Symposium on Harrison's "Lean and Mean": A Finance Perspective

Joshua Lerner

Bennett Harrison is to be congratulated for raising a series of tough and thought-provoking questions regarding the changing industrial structure in the United States and the world. By compiling earlier research by authors in a variety of disciplines with his own work, he argues powerfully that the case for small firms as the engine of economic growth is overstated. He presents considerable evidence suggesting that the focus of economic development officials on encouraging small enterprises, as well as industrial districts comprised of small firms, is misguided.

In his eagerness to make his case, however, Harrison exerts a great deal of selectivity in the studies that he discusses, and in the nature of their presentation. As a consequence, the volume lacks balance in its presentation of several critical issues. This "stacking the deck" leads to an unfortunate weakening of the effectiveness of the book's overall argument, at least in the eyes of this reader.

Nowhere is this limitation clearer than in his treatment of corporate finance. Harrison discusses financial issues in several contexts. I will concentrate on one of these discussions: the strengths and limitations of the venture capital industry in California's Silicon Valley. This argument is central to the thesis of his work, and is symptomatic of his general approach to these issues.

Harrison begins by noting that Silicon Valley serves as a model for many economic development planners. The promotion of small firms that will coalesce into an industrial district of this type has been a goal in many regions. Harrison argues, however, that the appearance of small firm-led growth is illusionary:

> Silicon Valley was created by, and remains profoundly dependent on, major multinational corporations and on the fiscal and regulatory support of the national government – especially in shape of the U.S. Department of Defense (p. 107).

Rather than being driven by small high-technology firms, he argues that economic growth and development was largely shaped by "concentrated public and private capital" (p. 108).

This argument, like many in *Lean and Mean*, is troubling. Certainly, the initial economic activity in Silicon Valley was largely dominated by units of larger firms. Many of the first start-ups in the region were defense electronics firms who funded much of their R&D through the U.S. Department of Defense. Today, many large companies continue to have production facilities and offices in Silicon Valley.

But it is difficult to argue that the region's economic vitality has not been driven by the network of specialized providers of capital and expertise to emerging technology firms, including venture capitalists, accountants, lawyers, and investment bankers. AnnaLee Saxenian (1994) estimates that venture capitalists, in conjunction with these other specialized intermediaries, disbursed $9 billion dollars in Silicon Valley during the 1980s.[1] One way to assess the impact of these expenditures is to examine the venture-backed firms based in Silicon Valley that have gone public since 1980. The 168 such firms that continue to be traded in August 1994 had a combined equity market capitalization of $76 billion.[2] These venture capital funds are at the very opposite extreme from "concentrated capital." Over 225 venture capital organizations had offices in California in January 1994 (Venture Economics,

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Harvard Business School
Morgan Hall, Room 381
Boston, Massachusetts, 02163
U.S.A.

1994), and many more funds from other regions participate through syndicated investments.

Harrison acknowledges that venture capital has played a role in Silicon Valley's development. But he ignores the wealth of analyses that document the detailed role that venture capitalists play in selecting, monitoring, and overseeing firms, and the relationship between this involvement and firm performance. (Many of these studies are summarized in Barry, 1994.) Rather, he characterizes venture capital in the following manner:

> [T]he explosive growth of high-tech U.S. start-ups in the 1980s was fueled mainly by the venture capital industry, as part and parcel of the general speculative financial boom that also gave us the savings and loan crisis. In what *Business Week* (and the British political economist Susan Strange) first named the "casino society", small firm start-ups became commodities, to be bought and sold to generate capital gains.... [W]hole companies are "grown" purely for the sake of asset appreciation and ultimate resale (p. 112).

This discussion reflects a profound misunderstanding of the nature of the U.S. venture capital industry. First, the growth of the venture capital industry during the early 1980s was largely due to the relaxation of the U.S. Department of Labor's guidelines. Prior to 1978, pension funds were essentially prohibited from placing even small portions of their resources in venture capital, on the grounds that the individual investments were too risky, even though the historical performance of this asset class as a whole was superior. Second, the focus on nurturing and ultimately exiting companies was not unique to the venture capital industry in the 1980s: since its birth in the 1940s, the industry's goal has been precisely to generate capital gains.[3]

Lastly, and more generally, Harrison fails to appreciate that the dominant institutional structure, the venture capital limited partnership, exists primarily to align the incentives of the venture capitalists and their long-term investors such as pension funds and university endowments. For instance, partnerships are structured to have ten-year lives, which relieves venture capitalists from the short-run pressure of generating immediate returns while maintaining accountability. Venture organizations also extensively syndicate with each other, and rely on close ties with the key investment banks that take such firms public. A fund that behaves in an opportunistic manner – and certainly during the 1980s, as in other decades, such organizations existed – finds itself unable to sustain the ties that it needs to find and exit attractive investments, and ultimately is cut off from further capital.

It is worth commenting as well about another assertion in this section. Harrison notes that much of freedom of movement within the Silicon Valley community has recently been impeded by the growth of intellectual property litigation between firms. Harrison concludes that this is another reason why networks between emerging firms are unsustainable. What *Lean and Mean* does not mention is that the growth of intellectual property litigation was largely the result of the creation in 1982 of the Court of Appeals for the Federal Circuit. This centralized appellate court for patent cases has taken an aggressively "pro-patent" stance. This shift was largely spearheaded by the specialized intellectual property bar, which has greatly benefitted from the increase in litigation. Rather than being a symptom of the inherent impracticality of Silicon Valley, the growth of intellectual property litigation is a consequence of an ill-conceived public policy innovation. Rethinking the recent shifts in intellectual property policy could do far more to promote the vitality of American innovation than the elaborate cultivation of alliances between industrial giants that the conclusion urges the government to pursue.

Notes

[1] She constructs this estimate using data from Venture Economics' *Venture Capital Journal.*

[2] Following Harrison, I define Silicon Valley as Alameda, San Mateo, Santa Clara, and Santa Cruz counties. I identify these firms and determine their market capitalizations through Compustat. I determine if the firms received venture financing prior to going public through a database compiled by Paul Gompers and myself from the publications of Venture Economics, venture capital offering documents, and filings with the U.S. Securities and Exchange Commission. For a description of the database, see Gompers and Lerner (1994). This total is probably too low, because I have not identified all venture-backed firms that changed their names after going public.

[3] Contrary to the impression left by *Lean and Mean*, venture capitalists are severely restricted in their ability to sell shares of start-ups prior to going public by the U.S. Securities and Exchange Commission's Rule 144 and the partnership agree-

ments governing the funds. Another misleading statement is that "the 1980s saw a steady increase in . . . indirect foreign investment in the form of venture capital funds structured so that, after a number of years, the limited partners obtain ownership shares in the Silicon Valley companies in which the funds have invested" (p. 113). In actuality, the distribution of shares to limited partners have a primary mechanism for "unwinding" successful venture capital investments since at least the 1960s.

References

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