Pearl Meyer

ADVISOR BLOG | APR 2019

Driving Innovation Through Corporate Venture Capital and Carried Interest

Brett A. Herand

MANAGING DIRECTOR

Haleigh Stilton

VICE PRESIDENT

Innovation is a critical ingredient to long-term corporate success. An inability to adapt to changing consumer tastes and new technologies has doomed many once high-flying companies to the ash heap of history. How can corporations incent innovation and get out in front of stale markets ripe for disruption? By mirroring the pay practices of those paid (and paid well!) to disrupt markets in the first place.

So, whose pay and employment practices should you try to mirror?

Venture capitalists, or VCs for short. Their carried interest plans and employment practices focus on maximizing returns, closely align pay with performance, and create a business environment that fosters outside-of-the-box thinking and is free of bureaucracy.

Companies struggle with incenting innovation because they try to force square peg innovation incentives into round hole conventional incentive plans. These innovation incentives come in all flavors, and despite a company's best intentions, are downright ineffective in aligning pay with real innovation results. Innovation cannot be measured in annual bonus plans or multi-year performance share plans. Innovation is unpredictable, fickle, and volatile.

While traditional VC investors focus on profitable exits, the focus of corporate VC is broader. While financial returns are important, strategic returns are just as critical. Strategic returns can take many forms, including the identification of acquisition targets, future business partners, potential sales channels, and industry and industry-adjacent disruption forces.

So what is carried interest anyway? Carried interest represents a share of profits from harvested investments paid to investment professionals. Practically speaking, it is a form of incentive pay. Carried interest is standard in the VC and broader private equity industry because it aligns pay with performance over uncertain investment horizons, provides strong line of sight with business results, and can be tax advantaged if structured as a partnership. In other words, carried interest plans are structured to perfectly capture non-linear value creation from innovation.

Carried interest plans are similar to traditional incentive plans in that there are minimum performance requirements, target payouts are based on achieving some expected level of performance, and smaller payouts are earned for performance below expectations and vice versa. The main difference is the payout structure and timing as carried interest is paid when earned based on investment harvesting patterns.

In designing a carried interest plan, key design parameters include:

- Carried interest pool magnitude: What percent of investment profits are shared with investment professionals?
- Carried interest vesting requirements: How do investment professionals vest into carried interest?
- Carried interest performance requirements: Will there be a minimum performance requirement before investment profits are shared?
- Carried interest allocation: When and how is carried interest allocated to investment professionals?
- Carried interest earning and distribution: Is carried interest earned and counted at the fund level, the investment level, by year? How and when is carried interest distributed?
- Termination: How is vested and unvested carried interest treated under various termination scenarios?

There are certain corporate VC practices and employment constructs that further support the innovation mission. The right structure and set of employment practices is paramount to a successful corporate VC strategy. Some things we have learned:

1. Management must be committed to the concept of corporate VC investing. Without a firm management commitment, the fund will fail to get access to deal flow and will fail to attract qualified investment professionals.
2. Corporate VC teams are made up of a combination of investment professionals and industry experts. The teams are often physically located in a different place from the sponsor. This serves to reinforce the separation of the corporate VC mission from the sponsor's business objectives and support a bureaucracy-free operating model.
3. Pay for investment professionals must be reasonably competitive with stand-alone VC funds. Investment professionals see employment risk with corporate VC groups whose existence is subject to boardroom decision-making and capital budgeting. On the other side of the coin, corporate VC professionals benefit from the corporate wrapper by not having to raise investor funds and getting back-office and other support from the mother-ship. Additionally, corporate VC professionals are seldom required to put up their own investment capital as is typically required in stand-alone VC firms.

Corporate VC is here to stay and the market for talent will remain competitive. Successful corporate VCs will have opportunities with other corporate VC funds and with stand-alone funds where carried interest opportunities can be lucrative. If corporate VC sponsors are committed to VC investing as a strategy, it should include ensuring pay programs are competitive.

About the Authors

Brett Herand is a managing director at Pearl Meyer. Specializing in executive compensation, he works with boards and management on issues related to performance measurement and value creation, incentive plan design, and technical advisory work with respect to tax, accounting, and SEC regulatory issues. Brett works with public and private companies across many industries, including financial and diversified services, technology, and manufacturing. He has been quoted in various publications, including Workspan and Directorship magazines, Agenda, and Bloomberg.

Haleigh Stilton is a vice president at Pearl Meyer. She specializes in advising directors and executives on all issues related to compensation, including short- and long-term incentive program design,

compensation benchmarking, equity utilization, and severance and change-in-control provisions. She has worked with a variety of companies across many industries, ranging pre-IPO to the Fortune 500, with a particular focus on manufacturing, technology, financial services, healthcare, and media.

About Pearl Meyer

Pearl Meyer is the leading advisor to boards and senior management helping organizations build, develop, and reward great leadership teams that drive long-term success. Our strategy-driven compensation and leadership consulting services act as powerful catalysts for value creation and competitive advantage by addressing the critical links between people and outcomes. Our clients stand at the forefront of their industries and range from emerging high-growth, not-for-profit, and private organizations to the Fortune 500.