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Corporate venture capital and the returns to acquiring portfolio companies ☆

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ABSTRACT

A prominent motive for corporate venture capital (CVC) is the identification of entrepreneurial-firm acquisition opportunities. Consistent with this view, we find that one of every five startups purchased by 61 top corporate investors from 1987 through 2003 is a venture portfolio company of its acquirer. Surprisingly, our analysis reveals that takeovers of portfolio companies destroy significant value for shareholders of acquisitive CVC investors, even though these same investors are "good acquirers" of other entrepreneurial firms. We explore numerous explanations for these puzzling findings, which seem rooted in managerial overconfidence or agency problems at the program level.

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1. Introduction

From 1980 through 2003, established firms invested over $40 billion in entrepreneurial ventures (Venture Economics, 2005). Like independent venture capitalists, corporate investors often seek financial returns through exit events such as initial public offerings (IPOs) or sales of portfolio companies to third parties (Gompers and Lerner, 2000a). Corporations also invest for strategic reasons (Hellmann, 2002). In surveys, managers rate "identifying acquisition opportunities" and the "potential to acquire companies" as prominent motives for investing in start-ups (Siegel, Siegel, and MacMillan, 1988; Alter and Buchsbaum, 2000).

In principle, the provision of corporate venture capital (CVC) could help established firms assess the value of innovative young companies and gain efficiencies post-acquisition. Corporate investors commonly provide

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technical and commercial advice to portfolio companies and assume roles on boards of directors (Chesbrough, 2002; Maula and Murray, 2002). By reducing information asymmetries in markets to acquire entrepreneurial firms, the provision of venture capital could help corporations mitigate the "winner's curse" of overpayment in the event of subsequent acquisition (Thaler, 1988). Despite survey and case study evidence that CVC investments are used to inform entrepreneurial acquisition decisions, little is known about the extent to which CVC investors have preexisting venture ties with startups they acquire. More generally, prior studies have not examined whether CVC investors earn positive abnormal returns (net of investment and acquisition premiums) when acquiring startups from their portfolios of investment companies.

This paper contributes new evidence based on the returns to top U.S. corporate investors when acquiring entrepreneurial firms.[1] Integrating acquisitions data with information from press releases, news articles, and venture financing databases, we distinguish between acquisitions of entrepreneurial firms that are (and are not) CVC portfolio companies of their acquirers, which we refer to as "CVC" and "non-CVC" acquisitions, respectively. In total, we identify 530 entrepreneurial-firm takeovers by 61 CVC investors during 1987–2003. Of the entrepreneurial targets, 89 (17%) are portfolio companies.

The results of our event study are more surprising. For private takeovers of non-portfolio companies, we find a significant and positive acquirer return of 0.67% on average. This result closely approximates estimates of Moeller, Schlingemann, and Stulz (2004) for large acquirers of private targets and suggests that established firms in our sample are not necessarily "bad acquirers" of startups relative to the larger population of U.S. corporations. Indeed, private takeovers of non-portfolio companies created over $32 billion in shareholder value for these acquirers in 1999 and 2000, a period associated with "wealth destruction on a massive scale" in the market for corporate control (Moeller, Schlingemann, and Stulz, 2005).

In sharp contrast, CVC acquisitions tend to *destroy* value for shareholders of these same acquirers. For CVC (portfolio-company) acquisitions, acquirer returns are significant and negative at both mean and median values (-0.97% and -0.75%, respectively). We find no evidence that this negative market reaction reflects disappointment relative to higher payoffs anticipated from the initial investment. Moreover, the average return to CVC acquisitions remains more than 1.5% lower than the average return to non-CVC acquisitions in multivariate analyses that control for detailed characteristics of the acquirers, targets, and deals that could affect the market reaction. The results are not driven by "boom years" or outlier observations and remain stable across specifications that restrict the sample to matched pairs of CVC and non-CVC targets and that allow for unobserved heterogeneity among acquirers. On a dollar-value basis, our estimates suggest that acquiring-firm shareholders gain $8.5 million from the median non-CVC acquisition but *lose* $63 million from the median CVC takeover.

These findings naturally invite causal explanation: Why would acquisitions of portfolio companies destroy value for shareholders of the acquirers? As a first step toward investigating this issue, we explore three prominent explanations in the acquisitions literature: (1) overbidding due to "owner's curse"; (2) firm-level governance problems; and (3) managerial overconfidence. According to the "owner's curse" hypothesis, investors with a prior equity stake (toehold) may overbid in hopes of provoking higher counteroffers (Burkart, 1995; Singh, 1998). Assuming that bidders are unable to renege on their offers, toehold investors may end up overpaying for some of the targets they acquire. A second hypothesis is that firms with weak governance structures disproportionately make value-destroying takeovers of portfolio companies. In this view, value destruction is rooted in classic agency problems and misaligned incentives (Jensen, 1986). A third hypothesis is managerial "hubris" (Roll, 1986) or "overconfidence" (Malmendier and Tate, 2005, 2008). In this view, value-destroying CVC acquisitions stem from upward biases among managers when valuing portfolio companies.

Empirically, we find no evidence that the negative market reaction to CVC acquisitions is due to competition-driven overbidding (owner's curse), firm-level governance problems, or hubris among CEOs of these investors. Probing deeper, our analysis does reveal more favorable outcomes for investors that do (versus do not) house CVC programs in autonomous organizational units—both in the value captured from portfolio-company acquisitions and in the proclivity to "throw good money after bad" by reinvesting in startups that languish. Consistent with overconfidence-based theories, managers from dedicated CVC units may be less prone to bias when valuing portfolio companies due to greater exposure to investment opportunities ("deal flow") or superior training in finance. Alternatively, organizing CVC activities in standalone units could enable superior monitoring and compensation of investment activities, thus helping mitigate intra-organizational agency problems. Our conversations with managers point toward both explanations.

This paper contributes to several strands of literature. First, we add to an emerging body of research on corporate venture capital and the vehicles used to finance entrepreneurial firms. Empirical studies on the returns to CVC investing primarily focus on the returns to corporate investors when portfolio companies exit via IPOs or acquisitions by third parties (e.g., Gompers and Lerner, 2000a). We provide the first systematic evidence on how prior venture ties affect the returns to CVC investors as *acquirers* of entrepreneurial firms. Despite recent theoretical attention to the strategic nature of CVC investments (Hellmann, 2002), empirical research is largely limited to case studies and managerial surveys.[2] Within this

[1] Targets are classified as "entrepreneurial" or "startups" if they are less than 12 years old when acquired.

[2] In addition to generating returns on investment, CVC can stimulate internal research and development (R&D) productivity through improved management of internal projects (Thornhill and Amit, 2000) and information gained from portfolio companies (Hellmann, 2002;

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