

**TESTIMONY OF ROBERT E. GRADY
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STANFORD GRADUATE SCHOOL OF BUSINESS
BEFORE THE
COMMITTEE ON EDUCATION AND THE WORK FORCE
U.S. HOUSE OF REPRESENTATIVES
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Mr. Chairman and Members of the Committee. Good morning. My name is Robert Grady, and I am here to testify on behalf of the National Venture Capital Association, the "NVCA". The NVCA is the premier association representing the venture capital industry in the United States, with over 450 member firms, representing the overwhelming majority of venture capital funds professionally managed in this country. Our mission is to foster greater understanding of the importance of venture capital to the U.S. economy, to represent the public policy interests of venture capitalists and portfolio companies, to stimulate the flow of equity capital into emerging growth companies, to provide reliable industry data, to maintain high professional standards in the industry, and to sponsor professional development opportunities for our members. On behalf of the NVCA, let me first express my thanks for the invitation to testify.

My firm, Carlyle Venture Partners, is a member of the NVCA. I serve as the managing partner of Carlyle Venture Partners, which makes investments in early stage (generally pre-initial public offering) companies which provide technology infrastructure -- such as semiconductors, software, security and storage solutions, and radiofrequency identification equipment -- to enterprises, and which develop and manufacture medical devices to treat more effectively conditions such as spine problems, macular degeneration, and congestive heart failure. We have offices in San Francisco, California; Tyson's Corner, Virginia; and Washington, D.C.. Carlyle Venture Partners is part of the Carlyle Group, which is by most measures one of the largest private equity firms in the world, with about \$16.5 billion in private equity funds under management and over 500 employees.

In addition to my work at Carlyle, I have served since 1993 on the faculty of the Stanford Graduate School of Business (which I am proud to call my *alma mater* as well), where I serve as a Lecturer in Public Management, teaching courses in the investment process and in understanding the regulatory environment.

Interestingly, although Carlyle Venture Partners was only started in 1997 and began making investments then, the 35 companies which we helped to get started and in which we still have investments today employ over 3,700 people. Our most recent fund, Carlyle Venture Partners II, which was closed in 2002, has helped fuel the growth of startup companies that today employ over 1,100 people.

My point in highlighting the experience of Carlyle Venture Partners to the Committee is not to tout our own firm, although we are proud of its record, but rather to illustrate the point that venture capital investment has been a major source of job-creating capital in the United States for the past thirty years.

Two years ago, the NVCA commissioned the firm Wharton Econometrics/Decision Resources, Inc. (“Wharton/DRI”) to undertake a study of the impact of venture capital investing on the U.S. economy. The results of the study were staggering: Wharton/DRI found that, in the year 2000, venture-backed firms accounted for \$1.1 trillion in sales – or about 11% of U.S. Gross Domestic Product. Further, the study found that venture-backed firms directly employed over 12.5 million people, and directly or indirectly supported over 27 million people. In addition, the study found far higher than average levels of R&D spending as a percentage of sales and patents generated per employee. Finally, it found that these benefits were widely spread across the United States, with venture-backed companies employing people in 49 of the 50 states. The point that the study made clear is that the leverage on venture capital investing, in terms of job creation and innovation, is substantial – everywhere in America. In 2003, \$18.2 billion in venture capital investment was directed at more than 2,700 companies in 48 states across a broad base of industry sectors.

This data shows that, contrary to common belief, venture capital investment is not just a Silicon Valley, high technology phenomenon. Opportunities for innovation are everywhere, not just in the technology sector of our economy. In addition to Genentech, Intel, Cisco and e-Bay, U.S. companies that were originally venture-backed include Airgas, Amazon, Boise Cascade, Costco, Starbucks, Home Depot and Federal Express. Collectively, these innovative organizations have obtained countless patents, created business models that have been imitated and leveraged by others, and developed product lines and service delivery channels that never before existed.

America’s venture capital industry, which has helped fuel so much job creation in the past few decades, appreciates the opportunity to offer the Committee our views on how to create and foster the type of environment that will allow America to keep creating jobs.

I believe the Committee’s concern this morning is how to respond to the changing nature of our economy. For example, there has been, in the press and elsewhere, a great concern expressed regarding the so-called outsourcing of certain functions to other nations. Our economy has always been extremely dynamic – that is one of its greatest strengths. The US economy has continuously reinvented itself cycle after cycle through innovation while simultaneously raising the standard of living of Americans and improving the quality of our lives. One of the roles of venture capital has been to spawn new companies that in some cases went on to create whole new industries. Venture capital has been a critical catalyst in creating entire industry clusters such as biotechnology, Internet services and software. It has also impacted more traditional sectors such as manufacturing, retail trade, business services, and construction.

Let me give the Committee two examples:

- In 1976, a biochemist and a venture capitalist founded a small company to explore a new field called recombinant DNA technology. They called the organization Genentech and went on to help invent the biotechnology industry. Today Genentech employs more than 5,200 individuals of which more than 80% have college degrees. The company is consistently named one of the Best Companies to Work For. Two weeks ago, Genentech received FDA approval for Avastin, a therapy for first line colorectal cancer patients.
- In 1965, a Yale undergraduate student named Frederick Smith wrote a term paper on the inadequate airfreight system in the U.S.. In June 1971, Federal Express incorporated and on its first night it delivered 186 packages to 25 US cities. The company went on to change the way our country works. Federal Express not only improved business productivity exponentially; it created the \$27 billion U.S. ground and air express market and that spawned more than 550,000 jobs and innovation through the operations of competitors such as DHL, Airborne Express, UPS and the US Postal Service.

This culture of innovation and entrepreneurship had given our society unique characteristics. We have some of the greatest social mobility in the world – meaning that in our society, it is still possible for a person to come from humble roots, or to be new to this country, and within one lifetime to have a realistic chance of moving up the economic ladder to the upper reaches of our society in terms of income or wealth. The data overwhelmingly support this, and this has been our history.

We believe that America's job creation record and economic performance generally is enviable. We are of course the largest economy in the world, but throughout the last decade, we have grown faster and consistently generated more employment than, for example, the advanced economies of Europe. Even during the boom of the late 1990s, unemployment rates in Germany, France, and other European nations remained stubbornly high at around ten percent, and economic growth lagged behind that of the United States. Many of these countries had policies that may have sounded attractive, but had the effect of discouraging investment and ultimately discouraging both competitiveness and job creation. So it is worth examining the causes of America's economic out-performance to date in seeking to chart a course for the future.

The NVCA, and I personally, believe that the correct response to the evolving nature of the economy is to be prepared to compete, and to compete well. In the short term, America is not in economic crisis. Our unemployment rate is 5.6%, inflation and interest rates are low, and economic growth has been strong. But over the long term, there is cause for concern – and we believe that we must take the steps today that will allow us to innovate and compete in the knowledge economy in the future.

So what have been the keys to America's economic out-performance? And what are the keys to being able to compete in the knowledge economy of the future? In our view, several imperatives stand out:

- Ensuring the continued availability of risk capital;
- Maintaining transparent, liquid, trusted capital markets;
- Strengthening our educational system;
- Constantly seeking to maintain the world's best system of higher education;
- Investing in basic R&D to keep America at the forefront of innovation;
- Maintaining flexible labor markets; and
- Expanding world trade.

Let me cover each of these topics briefly.

I have already outlined the data with respect to the contribution of venture-backed companies to U.S. employment, but our capital markets are of course deeper than that. This culture of risk capital has allowed a wide range of startups to flourish. Data from the Census Bureau shows that since 1988, almost 10 million jobs have been created by companies with less than 500 employees. As you know, venture capital is the investment of equity money to support the creation and development of these new businesses. Venture capital deliberately focuses on smaller, younger entrepreneurial companies that do not have the track record and stability to obtain traditional financing. These businesses carry very high risk and many do not succeed. Yet those that do contribute greatly to our economy in terms of job creation, revenue generation and innovation. The NVCA believes that incentives for capital formation and risk-taking investment should remain in place. We supported the passage of amendments in 2003 to reduce the tax rate on long-term capital gains to 15%, and we believe that such a rate should be made permanent.

Our public capital markets are widely acknowledged as the deepest and most transparent in the world. We believe that Congress and the financial system should do everything possible to keep them that way. We have supported reforms to improve transparency in reporting and congratulate the SEC and other agencies on their efforts to curb the abuses of those who have not been accurate in their reports. That being said, we believe that we should not adopt measures in the name of corporate reform that will have the effect of making financial statements less reliable and will choke off the innovation that is so critical to American success. In that regard, the NVCA does not believe it is either prudent or financially correct to require companies, especially small private companies with no public stock price history, to expense against income the awarding of incentive stock options to employees. At a fundamental level, these options are shares and not claims against the cash resources of the company – they should be counted in the denominator of an earnings per share calculation, not double counted against income as well. As a matter of accounting transparency and reliability, a requirement to expense options would make income statements less reliable, as there is no agreed-upon method for valuing options, and several of the types of methods proposed rely on estimating the volatility of the stocks of companies with no trading history. Lastly, expensing options

would punish the most successful companies – by valuing most highly the options of those companies with the best growth prospects. Expensing would be economically damaging to the country by changing the ability of the most innovative and high growth companies to allow people to work for ownership instead of cash compensation.

Thirdly, if we are to compete successfully, our people have to be trained to do so. The NVCA has long been of the view that the health of our schools is essential to the health of our country. In this regard, we congratulate the Committee on its leadership in crafting and passing into law the No Child Left Behind legislation to ensure that our schools are performing, our kids can read, and parents of children in failing schools have more rights to do something about it. We believe that there is a bipartisan consensus to invest more in education at the Federal, state, and local level. The trick now is to make sure that the resources this consensus can provide are used to maximum effect – attracting the most talented people to the classrooms to teach, allowing the use of both technology and better infrastructure in the classrooms, and addressing critical problems. In particular, we would urge the Committee to investigate what can be done, and to support programs, to increase the number of students pursuing mathematics, science, and engineering education in the United States. This is one area in which America *is* falling behind.

Related to this point is of course the condition of our system of higher education – long acknowledged as the best in the world. Here too we need to increase the proportion of science, math, and engineering graduates if we are to remain competitive in a knowledge-based economy. We should be aware that our competitors are making this investment. According to a research report by Think Equity Research, the Chinese government has set as a goal to increase the proportion of those in the 18- to 22-year old age cohort that attend four-year college or university from its current level of four percent to twenty percent, within twenty years. Think reports that this will require the building of 10,000 universities the size of the University of Indiana. Beyond that, we believe that Americans must ensure that access to education continues – that from K-12 all the way through the community college and university system, Americans have access to preeminent education. Just as “no child should be left behind” so too should “no adult in need of retraining be left behind.”

A key feature of our preeminent university system has been the funding of individual investigators at our research universities through the research agencies of the Federal government – the National Institutes of Health, the National Science Foundation, the Department of Energy, the Department of Defense, and so on. The investments made by this and previous Congresses in the basic R&D enterprise in the United States have been critical to spawning innovation and ensuring our economic leadership. The advances this research has promoted in materials science, high performance computing, high energy physics, biomedical research – in a wide array of areas – has laid the groundwork for American leadership, and American competitiveness, in a large number of related industries.

We hope that this and future Congresses will continue this investment in innovation. We recognize that this year's budget contains a record amount for Federal R&D, but also recognize the budgetary constraints facing the Congress going forward – particularly in non-defense discretionary spending. In this regard, venture capitalists particularly among your many constituents are focused on the future. Yet many of the investments most critical to that future – in education, in universities, in transportation infrastructure, in education – are in this category of discretionary spending. Venture capitalists in particular therefore recognize that without entitlement reform, investments in the future will be under-funded.

One oft-cited point of comparison with the European economies I mentioned earlier is that of labor market flexibility. In several European economies, employees who work for a certain relatively short time cannot be terminated, for up to two years. This has not had the effect of creating more jobs, but rather of discouraging employees from being hired in the first place. Similarly, lengthening plant closing notification requirements, as some are proposing we do in response to the wave of news reports on outsourcing, may simply discourage the opening of facilities in the first place. We do not believe that reducing labor market flexibility in the United States will create more jobs, and we would urge the Committee to consider that the more flexible system extant in the United States today has attracted rather than destroyed jobs.

Finally, part of our faith in an innovation-led, knowledge-based economy is the conviction that American ideas and products can compete anywhere in the world. The NVCA believes that more open markets will yield more growth, more jobs, better and more affordable products and services, and higher standards of living for Americans. According to the U.S. Trade Representative's office, over the past decade, exports accounted for 25% of America's economic growth and have supported over 12 million jobs. We generally believe that a level playing field that opens international markets to American innovation and the products and services it has yielded, while allowing our innovators to secure the highest quality components and services at the best price from wherever they may exist in the world, will contribute the most growth to the American economy. In this regard, we congratulate the Congress for its role in making various trade agreements possible and for approving them once they have been negotiated and found to be acceptable.

It is easy to look at the rapidly changing nature of the economy and react with fear. This has happened several times in the past, often with adverse consequences. In the late twenties, concerns about America's ability to compete against lower cost producers led President Hoover to recommend and Congress to enact the Smoot-Hawley tariffs. Growth and employment shrunk by a staggering 25% in the years that followed. In the seventies, there were concerns about the U.S. automakers ability to compete against Japanese producers, but a new cycle of innovation and product quality later led to market share gains. In the 1980s, Congress and others were concerned about our ability to compete in semiconductors – yet the biggest growth in value and in job creation in semiconductors in the 1990s was right here in the United States.

Today, it is true that the world remains highly competitive. As venture capitalists, we see our challenge as to find and fund new areas that promise to change -- for the better -- the way we live and work. As we meet this morning, a new generation of venture capitalists is funding a new generation of companies in emerging areas such as nanotechnology, genetics, photonics, energy, fuel cells, and lasers. What do these areas have in common? In every one, the United States is the leader.

I am here today on behalf of the venture capital community because we share the concerns of this Committee of surrounding sustainable job growth in the United States. As a country that has been built on the pioneering of new markets and industries, the U.S. will always be faced with the challenge and the question of whether to continue to pioneer, or to turn inward in some attempt to consolidate our gains. The NVCA wishes to be on the record before this Committee in favor of making the investments we need to make today to ensure our continued leadership tomorrow. In the end, we believe that it is the combination of innovation and entrepreneurship that will continue to improve the lives of Americans, maximize the creation of new jobs to help offset the job erosion that has always been part of our economic landscape, and provide Americans with an exciting set of new opportunities for growth.

Thank you very much.

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