheme may enhance trust from the venture, because it signals that HQ will not steal the novel idea of the venture. Finally, there is also a strategic reason behind it. Corporate venture financing can be used as a strategic vehicle to generate demand. In this paper, we focus on this last motive.

There are some real examples of this kind of motive. For instance, Oracle Corporation, a leading IT company, invested in Red Hat Inc. (a company providing Linux operating system) in order to seize the opportunity to sell version of its programs to run on Linux (Wall Street Journal Europe, 2000). In that way, Oracle Corporation can generate demand for its own products. Another example is Intel Corporation which nurtures new start-ups, that Intel Corporation hopes will grow and become customers for their microprocessors (Wall Street Journal Europe, 2000). Still another example is Cisco Systems, a leading IT company, which constantly finances start-ups (see The Economist, 2000; Paulson, 2001). The following quotation nicely captures the motive behind Cisco's strategy.

> "Cisco finds a particular technology or company that is interested in cultivating, but the company is not at the stage where an acquisition is appropriate. Cisco places some key Cisco employees inside the external company. These people have the charter to cultivate the desired technology and build it into a marketable product that meets Cisco's future expected product requirements." (Paulson, 2001, p. 158)

The use of corporate venture financing potentially allows HQ to influence the degree of complementarity between its own product and the final product of the venture. For instance, when HQ's product is used as input by the venture, the use of it allows HQ to *secure demand* from other companies when its product can be substituted with other inputs. More clearly, let us consider the case of an innovative venture that produces an electronic final good. Suppose that in producing the good she faces a choice between using a specialized and a standardized processor as an input in the production. Assume that even if the price of a specialized processor is higher than the price of a standardized one, utilizing the former may enable the venture to produce the final good at lower marginal costs than using the latter one. However, in order to enable this reduction in marginal costs, the venture has to adapt its product to HQ's one. We can think of it as effort that the venture has to exert in order to

[1] See, for instance, Siegel et al. (1988), Winters and Murfin (1988), Gompers and Lerner (1998), Maula (2002), Maula and Murray (2001), Birkinshaw et al. (2002), Chesbrough (2002), Hellmann (2002), Santhanakrishnan (2002), Dushnitsky and Lenox (2005a), and Dushnitsky (2004).

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