SHIFTING TIDES: THE IMPORTANCE OF SECONDARIES AS CORPORATE VC MOVES TO EARLIER STAGE INVESTMENTS

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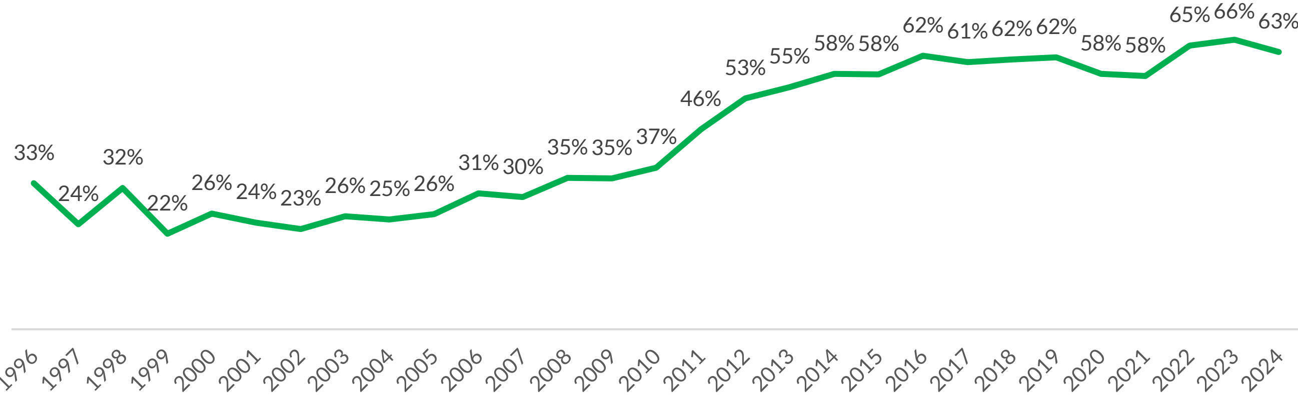
TL; DR:

- CVCs are investing earlier to get a view into emerging technologies, which opens the door to new opportunities but also comes with a new set of challenges such as larger portfolios, higher risk and a longer timeline for liquidity
- Secondary sales can be helpful to prune portfolios, generate liquidity and focus efforts on the most important strategic objectives

In the ever-evolving landscape of venture capital and the role deep-pocketed corporations play, one trend stands out: the transition of Corporate Venture Capital (CVC) firms toward earlier-stage investments. In the late 1990s and early 2000s, two-thirds of all CVC deals were geared toward late-stage companies, which enabled corporates to secure strategic partnerships and drive more meaningful outcomes on the top and bottom lines. In the last decade, this trend has inverted, with two-thirds of all CVC deals now directed toward early-stage deals.

Early-Stage (Seed and A) CVC Deals as a % of Total CVC Deals[1]



WHY ARE CVCS MOVING EARLIER?

As Reese Schroeder, Investor at Allstate Strategic Partners, puts it, "Valuations have gone up quite a bit and I think that is a big part of it. The other reason is that, in a hot space like AI, you need to get in early or the company could get away from you quickly with huge increases in valuation. As I think back to the late 90s / early 2000s when I was at Motorola Ventures, CVCs were more multi-stage

[1] Source: Pitchbook. Data is by # of deals. "Early stage" is defined as pre-seed through Series A rounds, and "Late Stage" defined as Series B+.

doing As, Bs, and Cs – it was more about strategic fit than anything else. We generally passed on getting in on D or later as we felt we wouldn't have time to really capture any strategic value."

Enhanced Influence and Partnership Opportunities: By investing in early rounds, investors get a seat at the table during the formative stage of a company and may even have a chance to influence product roadmaps and design. This involvement can create symbiotic relationships, where corporations bring industry expertise and resources to the table, while startups bring agility and innovation. Furthermore, CVCs have an unfair advantage relative to financial VCs: if a large strategic investor becomes a sizable customer of an early-stage company, even one deal could meaningfully change the revenue scale of a business that has relatively little revenue to begin with.

Ownership Dynamics: With an average CVC check size usually ranging from $2M to $10M[2], allocating funds toward earlier-stage deals translates into greater ownership stakes and access to management, and sometimes comes with board or observer seats. That same check size in a larger, late-stage round may not even buy "Major Investor" or information rights in the company. By playing at the earlier stage, active corporates can commit to CVC with annual commitments as low as $25M-$50M from the balance sheet, which for larger corporates is a relatively affordable cost for "insurance" to protect themselves from the risk of new technologies eroding their core business over time.

SO, WHAT'S THE DOWNSIDE?

While early-stage investing makes sense for most CVC programs, it also has several challenges that make it particularly difficult in the corporate setting.

Higher Loss Rates: While early-stage portfolio companies possess immense growth and strategic potential, loss rates can be as high as almost 70%[3]. In early-stage venture, we often say that "the lemons ripen early" and to expect the J-curve effect. In the corporate setting, every loss must be recognized in quarterly P&L, and not all C-suite executives are accustomed to the extreme dispersion of outcomes of early-stage venture capital. Consequently, CVCs must navigate a landscape where a large portion of the portfolio may be deemed a "failure."

Portfolio Management Complexity: Shifting into early-stage deals generally tends to lead to smaller checks, longer investment duration and therefore a larger number of portfolio companies. Early-stage companies need more help from investors, which in turn leads to more time spent by CVCs in portfolio management. Managing a larger cohort of startups requires robust oversight mechanisms, from due diligence during the investment phase to active monitoring and support post-investment. This heightened level of engagement has a "hidden cost" to a CVC that can be counter-productive if not managed properly.

Extended Time to Liquidity: Early-stage investments can take upwards of 8-10 years or even more to achieve a liquidity event via M&A or IPO. Given frequent strategy shifts, turnover at the CVC

[2] Sourced from Industry Ventures' proprietary data and Pitchbook data, 2024.

[3] Hans Swildens, "Winning by Losing in Early-Stage Investing", 2016

team level, and new product developments at the parent company level, this can lead to challenges and orphaned portfolios of assets that are no longer strategic.

IMPLICATIONS FOR CVCS:

As CVC moves earlier, the rewards are greater, but the risk and rate of failure will also increase. While expanding into early-stage startups fuels innovation and growth, it also necessitates a dynamic strategy to optimize team resources and drive liquidity to make a CVC more sustainable as the portfolio grows in size.

One avenue for achieving this is through active portfolio optimization, leveraging the secondary market to divest non-strategic positions and reallocate resources toward continuing to support the core portfolio or making new investments in companies that fit the current strategic initiatives. Alternatively, CVCs may choose to assist portfolio companies with finding a strategic acquirer or private equity sponsor.

While partnerships with (and investments in) later-stage companies will continue to play a role in the CVC world, the ascendancy of early-stage investments within the realm of Corporate Venture Capital marks a transformative chapter in the evolution of venture capital. By aligning strategic objectives with dynamic market forces, CVCs are poised to catalyze innovation, drive sustainable growth, and chart a course toward enduring market leadership in an ever-changing landscape.

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