Strategy & Corporate Finance Practice

How to make investments in start-ups pay off

Both large corporations and start-ups have much to gain from collaboration, but corporate venture capital investments need a clear strategy, focus, and operating model.

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Traditionally, established corporations have tended to view start-ups as undisciplined and naive, while start-ups might dismiss incumbents as stodgy and behind the times. It's (mostly) not like that anymore, as both sides increasingly recognize each other's strengths and the value of collaborating. In fact, large companies are now involved in about a third of all venture deals—an all-time high. More than three-quarters of the Fortune 100 are active in the venture capital (VC) space and half have a VC arm set up as a subsidiary, not including companies with internal VC business units.

But incumbents' broad embrace of corporate venture capital (CVC) investments belies a sobering reality: these marriages are difficult, and the majority fail. When we analyzed private and public data from more than 2,000 companies that participated in McKinsey surveys, then combined that with public and private data and dozens of executive interviews, we discovered that only 14 percent of incumbents that invest in young companies have adopted the practices necessary to sustainably generate value from such relationships (more on those practices below). Success is so elusive that a quarter of those that invested in 2015 were gone from the venture scene just three years later. We also found that more than 70 percent of CVC activity is sporadic or opportunistic, an approach that correlates with poor ROI.

When executed well, however, CVC investments can be a boon for both parties. Top-tier corporate innovators[1]—which tend to be twice as active as their industry peers in start-up investing and mergers and acquisitions (M&A)—have been able to capture between two and three times the economic profit from these deals as their industry competitors. As for start-ups, their reported rate of success with CVC partnerships is a discouraging one in ten, but those that beat these tough odds enjoy a lower rate of bankruptcy, faster growth, and a greater likelihood of staying viable and producing an "exit."

The appeal of CVC

Industry after industry finds itself disrupted by start-ups. Yet amid the excitement over emerging companies with innovative business models, products, and services, what's often less appreciated are the significant inherent strengths of established corporations—from financial firepower to deep industry knowledge to sophisticated processes.

CVC is attractive to start-ups because it provides them with access to those strengths. For incumbents, in turn, venture investing presents a route to radical innovation with (seemingly) reduced uncertainty. While CVC activity has slowed in 2022, last year corporations invested over $190 billion across more than 5,000 venture-backed deals (Exhibit 1).

Our research found that corporations are drawn to CVC primarily by the potential for long-term strategic benefits: 75 percent of the corporate respondents were motivated by the desire to gain market insights and cutting-edge ideas, 55 percent by access to new products, 45 percent by the opportunity to build important capabilities and participate in a broader ecosystem, and 25 percent by the chance to secure strategic options. Just 15 percent cited the opportunity to use CVC as a way to make money that could be invested in other sources of growth—even though, in our experience, companies with effective CVC programs have much to gain financially.

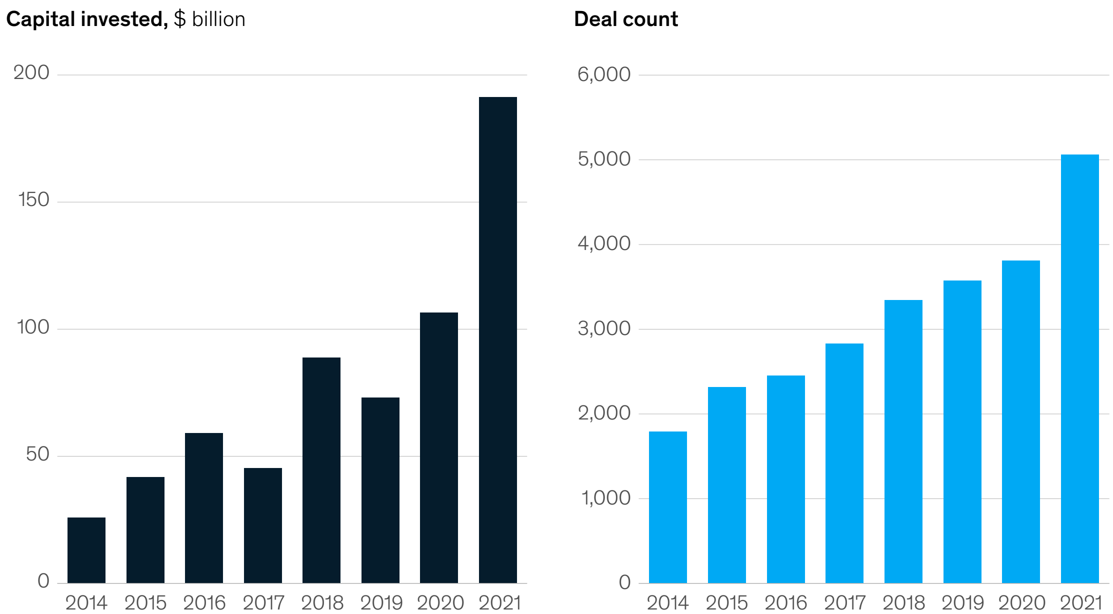
Among start-ups, finding potential new clients was mentioned by almost all respondents as a

[1] Companies whose executives rated their organizations' innovation performance between eight and ten on a ten-point scale for mastery of innovation essentials.

Exhibit 1

Venture investing by corporations has become commonplace.

Global disclosed venture capital deals, by corporate venture capital



Source: CB Insights; PitchBook; press search

key draw of CVC, with 40 percent also seeking access to distribution channels and 25 percent looking for help with branding. Those that manage to strike successful partnerships enjoy significant benefits (Exhibit 2). Start-ups that receive CVC within their first three financing rounds have a higher chance—between 21 and 64 percent—of making a successful exit than those relying solely on traditional venture capital. What's more, the earlier in their development they receive that corporate support, the higher their chances of going public or securing a merger or buyout. CVC-backed start-ups also have a much lower rate of bankruptcy.

Three essentials of an effective CVC program

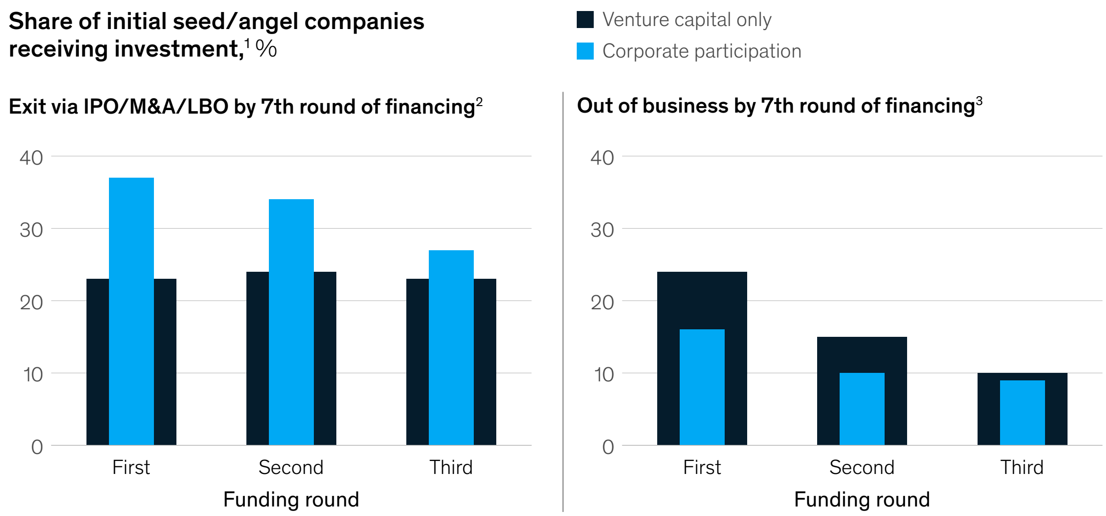
So how can the two sides develop fruitful and lasting relationships? Our research suggests that corporations need to take three steps to create a sustainable CVC program. First, they must set a clear vision and strategic objective for the partnership. Second, they should determine the kind of start-up partners they will focus on by developing specific investment theses and identifying targets that can best help fulfill them. And third, they need to formalize an operating model for the CVC program. The best corporate–start-up collaborations result from a deliberate process that ensures benefits for both sides.

The vision: Why should you engage with start-ups, and why should they engage with you?

Corporations and start-ups almost always have very different goals in working with one another. Start-ups want to grow as fast as possible and

Exhibit 2

Start-ups with corporate participation are more likely to grow and less likely to fail.



[1]Venture-backed companies founded between 2009–12 in the US.
[2]Companies without corporate venture capital (CVC) for corporate/VC investment in the first round, n = 13,533.
[3]Companies with CVC for corporate/VC investment in the first round, n = 558.
Source: Accelerator data from PitchBook; McKinsey analysis

are ready to adjust their strategies quickly, often pivoting as they learn more about the product-market fit. They see incumbents as channels to customers, but they want to protect their technology or other competitive advantages. Incumbents, on the other hand, seek access to new solutions but want to be able to steer the strategic direction of their investments, prevent cannibalization of legacy businesses (often a misguided endeavor), and preserve their reputation with customers. Agreeing on a clear strategic goal that meets both parties' ambitions is thus critical.

That's often challenging. The head of the CVC program at an airline, for example, reported that the goal of its program was "not necessarily successful points of contact with start-ups but educating executives and business units on new technologies to identify where and how they can make changes in those business units." It's easy to understand why that objective would not be enticing to a start-up.

Avoiding friction caused by conflicting objectives requires aligning from the outset on how the partnership will deliver long-term value to the corporate investor as well as its start-up partner. The two sides need to agree on objective success metrics, or key performance indicators (KPIs), that are clearly tied to business goals. Companies that reported the most success with CVCs had multiple KPIs—both "hard" metrics (such as investment returns and revenue/EBITDA generation) and "soft" ones (the number of insights generated or the frequency of interactions between the start-up and the business). For example, a large insurer working with a technology company told us it initially focused on softer metrics such as number of leads generated but, as the program evolved, began looking at tangible business-impact measures such as cost savings and conversion costs.

Finally, basing a relationship on capital alone is rarely a winning formula. In the most successful collaborations, corporations don't merely offer start-ups funding but also knowledge, customer access, and advice on developing their business.

The focus: What types of ventures are you seeking, and what kinds of companies would make the best partners?

CVC practitioners need to decide on the size of the investments they plan to make, their appetite for risk, and any limitations surrounding their start-up engagements, such as geography or regulatory requirements. They should also weigh how quickly they expect the start-up to deliver value, as that may affect whether they should engage with early-stage or more mature companies.

A misalignment between stage, risk appetite, capital allocation, and time to exit or ROI can complicate the selection process. For instance, many companies want to see a return in a relatively short period of time, but their resource limitations may mean they have to focus on early-stage ventures that are less tested. Those, however, generally take longer to deliver value and tend to have higher failure rates.

Before starting to select partners, key stakeholders in the CVC program should agree on the challenges the investments aim to address, whether it be growing beyond the core business, building new capabilities, or protecting against industry disruption. An insurance company, for example, may want to invest in a smaller firm in order to acquire technology to improve underwriting, explore new services for its policyholders, or test distribution through e-commerce. The CVC team should then identify ways a given start-up could assist the company in those pursuits. The articulation of these use cases serves two purposes: it sets out a clear value proposition when approaching the start-up and it helps the CVC team make a case for the investment to the management team.

The model: How should you formalize and manage your CVC program?

Given the high failure rate of new ventures, successful CVCs need to be prepared to make multiple bets to maximize their odds of hitting the investment jackpot. Operating a portfolio of investments in turn necessitates developing mechanisms to collaborate with start-ups in a systematic manner. Yet many companies fail to take this critical step. Even among companies that define their CVC programs as having high impact, about a third report having no plans to expand their existing partnerships to other parts of their business.

A sustainable CVC program also requires creating dedicated roles to manage the collaborations. This can be challenging for corporations, as investing in and working with start-ups calls for very different skills than those usually sought by corporate talent departments. HR professionals may need to develop new capabilities, from recruiting executives with venture capital experience and an entrepreneurial, founder’s mindset, to devising compensation and incentives more akin to the venture capital model than the corporate model.

An important part of the collaboration structure is a clear model for how the business units will interact with their start-up partners. Corporations can be overly prescriptive and controlling in pursuit of their own objectives at the expense of their junior partners’ long-term success. For example, developing plans to scale the start-ups’ businesses is a step often missed by corporate start-up engagement teams, which are mainly interested in innovation and tend to focus more on testing their partners’ concepts than on supporting the younger companies’ growth. This often leads to larger portfolios of small bets—not the new pillars of growth many incumbents fundamentally seek.

Another big hurdle to CVC success is bureaucracy: early-stage ventures often have problems with the scope and complexity of an established company’s processes. “The whole start-up ecosystem necessitates moving fast,” one start-up CEO told us. “Start-ups have to align with VC timelines and fundraising cycles, and many corporates don’t understand that.” Indeed, at least a third of the corporations we surveyed struggled to establish the right fast-track procurement process for their start-up engagements. “Our standard info security and legal requirements are too slow, cumbersome, and costly for a start-up to handle,” a retail executive admitted. One agricultural company lost an opportunity to partner with a promising young company because its staff moved too slowly, even on simple tasks such as completing a nondisclosure agreement. The start-up saw a weeklong delay in signing as indicative of the corporation’s lack of agility—and walked away.

Start-ups also report difficulty in getting to the right decision makers. “Innovation teams [at large companies] are door openers,” one start-up executive said, “but you still have to convince the business or product people, and we need help navigating this broader organization.” In fact, over a third of the start-ups we surveyed feel corporate innovation teams lack the authority or budgets to drive projects forward. Start-ups should be proactive in asking their CVC sponsors for introductions to key corporate stakeholders so they can lay out the “who” and “why” of a potential collaboration and hopefully smooth the path to fast decisions.

To overcome these challenges, it’s helpful for the CVC to have sponsorship from top management (and often the board of directors) to convey the importance of the start-up partnerships to the organization. Forty percent of corporations reporting a high measurable impact from their CVC efforts have direct reporting links from the CVC to the CEO, compared with none of the low-impact CVCs. At the same time, the CVC needs to maintain a healthy distance from the core organization. Half of the high-impact CVC programs were, by design, independent from their business units, giving program managers some autonomy and the ability to move with agility.

What separates the best corporate–start-up collaborations from those that get stuck in “pilot purgatory” is a clear and aligned strategy, the selection of the right candidates, and a shared road map for execution and scale. Companies should define success clearly, assess use cases and operating constraints, and choose the right operating model. By following these best practices, established corporations can successfully embrace the power of disruption. The alternative, one CVC executive noted, is to “be disrupted by someone else.”

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