Corporate VCs make value-destroying deals

Independent venture capital firms aren't the only ones making VC investments. Many corporations also have their own investment operations. Usually aimed at eventually buying the most promising startups, these entities often aren't run as independent business units.

Only their bets don't usually pay off, at least not for shareholders.

That's the conclusion of a recent study by two researchers, who surveyed acquisitions of about 450 entrepreneurial firms made by 61 top US corporate venture capital arms from 1987 through 2003. About 20 percent of those acquisitions were of companies in the corporations' own venture portfolios. The study is going to be published in a forthcoming issue of the Journal of Financial Economics .

What the researchers found was a notable difference between the ultimate outcome of purchases in the corporations' own portfolios vs. those in outside, independent VC firms. In fact acquisitions of internal firms tend to be what the researchers call "value destroying deals", with a record of systematic overpayment. Specifically, shareholder value fell by a median of $63 million. On the other hand, for acquisitions of firms in outside portfolios, shareholder value increased by $8.5 million.

"Before starting the study, I thought that, in effect, by trying before you buy, the results would be better," said David Benson of Brigham Young University, one of the researchers, to me. "But it didn't turn out that way."

How come? The researchers, Benson and Rosemarie Ziedonis of the University of Oregon, looked at a few explanations: overbidding due to the "owner's curse"--bidding too high to get a more-lucrative counteroffer; managerial "hubris", that is, overly optimistic forecasting; and internal governance problems.

What they found, however, was something else: The analysis of firms by outside, independent VCs was more objective and based on sounder information and a deeper breadth of knowledge. Therefore, they made better decisions about investments. And when corporations purchased those firms, they were able to make smarter acquisitions, because they were drawing on a pool of better investments.

The study, of course, has some pretty clear implications for corporate venture capital--namely, that big companies interested in acquisitions of startups should set up more sophisticated independent VC arms, something suggested by small-business expert Scott Shane in a recent post . The strategic benefits of buying companies with promising technologies and access to complementary markets are important enough to warrant a more effective approach.