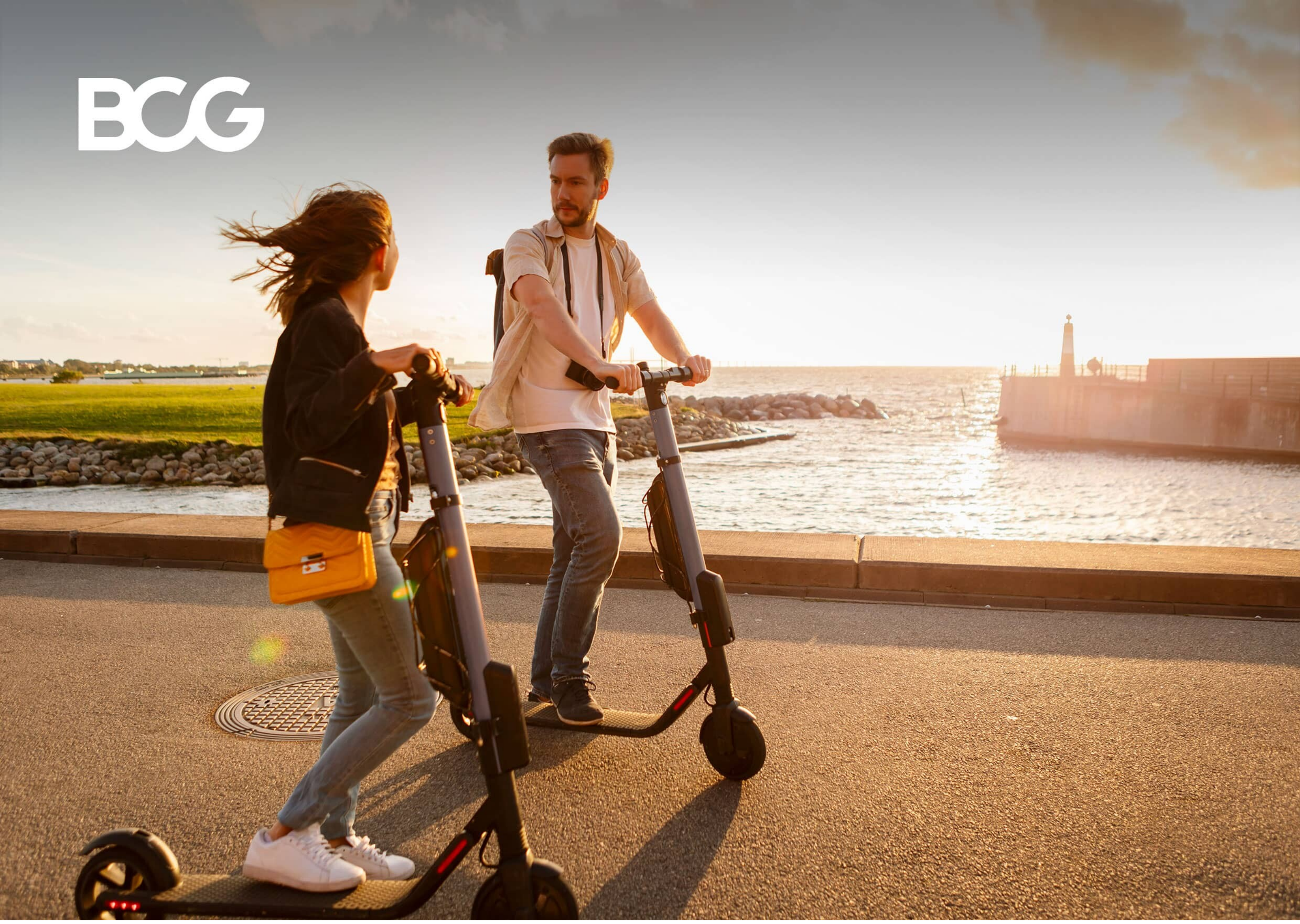

The Venture Builder Strategy for Principal Investors

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> **For sovereign wealth funds and pension plans, fostering a portfolio of innovative new ventures is a powerful opportunity. You might even create your own unicorn along the way.**

Recently, principal investors—such as sovereign wealth funds (SWFs), pension funds, and private investment holdings—have increased their appetite for investing in early-stage startup financing: either private equity or venture capital. Often, they have dipped their toe into this asset-class pool by investing in funds or co-investing with established managers. According to Pitchbook and Reuters, the number of early-stage venture capital deals made by SWFs alone has risen from 138 in 2016 to 193 in 2020.

Yet principal investors are still leaving important value creation opportunities on the table, especially given their strategic position in the national financial ecosystems of their home countries. Their investment teams constantly see disruptive investment opportunities and learn about interesting startup ideas. But they have not been able to translate these opportunities into actual ventures. Some of these startups could become unicorns—companies with rapid valuations of $1 billion or more. Others could be merged with companies already in the investment portfolio, providing a range of benefits to that portfolio and potentially to the wider group of businesses with whom the fund does business or invests.

Bridging that gap is the role that a venture builder (VB) can play. A venture builder is a focused unit of multidisciplinary practitioners who have a mission of developing new business concepts and launching new companies or products and helping them become successful.

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At this historic moment amid a pandemic, the timing is right for venture builder funds. Other forms of investment are showing diminishing returns and increasing competition. While the pandemic has reduced demand for some startup products and services, it has increased demand for others. It has also shown companies how to streamline management bureaucracy and IT costs in ways that benefit digital and tech startups. The VB investment model, which assumes that management guidance matters, is in line with all these trends. That makes it relevant for SWFs and pension funds looking for postcrisis opportunities to build a private equity-style portfolio.

An Opportunity for High-Impact Investment

The VB approach is not suited for most private equity firms, because it might take five to ten years to reach a payoff. But for principal investors with a longer time horizon and the requisite digital business development skills—or the willingness to partner with organizations that have them—the VB brings significant financial and nonfinancial benefits. It also offers a way for fund managers to get their hands dirty, roll up their sleeves, and reap the intangible rewards of mentoring and learning from extremely high-potential people.

To date, most venture builders have been run by private companies. Typically, the VB organization takes the form of a subsidiary fund within its parent company. This gives it an independent character and enables a true startup atmosphere. The VB subsidiary manages a portfolio of ten or more early-stage investments, adding a handful of new venture build initiatives each year. The fund is the principal investor in every venture and maintains a close working relationship, often appointing or overseeing some of the leading executives.

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Each new venture in the VB portfolio is developed through a shark tank approach, where only the most convincing ventures are selected. Very often, the new ventures leverage the competitive advantages of the rest of the portfolio, while adding other benefits of their own. The benefits could include customer access, installed equipment, specialized expertise, intellectual property, greater public influence, and better name recognition and branding for the fund.

It's not always clear which companies in the VB portfolio will do best, but the prospects are improved for every startup that joins. The VB's expertise and network access are applied to all the companies in which it invests. An SWF or pension fund can also use the VB to enhance the overall value of the city or community where it is based.

The Venture Builder Track Record

There are more than 500 venture builders around the world—generally run by corporations, but a growing number are run by sovereign wealth funds or pension funds. A typical VB-managed group might have ten or more companies operating at any given time, with investments for each that might start as low as $50,000. There are generally expectations to meet progress markers set during the initial transaction, and a goal of sale or going public within ten years.

Some well-known VBs include Rocket Internet in Germany, known for its fashion startup Zalando; Prehype, which funded Bark & Co and Roman; and BCG Digital Ventures, the original VB for Twill, which is now a Maersk company. The influential platforms Twitter and Medium were originally startups funded by the VB Obvious Corp. Another venture builder, called HVF, funded Affirm, Yelp, and Glow.

There is a growing trend among SWFs and other principal investors to focus their efforts on creating value and growth in their home countries. The International Forum of Sovereign Wealth Funds has estimated that SWFs invested about $12.7 billion in domestic companies and projects—more than three times the amount they invested in 2019. According to the *Wall Street Journal*, this group includes SWFs in Kuwait, Malaysia, Singapore, Saudi Arabia, and the United Arab Emirates. The Global SWF Times reported an "explosion in startups" in the first three quarters of 2021, with state-owned investors injecting $14.9 billion in more than 250 deals—more than double the number of deals in 2020. According to its October 2021 newsletter, these tend to be early-stage investments, the sort of deals where VBs can make a tangible and valuable difference.

A few large pioneering principal investor funds have set up VBs of their own in recent years. In Canada, the SWF Velocity, managed by the University of Waterloo in Ontario, has worked with more than 400 companies and created 5,000 jobs. Beyond financial gain, a well-designed VB with well-chosen member companies can provide a principal investor with reputational and societal benefits, as well as a foothold in the world of advanced technology. It can allow an SWF, for example, to differentiate itself as a cultivator of high-value, rapid-growth innovation. This helps increase deal flow and multiples for the full portfolio.

Designing and Managing the Venture Builder

The question remains: How to make it happen? For all their experience as asset managers, many SWFs and pension funds do not have experience in setting up or improving startups. Working with external partners who are proficient at digital enterprise offers the most effective approach. The fund makes the initial investment and brings together the external firm and the portfolio companies. If the external firm is experienced and capable enough, the rest of the process may happen naturally. After a few experiences, the fund begins to develop its own center of excellence, with capabilities that can now be applied to most of the companies in the fund's portfolio.

One state-owned firm set up regular meetings for its VB leadership team, convening people from the startups, the pension fund, and the external provider of digital management expertise (in this case, BCG Digital Ventures, which manages VBs for clients). They all worked together on the startup's challenges, following a transfer model where the skills migrated to the startup and to the fund, enabling the fund to grow into a source of expertise. To make this type of transfer model work, a large portfolio is needed: a group of companies that are worthy of equity stakes and can share guidance and other resources with one another.

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The leaders of a VB initiative at a sovereign wealth or pension fund may find that this new role requires a change in mindset. In the past, they may have focused on rapid growth prospects, with corresponding expectations for a payout. A venture builder might involve more gradual returns, but it gives the principal investor more involvement in the company’s growth. The leaders of the initiative, therefore, ideally should be present at each significant stage gate, because the overall success rate depends on the quality of their involvement.

The VB unit should typically be set up as a separate entity from the rest of the fund that sponsors it. The VB leaders should have discretion over hiring and their own internal processes. They can be wholly owned by the fund but autonomy is critical, because the skills are different. An advisory board of senior people from the rest of the fund, people who understand the value of this initiative, should hold the VB leaders accountable for results.

For day-to-day decision making, venture builders tend to need a multidisciplinary management team that augments financial roles with experts in design, programming, engineering, and agile operations. There might be a need to recruit new people, which can be difficult. A sovereign wealth fund or pension plan cannot typically compete for global talent against the tech and consulting industries. One way to cultivate recruits is to seek skilled people who are already attached to the same location, perhaps through their families or local universities. The location can be promoted as an up-and-coming innovation hub, and the VB could be aligned with government-sponsored national research and innovation centers. In the VB's home community, this will all be seen as nurturing the next generation of local talent.

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Venture builders can also develop some of the necessary skills among existing staff through deliberate "upskilling" efforts. Staff members can be sent to technical training, or they can be immersed in the right approach through a "build-operate-transfer" model. In the first few years of operation, selected staff members at the fund can be tapped to join the effort shortly—meanwhile watching and learning before eventually taking it over. A more flexible pay structure can give staff the incentive to maintain a high level of commitment even at times of maximum stress.

From Launch to Influence

One important factor in starting this type of effort is the ability to strengthen the fund's home community and the level of economic growth there. The VB links the fund in peoples' minds to successful startups and the prosperity of the entire region. The portfolio approach can also expand the fund's network of funders, experts, and technologists, creating a virtuous cycle where capabilities, influence, and profitability continually reinforce each other. A leading-edge venture business can also nurture the next generation of local talent.

A sovereign wealth fund or pension fund is expected to generate returns and, increasingly, to support the local economy. For the fund itself, the establishment of a VB provides access to potential unicorns and high-growth ventures that otherwise might not exist. It also reduces the risk of failure, because the success of the venture is closely linked with a portfolio company and the SWF or pension fund itself. As principal investors and related funds develop a more multifaceted approach to fostering economic development, the venture builder may evolve into one of their primary tools. There may come a day when young entrepreneurs and established SWFs think of each other first when they consider the raising of capital.

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