

The high-stakes game of in-house venture capital funds

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Photograph Ryan Girard

A winning hand is about as difficult to achieve in venture capital investing as in a game of poker. In a venture capital fund of five portfolio companies, investors expect only one to produce a worthwhile financial return or develop a breakthrough technology. Despite these odds, several of Canada's major energy companies have followed their American and European peers into the venture capital game in pursuit of innovative new technologies to address their business challenges.

The emergence of corporate venture capital funds in the energy sector started in the 1970s and '80s with companies like Shell Oil Company Ltd., Exxon Mobil Corp., Total SA, and Schlumberger Inc. It wasn't until the '90s and the early part of the last decade that Canadian energy players began to join the club. The burst of the tech bubble led many to shut down their in-house venture capital funds and focus on internal research and development. But by 2009, several companies, including Cenovus Energy Inc., Suncor Energy Inc. and Enbridge Inc., began re-establishing their own venture capital funds to keep their companies on the cutting edge of new technologies and to become more efficient and environmentally focused.

Energy-focused venture capital funds now fall into two general classes: those created by independent venture capital companies (IVCFs) and those created as subsidiaries or subdivisions of publicly traded, integrated energy companies, or corporate venture capital funds (CVCFs). But why would large energy companies set up their own CVCFs to pursue technological innovation when most already have their own research and development departments?

For each company, the answer is slightly different. Local oil and gas companies are gambling on developing new technologies to solve their major environmental, operational and processing challenges. Three distinct strategies for developing solutions for industry challenges have emerged: internal research and development, collaboration with other companies and partnerships through agencies like COSIA, or through CVCFs. Despite Cenovus, Suncor and Enbridge developing their own CVCFs just five years ago, some executives are now looking to get out of the game.

There is a major difference between what Jean-Michel Gires calls cutting-edge, “breakthrough innovation” and the research and development which occurs within a large company.

“Big companies are pretty good at doing incremental innovation to improve their own processes on a continuous basis,” says Gires, the former president and CEO of Total E&P Canada, and now a partner in the Vancouver-based venture capital firm Chrysalix. He started Total’s corporate venture capital fund in 2008 and now has a dual perspective on how venture capital funds are managed. As an executive, he knows the venture capital business both from the inside working with a large company and from the outside working with an independent venture capital firm.

“When you talk about breakthrough innovation, trying to change the game with new solutions, it is a bit more complicated and further away from what we are used to doing in the core business [of a large company],” he says. Small technology companies made up of entrepreneurs are more nimble and able to put new ideas on the table and into action.

“We discovered at Total that venture capital was an efficient way to pursue innovation,” he says. Calgary-based Enbridge has taken a similar approach. “We don’t have a standalone R&D area,” says Chuck Szmurlo, vice-president of alternative and emerging technology at Enbridge. “My group has embraced the concept of developing new technologies by partnering with [external, research-oriented] companies.”

Fourteen years ago when he was head of strategic planning, Szmurlo says he recalls discussions about hydrogen power and the questions about whether hydrogen would put Enbridge out of business. “We decided to investigate that space and we came across fuel cells that were fueled by natural gas. At that moment, we decided to try to create our own destiny by helping companies to invest in fuel cell technology.”

“We moved from that to clean sources of electricity,” Szmurlo recalls. “We were concerned about emissions from coal-fired electricity, so we looked into wind power. We partnered with Suncor in

Saskatchewan and, since then, the wind business has grown. We now have \$3 billion in wind power, and almost \$1 billion in solar power. It has led us to make investments in similar technologies.”

Enbridge typically funds external projects to the tune of \$5 million to \$25 million each. Szmurlo says the company has now made 14 such investments. “Our recent interest has been in electricity storage devices. We are faced with the challenge of getting wind and solar power integrated into the grid, and handling the intermittency of wind and solar.” For example, Enbridge is funding Temporal Power, a company which manufactures electrical storage systems called flywheels, which allow electrical energy to be extracted into the grid when needed.

Rather than developing these technologies internally, Enbridge has used its venture capital funds to screen technologies and take a minority position in new technology companies. Enbridge has been motivated to do so to reduce its environmental footprint but also to augment, supplement and diversify its business. That is what has guided its choices for where to invest its venture capital funds.

The two-year old Cenovus Environmental Opportunity Fund (CEOF) has invested in early-stage companies that are developing technologies that could improve the company’s environmental and financial performance. According to the Cenovus website, it typically invests between \$500,000 and \$5 million per round with a major focus in four areas: oil and gas innovative technologies, energy efficiency technologies, alternative energy sources and renewables and water treatment and management technologies.

Corporate venture capital funds face a different set of challenges from the independent funds. How they are conceived within their larger corporations, and their corporate cultures, has a great bearing on their ability to succeed.

In March, Cenovus made the decision to “curtail all new investments” in the CEOF, while continuing to fund its existing portfolio of technology companies. According to Mark Blackwell, a former investment advisor with Cenovus, a debate has existed within the company since the early formation of the fund. Should it be a corporate social responsibility tool? Should it be tied to operations?

When changes occurred at the executive level, technology development priorities at Cenovus also changed. “When times get tough, if the funds are not aligned with the corporate strategy, they are an easier target,” Blackwell says. He also commented on the reality that sometimes it takes a long lead time for some of these technologies to come to fruition and to make any financial returns. “We had a great portfolio,” Blackwell says, “but it was not necessarily well-linked to the core strategy.” He is now vice-president of business development for a new startup, GNS3.

Gires experienced a similar issue with the venture capital fund he helped establish at Total. “The major risk is not to position the VCF correctly enough with the company,” Gires says. It took three years to establish the fund at Total, he says, and that time was required to come up with the

strategy and convince all the stakeholders of why it was needed. "It needs to be well connected to the main strategy of the company and have good sponsors internally," Gires says.

For entrepreneurs seeking funding, approaching CVFCs is different than IVCFs. The CVFCs are not just looking for a financial return on investment. They are seeking solutions to major business challenges. So they measure success with two scales: the outright financial return as well as the much more valuable return that arises when a major business challenge is solved. For example, a \$10-million investment might provide a financial return, but if it is solving a \$100-million problem, that is worth much more to the energy company in the long run.

"The biggest difference is that the corporate funds take more of a passive role, and never over 20 per cent ownership in the company," Blackwell says. "What is the most valuable is to be able to purchase a product at the end of the process."

"We tend to invest in technologies when they are close to having a field pilot that would prove the technology is viable," says Enbridge's Szmurlo. "We think that venture capital is an efficient mechanism for us." He adds that the fuel cells the company has invested in haven't "taken off as quickly as we would like, but we haven't given up on any of our investments so far."

Cenovus hasn't entirely given up on its venture capital investments so far but, unlike Enbridge, the company has signaled that it is considering getting out of the game. Cenovus is currently trying to figure that out, while Enbridge seems like it's in for the next round.

"I think inevitably that when you are dealing with new things, you hope the successful ones help carry the ones that aren't so successful," Szmurlo says. "Some VCFs have a five-year horizon. We don't. We stay with these technology companies over the long haul."

Picking Winners

At the Banff Venture Forum in 2012, Randy Smerik, CEO of Osunatech Inc., explained to a roomful of entrepreneurs what venture capitalists are looking for, and what to expect when seeking venture capital funding.

VCFs are looking for companies they can buy a stake in, and eventually buy out completely and then sell or take to an IPO. In other words, they are not looking for companies in which the entrepreneurs see themselves at the helm long term.

Smerik warned his audience that funds from venture funding come with strings attached. They demand control of your business and, in essence, become your executive chairman. They are looking for a quick return on investment, and they usually provide funds with a shorter funding horizon. They also take a larger position and demand more control of the recipient company in the form of protective provisions, because most are looking for as much as 10 times the return on their investments. Their business model is to invest in, for example, 10 technology companies, hoping that two will be successful enough to cover the losses and failures of the other eight.

This is a game of high stakes, but it is an important business reality in how new technologies are selected for funding by VCFs.

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