Close encounters
The power of collaborative innovation
About Womble Bond Dickinson

Womble Bond Dickinson is a new breed of transatlantic law firm, created through the combination of UK firm Bond Dickinson and US firm Womble Carlyle. Womble Bond Dickinson is a full-service commercial law firm with expertise across eleven key sectors including Energy & Natural Resources, Financial Institutions, Healthcare, Insurance, Manufacturing, Pharmaceuticals, Biotechnology & Life Sciences, Private Wealth, Real Estate, Retail & Consumer, Technology and Transport, Logistics & Infrastructure.

Womble Bond Dickinson ranks in the UK’s Top 20 law firms and has more than 420 partners, 1,000 lawyers and 2,395 people across 8 offices in the UK and 16 offices in the US. The firm’s reach also extends to Europe where it has strategic partnerships with other law firms in Germany and France.

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David and Goliath has become the cautionary business tale of our times, with game-changing competition just as likely to come from startups as established corporates. Business leaders know the game - disrupt or be disrupted.

Yet this traditional story of conflict is increasingly turning into one of partnership - bringing together the power and operational excellence of multinational giants with the drive and dexterity of smaller innovators.

Corporate leaders recognise their organisation’s strengths can act as barriers to business critical innovation. With the exception of a handful of technology firms, PLCs are rarely built for it. Top-down control cultures, integrated systems and careful governance create operational efficiency, not agility.

With the stakes high and the internal challenges ingrained, leaders are increasingly looking outside their own walls for answers. As our new research reveals, one promising strategy in this race to adapt is working in partnership with dynamic young SMEs, combining their very different capabilities to deliver collaborative innovation.

As lawyers of both established multinationals and mid-market disruptors at Womble Bond Dickinson we have been in the fortunate position of guiding alliances between the two from both sides.

We have been fascinated by the power of these joint endeavours, for corporates, entrepreneurs and the wider economy. While startups are often perfectly designed to develop new ideas, they typically lack the market reach, regulatory pathways and financial muscle to deliver on the full potential of their inventions. By contrast, corporates struggle to turn their R&D investment into innovation from within. What one half lacks, the other has in spades.

For the first time, Close Encounters, our new economic study, quantifies collaborative deals between UK SMEs and domestic and international corporates. It also reveals how firms are choosing to collaborate, with joint ventures, specifically those which create a new corporate entity, becoming an increasingly rare choice between these two groups. Instead we have seen a rise in more flexible partnerships, including minority stakes and acquisition without integration.

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In the last twelve months large organisations invested £21 billion in more than 1,100 collaborative deals with SMEs in the UK. This significantly exceeds the innovation large businesses spend on UK R&D in 2016 - making collaborative innovation a vital corporate strategy.

This report investigates the drivers behind those numbers, as well as examining the substantial fall in deal volumes since the EU referendum and implications for innovation in the UK and beyond.

While full of promise, these collaborations present many challenges. Alongside the headline trends, this paper shares insights from the business leaders and legal advisors behind the alliances. One key learning is the benefit of remaining close, yet still retaining a degree of separation.

Whatever part of the economy you work in, I hope you find this report an insightful guide in your own journey to derive valuable innovation using the power of partnership.

"Modern businesses are increasingly recognising the importance of collaboration to successful innovation.

Outward-looking companies are building networks and tapping into entrepreneurial talent to make them more productive and improve their products and services.

Large and small firms have different strengths – by working together they can often create something that is greater than the sum of its parts."

Tom Thackray,
Director for Innovation, CBI

"Giants are not what we think they are. The same qualities that appear to give them strength are often the sources of great weakness."

Malcolm Gladwell, David & Goliath

Foreword
Jonathan Blair
Managing Partner, Womble Bond Dickinson
Key findings

Large organisations are spending more on collaboration than R&D

- Invested in SME collaborations by large organisations 2013/14-2016/17: £102bn
- Invested in R&D 2013-2016: £62bn

Collaborations between large and small businesses are happening in great volume

- 3,011 M&A
- 2,409 Minority stakes purchases
- 27 Joint ventures

However the volume of collaborative deals has declined in the past 12 months

- Volume of collaborative deals has dropped 28% from 2015/16 to 2016/17

Financial services lead the way for collaborative deals

- 1,864 Financial services (volume)
- 770 Manufacturing (volume)
- 504 Insurance (volume)
- 482 Technology (volume)

A brief history of collaborative innovation

1990s
- The roots of collaborative innovation go back to strategies pioneered by global pharmaceutical firms two decades ago, with small innovators relied on for early stage drug development and multinationals stepping in to fund clinical trials and take the best medicines to market. Today more than half of R&D programmes at GlaxoSmithKline and Unilever involve working with smaller innovators.

2000s
- Microsoft, Telefonica and Citrix set up corporate accelerator programmes in close succession. All followed the blueprint of the equity-funded seed accelerator Y Combinator. Set up in Massachusetts in 2005 and moved to Silicon Valley in 2009, its distinguished alumni include Dropbox and Airbnb.

2015
- The World Economic Forum recognised the power of working together to help Europe meet the twin challenges of globalisation and disruption in its report Collaborative Innovation: Transforming Business. Driving Growth. WEF’s definition of collaborative innovation considers a wide range of partnerships between young dynamic SMEs and large established organisations: ‘Leveraging the resources of both to create value that spills over from firms to customers to entire economies.”

2013
- The concept of open innovation was brought into the spotlight by Berkeley professor Henry Chesbrough, with his book Open Innovation: The New Imperative for Creating and Profiting from Technology.

Invested in R&D 2013-2016

- £62bn

Invested in SME collaborations by large organisations 2013/14-2016/17

- £102bn

Key findings figures are related to the period 2013/14-2016/17.
Bridging the innovation gap

Perfect asymmetry:

Collaborative innovation, in the form of partnerships with dynamic SMEs, has emerged as a key strategy for delivering corporate innovation.

Our study on collaborative deals between UK SMEs and both national and international corporates reveals an extraordinary volume of activity.

In the last four financial years (2013/14 – 2016/17) large organisations invested £102bn in 5,447 deals with UK-headquartered SMEs. This far exceeds the £62bn large organisations invested in UK research and development between 2013 and 2016 and equates to more than a seventh of the £583bn total business investment figures for the UK for the same period. In short, corporates are now estimated to spend 65% more on collaborative deals with smaller partners than they do on R&D.

Since 2013/14 the vast majority of deals were either acquisitions of SMEs by large organisations, or minority stake investments, with the latter proving more resilient to macro economic factors than acquisitions. Formal joint ventures, specifically those which create a new corporate entity, are notable by their almost complete absence as a collaboration vehicle between these two particular parts of the economy. There were just 27 such deals between large organisations and UK-based SMEs in the last four years, accounting for less than half of one percent of deal volume, reflecting a trend towards more flexible partnership models.

Collaborative innovation has become a key strategy for delivering corporate innovation.

The significance of these asymmetric deals far exceeds the acquisition of turnover value, with these “mergers of unequals” enabling corporates to use their scale to leverage not only the product and service innovation they have acquired, but the culture of sustainable innovation corporates have found so elusive.

Partnerships between the Davids and Goliaths of the business world are now important to the performance of the UK economy as a whole, with the rise of corporate innovation centres, accelerator programmes and technology clusters helping to bring these two diverse, but mutually dependent parts of the economy together.

Collaborative innovation is a very different kind of M&A with novel objectives and outcomes. When collaborating with innovative SMEs, corporates must balance giving the innovator free reign and independence, with managing their own risk. Considering this carefully, will help ensure that the valuable innovation culture they are acquiring is sustained.”

Ben Butler
Corporate Partner, Womble Bond Dickinson

“Despite their scale and success, the majority of today’s leading corporates are built to operate, not to innovate. Acquiring innovation from new and nimble start-ups has become a powerful approach for leaders who want to stay ahead of disruption.”

Stephen Pierce,
Partner and Head of Corporate, Womble Bond Dickinson
Breaking up the federation:

What happens brex’t?

“Multinationals earning in dollars are in clover right now, and borrowing costs are at an all-time low, yet we’ve still seen a major slowdown in deals with UK SMEs following the Brexit vote. Decisions are being delayed and negotiations strung out as corporates continue to work out how the final EU deal, or lack of one, will affect their business conditions. However, fortune favours the brave and this drop in activity creates a short term window of opportunity for strategic acquisitions.”

Simon Pilling, Corporate Partner, Womble Bond Dickinson
Given the importance of collaborative innovation to delivering corporate strategy, the dramatic slowdown in deals following the UK’s EU referendum decision should concern corporates and policymakers alike.

While business investment is notably less erratic than aggregate deal value trends, both have been hit by the same key factors: a fall in expectations for UK GDP growth in 2017-18, continuing uncertainty following the EU referendum and the triggering of Article 50.

Our study shows a significant drop of 28% in the volume of deals between large organisations and UK SMEs from 2015/16 to 2016/17.

Across the last four years the data shows slow but steady growth in collaborative deals, rising from 1,326 in 2013/14 to 1,474 in 2014/15, and peaking with 1,536 in 2015/16, before a major fall in 2016/17 to 1,111. This drop matches a disappointing run of business investment figures since the Brexit referendum, which shrank by 1.5% in 2016 - the first contraction since 2009 - and has continued to lag behind the recovery of GDP buoyed up by consumer spending in the first months of 2017.

Sectors such as financial services and manufacturing are particularly active in collaborative innovation, and uncertainty over the outcome of the Brexit negotiations continues to weigh heavily on these industries.

Amid these challenges there are some brighter opportunities. The fall in the value of sterling has to some extent helped offset the negative effect of uncertainty faced by large overseas firms wishing to collaborate with UK SMEs.

While worrying news for the UK’s innovation prospects, the recent fall in collaborations between SMEs and large companies may create an opportunity for those who wish to get ahead of the competition as others are stuck in delays and uncertainty.

Our study shows a significant drop of 28% in the volume of deals between large organisations and UK SMEs from 2015/16 to 2016/17.
Collaboration not consumption

“Innovation is vital to the on-going success of Reece Group, therefore we established the Reece Innovation Centre (RIC) to provide expert resources to support all of our group companies. However the RIC is also externally-focused, working with a wide network of partners, including universities, large businesses and SMEs. These valuable partnerships are two-way: we gain input and support from our partners and we provide services and expertise to them. Everyone wins.”

Ryan Lamb,
Head of Finance, Reece Group
“The major flaw with the M&A model is integration – costing vast sums and repeatedly failing to deliver value. When the aim is to promote innovation, a minority stake can be more naturally structured to incentivise both parties as it is aligned to capital growth.”

Lucy Pringle,
Commercial lawyer, Womble Bond Dickinson

Minority report:
Collaboration not consumption

A successful collaboration depends on finding the right deal structure, as well as the right partner.

 Corporates today are focused on acquiring sustainable innovation – the ability to innovate multiple times – rather than a single new product or service. The need to retain innovation culture is leading to strategies of separation, rather than integration, with obvious implications for issues from corporate governance to real estate portfolios.

Moreover corporates increasingly acknowledge the value of the entrepreneurial mindset and are seeking to retain the founders of the partner business for the long term, even when that means sharing a large chunk of the investment upside.

Minority stake investments can enable corporates to form a flexible partnership in a way that protects startup culture and aligns the founders of the SME with corporate value-creation goals. In comparison to acquisitions it can also help risk manage investments, enabling the corporate to create a balanced portfolio of investments. These strategic alliances balance startup development capability and innovation culture with corporate scale, infrastructure and resources, alongside shared decision-making.

Our study reflects a clear rise in minority stake investments from 587 deals in 2013/14 to 716 in 2015/16, while values increased from £5.2bn to £6.8bn. Following the Brexit vote these minority stake investments dipped in 2016/17 to a total of 510 deals at a value of £5.7bn. Yet the growing investments in minority stakes in UK SMEs seems to be slightly more robust than other types of collaborations. At £5.7bn investments in minority stake purchases between large organisations and SMEs in 2016/17 were still higher than the £5.2bn invested in 2013/14 and the £5.4bn invested in 2014/15, while overall collaborations volume dropped below 2013/14 levels.

<table>
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<th>Year</th>
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<th>Minority stake investment value</th>
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<td>587 deals</td>
<td>£5.2bn</td>
</tr>
<tr>
<td>2014/15</td>
<td>716 deals</td>
<td>£6.8bn</td>
</tr>
<tr>
<td>2015/16</td>
<td>510 deals</td>
<td>£5.7bn</td>
</tr>
</tbody>
</table>

Investment in minority stakes
16% drop from 2015/16 to 2016/17
The five secrets of successful collaboration

“Partnership negotiations to structure collaborative innovation involve a great many moving parts. The trick is balancing these friction-filled elements, so that both parties feel fairly treated and duly incentivised.”

Caroline Churchill
Commercial Partner, Womble Bond Dickinson
First contact: The five secrets of successful collaboration

1. Culture
For PLCs there is an enormous chasm between the desire to support innovation and the corporate imperative to fit everything on a standard spreadsheet. The culture question is key for SME negotiators too. Whether a business was founded by a millennial keen to avoid the rat race or a second generation entrepreneur who eschewed corporate life, founders need to consider whether they can tolerate corporate controls and assessment of exit routes – particularly when today’s corporates often want to keep the founder in the business. The extent to which an SME can keep its original culture versus how much it must be controlled by the larger partner is a fraught issue that cuts to the heart of collaboration. Approaches to risk can be vastly different, with the compliance responsibilities of large organisations in direct conflict with the “risk forgiveness not permission” approach of many dynamic SMEs. Yet this dynamism is the very strength that makes startups essential partners for corporates.

2. Motivation
At their best, alliances between corporates and SMEs involve two distinct partners driven by the same positive desire to further innovation. Yet even when this is the case each partner will come at it from a different perspective, with SME shareholders seeking to create maximum value from their proof of concept while corporates need to generate return on investment. Over and above the obvious question of negotiating a fair financial settlement both parties need to be aware of how any conflict in motivation can play itself out down the line. For example one party might be seeking a full turnaround while the other is interested in long-term value.

One danger to watch out for is a defensive motivation on the part of the corporate. Those entering a deal with the aim of keeping a technology away from competitors – or even neutralising the startup competition itself – can be less motivated to drive innovation forward. This can lead to frustration on the part of the existing shareholders.

3. Brand
One of the biggest sources of concern over collaboration comes from risks to the larger party’s brand. This can be particularly pronounced in industries sensitive to consumer trust such as financial services and utilities. Reputational threats add an extra dimension to all other risks – escalating the drama of a data breach or regulatory fine in the way that only a PR crisis can.

The need for central brand control suggests a degree of conformity that goes against the desire to retain an SME’s autonomy – and for SME founders to have full control of development. But this creates a conflict of interest with the very strength that makes startups essential partners for corporates.

4. Tax
It’s not in the interests of both the corporate investor and the SME shareholders to optimise their respective tax positions. On the one hand the larger company will want to maximise the tax efficiency of its investment by claiming R&D relief and to do this will push for a bigger stake. In contrast the SME’s individual shareholders will want to retain as much equity interest for each of them to qualify for Entrepreneur’s Relief. Reconciling these two conflicting objectives can be particularly challenging when there are a number of individual shareholders, for the simple reason that there is less equity to go round.

5. Exit
Recent years have seen a considerable shift in exit strategies. Fast-growth tech-powered startups are no longer designed to build up to an IPO, but a corporate sale. This can be seen in the decade’s lowest global IPO rate in 2016. The rise in minority stake purchases, rather than full acquisitions, might suggest corporates are getting wise to these short-term exit strategies, and understandably wanting to buy continued development potential rather than IP alone. However this presents a substantial problem. For an entrepreneur minority stakes are not designed to replace an attractive exit.

One solution may be to structure deals around sustainability of the company and succession planning, rather than trying to lock individuals in for an unforseeable time period. Earn out is typically structured in line with trigger points around revenue generation – but one alternative is to use innovation goals, such as development milestones. Either way there are advantages in keeping earn-out goals one or two years ahead to encourage agility.

Ian McLaren, Finance and Contracts Director, London Midland
The sector perspective

Collaborative innovation has become strategically important across a range of industries, with significant variations in both its relative worth to the sector, and preferred deal structures.

“Large energy firms weathering low oil prices have a major challenge in making money from mature sources in the North Sea. This is where collaboration with agile SMEs comes in. Likewise SMEs are playing a vital role in creating renewable technologies, which will one day need the reach and resources of a major energy firm to be rolled out across the world.”

Paul Stockley, Head of Energy and Natural Resources sector group, Womble Bond Dickinson

Financial services is leading the way, accounting for one third (34%) of deals between large organisations and UK SMEs by volume and investing £31bn in 1,864 deals between 2013/14 and 2016/17. Seen against the 7.2% that financial and insurance services contributed to UK GVA in 2016, this intense focus on collaboration with startups mirrors the sector’s drive to exploit the opportunities presented by fintech. The approach has flipped from competition to collaboration, as financial services giants harness the power of startups that can develop from the ground up, unhampered by legacy systems or corporate processes.

Those looking to learn from the way financial services firms have risen to the fintech challenge should note the sector’s remarkable preference for minority stake investments (75% of deal volume) over full acquisitions or joint ventures. This fits a wider picture of startup incubation, rather than simply buying IP, or attempting to integrate smaller firms.

Under the microscope:

83% of manufacturing deals are M&A

Hot on its heels, the technology sector, with 482 deals, exhibits a preference for M&A (62%) rather than minority stakes. While collaborative deals in technology rank higher than its contribution to UK GVA might suggest, this overrepresentation ties in with the role of technology at the cutting edge of just about any industry. Cross-sector collaboration between insurance, financial services and technology firms are also at the heart of these rankings.
Spotlight on financial services

“20 years ago Bill Gates said ‘Banking is necessary. Banks are not.’ Financial services have been facing up to the challenge of disruption ever since and they’ve become masters at rising to challenges and taking opportunities including finding successful ways of working with innovative SMES.”

Simon Richardson, Head of Financial Services sector group, Womble Bond Dickinson

Across the board collaborations between large and small organisations are being used to solve industry-specific dilemmas.

Of the 2,409 minority stake purchases conducted between large organisations and UK SMEs between 2013/14 and 2016/17, almost 60 percent (1,390) involved financial services. £14bn was invested in these deals.

This mirrors strategic investments in accelerator funds, startup events and incubators, amongst banks in particular, which together create an ecosystem for collaborative innovation.

Banking has recently seen the biggest change in regulations for a decade through measures like PSD2 and the Open Banking Initiative. This has created a step-change in how customers interact with their bank and opened the door to new entrants.

While large financial services firms’ ability to respond to these forces can be held back by dependence on legacy systems, dynamic young SMEs have the advantage of being built to develop from scratch.

Partnering with startups has become a key element to the digital transformation strategies which are now of vital importance to the financial services sector’s future prospects.

“Our investment partner BBVA shared our vision of transforming people’s lives and changing banking for the better. They understood what we were trying to achieve because they are trying to do something similar themselves elsewhere in the world. We also really like the people in their team.”

Anthony Thomson, Atom Founder and Chairman

£14bn

Financial services minority stake purchases 2013/14 - 2016/17

Our new data shows insurance multinationals are following a similar path. Others facing digital disruption may benefit from this approach.

£6,153.4m

Financial Institutions

£1,681.2m

Manufacturing

£1,609.2m

Transport and Infrastructure

£256m

Insurance

£1,948.6m

Real Estate

£343.7m

Other Markets

£6,153.4m

Retail and Consumer Goods

£629.9m

Energy and Natural Resources

£1,681.2m

See our interactive charts www.womblebonddickinson.com/data-tool

Simone Richardson, Head of Financial Services sector group, Womble Bond Dickinson
“On the brink of a major shift in its international trade relationships, the UK has a unique reason to sharpen its competitiveness.”

The UK is an economy of two halves, with contrasting strengths residing in powerful corporates and dynamic SMEs. Neither is perfectly built to deliver innovation on its own, but together the two can be a powerful combination.

On the brink of a major shift in its international trade relationships, the UK has a unique reason to sharpen its competitiveness. By leveraging the strengths of firms at very different stages in their lifecycle, collaborative innovation has the potential to create long-term economic growth and help the nation compete on the world stage. Yet the steady annual rise in collaborative deals suggests both parties are working together to increase R&D spending to 3% of GDP. While this financial commitment is vital, now is also a timely opportunity to consider the strategies that can be used to effectively deliver corporate innovation.

Our research shows there are significant lessons to be learned from the financial services and insurance sectors, in the way they’ve faced digital disruption by embracing collaborative innovation. These highly regulated industries have found ways to codevelop and welcome dynamic partners—forging alliances that benefit both parties while respecting the individuality of each separate entity.

While the challenges of navigating joint decision-making and divergent motives are considerable, the rewards of delivering collaborative innovation may be priceless.

Simon Watts, Head of Corporate & Commercial Services, Womble Bond Dickinson

1  https://www.ons.gov.uk/businessindustryandtrade/businessinnovation

R&D comparison

The total values of business collaborations in each year have been put in context by comparison to the Business Enterprise Research and Development (BERD) expenditures sourced from the Office for National Statistics (ONS) as part of the annual ONS Business Innovation statistical release.1

As the definition of business collaborations used in this study covers deals featuring UK SMEs as the target, where the large business acquirer can be of any domicile, the comparison used BERD expenditure taking place in the UK and undertaken by large businesses, regardless of whether their ownership was foreign or domestic.

The ONS produce BERD statistics on a calendar year rather than financial year basis; direct comparisons should therefore be treated as indicative. While the ONS had not yet released their statistical estimate for the total value of large business R&D expenditures in 2016 at the time of the analysis, Cebr provided a forecast based on the historically stable ratio between business R&D expenditures and wider business investment using full data for 2016.