

## Early-Stage Corporate IP Spinouts

### Running with the Numbers

By Bart Schachter and Richard Yen, Blueprint Ventures

DECEMBER 2006 - For many years we have articulated the need for capital efficient businesses in venture investing. This requirement has become



even more relevant in light of recent accusations that the venture capital model is "broken." We believe the model is not broken as much as it is obsolete in the face of current exit-market conditions and the need

to build businesses *differently* and on shoestring budgets. Many of our peers have taken to this message via new strategies that pursue India, China, or even Web 2.0 opportunities for capital efficiency. During this time, we have continued to grow our Early-Stage Corporate IP Spinout practice with a now well-accepted conviction that the investments made by major high-tech corporations can be successfully leveraged into venture-style returns.

But how successful is this strategy in reaching the nirvana state of higher *risk-adjusted* returns on lower capital needs?

#### Let's Go to the Numbers!

We recently decided to put our own investment thesis to the test to see how it stacks up quantitatively. Over the past five years, Blueprint Ventures has focused primarily on Early-Stage Corporate IP Spinouts, where we leverage stranded IP (typically prototype/pre-revenue technology projects) from corporations and spin them out into new venture-backed start-ups. These projects often have several years of technology development and tens of millions of dollars in prior R&D but are no longer strategic to the corporation. In these cases, the corporation seeks to monetize their prior investment

through early-stage spinouts. This history provides a "running start" which the NewCo can effectively use to reduce its capital needs.

Our team's experience with 13 Early-Stage Corporate IP Spinouts tell us that they have attractive investment characteristics. But we wanted to back up our investment thesis with hard data over an extended period of time. We examined Dow Jones VentureSource data for private companies fitting the following criteria:

- Information Technology companies
- Headquarters based in the US
- Founded between 1990-2005 (inclusive)
- Received venture funding during its lifetime
- Were realized (IPO, M&A, or went out of business) by the end of 2005

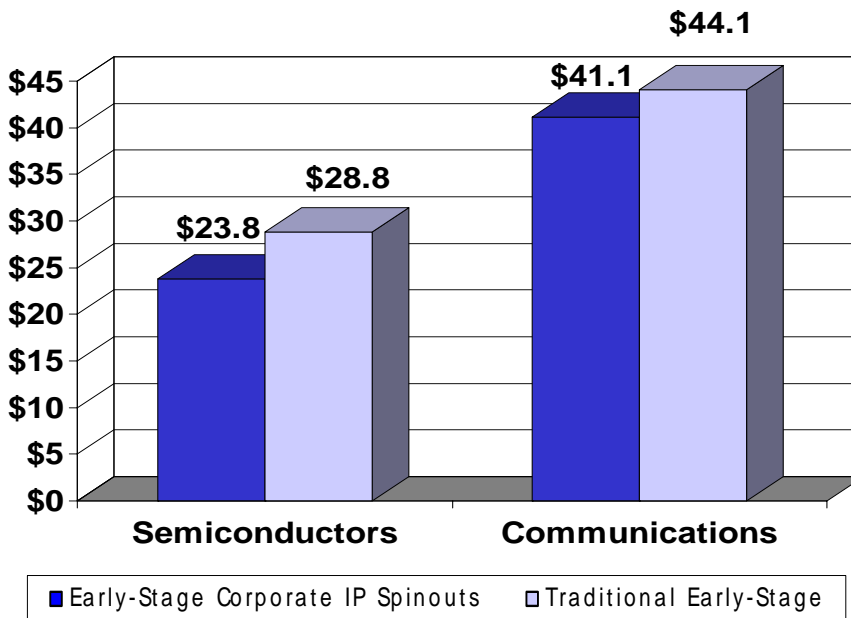
Analysis of the resulting data set—205 Corporate IP Spinouts and 2,930 traditional start-ups—yielded several interesting insights.

#### Stretching VC Dollars

One of the first differences we noticed between Early-Stage Corporate IP Spinouts and traditional start-ups is the amount of venture funding required to reach an exit. Corporate IP Spinouts required less VC funding than traditional start-ups most notably in the semiconductor and communications sectors. (Figure 1.) Corporate IP Spinouts leverage significant prior investment and technology from the corporate parent, giving them a head start versus a traditional start-up started from scratch. Not surprisingly, the capital efficiency benefits are most evident in the capital-intensive semiconductor and communications sectors.

This capital efficiency finding was not

Average VC Funding before IPO/M&A (\$M)



surprising to us because it was the reason we first became interested in Early-Stage Corporate IP Spinouts. M&A has become the most common exit route in recent years due to the overhead imposed by Sarbanes-Oxley to go public. Given that M&A exits are typically less lucrative than IPO exits, we believe that venture investors must find a way to invest fewer dollars over a start-up's lifetime to generate a venture-style return. Corporate IP Spinouts, which require fewer investment dollars to reach market validation and achieve an exit, are one way of achieving this capital efficiency.

**To Live and Let Live**

The VentureSource data also indicated that Early-Stage Corporate IP Spinouts have a lower mortality rate than traditional start-ups. (Figure 2.) In other words, Corporate IP Spinouts were more likely to reach an M&A or IPO exit and less likely to go out of business than traditional start-ups. This finding reflects the reduced technology risk associated with Corporate IP Spinouts.

The lower failure rate makes intuitive sense because Early-Stage Corporate IP Spinouts are more mature and fully developed than traditional start-ups at the time of initial funding. All things being equal, most people would agree that a Series B start-up is less risky than a Series A start-up simply because the Series B start-up is further along in its progression. Corporate IP Spinouts have the technology maturity and future capital requirements of a later-stage start-up with the valuation of an early-stage start-up. That's an extremely attractive value proposition for venture investors.

**Why Isn't Everybody Doing It?**

What's the financial downside to this differentiated strategy? According to our research, Early-Stage Corporate IP Spinouts were less likely than traditional start-ups to generate 10X or higher multiples. By this definition, start-ups that had \$10 million in lifetime venture funding would have to exit for more than \$100 million. The 1990-2005 time period undoubtedly

vest in Corporate IP Spinouts face an adverse selection problem where they only evaluate technology projects that the corporate parent has decided to abandon. Many of these projects are simply unattractive and have been discontinued for sound business reasons. Corporate IP Spinout investors must be disciplined and scrutinize each opportunity carefully if they are to find winners like past spinouts Ciena, VeriSign, and Documentum.

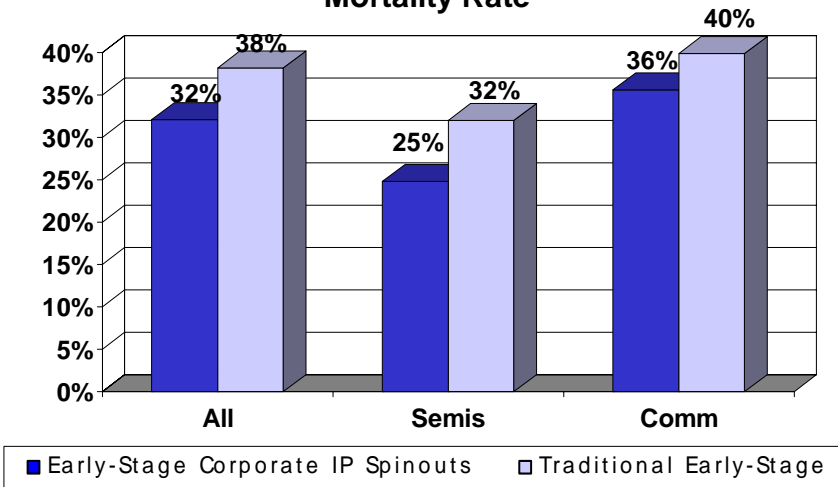


**Trust but Verify**

This statistical performance review validated to us that the Early-Stage Corporate IP Spinout strategy not only generated solid returns in the past but also yielded the tangible benefits we expected.

Historical data showed that these deals were more capital efficient, were likely to achieve a positive realization, and had solid home run potential. The VC landscape changes frequently of course so we plan to revisit these performance figures periodically to ensure Corporate IP Spinouts remain an attractive area for investment. If you're a VC targeting an emerging market space, a new geography, or a unique deal sourcing strategy, we encourage you to run the numbers and see if your strategy holds water. You, your colleagues, and your Limited Partners will be glad you did.

**Mortality Rate**



Whereas traditional start-ups can fail in the early stages due to technical infeasibility, Corporate IP Spinouts typically have significant intellectual property and working technology prototypes before the first venture dollars are invested.

favors traditional start-ups thanks to the numerous Internet bubble IPOs, yet Corporate IP Spinouts fared well with 31% resulting in home runs.

The fact that Early-Stage Corporate IP Spinouts lag behind traditional start-ups in 10X returns underscores the "buyer beware" concept. VCs that in-

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