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Corporate venture capital: The role of governance factors

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ABSTRACT

Research on corporate venture capital (CVC) has consistently proven its importance for innovation and other strategic goals, yet information on the antecedents of CVC activity is scarce. This study provides theoretical arguments for the role of governance factors including board, CEO, and institutional ownership characteristics. Empirical evidence from an international sample of global CVC investments shows that factors such as having a board with multiple board mandates and institutional ownership are important factors for CVC activity. The conclusion is that the role of governance factors is important, and that subsequent research should not ignore this group of factors.

1. Introduction

With the growing acceptance of the open innovation paradigm (Chesbrough, 2013), scholarly investigations of new practices in open innovation such as corporate venture capital (CVC) have increased substantially over the last decade. Focus has fallen on whether such practices actually stimulate innovation and achieve other strategic goals. Numerous articles have examined the effects of CVC, including inducing corporate innovation, comparing the impact of CVC to other forms of open innovation programs, investigating the conditions under which reaching mutually satisfying arrangements between the incumbent and a start-up is more or less likely (Dushnitsky & Lenox, 2005), and scrutinizing the pros and cons of various structural arrangements CVC adherents have adopted (Chesbrough, 2013). In short, the literature offers a relatively comprehensive picture of the significant consequences of an organization's commitment to and investment in its CVC program. Surprisingly, however, very little is known about the antecedents of CVC commitment and scale.

Given that the resources allocated to CVC come from other intracorporate areas, including internal R&D and alternative modes of open innovation, the lack of attention to what drives firms to commit to and invest in CVC is startling. CVC represents a major strategic commitment of incumbents' resources both financially and the upper echelon's time (Freese, Keil, & Teichert, 2007). Yet poor information and documentation exposes what prompts corporations to consider (and ultimately approve) such commitment. Like other strategic decisions, instituting a formal CVC program is not easy to reverse; as such, understanding the drivers behind this program is essential (Schildt, Maula, & Keil, 2005). Surprisingly, the literature neglects the role of corporate governance factors as likely drivers of such commitment.

Historically, scholarly investigation of corporate governance factors has focused on effects on distant firm outcomes. Despite decades of empirical work, the links between such factors and firm performance are inconclusive and few consistent findings have emerged (Dalton, Daily, Ellstrand, & Johnson, 1998). As Zahra and Pearce (1989) note, this situation may owe to the high amount of likely factors. In essence, too many intervening processes between board characteristics and firm performance are likely to affect boards' relationship to performance outcomes. Likewise, too many influences on performance are likely to lead to a strong, direct association.

A more promising line of enquiry flows from examining the effects of governance characteristics on one of the intervening variables in terms of corporate strategy (e.g., Goodstein, Gautam, & Boeker, 1994). Yet scholars have seemingly ignored the role that governance factors play in the corporate adoption of VC practices (e.g., the ratio of board members that keep outside board directorship, multiple board mandates, as well as CEO pay mix and tenure). Scholars have approach the relationships between venture capital and corporate governance from one side. Namely, researchers have looked at the impact of accepting VC funding on the governance arrangements funding recipients have adopted. For example, new ventures receive funding may replace their founders and original board members by investing incumbents' representatives (Wasserman, 2006). However, this situation is likely to be a two-way street: corporate governance factors may help explain a corporation's degree of commitment to engaging in CVC programs.

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This study examines the effects firm ownership and corporate governance on a particular type of strategic investment decision, namely the firm's decision to invest in CVC. This study contributes by explicitly linking an aspect of a firm's investment behavior (the firm's involvement in CVCs) with the features of the board, CEO compensation, and ownership. The method consists of developing a matched sample of firms that do and do not engage in CVC investments.

2. Literature review and hypotheses

Dushnitsky and Lenox (2005) define corporate venture capital as equity investments in entrepreneurial ventures by incumbent firms. Unlike more standard forms of investment, financial gain is not the sole purpose of such investments. The corporate venture capital literature reports a plethora of entrepreneurial strategic objectives corporations pursue through CVC investments, including window on technology, leveraging internal technological developments, importing/enhancing innovation with existing business units, corporate diversification, securing demand on own products, searching acquisition targets, and tapping into foreign markets (Chesbrough, 2013).

Firms can use several modes or organizational forms when conducting corporate venturing. CVC investments, alliances, joint ventures, and acquisitions all fall under this definition. As Schildt et al. (2005) advance, different governance modes used to conduct such external corporate ventures are likely to differ in the degree to which they support explorative and exploitative learning. March (1991) suggests explorative learning emphasizes firms' search in areas where they do not currently have expertise. In contrast, exploitative learning involves deepening the firms' current knowledge base. March argues the need for firms to balance explorative and exploitative type activities in rapidly changing external environments.

CVC investments are the most arm-length investment of the mechanisms noted above for engaging in corporate venturing. Schildt et al. (2005) argue, somewhat contrary to expectations that this distance allows for the most effective form of explorative learning. Although the lack of "tightness"—when compared to joint ventures or alliances—might inhibit the development of explorative learning, the freedom to engage in learning away from the firm's dominant culture or capability rather promotes explorative learning. As they note, CVC investments entail less investment into unique assets tied to a specific partner (e.g., relationship specific) than non-equity alliances do, because these relationships result from a financial objective beyond the strategic learning objective. Taken together, the uncertain nature of explorative learning (March, 1991) and unknown strategic importance and operational relatedness of ventures aiming at explorative learning might lead firms to choose less integrated governance mechanisms, such as CVC, for projects that are explorative in nature.

2.1. CVC as a function of board structures

Agency theoretic logic suggests that board independence is one of the most important prerequisites of board effectiveness (Pugliese, Minichilli, & Zattoni, 2014; Upadhyay, Bhargava, & Faircloth, 2014). Studies examining independence summarily fail to isolate a strong link between notions of independence and corporate performance. Evidence shows independence's effect on specific board tasks such as executive dismissal (Borokhovich, Parrino, & Trapani, 1996), CEO compensation arrangements, and corporate turnarounds (Mueller & Baker, 1997). However, some doubts exist on whether outside directors are in a position to make substantial contributions to corporate strategy. Perhaps most crucially, the limited time investment of outside board members in any given board mandate results in a lack of intimate knowledge on the company and its operations. Given these informational disadvantages, outside directors are arguably prone to rely on measures of financial control. Such reliance may reinforce executive behavior that is short-term and low-risk orientated (March, 1991). Evidence on the mix of insiders and outsiders on the board with respect to strategic involvement in decisions is inconclusive (Dalton et al., 1998). Still, scholars have pointed to the need for directors to have intimate company and industry knowledge. Without this knowledge, the board may tend to favor a financially crafted and quantifiable strategy. Although the outputs from CVC may be inherently long-term or involve the firm profiting from exploration activities, the initial decision to invest via a dedicated CVC department is essentially one of financial control. Directors will tend to approve the funding and strategy of the CVC unit in much the same way that they approve and monitor plans from other departments. Indeed, the arms-length relationship from the main firm may mean that outside directors, or those with particular skills in decision (financial) control, are particularly suitable to appraising the performance of such CVC operations. These arguments suggest that key structural and composition features of boards may have an association with the likelihood of the firm engaging in CVC.

H1a. The ratio of directors holding multiple board mandates on the firm's board has a positive relationship to the firms' CVC activity.

H1b. The ratio of outside directors on the board presents a positive association with the firms' CVC activity.

2.2. CVC activity and CEO characteristics

A CEO duality refers to the situation where the CEO is simultaneously the chair of the board. Proponents of combining the two roles note that such clear-cut leadership removes the ambiguity of accountability and responsibility for firm processes and outcomes (Dalton et al., 1998). Research has also suggested that CEO duality is the best structure for a company facing a crisis or in situations requiring quick decisions and a clear strategic orientation (Mueller & Baker, 1997). Pragmatically, a CEO-Board chair is responsible for organizing board meetings, developing the agenda, and providing information. Other work suggests that with increased environmental instability—particularly with new, disruptive technologies—separating the roles of CEO and board chair might be a way to cope with higher information-processing demands. For example, as Sanders and Carpenter (1998) note, companies with significant levels of international operations (signaling complexity) are more likely to have separate leadership structures. This study posits that when the CEO also chairs the board, the board's power to affect the firms' innovation strategy directly is likely to be lower.

H2. CEO duality has a negative relationship with firms' CVC activity level.

This study examines a key feature of the executive compensation plan drawing on the importance of executive compensation contracts as a governance mechanism in reducing latent moral hazard problems between investors and management. As Walsh and Seward argue, CEOs have certain incentives to entrench themselves, compromising the board's ability to attribute poor performance, for example, to the top managers. "The key to neutralizing the incentive controls is to avoid pay-for-performance plans that tie company performance to the stock market" (Walsh & Seward, 1990, p.432). The authors note that the entrenched CEO would seek to engineer a large fixed salary component at the expense of compensation that has a high link to stock price, for example. The problem is whether investing in CVC activities is more or less risky than investing in traditional R&D. To the extent that CVC is predominately a vehicle for exploration, CVC make the future payoff to these activities noisier than short-term orientated investments or investments that might favor exploitation. However, Sanders and Hambrick (2007) develop a behavioral agency model suggesting that the specific form of equity compensation matters; they propose that the proportion of option-based compensation (as opposed to direct equity compensation) has a positive relationship with more managerial risk-taking. According to their view, a large proportion of option-based