The Last Legacy of the Dotcom Era

Known as corporate venturing, it's a risky tool that can bring big rewards.

By John Donahoe, Phil Schefter, and David Harding

Venture capitalists have been portrayed by the media as a breed apart, with little to teach traditional companies about their speculative investments. This isn't true. In fact, the smartest brick-and-mortar companies are using the disciplines of venture capital to build their own businesses and expand profitably in an adapted version of betting high risk for high reward.

The approach is called corporate venturing, and it enables existing corporations to build new businesses from the ground up, based on new ideas from within the company, with venture-capital disciplines. These businesses should be related to the parent company's core offerings, but with the leeway and autonomy to compete with and redefine the core if the new business merits, and with each phase of funding pegged to demonstrated achievement of specific business milestones.

Two circumstances in particular are increasing attempts at business-building: The first is the ongoing threat of successful start-ups that spring from new technologies and business models, fundamentally restructuring industries. This impetus for business-building is unlikely to disappear. The past decade is replete with examples of street-level start-ups that might have been founded by traditional industry leaders. Witness Extended Stay America's staking of unclaimed territory in longer-term hotel lodgings, which could have been done by Marriott; or Home Depot's capture of do-it-yourself customer territory, which could have been annexed by Ace Hardware or Sears; or Dell Computer's direct channel challenge to Compaq and IBM.

Indeed, the new economy's wake-up call to corporate venturing came with Amazon's land grab of online book retail, right out from under bookstore giants Barnes & Noble and Borders. As promising newcomers nibble, then chomp, away at related markets, established firms feel the urge to build new businesses themselves. They want to leverage corporate assets—brands, customers, suppliers, or capabilities—to secure a piece of the action.

The second force was the high valuations that many start-ups, particularly in the e-commerce space, initially received. Not wanting to miss out, established firms have started businesses with the intention of later spinning them off and reaping the rewards. The Nasdaq's plunge has dampened some enthusiasm for spin-outs and increased risks. Nevertheless,

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corporate venturing remains an appropriate tool for exploring new business models and harnessing new technologies for companies that have the discipline. Corporate venturing requires tightly screening business ideas for profit potential; staging—even drip-feeding—cash based on hard measures of progress; deploying strong entrepreneurial management and governance with incentives for results; and closely charting progress and managing the exit from the venture. Without these disciplines, ventures can go off the rails.

In fact, many have. While corporate-venture investments grew an eye-popping 158 percent per year from 1996 to 2000, as traditional firms scrambled to get atop the Internet wave in product and channel innovations, corporate venturing as a management tool rated lowest in user satisfaction out of 25 tools queried in Bain & Co.'s Management Tools 2001 survey. Almost half of all respondents who had tried corporate venturing had sworn off it.

So why do companies keep trying? And what's the difference between successful corporate venture capitalists, like American Express (see "How American Express Seeds Ventures," below) and AOL Time Warner, and unsuccessful ones, like Priceline and Amazon?

Close to Home

When Bain & Co. analyzed 2,035 publicly held companies with annual revenues of $500 million or more in the United States, Canada, Britain, France, Germany, Italy, and Japan, we found that only 14 percent had achieved sustained, profitable growth for a decade. And we defined *sustained* as posting year-on-year real revenue and profit growth of at least 5.5 percent while repaying their cost of capital.

What distinguished these performers from the rest? A strong core business, or multiple cores, that dominated their industries. This rare, valuable trait primes a company to successfully pursue a broad set of corporate-venturing opportunities. For companies with a weak core, however, such opportunities are limited. The first priority of these companies should be to strengthen their core, not divert people and capital into new ventures.

Priceline leapt too far from its still-developing core and landed hard. The dotcom built a market-leadership position in reverse auctions in industries with highly variable capacity and low marginal costs—airline seats and hotel rooms. But before it sufficiently strengthened its core, it moved into entirely different sales processes, launching ventures in mortgage lending, groceries, and gasoline sales. The result? In 2000, when TheStreet.com Internet Index lost 78 percent of its value, Priceline's market capitalization plummeted 98 percent, and the company had to shut down newer businesses like groceries and gas. To make matters worse, while it had been building tangentially related businesses, Priceline became vulnerable to attack on its core air-ticket auctions from airline consortia.

How American Express Seeds Ventures

Corporate venturing at American Express began informally. When American Express was assessing how the Internet would affect its business model, it took a small stake in a precocious start-up, freemarkets.com—an online business-to-business (B2B) exchange. Early returns led to a second round of investment, and to American Express learning a lot about B2B e-commerce and making some money to boot.

American Express soon formed a venture fund and established principles to guide investments and management participation. When the venture group finds a viable partner company, it takes an ownership stake. Where that stake is 5 percent or more, it wants a board seat. In addition, the venture has to be a profit center. New ventures strive to provide superior value to customers the company chooses to serve, and do so in a way that achieves best-in-class economics and enhances the brand.

"These are simple rules . . . but they are incredibly hard to follow," says Ken Chenault, CEO of American Express. "And you have to follow all of them; one isn't enough." The principles allow Chenault to, as he puts it, listen and get out of the way. "Great strategies are sometimes post-rationalized," he remarks. "But if you use principles and criteria and have an overriding vision, you can move forward aggressively without a clearly defined and agreed-upon overriding strategy."

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On the other hand, Internet companies that lost the least value in 2000 were those that built businesses close to their cores. EBay, the most successful online auction company, ventured from its core consumer auctions to business auctions, which built on the company's base technology and processes. It lost 58 percent of its market cap, bad but considerably better than the industry average.

No Distractions

Even companies with strong core businesses should clarify their strategic rationales before leaping to launch ventures. There are three strategies that companies with strong cores should consider:

Broaden or deepen the core. Publisher Ziff Davis both broadened and deepened its existing core of publications by moving into online media—ZDNet.

Reinforce the core business by expanding into closely related businesses. Through its venture in Hain Celestial, food maker Heinz expanded into the highly related business of health foods.

Explore new business models without distracting the core team. American Express managed to accomplish this with its recent joint venture, "MarketMile," a platform for online trading of stationery, computers, office equipment, and even temporary staff. By investing alongside venture-capital firm eVolution Global Partners, Amex hopes to get in on the ground floor of new business markets for its core charge card. Another example is LevelSeas, a joint venture involving eVolution, commodity shipper Cargill, and oil groups BP Amoco and Royal Dutch/Shell to auction cargo space on seagoing vessels.

Companies can explore a new model to test its potential, and if the new model is successful, the company can filter it back through the core business, essentially redefining it. This is particularly true if the new model is born of a market disruption that ultimately redefines the core's economic environment, technology, or customer demographics.

Remember the oft-told tale of Schwab.com? The company ventured online to launch an Internet brokerage unit, eSchwab, in 1996 to defend and strengthen its core as dotcom start-ups like E*Trade began nibbling at its business. But by 1997, Schwab had to address inherent channel conflicts in pricing and services. So the discount broker made a bold decision: to allow the new venture to transform the core. It priced trades of up to 1,000 shares at $29.95, giving up revenue and margin in its offline accounts, and it melded its electronic services into Schwab.com, which became the firm's centerpiece. How risky was this? Analysts had predicted that Schwab would lose as much as $125 million in revenues in the first year. But by January 1999, just one year after Schwab integrated its online unit with the rest of the business, online assets nearly doubled to $219 billion.

Six months later, the firm's online customer base had nearly doubled, with online accounts totaling nearly $350 billion. Indeed, such was the success of Schwab's redefined business model that today 70 percent of new assets come in through street-level branches, while about 85 percent of trades take place online. Although Schwab, like other brokerage houses, was hit by slowing investor activity in 2001, both channels have now become indispensable to sustaining Schwab's profitable growth.

How to Do It Wrong

Companies that pursue business-building from a weak core often do so in a desperate attempt to improve themselves. Unfortunately, expanding a weak core does not make it strong. Instead, such moves usually distract management's time and attention.

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Amazon is a case in point: Is it just a seller of books and information, or does its business extend to all consumer retail on the Web? The company began by defining its business as an online bookseller that dispensed with a notoriously inefficient multi-tier distribution channel that returned or discarded 40 percent of inventory. But Amazon prematurely stretched its definition to all retail, aggressively building new businesses in power tools, cosmetics, and consumer electronics. In these new arenas, the company found tougher competitors. The sale of tools pitted Amazon against Home Depot; the sale of electronics put it up against Best Buy and Circuit City. The result: $41 million in losses for the second quarter of 2001.

By October, Amazon had changed its tune. CEO Jeff Bezos commented: "We want to be the place for people to find and discover anything they want to buy online, but we've never said we had to do it all." By defining and manning far-flung competitive borders, Amazon has left its core unprotected. Rival Barnes & Noble is gaining in online book sales.

Another example of prematurely veering from the core is Webvan, which attempted to create an online grocery store with direct delivery to the home. Webvan bet that it could overcome

notoriously thin margins and tough regional competitors by removing the storefront and expanding the product shelf. But home delivery is a game that requires customer density. Webvan struggled with this, even in its core geographies, not coming close to turning a profit anywhere. In spite of this, it deepened and broadened its focus. It bought a rival, HomeGrocer, in a stock transaction valued at $1.2 billion, creating the added challenge of integrating two companies with huge negative cash flows. Then, before the integration was complete, Webvan announced an internal corporate venture—a new site to sell everything from personal electronics to pet supplies to books to DVDs. The market reacted, driving down the Webvan stock price to 6 cents in July 2001, from a high of $34. That same month, the company filed for Chapter 11.

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One of the only successful rationales for venturing from a weak core is to replace it with a new, stronger one. For example, Woolworth, a variety-store chain in decline, in 1974 built a venture in athletic footwear, Foot Locker. In 1993, the company restructured around Foot Locker and a related venture in sporting goods called Champs Sports. Shortly thereafter, it closed the variety stores and renamed the company The Venator Group. The new core now accounts for 60 percent of revenue. Such successes at leapfrogging a weak core are striking but relatively rare.

Disciplining the Process

Once a company determines that building a business makes sense, it needs to make a host of decisions related to process and a major decision as to whether to build the venture inside or outside the organization. Bain analyzed a cross-section of successful, business-building ventures dating back to the 1970s to identify best practices in overall implementation. They include several of the examples cited above, as well as IBM's investment in the then-emerging personal-computer market, circa 1980; wireless-technology leader Lucent's New Ventures Group; and EMC Corp.'s transition to its current core business, data storage.

To optimize results, these venturers adopted the following disciplines from venture capital:

Tightly screen a broad swath of ideas. Venture capital is largely a numbers game. Exposure to an enormous number of venture ideas means encouraging ideas from different business units, individual employees, and some external sources. Successful corporate venturers must carefully screen ideas, eliminating poor prospects and funneling promising ones to the most appropriate team. For instance, ideas that fit closely with the core business should immediately go to new business development. Other ideas that constitute a new business opportunity can flow to a new ventures group. Ideas that seem more like licensing opportunities can shift to an intellectual property division. Newly formed Time Warner Digital is nurturing technologies that could evolve to compete with the parent. Its ventures, such as its stake in online magazine Synapse, act as antennae, enabling the company to think about setting up divisions for tomorrow, not today.

Apply venture-capital-style funding. Many large companies mismanage venture financing in two ways: They overfund it, insulating the new venture from the rigors of fiscal discipline, or they fail to cut their losses in a timely fashion, prolonging an ailing venture. To avoid such pitfalls, companies can install a development process for new ventures. Continued funding depends on meeting the objectives established for each stage. American Express rigorously analyzes a target investment, watching to ensure that entrepreneurs stringently manage cash, nail their first objective before moving to their second, and offer a complete, mature product.

Deploy strong management and governance. To overcome the inertia that often thwarts innovation within a large organization, a new ventures team should have effective champions and leaders, composed of a diverse group of senior executives who can provide cross-functional expertise and advocacy. The team's president should report directly to the chairman, putting the group on equal footing with other operating divisions. American Express takes a board seat whenever its stake in a new, external venture exceeds 5 percent. United Parcel Service ventures groups put strong managers into new internal ventures, like its eLogistics business, and relieves those managers of their line jobs while the new ventures incubate. "You can't ask people to be functionally schizophrenic," says Mark Rhoney, president of UPS e-ventures.

Establish the right incentive structure. Like a start-up, companies can offer new venture managers and employees equity and/or compensation based on reaching milestones at each stage of a new business's development. EMC Corp., the data storage king, ties compensation and future funding closely to management goals, measuring success regularly and concretely.

Chart and closely manage the exit. Best-practice corporate venturers build value realization—or exit—into their plans, often defining their exit options while making this initial investment decision. Once a new venture has been commercialized, they routinely assess its future. The new venture can either be integrated into the core, sold privately, taken public, or eliminated. For instance, Lucent, which has recently fallen on hard times, has received kudos all around for its approach to corporate venturing, including managing the exit. Lucent's New Ventures Group has funded 31 projects within three years, achieving a 70 percent annual rate of return. Two ventures were terminated within this time and several integrated into the core business including Elemedia (voice IP software) and Lucent Digital Video (full videoconferencing solutions).

Inside or Outside?

When deciding where to locate the venture, the rationale, or "why," should inform the "how." The strategic intent should help answer the following questions: Is a given idea best incubated internally, as a semiautonomous division? Or externally, as a spin-off?

A few rules of thumb: If the idea is askew to the core business, like Woolworth's FootLocker or Amex's MarketMile—or is a defensive move that would cannibalize the core, like Barnes & Noble's online response to Amazon—it's best built outside the company to limit distraction, or worse, sabotage. Procter & Gamble, for example, spun off its venture in online customized cosmetics, Reflect.com, which risked cannibalizing P&G's customer base at Max Factor. Likewise, AMR's ticketing unit, Sabre, spun out its online ticketing venture for consumers. The new venture, Travelocity, would cannibalize Sabre's core travel- and airline-agent customers.

By these rules, Charles Schwab's decision to build eSchwab in-house was courageous and contrarian. Yet even eSchwab was run *like* an independent division, with its own P&L and its own staff, cordoned off in a separate part of the building to sharpen management focus and insulate against naysayers.

Schwab's subsequent moves more closely followed the rules. In June 2000, it began building an internal business, related to its core, by purchasing U.S. Trust. This extended the company's boundaries into an adjacent service segment: full-service brokerage. And it moved the firm into a new customer segment: wealthy investors. In yet another effort to expand its core, this time into a less highly related business, Schwab created an external venture in investment banking. It founded the investment bank Epoch Partners, in partnership with Ameritrade, TD Waterhouse, and venture capitalists Kleiner Perkins Caufield & Byers. The jury is still out on the full-service-brokerage venture, but it's rendered a verdict on investment banking: In June 2001, Schwab and its co-investors made a disciplined exit from Epoch. They sold the investment-banking venture to the Goldman Sachs Group, concluding that investment banking was not going to work as an online business. "It was just not going to happen for us to reinvent the investment-banking business," Schwab co-CEO David Pottruck told *The New York Times.* "There's much too strong an in-place structure to that industry."

There are also purely tactical reasons to build businesses externally. The scarcer a company's resources in cash and talent, the more likely it will have to build externally to create stock options that can attract investment partners and outside expertise. Wal-Mart, though flush with cash and retail talent, gained Internet-sector expertise by launching its online channel as a joint venture with Accel Partners. Venturing externally can also constitute a tactic for insulating the parent's earnings-per-share from any losses in the new venture, justifying the appointment of a new board, or minimizing sales tax.

Depending on your company's resources and abilities to implement a venture, you'll face a number of key questions:

- How closely is the opportunity related to the core?
- Should you develop the idea inside or outside of the current business?

Is an idea best incubated internally, as a semiautonomous division?

- Should you take outside money or fully fund it yourself? Do you have the currency required?
- Should you use internal managers or hire from outside? Is the right talent available within your ranks?

Corporate venturing is a risky tool but a rewarding one for those companies with the discipline to build new businesses close to their core operations and apply lessons learned from venture capital. Corporate venturing's revival may be the lasting legacy of the dotcom era, but launching businesses safely and profitably requires that corporations start with robust strategy and vision for expanding their businesses and clearly defined plans for achieving their goals. Today, you need to get both the "why" (rationale) and "how" (execution) right to successfully launch a new business and keep it in orbit.

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