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Center for International Security and Cooperation  
Stanford University  
Encina Hall  
Stanford, California 94305-6165  
(415) 723-9625

<http://www.stanford.edu/group/CISAC/>

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Center for International Security and Cooperation  
Stanford University  
320 Galvez Street  
Stanford, California 94305-6165  
(650) 723-9625

**The Application of Venture Capital  
and the Entrepreneurial Revolution in Russia**

Franklin P. Johnson

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## **Foreword**

The project on Industrial Restructuring and the Political Economy in Russia has dealt with the processes and problems of utilizing assets of Russia's military industry since the breakup of the Soviet Union. One of the most promising approaches to such utilization has been the establishment of new small businesses either as spin-offs from larger enterprises or as entrepreneurial start-up companies. In either case, obtaining financing and guidance for these small companies has been one of the major challenges. The problem has not been so much the lack of capital as the lack of the infrastructure, institutions, and skills that are routinely accessible in a developed market economy.

In the United States the venture capital industry has fulfilled the function of evaluating entrepreneurial proposals, obtaining early-stage financing, and providing expert advice on the structure and operation of small businesses. In the communist system of the Soviet Union a venture capital industry did not exist, since the state was the source of all financing, and entrepreneurship was not encouraged. As soon as the restrictions of the command economy were lifted, entrepreneurship blossomed, but it lacked the support of a venture capital industry.

Franklin "Pitch" Johnson was one of the pioneering venture capitalists of Silicon Valley. In addition to being a venture capitalist himself, he has studied the subject extensively and been an advocate for legislation that has made venture capital a key element in the growth of the American economy. He recognized in the early 1990s the importance of venture capital to the economic recovery prospects of Eastern Europe and the former Soviet Union. He has given freely of his time to lecture on entrepreneurship throughout the region, and he has aided in the establishment of venture capital

companies in Poland and the Czech Republic. This report is based upon a paper he delivered in St. Petersburg to the Russian Venture Capital Association in June of 1998. In it he summarizes the salient points of the history of venture capitalism in the United States and discusses how this can be utilized to foster entrepreneurship in Russia.

DAVID BERNSTEIN  
ENGINEERING RESEARCH ASSOCIATE  
CENTER FOR INTERNATIONAL SECURITY  
AND COOPERATION

# **The Application of Venture Capital and the Entrepreneurial Revolution in Russia\***

*Franklin P. Johnson*

## **Introduction**

As Russia undergoes transition from a command to a market economy, almost all aspects of the economic landscape are changing. One of the more promising changes is the emergence of entrepreneurship. Entrepreneurship depends heavily in turn on the availability of financing and advice for new businesses. For the past several decades in the United States this help has come largely from venture capitalists, so it is logical to consider the role that venture capital can play in Russia. Some understanding of this role can be gleaned from reviewing the development of venture capital in the United States. This paper reviews this development and suggests ways of building and utilizing venture capital firms in Russia, recognizing that there are many differences between the circumstances in Russia and those surrounding the development of venture capital in the United States.

In the United States, a nation built by immigrants who arrived with few material assets with which to build new lives, the entrepreneur has been an important figure. The political, legal, economic, and cultural environment created by these people fostered self-reliance, individual responsibility, and

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\* Based on a presentation to the first annual meeting of the Russian Venture Capital Association, June 5, 1998, St. Petersburg, Russia.

freedom of economic and political action. These are the basic requirements for an entrepreneurial society, although there are many other conditions in modern technological life that are required for entrepreneurs to thrive.

During several bursts of new-company formation in the nineteenth and early twentieth centuries, new technologies enabled the creation of new basic industries. In the aftermath of World War II, however, American industry came to be dominated by large companies created in their own entrepreneurial days many years earlier. A decade later, Congress made a decision to encourage the private financing of small businesses by passing the Small Business Investment Act of 1958, which set up Small Business Investment Companies (SBICs). Equity was provided privately, and additional capital was lent to the SBICs by the government. When combined with a moderate existing level of investment from private sources, including wealthy families and individuals, the SBICs, after a troubled beginning, pioneered the idea that there should be institutions which provide financing and help to young, small, and growing businesses. With the success of some SBICs, new, purely private firms were started to serve the market, and the modern venture capital business was born, manned in part by those who had created the business in the SBICs. In a short time, private venture capital companies became the dominant force in the business, and SBICs were a much smaller factor.

With the availability of venture capital meeting a flood of new technologies; with engineers, scientists, and business professionals coming out of the universities; and with reductions in income and capital gains taxes, a burst of entrepreneurial activity took place that dwarfed any other period in the history of the United States. What occurred in the next few decades was nothing less than an entrepreneurial revolution that shook the country and the world.

## **The Early Days**

While the phrase “venture capital” was developed by a Harvard Business School professor in the early 1940s, the business did not become a noticeable factor in American entrepreneurial life until the 1960s, when a number of partnerships and corporations were formed to augment the families and SBICs already in the business. The total amount of new money committed to venture capital firms in that decade remained around \$100 million annually, sometimes less, and increased only gradually by the late 1970s, as shown in Figure 1. The total money managed by venture capitalists displayed a similar pattern, as shown in Figure 2.



There was a small community of firms in the Boston, San Francisco, and New York areas, and the venture capitalists knew one another. There were only a few companies seeking financial and management help, and there was an open dialogue among the few venture capitalists about potential investments they were considering. It was quite easy for one firm to ask another what it was doing and to become involved in a deal that was being structured in the interests of reciprocity later. From the entrepreneurs' point of view, the system was uncompetitive, because the venture capitalists were working together closely in examining and pricing deals.

The people who began practicing venture capital then had no established pattern or ways of doing things; they made it up as they went along. In 1962, my partner in a new SBIC, Bill Draper, and I did a lot of things to find deals, since waiting around the office for people to approach us would have been fruitless. We developed the habit of getting out of the office a lot, visiting university laboratories, joining community service groups, talking to lawyers and accountants, and even going down the street in places where there were start-up companies and knocking on doors. I took some courses in computers and molecular biology at Stanford, since both areas had undergone major change since I was in college fifteen years before. When a possible deal came into view, we thoroughly checked out the people and markets, and spent a lot of time with the entrepreneurs getting to know them and assessing our compatibility. We had determined early on that we were not just investors of capital; we were also investors of our business skills and our commitment to the success of the company. Most venture capitalists in the United States have that point of view even today. Venture capital is not a part of the normal investment business; it is a special hybrid of capital, consulting, and commitment.

## **Silicon Valley**

We had set up shop in what was soon to be named Silicon Valley. It was a place which was a mixing chamber of the research of two great universities, a constant stream of well-trained engineers from several nearby schools, many entrepreneurially minded graduates of nearby business schools, a supply of technicians from the community colleges, and a growing group of venture capitalists encouraging and enabling people to start companies. What Silicon Valley also had was great weather, which attracted similarly skilled people from all over the country, and a little-

discussed, long history of technological entrepreneurship going back to the 1920s.

In addition to these local conditions, the generally favorable entrepreneurial climate of the United States included relatively low income and capital gains taxes, a large market for new products, clearly defined business laws, a normally orderly and lawful civil society, few government restrictions on serving any market chosen, a banking system interested in small business, a stock market for smaller companies, and an atmosphere of encouragement and approval of business success. This meant that entrepreneurial centers could evolve in other parts of the country. The Boston area, with the presence of Harvard and the Massachusetts Institute of Technology (MIT) as knowledge resources, developed early along with Silicon Valley.

## **The 1970s and 1980s**

Three developments in the late 1970s greatly affected venture capital. One was the success in the stock market of venture-capital-backed companies such as Tandem Computers and Teradyne, another was the reduction of taxes on capital gains by the federal government, and the third was a change in a law that made it easier for managers of corporate pension funds to be considered prudent when investing in venture capital funds. As can be seen in Figures 1 and 2, venture capital began to flow in large amounts from investors, with annual new commitments exceeding \$1 billion for the first time in 1980, and total money under management rising proportionately. The capital-investing community began to take venture capital seriously as an asset class, led by university endowments and corporate pension funds, because the rates of return on investment in venture capital appeared to be greater than the stock, bond, and real estate markets they had been using. As Figure 3A shows, the amount of money invested by venture capitalists grew in the 1980s to match the supply. All during the 1970s, the money invested by the venture firms had remained quite low, as shown in Figure 3B.

Politicians also became aware in these years of the job-creating power of dynamic new and young businesses, especially after a startling report by David Birch, an economist at MIT, pointed out that essentially all the net new jobs in the United States were being created by young companies. The newly formed National Venture Capital Association wasted no time in pointing this out to Congress, and this knowledge was a factor in the capital-gains tax reductions. Additionally, the popular press began to pro-

file the successful entrepreneurs, and the revolution that had occurred in the way the United States undertook free-market, entrepreneurial economic growth became more widely known.

The sluggish stock market in the early 1980s, which hindered the ability of young companies to access the public market, combined with a slow economy to produce an atmosphere of pessimism. This caused some institutions to pull back from committing further to venture capital. The venture capitalists, however, continued to help form and back young companies, using resources committed earlier. In this way Amgen, Microsoft, and Cisco, among hundreds of other companies, were supported. These three companies in biotechnology, personal computing, and networking, plus Intel, formed in the seventies, would become prime examples in the next decade of the power of venture-backed entrepreneurship in shaping economic growth in the United States, and in influencing how people throughout the world, including governments, thought about how to achieve job creation, exports, and national wealth. Despite a sharp market drop in 1987, the revolution in thinking about capitalism and its practice was well under way.

## **The 1990s**

Venture capital as an investment class, often defined by financiers for simplicity as part of private equity, began to attract much larger amounts of capital. This interest was fueled in the United States in the latter half of the 1980s by very large rates of return from venture capital firms to their investors, first from investments in biotechnology and later from the explosion of expectations created by the rapid growth of the Internet. Although biotech companies faded in value after a scare from the early Clinton administration about heavy government control of health care, the investors in the public stock market began to pay very high prices for companies exploiting opportunities in the Internet, other types of networking, and many kinds of software. In response, a large number of entrepreneurs formed companies to serve the commercial markets which were attracting so much attention in the stock market, and venture capitalists rushed to back them. The stock market then paid high prices for these young companies, as did some companies already on the market with high-priced stock of their own, which not only gave the venture capital companies high rates of return but created a lot of very wealthy young entrepreneurs, causing even more companies to be created and more money to come into

venture capital. This cycle has continued to accelerate almost unabated into the end of the decade, and has taken operating company valuations to a level unsupported in conventional thinking by the long-term earning power of those companies. Another look at Figures 1, 2, 3A, and 3B shows the extent of this growth through 1997.

Yet there are still large amounts of liquid capital around the world looking for work at the highest rate of return possible for the risk, and the managers of this capital have not yet begun to back off from feeding this venture capital–entrepreneur–stock market whirlwind. Meanwhile the supply of jobs in the United States has matched the number of workers available. This has meant quite low unemployment for the country as a whole, and what some call “negative unemployment” in places like Silicon Valley.

A by-product of the current prosperity in the United States, fed in part by entrepreneurial activity, is the probability of eliminating the current deficit in the federal budget. It is a well-known but little-appreciated fact that the federal government is a major partner in every business because of the corporate income tax, and a partner in every household because of the personal income tax. The government doesn’t share in the losses unless there are offsetting gains, and most importantly has little to say about what direction a business takes. It is a kind of “hands-off” socialism.

While there has been a good supply of private equity capital in Western Europe, the investors there called “venture capitalists” are much more interested in buy-outs and later-stage financings, and have largely ignored entrepreneurial start-ups until recently. In addition, the governments, elected by and acting for the people, have chosen to keep large, expensive social programs in place, and to keep production costs of companies high by other restrictions and rules, so that prices are high in world markets, restructuring of the labor force is difficult, and unemployment rates remain stubbornly high. New, rapidly growing companies developing and marketing products with new technologies are not a mainstay of the European economy, and are not yet a dominant source of new jobs. It is not clear that the American entrepreneurial model will work in Western Europe, anyway, because of cultural differences, a tradition of heavy government involvement in regulating business activity, and other missing elements of a favorable entrepreneurial environment. It is clear, however, that many Europeans believe that the American model is too tough on the economically unsuccessful and produces too much income and wealth differential. Many are also tired of hearing Americans extolling American economic virtues as solutions for every country.

## **Entrepreneurship and Venture Capital for Russia**

While a quick glance at the development of venture capital and entrepreneurship in the United States may be of some use in anticipating and guiding the development of venture capital in Russia, it is obvious that our histories, both recent and distant, are greatly different. Nearly every other aspect of life—cultural, political, economic, and legal—reflects that difference. Some threads common to most people, however, also emerge. Most people, in any society, would like to make money, live better, and have more control over their own lives. Somewhat fewer people like to create new things, which in the case of economically motivated people are products, organizations, plans, and companies. Even fewer can tolerate the risks and uncertainty of going into the economic unknown by investing in speculative new ventures. When given the chance, some people will combine all these characteristics and become entrepreneurs. These people, acting alone or in groups, are vital to the economic growth of both Russia and America. They exist everywhere, and will sprout and grow when given the chance.

Venture capital has no independent significance except as one of the elements that must be in place to create a modern, high growth, technological, entrepreneurial environment. In order to build a strong venture capital business, the new venture capitalists of Russia must not only find and learn ways to conduct their operations, but must be active in creating a climate conducive to entrepreneurs. Some of these conditions will be unique to Russia, and some will be obvious, but some of the basics assumed to be in place in the United States can be promoted in Russia. To restate them briefly, they are moderate taxes, a safe civil society, freedom to enter markets, the availability of large markets, a reservoir of talent and knowledge, a working business legal system, an infrastructure of supporting services, a functional banking system, a minimum of government regulation, a supply of skillfully administered venture capital, a stock market for smaller companies, and an atmosphere of approval and encouragement for entrepreneurs.

It is not a priori obvious that the venture capital experience in the United States can be applied to Russia. The successful application of this experience in Eastern Europe, however, is encouraging. Poland, in particular, has several successful venture capital firms with well over \$500 million under management. A surprisingly active stock market for smaller companies has emerged there, and this encourages further investment.

While Eastern Europe was undergoing its revolutionary (some say counter-revolutionary) political and economic changes in the early 1990s, the vital importance of entrepreneurship and the growth of young technology

companies to a nation's economy was becoming recognized by the governments and financial leaders of Western Europe and North America.

As the investment potential of venture capital becomes better recognized in Russia, members of the emerging wealthy class may see this as an appealing alternative to investing their money outside of Russia. Venture capital has already started to emerge in Russia, and the Russian Venture Capital Association (RVCA) was established in 1997. There are several actions that RVCA and other interested parties can take to help the venture capital business succeed as a part of a strong entrepreneurial economy and society. In particular they should:

- Become politically active as soon as possible, and spend some time thinking about what issues important to entrepreneurs and venture capitalists can be brought forth to affect legislation and policy at the national and local levels. They should then pick one or two of these issues and work to promote them with government officials and legislators. This can be done by direct contacts, by getting constituents interested in these issues, and by keeping the press well informed.
- Begin an active investigation of what types of investors of both domestic and foreign origin may be interested in Russian venture capital, and determine how opportunities in Russian venture capital can be made more widely known to financial and business institutions in and outside of Russia.
- Establish standards of conduct for the venture capital business that RVCA members agree to as a condition of membership. These may include such issues as confidentiality of information provided by entrepreneurs or other venture capitalists, participation in the recruitment of people from portfolio companies, and standards of reporting to limited partners and investors, including valuations.
- Develop some reporting system to the RVCA members for measuring and tracking venture capital and entrepreneurial activity in the country.
- Set up contacts with universities and institutes to promote the study of and training in entrepreneurship and venture capital, and help some institutions set up a specific training program for new employees of members.
- Encourage the formation of regional branches of RVCA that meet every month or so, primarily to enable the members to get to know one another, but with programs given by members, entrepreneurs, government officials, and university people.
- Begin an active program of public relations by giving information and interviews to the press, and by providing speakers and literature to a num-

ber of community groups in whom they can stimulate interest. Alert the investment community to venture capital and entrepreneurship.

- Develop an active relationship with the European Venture Capital Association (EVCA), and with other international associations, especially those from recently socialist countries with whom common problems may be shared.

The venture capital business can play an important role in opening the Russian economy to potential new leaders by promoting entrepreneurial vigor in this great and rapidly changing country.



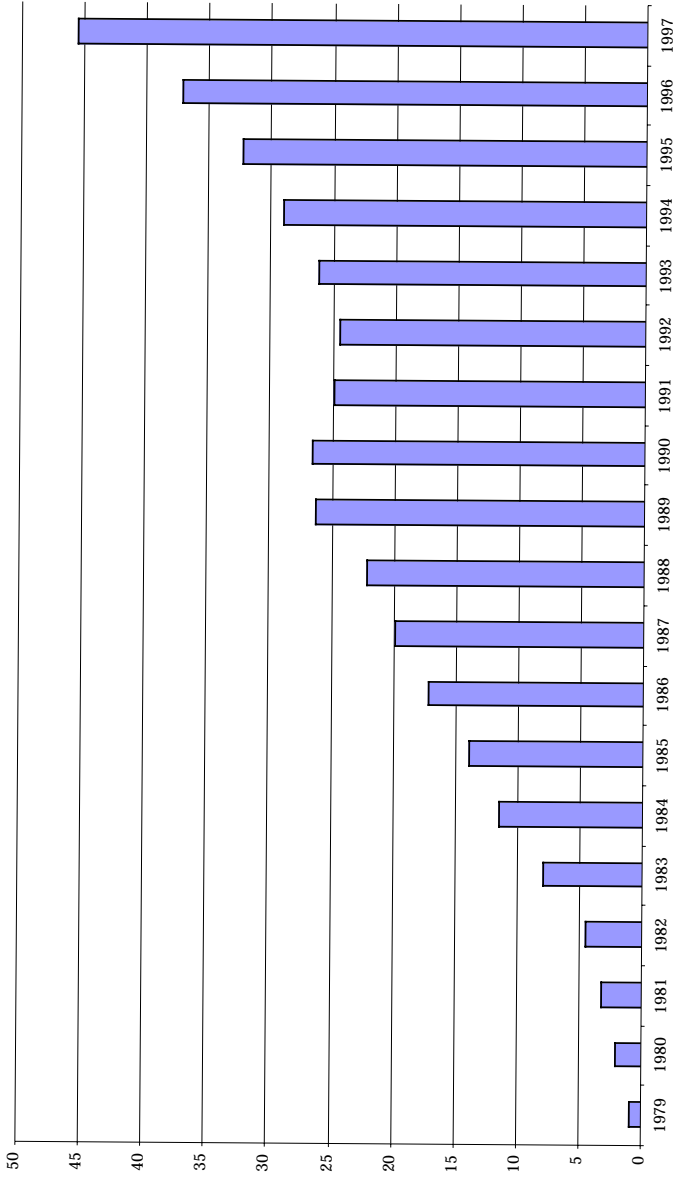


## **About the Author**

Franklin “Pitch” Johnson is an affiliate of the Center for International Security and Cooperation. He was co-founder in 1962 of Draper and Johnson Investment Company, and became an independent venture capitalist in 1965 as the founder of Asset Management Company, with which he is still associated. The Company manages four venture capital funds based in Palo Alto, California. He has been a director of several public and private companies, has been director of the National Venture Capital Association, and was president of the Western Association of Venture Capitalists.

He taught a class on entrepreneurship at Stanford Business School for twelve years. Since 1990 he has served as an adviser to several Eastern European countries in the area of entrepreneurship and privatization. In conjunction with ABM Amro Bank of the Netherlands, the European Bank for Reconstruction and Development, and a group of entrepreneurs and venture managers of Polish, Czech, and Slovak origins, Mr. Johnson helped form a venture investment company, European Renaissance Capital, to invest in and assist new and young companies in Poland, the Czech Republic, and the Slovak Republic. Mr. Johnson is also an advisor to the Russian Technology Fund.

**Figure 2**  
**Capital Under Management U.S. Venture Funds (\$ Billion)**  
(Source: Venture Economics)



**Figure 2**  
**Capital Under Management U.S. Venture Funds (\$ Billion)**  
(Source: Venture Economics)

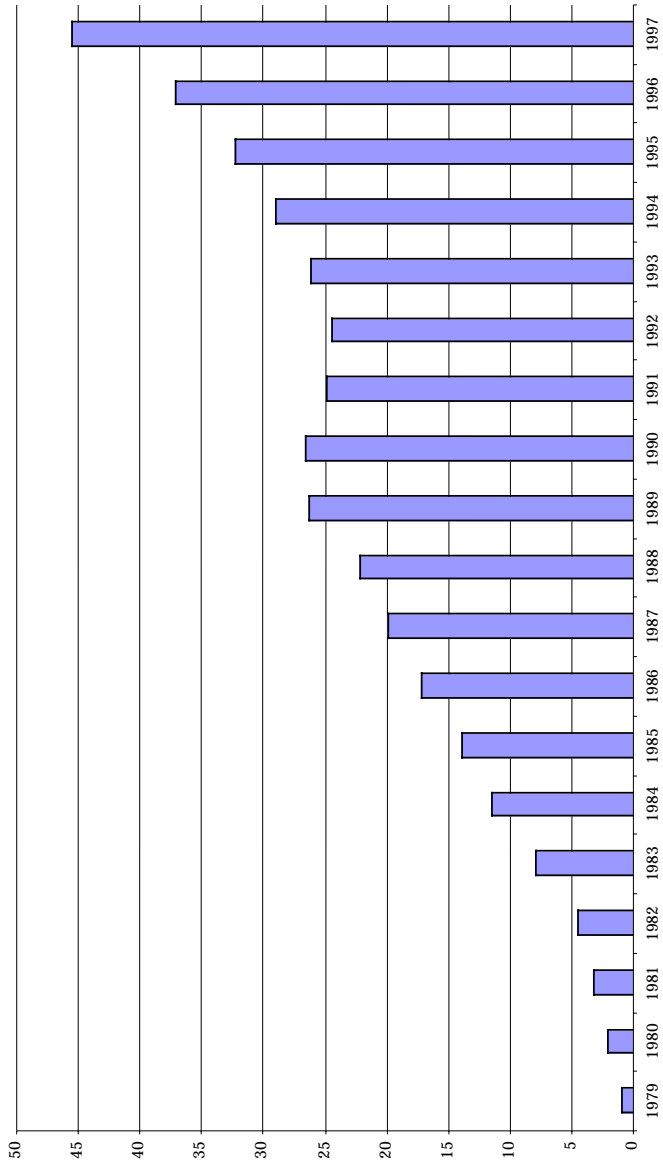
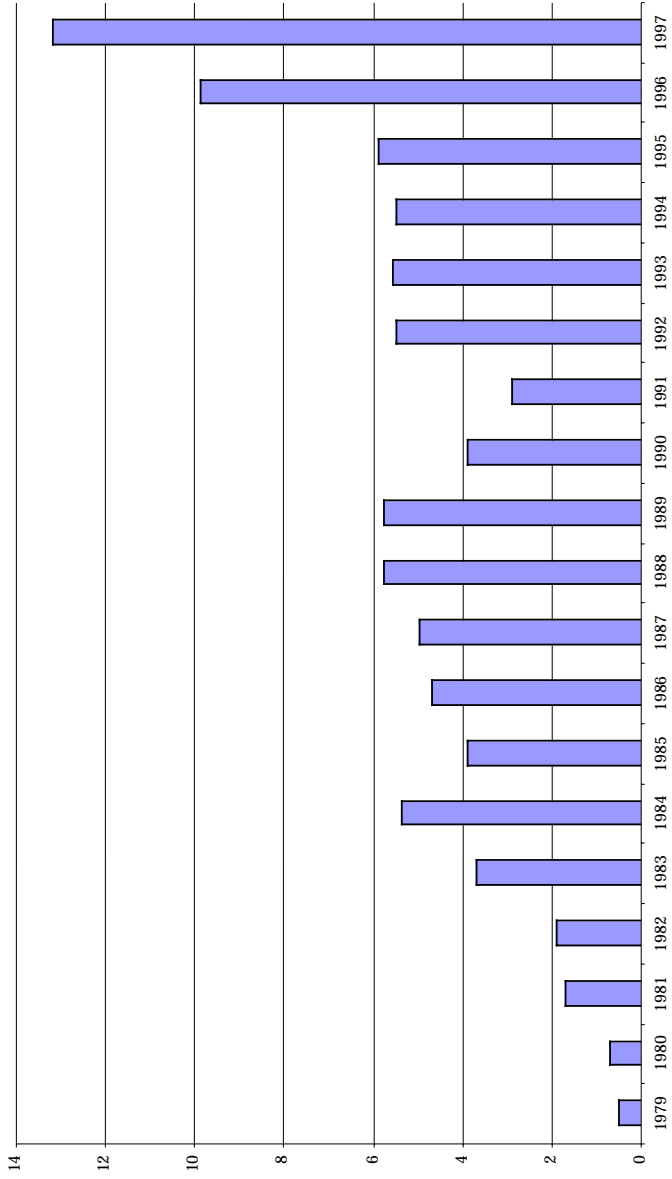
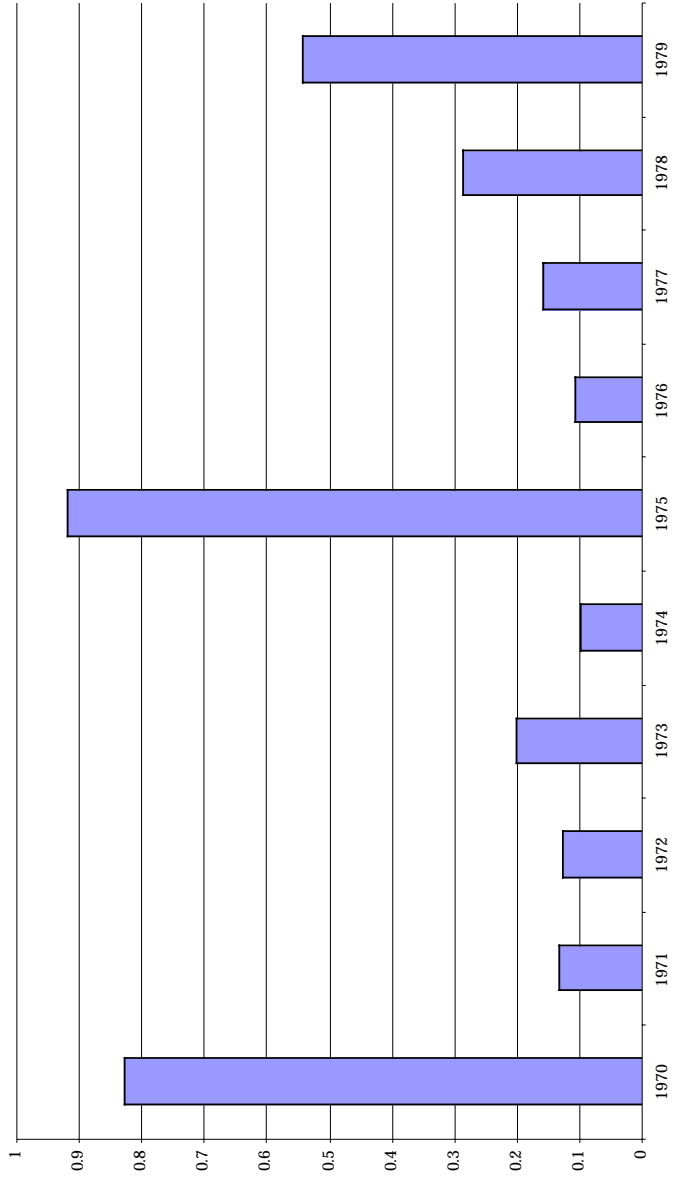


Figure 3A  
Disbursements to Portfolio Companies by U.S. Venture Funds (\$ Billion)  
(Source: Venture Economics)



**Figure 3B**  
**Disbursements to Portfolio Companies (\$ Billion)**  
(Source: Venture Economics)





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