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The Importance of Venture Capital in Promoting Entrepreneurship - Introduction

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THE IMPORTANCE OF VENTURE CAPITAL IN PROMOTING ENTREPRENEURSHIP

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Canadian Speaker – Brad D. Cherniak
United States Speaker – Cathy Horton-Panzica

INTRODUCTION

Daniel Sandler

DR. SANDLER: All right. Welcome back, everybody. Thank you very much for joining this session on the Importance of Venture Capital Promoting Entrepreneurship. Yesterday we heard a lot about the importance of entrepreneurship to the economy, and I think it is useful to go over some of the stats that we heard yesterday about the importance of small businesses to the economies in both Canada and the United States because the statistics are actually quite similar in both countries. In both countries, small businesses make up 99 percent – more than 99 percent – of all employers.[1] They employ about half of all employees in the country.[2] They significantly outperform large corporations in terms of job creation, and they carry on a significant amount of research and development.[3]

But, and this is an important but, as indicated yesterday, particularly in the Government session, not all small businesses are the same. A significant

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[1] Kenneth Hendricks, Raphael Amit, & Diana Whistler, *Business Taxation of Small and Medium-sized Enterprises in Canada*, at 1 (Canadian Technical Committee on Business Taxation, Working Paper 97-11, 1997) *available at* http://www.fin.gc.ca/taxstudy/wp97-11e.pdf (Canadian figures supporting the small business statistics); *see also* SMALL BUSINESS PROFILE: UNITED STATES, UNITED STATES SMALL BUSINESS ADMINISTRATION OFFICE OF ADVOCACY 2 (2004), *available at* http://www.sba.gov/advo/stats/profiles/04us.pdf (chart of number of employer firms in the United States).

[2] *Id.*

[3] *See generally* HANS LANDSTROM, PIONEERS IN ENTREPRENEURSHIP AND SMALL BUSINESS RESEARCH (Springer 2005), *available at* http://books.google.com/books?id=20X5XlJjzkYC&pg=PA150&dq=pioneer+entrepreneurship+and+small+business+research&sig=zPoglLbAP-e3RZjAfAJ_HQ2ik4c.

distinction has to be drawn between what I refer to as lifestyle businesses and rapid growth small businesses, sometimes referred to as "gazelles."[4]

The vast majority of small businesses, over 90 percent, are lifestyle businesses.[5] They do not tend to be technological innovators or job creators. The most important small businesses in terms of economic development are gazelles, and they make up only four to eight percent of all small businesses.[6]

But it is these small businesses that are the important job creators, accounting for 70 to 75 percent of net new jobs.[7] These small businesses, particularly today, are concentrated in the high-tech sector, and despite their growth potential, these small businesses have the greatest difficulty attracting capital, particularly from traditional sources such as banks.[8]

They have long startup periods, and at their earliest stages, the only asset that these companies have in many cases is the intellectual capital of their founders.[9] These are not ideal circumstances for bank financing. Venture capital is fundamentally important for these companies. Consider companies like Hewlett-Packard, Apple, Microsoft, Netscape, and Google – these are all household names and all these companies got their start from venture capital.[10] The venture capitalist is willing to invest in startup companies. The rewards can be great, but the risk, as we heard about yesterday, can also be great.

I just want to stop and take a little informal poll that I think would be helpful for those on the panel. How many people here would call themselves entrepreneurs? Okay. And how many people are venture capitalists? All right. Well, for those that aren't venture capitalists, how many ever put money into a family business or a friend's business or an acquaintance's

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[4] Jere W. Glover, *Small Business Finance in Rural and Urban Regions*, OFFICE OF ECONOMIC RESEARCH IN THE OFFICE OF ADVOCACY, at 168, *available at* http://www.sba.gov/ADVO/stats/fedsbfin.pdf.

[5] *See* George Rodriguez, *Making a Profit Out of Passion: Lifestyle Entrepreneurship*, POWERHOMEBIZ.COM, http://www.powerhomebiz.com/vol100/lifestyle.htm (last visited Oct. 5, 2007).

[6] *See generally* Glover, *supra* note 4, at 168.

[7] Martin Wolk, *Small Business Having Big Impact on Jobs*, MSNBC, Feb. 3, 2004, http://www.msnbc.msn.com/id/4142727 (last visited Nov. 8, 2007).

[8] *See* Private Sector Funding, U.S. Dept of Energy, http://www.eere.energy.gov/inventions/energytechnet/funding/private_sector.html (last visited Oct. 4, 2007).

[9] *See generally* NERMIEN AL-ALI , COMPREHENSIVE INTELLECTUAL CAPITAL MANAGEMENT: STEP-BY-STEP 19-20 (2003), *available at* http://books.google.com/books?id=15wveJpXMeUC&pg=PA19&lpg=PA19&dq=startups+and+%22intellectual+capital%22&source=web&ots=Iqdkpn53xE&sig=Nqs6O1_yLNd90Po2NEQHiNf0HOc#PPA20,M1.

[10] *See generally* VENTURE IMPACT: THE ECONOMIC IMPORTANCE OF VENTURE CAPITAL BACKED COMPANIES TO THE U.S. ECONOMY, NATIONAL VENTURE CAPITAL ASSOCIATION (2007), *available at* http://www.nvca.org/pdf/NVCA_VentureCapital07-2nd.pdf.

business? A few more hands. Keep those up for a minute. How many of you ever got your money out? How many got a lot more than their money out?

The formal venture capital industry - that's what we are going to be focusing on more than the informal venture capital industry - is generally traced back, as you heard yesterday from David Morgenthaler, to just after World War II.[11] Most people trace it back to American Research and Development. ARD was the first non-family venture capital business, and it was started up, as you heard yesterday, by a number of businessmen, academics and university administrators in Boston in 1946.[12] ARD invested in businesses that sought to exploit military technology for commercial purposes.[13]

This is a good topic for another session: there is nothing like a war or the threat of a war to spark technological innovation and, therefore, economic growth. But that's really, as I said, a talk for another time.

We won't go there today, but I want to talk about ARD just a little bit because it illustrates a number of things about venture capital. ARD's approach to venture capital is classic. It invested only in equity and invested for the long-term; it was prepared to live with losses and negative cash flow for the short-term.[14] Almost half of ARD's success came from one single investment: just under $70,000 invested in a company called Digital Equipment Corporation in 1957, grew to $355 million in 1972 when ARD was sold to Textron.[15] That's not a bad rate of return. That's about 500 times.[16] You can compare that to the big news in the last few months when Google bought You Tube for $1.7 billion.[17]

A number of venture capitalists backed You Tube, including Sequoia Capital, and I saw on one website that Sequoia Capital put in about $11.5 million and was estimated to get back $495 million on that investment.[18]

That was considered a huge home run. That's around 35 times return compared to ARD's return. ARD's total return from 1946 to 1972, before it

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[11] *See generally* Glenn Rifkin, *A Generation Gap in Venture Capital*, THE NEW YORK TIMES, May 25, 1995, *available at* http://query.nytimes.com/gst/fullpage.html?res=990CEED9153DF936A15756C0A96395826.

[12] *See* David H. Hsu & Martin Kenney, *Organizing Venture Capital: The Rise and Demise of American Research & Development Corporation 1946-1973* (Univ. of California-Berkley, Working Paper No. 163, 2004) *available at* http://repositories.cdlib.org/cgi/viewcontent.cgi?article=1128&context=brie.

[13] *See generally id.*

[14] *See generally id.*

[15] *Id.*

[16] *See generally id.*

[17] *See* Google buys YouTube for $1.65bn, BBC NEWS, Oct. 10, 2006, http://news.bbc.co.uk/2/hi/business/6034577.stm (last visited Nov. 8, 2007).

[18] Blogosphere probes 'GooTube' deal, BBC NEWS, Oct. 10, 2006, http://news.bbc.co.uk/2/hi/technology/6036691.stm (last visited Nov. 8, 2007).

was sold to Textron, was a 14.7 percent compounded rate of return; without Digital Equipment Corporation, the return would have been only 7.4 percent.[19]

What this session discusses is the importance of venture capital in promoting entrepreneurship, and like all good venture capitalists, the two individuals on the panel think outside the box. So we are going to run our panel differently from all the other panels that have run so far, and hopefully, it will be a success.

It is going to be innovative and will run like a dialogue. Brad Cherniak and Cathy Panzica will carry on a conversation about a series of topics and I will put up this series here. They will talk a little bit, but we would like to get as much audience participation all the way through the panel as possible. And so I hope that the people carrying the mikes will be nimble for this. Even though it says Q & A at the end, we would like to have Q & A all the way through.

Cathy Horton-Panzica has degrees from the University of Michigan, Ohio State College of Law, and the University of Kent's Canterbury Theological College. Cathy is an ordained Episcopal priest, and as you might expect, she brings both passion and compassion to venture capital investments. Cathy is the founder and leader of Red Room Revolution, a set of 20 economic development initiatives in the North Ohio region. She is the founder of Beta Strategy Group and Beta Opportunity Partners, a fund that intends to fund 24 companies in 18 to 36 months. To date, she has funded six companies and founded three companies herself. She envisioned and started the Beta Technology Park in Mayfield Village, Ohio, which transformed a decaying Industrial Park into a tech park for businesses that use a shared services platform to reduce overhead. One of her latest ventures is a children's workshop, which educates elementary school students in a creative play using technology. And when she is not doing these things, you may find her leading services as an associate priest at Trinity Cathedral here in Cleveland. I think she brings a new spin to the term "angel capital."

Brad Cherniak is not a member of the clergy, so I am not quite sure why we invited him. I think he may be here more to play devil's advocate. Brad graduated Summa Cum Laude from the University of Chicago's Graduate School of Business, which for those of you who know the Chicago GSB, they probably think they have their own theology. He is a co-founder and partner of Sapient Capital Partners, a Toronto-based firm that advises mid-market and early stage companies in areas of growth and economic strategy, acquisitions and divestitures and the sourcing of capital. Brad has 20 years of experience in investment research, corporate and investment banking,

[19] *See generally* Hsu & Kenney, *supra* note 12.

merchant banking, and private equity and venture capital, with firms like CIBC, Bank of America, Chemical Bank, and even First Ontario Fund, which is not noted in his bio, but is a labor-sponsored venture capital fund in Canada. So I think he is in a good place to comment on the pros and cons of that model of Government intervention. Brad specializes in small cap private and early stage companies both as an advisor and principal. He has served on a number of boards of directors and advisory boards for these companies.

Without any further ado, because I know Henry is getting a little impatient, I am going to turn to Brad to start the discussion on the first subject, the relationship of venture capitalists and entrepreneurs: the good, the bad and the ugly.

CANADIAN SPEAKER

*Brad D. Cherniak**

&

UNITED STATES SPEAKER

*Cathy Horton-Panzica**

MR. CHERNIAK: Let me start by saying that when I heard about this topic, I was actually quite excited to come here, because it is a topic quite near and dear to my heart. When I started in my field, my first deal was $366 million, and my last deal in March was $5 million . . . so either my career is in inexorable decline or I made the strategic decision, which I like to think I have, to focus on entrepreneurs and their companies – because I think it is a very challenging and rewarding world, and it is a great place to spend a career.

But I thought what we would do is discuss – first, can you hear me okay in the back? Is my voice carrying? Okay. We thought we would delve into the relationship between VCs and entrepreneurs . . . and that we might as well start with the dirt!

You know, if you are going to discuss a relationship, you want to start with the bad side rather than the good side. So I'm here to give you the straight goods – but, this being said, I have to say I feel a little bit duped and misled by Daniel and by this Institute, because I was brought here to sort of tell you the straight goods on deals and VCs and what really goes on in the trenches . . . but I find out I am sitting next to a reverend, and my every word