ENGINEERING A VENTURE CAPITAL MARKET :
LESSONS FROM THE AMERICAN EXPERIENCE

Discussion Outline on paper by Ron Gilson,
Financial Markets Conference,
Sea Island, Georgia
May 4, 2002, 10:15 a.m.

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1. Overview

   A. Agree with most of the major premises of Ron's paper

      - Differences are ones of emphasis in most cases

   B. But I would shape the overall buttressing argument substantially differently, first, with respect of the legal artifices that bind all parties to the venture capital process, which I would de-emphasize, and second, with respect to creating the conditions for liquidity, which I would emphasize above all. You cannot have a venture capital market with ability to realize returns at capitalized values, period.

   C. My key divergence from the thrust of his paper arises then from my view of the role of government. I see it very differently – as an "enabler" in the most profound sense, in part by design, in part by accident over time in the U.S.

      - As I will elucidate further below, I see government not as a programmatic participant in risk capital provision, except at the very margin.

      - Rather, I see it as a crucial participant in shaping the "policy toolkit", indeed the rich and complex aggregation of policies that gives rise to an entrepreneurial economy over time, with risk capital available to fuel it, precisely because of the high return potential (back to liquidity).

D. What is the consequence of this difference of opinion? I've come to view over time that the transferability of the U.S. model lies mainly in a country's acceptance in whole or in part of the underlying policy toolkit. It is not in implantation of the specific terms of trade and structural convention, enshrined in legal documentation bonds as described in the bulk of Ron's paper These in fact have changed over time as a function of markets and liquidity.

II. What do I mean by all these generalities?

A. Agreement on certain premises.

1) Paper: "The manner of development of the U.S. venture capital industry is not duplicable elsewhere."

I'd agree. Each country develops risk capital activity in its own way. In fact, where there is economic growth, there is risk capital being deployed, by definition. The shape it takes varies with mainly local investors' appetites for risk, their confidence in ability to realize returns, and intermediaries to put deal together that minimize risk.

- In Russia today, where I chair (pro bono) a privately-managed equity fund, funded by the USG, risk capital is being deployed (some would say "ultra risk capital), and growth is being achieved.

- But the process whereby deal standards and norms are emerging there is uniquely Russian, as the financial and legal structures emerge.

- The specific form the deals may take is market specific.

    - Brazilian example from 1981. Use debt with long-term detachable warrants instead of convertible preferred to accommodate then-prevailing absence of liquidity in the equity markets.
    - Moreover, in emerging markets, you don't have to take technology risks to get high returns. You can back grocery chains, or horizontally integrate the automotive aftermarket, well-known businesses. But in exchange you take managerial risk and over-arching macro risk. It's all risk trade-off.

2) Paper: "…the keystone of the business is the private ordering … the contract structure … developed to manage the extreme uncertainty, information asymmetry and agency costs that … bedevil early stage high tech financing."

I'd agree. But I'd emphasize the "private ordering" part of this premise, not the specific contract structure.

- Venture investors have to be at risk with their own money to make the compact work. And they have to be positioned to make money (realizable returns) in accordance with their position in the venture pecking order:

    - Sources of capital (today institutional)
    - Venture managers
    - Entrepreneurial managers

3) Paper: Ron asserts an engineering problem, one of "simultaneity", i.e., needing capital, specialized financial intermediaries, and entrepreneurs at once to make this work.

- I'd be nuts if I didn't agree with this one. But I'd make two additional observations:

    - o The three elements are necessary, but aren't sufficient. Japan has all three in differing measures, but little happens. Individual incentives to "write new scripts by tackling entrepreneurship have lagged. (True in U.K. when my firm opened in that market in 1975. In a Gallop poll at that time, entrepreneurship ranked with trash collection in prestige).
    - o A fourth dimension greatly adds - at least in mature economies - and that is the presence of an R&D base, whether corporate, governmental, academia, or garage-based, that can be exploited commercially.

B. Disagreement

1) Paper: " … who will be the engineer? The U.S. venture capital market developed organically, largely without government assistance and certainly without government design."

- o Here Ron's and my world views diverge, though not completely.

    a) Programs: He debunks most government programs where government acts as the intermediary. I strongly agree. The agendas, the incentives, and the skills associated with such programs tend to have nothing to do with value creation, so they flop. They're also frequently subject to politically-driven decision-making, especially around election time, I've noticed.

- o There are exceptions, as pointed out in Ron's paper. I'd add to his example the SBIC program of SBA. The program was formed pursuant to a Federal Reserve Board report in 1956 and to Statute in 1958. It has private capital and private investment managers as its foundation, with government leverage on top, today in the form of participating preferred securities. (The private foundation of SBIC's was the brainchild of William McChesney Martin, Fed Chairman at the program's inception, on the theory that private investment manager's interest in <u>not</u> losing their own money would discipline them to go to work each day and help the portfolio companies succeed.) The SBIC program was in many ways the forerunner of today's large private venture capital industry in the U.S. Its major contribution to our economy, in my view, was and still is, the preparation of a cadre of venture managers, of people skilled in the art of risk capital intermediation. Ron stresses this function in his paper. It most countries in which I've worked, this is the critical mission missing link. Many of today's largest firms, including my former one, Apax, grew from SBIC's formed in the 1960's and 1970's. The program has been emulated abroad, most notably in Australia.

b) <u>Policies</u>: It is in the policy area, not discussed in the paper, where the government at all levels in the U.S. has tended to facilitate venture capital rather than inhibit it. Was it by design? Largely no, but increasingly so since the 1960's. What is the policy toolkit? Here are some elements:

- Securities Laws: Enron and Global Crossing notwithstanding, these laws generally inspire investor confidence and give rise to securities markets that provide liquidity to investors. And the private placement exemptions has accommodated the private equity business.
- Tax laws: Favorable rates of long-term capital gains tax and ability to deduct losses incentivize the long-term view and soften losses.
- Intellectual Property: The patent, trademarks, and copyright system facilitates investment, indeed heavy investment, by providing protection from knock-off for sufficient time to recover investment and realize capitalized value. We'd have no biotech industry without it.
- Pension laws: These liberate a tiny fraction of the nation's aggregate savings to be put at risk to create new capital values. (1979 decision on Provident Man increased aggregate venture capital under management from $700 million before then to over $100 billion in all of private equity today.
- Government Investment in R&D: Largely through Defense and N.I.H., with universities as handmaidens. From Morrill Act in 1888, creating the Land Grant Colleges, to today, Americans have permitted commercializations of the R&D they fund.
- Bankruptcy Laws: These provide a second chance to failed risk-takers. Germany still has the equivalent of debtors' prison, not an inspiring option.
- Judiciary/Rule of Law/Contract Enforcement. This is the sine qua non of the whole system.

<u>Conclusion</u>

A. To me, government is a major player.

B. It is important to come to grips "with the policy toolkit, if nothing else, to protect it from damage.

C. The "enablers" can be adapted elsewhere and they have been (U.K., France, Germany, increasingly. But in a democracy it's by social and political pact of citizens with themselves.

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