Corporate Venturing, Agency Problems, and Environmental Antecedents

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ABSTRACT

Corporate venturing (CV) provides firms a useful means to cope with today’s fast changing environments. It allows firms to identify new opportunities, rejuvenate competences, and generate new sources of revenue. Yet, the meaning of opportunities may diverge from person to person, given their different self-interests. The disparity of interests among stakeholders may cause agency problems that affect firms’ propensity toward CV activities. This paper distinguishes three distinct types of agency problems embedded in the CV process. Specifically, they are: (i) the risk-averse attitude of top managers, (ii) the rivalry caused by the interest conflicts of mainstream divisional managers, and (iii) the self-seeking actions of venture managers. This study also contributes to the literature by exploring two sets of environmental antecedents to the agency problems, (i) the profitability and the growth rate of the mainstream business market, and (ii) the uncertainty and complexity of the venturing market. In doing so, this paper complements existing studies on CV activities, which have shown a connection between internal organizational factors and the tendency of agency problems. This study also offers insights to venturing firms so as to allow them find specific ways in dealing with such problems.

Keywords: Corporate Venturing, Agency Problems, Market Characteristics

INTRODUCTION

Corporate venturing (CV), the effort of established companies to explore and penetrate new business territories, has drawn considerable scholarly attention (MacMillan & George, 1985; Parker, 2009). Existing research on this topic has revealed various benefits associated with this organizational behavior. Among others, CV can rejuvenate firms’ pools of competences, enhance knowledge construction, foster creative thinking and problem-solving skills, and improve enterprise innovation capacities (Baden-Fuller, 1995; Burgelman, 1983; Kuratko, Montagno, & Hornsby, 1990; McGrath, 1995). Participating in CV can also contribute to organizational performance by providing growth opportunities and generating new sources of revenue (Antoncic & Hisrich, 2001; Zahra, 1991, 1993).

Despite its benefits, CV is generally regarded as a risky decision. Indeed, every year firms waste billions of dollars on unsuccessful venturing projects (Block, 1989; Campbell et al., 2003; Shepherd, Covin, & Kuratko, 2009). Studies (Chesbrough, 2000; Zahra, Newbaum, & Huse, 2000) indicate that the high failure rate of CV may be attributed to conflicts of interests among stakeholders in organizations. However, in spite of the pervasiveness of CV activities in the business world and the implications of agency costs to venturing firms, our knowledge about these problems and their contextual antecedents remains limited.

The primary purpose of this study was to extend our knowledge in this area by addressing the following research questions: What are the major types of agency problems embedded in the CV process? How do they vary with market conditions? This paper contributes to the literature in two aspects. First,
by taking a comprehensive approach, this paper identifies three unique agency problems inherent in the venturing process. While prior research (Chesbrough, 2000; Jones & Butler, 1992; Zahra et al., 2000) has been concerned about the divergence of interests among parties involved in venturing projects, most of these studies have focused on the opportunism of top executives, while little attention has been placed on lower level managers, e.g., venture managers or other divisional managers, who have a direct (or indirect) influence on operations of new ventures. Specifically, the agency problems investigated here are: (i) the risk-averse attitude of top managers, (ii) the rivalry caused by the interest conflicts of mainstream divisional managers, and (iii) the self-seeking actions of venture managers. Second, this paper explores two sets of environmental factors that may intensify (or attenuate) the above agency problems: (i) the profitability and the growth rate of the mainstream business market, and (ii) the uncertainty and complexity of the venturing market. While previous work (e.g., Jones & Butler, 1992) in this line of research has examined the role of multiple internal organizational factors (e.g., firm size, firm age, and firm structural complexity), existing studies have been silent on how external (market) conditions may relate to agency issues in CV activities. This paper seeks to fill the gap in the literature.

The remaining of the paper is organized as follows. The next section provides a review of the literature. Then, I detail three agency problems in the venturing process (those related to senior managers, mainstream divisional managers, and new venture managers). This is followed by an analysis of the interaction between environmental factors and agency problems. The paper concludes with a summary.

CORPORATE VENTURING AND THE CHALLENGE OF IMPLEMENTATION

Due to rapid technological breakthroughs and the trend of globalization, firms face a more dynamic environment than ever before. Schumpeter (1976) points out that the emergence of new commodity, new technology, new source of supply, and new type of organization has a significant impact on existing firms, which is not just at the margins of their profits or outputs but at their very foundations. For example, facing the competition of emerging computer technology, Encyclopedia Britannica, a once successful company, which had a history of over 200 years, failed to respond quickly, consequently lost its edge and was acquired by another firm.

CV allows firms to adapt to fast changing environments. This benefit of CV can be understood from the resource-based perspective (Penrose, 1959; Barney, 1991). Given the fact that firms’ competitiveness is mostly a function of their resource conditions, venturing projects are useful in the sense that they give rise to opportunities for combining and recombining existing resources, facilitating new competence development. CV also cultivates an interactive organizational learning environment that encourages interdepartmental idea exchange, employee communication, and diffusion of knowledge (Burgelman, 1983; McGrath, Venkataraman, & MacMillan, 1994; McGrath, 1995). Additionally, CV enables firms to identify unsatisfied market niches, better fit customer demand, and thus increases their chance of survival.

Despite the evidence that CV is essential to firms, CV implementation is a challenging task (McGrath, 1995; Weiss, 1981). To illustrate, let’s look at Exxon as an example (Chesbrough, 2000; Sykes, 1986). During 1970s to 1980s, Exxon carried out a two-stage venturing program. At the first stage, the firm engaged in numerous investments alongside private funds. Totally Exxon devoted about $12 million in 18 ventures, the value of which sky-rocketed to $218 million in 1982. This led to an annual internal rate of return of approximately 51%, financially a great success to the firm. During the second stage, intrigued by the potential of the areas that it identified through the first stage, Exxon launched
nineteen projects to further explore and capitalize on the opportunities. Surprisingly none of the nineteen entities ever succeeded in reaching a break-even point. Finally Exxon stopped its venturing program and liquidated all of the ventures. The astounding difference between Exxon’s two-stage investments deserves attention. To firms like Exxon, financial constraint is unlikely to be the cause. Indeed, Exxon offered a larger amount of financial support over a longer time horizon to its internal ventures than what it committed at the first stage. Lack of market knowledge and information also fails to explain the above phenomenon because Exxon’s choices of second stage ventures were based on what it had learned from earlier trials. Of importance to note, Exxon’s experience is not exceptional. In fact, evidence shows that venturing projects often fall short of expectations, and their common failure rate is over 35 percent (Boulding & Morgan, 1997; Shepherd et al., 2009).

Prior studies (Jones & Butler, 1992; Zahra et al., 2000) indicate that agency problems are inherently serious in CV programs. This provides a plausible explanation to why Exxon did a worse job in its follow-up experiments. The entrepreneurship literature highlights the importance of entrepreneurial opportunities (Venkataraman, 1997; Shane & Venkataraman, 2000). Entrepreneurial opportunities refer to “those situations in which new goods, services, raw materials, and organizing methods can be introduced and sold at greater than their cost of production” (Shane & Venkataraman, 2000: 220; also Casson, 1982). While, by definition, opportunities are of importance to firms, they may have different meanings in the eyes of different beholders. In fact, an opportunity to certain stakeholders may be viewed as a threat by others. Jones and Butler (1992) point out that firms are characterized by risk-averse managers, who may care more about their own interests (such as, job security and personal reputation) than maximizing shareholder wealth. This can lead to serious agency problems, about which MacMillan and George (1985) show a good example. One company appointed a senior manager to be in charge of a venture developing program due to his experience and past achievements. But as the manager was close to his retirement, he had little incentive to take additional risk. Over the next four years, he reviewed dozens of projects, which were all finally rejected with different excuses.

Different types of agency issues may arise as a consequence of CV activities. For example, top managers may be too conservative to support venturing activities; mainstream business managers may be reluctant to help, or even impede new venture development because they may view these ventures as potential rivals for internal resources; or venture managers may manipulate their power to pursue personal interests at the cost of their firms. However, up until now, few studies have systematically examined these agency problems. Moreover, no study has analyzed how firms’ external environments could influence the odds of such agency problems in the venturing process. I am going to address these issues in the following sections.

AGENCY PROBLEMS IN CORPORATE VENTURING

CV has been widely adopted by firms around the world, especially by large enterprises, e.g., Google, Microsoft, General Electric, Intel, Procter & Gamble, etc. To organize these activities, firms often set up new venture divisions directly under the control of top executives. As compared to smaller firms, larger companies tend to have more sophisticated agency relations. While top managers serve as agents of stockholders, they typically delegate decision rights to divisional managers, who may further empower their subordinates to take in charge of certain activities. Thus, the problem of agency risk increases as more levels of hierarchy are added to the organization (Jones & Butler, 1992).
In his landmark work, Burgelman (1983) depicts a dynamic framework of CV programs (Figure 1), which distinguishes two sets of strategic behaviors—namely, induced strategic behavior and autonomous strategic behavior. Induced strategic behavior fits into firms’ existing strategic planning and orientation, and is oftentimes provoked by internal rewarding systems. Autonomous strategic behaviors, by contrast, are initiated by self-motivated junior employees (or entrepreneurial participants, idea champions). These activities are not planned by senior managers and are typically, at least at the very beginning, not supported by organizational strategies and structure. As such, the personal belief of the idea champions is critical to the success of such activities. While Burgelman depicts an ideal picture of the CV process, in practice the operations of venturing activities could be complicated by agency issues inherent in the process (see Figure 1). Specifically, three types of agency problems are of particular relevance, i.e., the agency problems of top managers, the agency problems of venture managers, and the agency problems of divisional managers of mainstream businesses.

Figure 1: Agency Problems in Corporate Venturing

Agency Problems related to Top Managers

Top management support is especially important to the success of venturing projects (Antoncic & Hisrich, 2001; Kuratko et al., 1990; MacMillan & George, 1985). Evidence of venturing practices in the last several decades indicates that lack of top management involvement and attention is a major cause for failure of CV projects (Block, 1982; Fast, 1981; MacMillan, Block, & Narasimha, 1986).

Unfortunately, given their diverging interests, top managers may not always act on behalf of their principals. The occurrence of the Enron disaster indicates that agency problems related to top managers could be potentially serious and devastating. Indeed, top managers are often risk averse (Jones & Butler, 1992), especially in context where their income is not directly related to long-term organizational performance. Given the nature of their reward—salary compensated for normal level of risk taking, top managers may forego risky but highly promising projects. Job security, instead of organizational growth, could be their priority. In fact, there is evidence that senior executives tend to view venturing projects as insurance against possible fluctuating or declining demand of their mainstream businesses, rather than as a corporate necessity (Burgelman, 1984). This risk-averse attitude may affect firms’ commitment to CV activities, which may become more pronounced when firms’ present businesses are in good shape.
Because of top managers’ conservative attitude toward risk taking, the path between corporate strategy and induced strategic behavior is likely to be blocked, which could lead to the reduction of venturing activities within firms. 

**Proposition 1:** Risk-averse attitude of top managers (agency problems with top managers) will negatively influence venturing activities.

**Agency Problems related to Divisional Managers**

Although CV provides growth opportunities, this benefit may have different implications for different parties involved. In fact, new knowledge derived from venturing projects may conflict with those in firms’ existing knowledge stock. This may challenge organizational routines and systems that are valued by current mainstream businesses (Burgelman, 1984). As they grow larger, venturing divisions will be positioned to compete head-to-head with other business units for scarce internal financial and administrative resources. Hence, they are often conceived as potential rivals by their peer groups (Fast, 1978; McGrath et al., 1994).

Because of the above reasons, CV may intensify political tensions within firms. Indeed, Shrader and Simon (1997) note that strategic breadth of corporate ventures is often narrower as compared to independent ventures. This is possibly owing to the fact that expanding strategic breadth may infringe onto “someone else’s turf” and thus may be discouraged. In addition, there is evidence that knowledge exchange and dissemination within firms is far from easy or automatic (Hedlund, 1994; Lord & Ranft, 2000; Nonaka & Takeuchi, 1995; Szulanski, 1996). All these point to the conclusion that agency problems may arise as a consequence of interest conflicts between mainstream businesses and new ventures.

To divisional managers, they tend to care more about their own divisional operations rather than overall firm performance, because their compensation is directly related to the former outcome. A successful venturing project may be of little relevance to these people, or may even have an adverse effect – raising performance expectation and standards within the organization. Hence, divisional managers may hesitate to help new ventures, even if they are able to contribute. Unfortunately, assistance and tutoring from peer units is important to the growth of new ventures. Evidence shows that interdepartmental transfer of strategic assets into new businesses is critical to their competitive advantages (Chang, 1995; Porter, 1987). Thus, the hostile attitude of divisional managers toward new ventures would constrain CV activities.

**Proposition 2:** Hostile attitude of mainstream divisional managers toward new ventures (agency problems with divisional managers of mainstream businesses) will negatively influence venturing activities.

**Agency Problems related to Venture Managers**

Agency problems could also happen to venture managers. Previous studies show that venture managers are commonly underpaid. Many firms with new venture divisions often don’t distinguish the level of compensation to venture managers from that to other divisional managers (Block & Ornati, 1987; Chesbrough, 2000). Moreover, traditional CV practices change the authority of a given venture from the new venture division to some other division, once it becomes successful. This further demotivates venture managers from making long-term investments. Lack of appropriate rewarding would negatively affect CV activities. One sad case is Xerox, one of the most successful firms in the CV history. It is estimated that the company realized a 56 percent internal rate of return over an 11-year period from 1986
to 1996. However, the firm dropped its venturing program in 1996, as its rewarding system failed to keep talented people. Disappointed by their income, venture managers may pursue their personal interest at the cost of their firms. As venturing projects are new to the firm, it is hard to monitor and assess the behaviors of venture managers. Consequently, venture managers may use their power to experiment high-risk activities and build personal social networks. While these activities may be suboptimal to firms, they could bring personal benefits to venture managers. For example, venture managers may take unnecessary risks. If they succeed, they get a chance to be promoted; if they fail, personally they may not lose a lot and may attribute the failure to the difficulty of venturing. In the long run, these behaviors of venture managers would thwart firms’ venturing activities. 

**Proposition 3:** Self-seeking actions of venture managers (agency problems with venture managers) will negatively influence venturing activities.

**ENVIRONMENTAL ANTECEDENTS**

Given that agency conflicts could affect the extent to which a firm is willing to engage in entrepreneurial activities, the knowledge of how its contextual environments would exacerbate or attenuate such problems is of practical importance to the venturing firm in that it could help the firm to find ways to prevent or solve these agency problems. Studies (Antoncic & Hisrich, 2001; Jones & Butler, 1992) have started to shed some light on this issue. Some of the context factors that have been found to be relevant are the size, the age and the complexity of the firm. Yet, all these factors reflect the internal context of CV projects. Little is known about the impact of the external organizational context on the level of interest misalignment among parties involved in CV programs. This study makes the first effort to fill the gap.

Here, I focus on two sets of environmental characteristics, the profitability and the growth rate of the mainstream business market and the uncertainty and complexity of the venturing business market (see Figure 2). Drawing on the industrial organizational (IO) perspective and the literature on organizational learning and behavior, I propose that the characteristics of the firm’s market structure would influence the perception of managers in organizations, which consequently affects their behaviors and the occurrence of agency problems.

**Figure 2: Environmental Antecedents to Agency Problems in Corporate Venturing**

**Characteristics of the Mainstream Business Market**

According to prospect theory (Kahneman & Tversky, 1979; Wiseman &Gomez-Mejia, 1998), a person’s risk attitude depends on his/her target or “reference points”. Specifically, individuals tend to be
risk averse under gain situations and become more risk seeking in loss states. In this light, in contexts where mainstream businesses are highly profitable, say beyond the industry average, agency problems associated with top executives would be more acute because under such conditions, the executives have less incentive to undertake CV projects. Polaroid’s venturing program in digital cameras (Tripsas & Gavetti, 2000) lends support to this argument. While the company had designed and successfully developed a prototype as early as 1992, Polaroid didn’t publicly announce its first formal digital camera until 1996. The reason is because its senior management team was content with the company’s status quo so that they stayed faith to its original business model and was reluctant to support digital cameras. The managers believed that developing digital cameras would have a depressing effect on its lucrative film business.

There are several reasons for why top managers tend to be more conservative when facing profitable mainstream businesses. First, the literature on organizational learning and behavior hold that people tend to repeat actions that have resulted in favorable outcomes and avoid uncertain situations. When existing mainstream businesses are quite successful and can attain superior performance, top managers have a tendency to devote more resources to these organizational units. However, this reduces available support, resources and administrative attention to CV projects. Second, the behaviors of top managers are justified and legitimized if they are able to meet organizational performance targets. Accordingly, the presence of financially successful mainstream businesses makes it more difficult for principals to question and challenge top executives’ decisions. Yet, as noted above, managers have different interests from those of their principals. They may forego profitable investment opportunities that they conceive as too risky to their careers. The risk-averse attitude of top managers is detrimental to the long-term well-being of firms. The literature has shown that both exploitative learning from existing business domains and exploratory learning from new business markets are essential for organizational development (March, 1991). Without exploring new markets and/or tapping new technologies, firms would be constrained by their limits of knowledge pools, making them subject to environmental changes and shifting customer demands.

In sum, when firms’ present mainstream businesses are profitable, top managers are less likely to support entrepreneurial activities. Accordingly, the likelihood of agency problems at top management level tends to be higher under this condition.

**Proposition 4:** The level of profitability of mainstream businesses will be positively related to top managers’ risk-averse attitude toward new ventures (agency problems with top managers).

The growth rate of the mainstream market might also play a role in explaining agency problems in the CV context. An increased market demand puts a need for more working capital, more employees and more R&D expenditure, forcing business units to look for more resources to keep their market positions. There is only certain amount of resources within a firm, however. Allocating more resources to specific business units means reduced quantity of resources accessible by others. Since, as has been mentioned above, the compensation for divisional managers is commonly independent from the outcome of CV projects, these managers would have no incentive to help new ventures. Rather, they would see the later as rivals for scarce internal resources. In this regard, a higher growth rate of the mainstream market will intensify intra-organizational competition for resources.

In addition, top managers also tend to be less supportive to CV projects when the mainstream market is on a rapid growth track. Given that these people are risk-averse, top managers would favor mainstream businesses about which they have more knowledge and experience. Indeed, a fast growth of the mainstream market will make it easier for managers to justify their decisions. Hence, under such
market condition, top managers tend to ignore opportunities in the venturing market even though they may lead to higher expected performance than those available in the mainstream market.

**Proposition 5:** The growth rate of mainstream businesses will be positively related to divisional managers’ hostile attitude toward new ventures (agency problems with divisional managers of mainstream businesses).

**Proposition 6:** The growth rate of mainstream businesses will be positively related to top managers’ risk-averse attitude toward new ventures (agency problems with top managers).

**Characteristics of the Venturing Business Market**

Two features of the venturing business market are considered here, i.e., the uncertainty and the complexity of the market. Following prior research (Dess & Beard, 1984; Sharfman & Dean, 1991), uncertainty refers to the difficulty in predicting the future of a given business market. Complexity is defined as the heterogeneity and range of activities pertinent to a certain business.

According to the IO perspective and complexity theory, an industry is subject to the influence of multiple forces. Rather than staying at a stable equilibrium, an uncertain market is at the “edge of chaos”, affected by the interactions of various factors (Brown & Eisenhardt, 1997). The uncertainty of the venturing market will hinder the principals’ ability to understand cause-effect relations, making it more difficult for them to monitor venture managers’ behaviors. If the venturing program turns out to be a great success, venture managers would attribute the success to their own hard work; on the other hand, if the venturing project ends as a failure, venture managers would blame the market for the outcome. Hence, venture managers would always find excuses for their actions, while their real motivation behind their decisions could be hard to detect. This increases the odds of opportunistic behaviors.

By a similar logic, the complexity of the venturing business market may also provoke agency problems in venture managers. The complexity of the market is due to the scope of activities related to the industry. When the performance of a CV project is likely to be determined by a wide range of factors, it becomes more difficult to explain the CV outcome, considering the number of possibilities that may exist among the factors. As a consequence, egoistic behaviors are more likely to occur under this condition.

**Proposition 7:** The uncertainty of venturing businesses will be positively related to the self-seeking behavior of venture managers (agency problems with venture managers).

**Proposition 8:** The complexity of venturing businesses will be positively related to the self-seeking behavior of venture managers (agency problems with venture managers).

**DISCUSSION**

This paper depicts three agency problems in the CV process, those with top managers, with mainstream divisional managers, and with venture managers. It is argued that the occurrence of each of the problems would have an adverse impact on firms’ venturing activities. The distinction of the agency problems is of practical implications to firms. Past studies on CV programs typically focus on the opportunistic behaviors of top managers while ignoring the complexity of agency relations in organizations. In this sense, the knowledge derived from this study could help firms design specific ways to streamline their venturing activities.

Another contribution of the paper is that it accounts for some environmental antecedents to the aforementioned agency problems. In this regard, this study complements Jones and Butler’s (1992) study
about how organizational factors could influence agency conflicts embedded in the CV context. Two sets of environmental factors are discussed in the paper, the profitability and the growth rate of the mainstream business market and the uncertainty and complexity of the venturing market. It is argued: (1) both the profitability and the growth of mainstream businesses have a positive influence on top managers’ risk-averse attitude toward new business venturing; (2) the growth rate of the mainstream market is positively related to the hostile attitude of divisional managers toward venturing projects; and (3) the uncertainty and the complexity of the venturing market could trigger self-seeking actions of venture managers.

This study suggests some avenues for future research. First, given the theory developed in the present article, a future empirical test of the propositions raised in the paper is thus well warranted, the findings of which might potentially make some important contributions to the literature. Second, it would be important to compare venturing practices of successful firms and those of unsuccessful firms and understand how the methods applied by the successful firms help them overcome agency problems. Moreover, cross-culture studies could be done to analyze how cultural factors would influence agency problems in venturing practices in different countries.

REFERENCES


