Written Testimony of Patricia Nakache
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before the U.S. Senate Committee on the Judiciary,
Subcommittee on Antitrust, Competition Policy, and Consumer Rights

Competition in Digital Technology Markets: Examining Acquisitions of Nascent or Potential Competitors by Digital Platforms

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Chairman Lee, Ranking Member Klobuchar, thank you for the opportunity to testify before the Senate Judiciary Committee's Subcommittee on Antitrust, Competition Policy, and Consumer Rights. I am pleased to share my perspective on competition in digital technology markets and how venture capitalists (VCs) like myself think about acquisitions of early-stage companies by larger competitors. My name is Patricia Nakache and I serve as a General Partner at Trinity Ventures, a venture capital firm based in Menlo Park, California with more than $1 billion in assets under management. Trinity has a three-decade track record of investing in successful early stage startups, backing iconic consumer and enterprise brands like Starbucks, Zulily, and New Relic. As an investor, I partner with world-class technology entrepreneurs who are working to deliver innovative products and services to the American public and challenge the status quo and have been fortunate to invest in outstanding companies such as thredUP, Turo, LoopNet and Care.com. In addition to my role at Trinity, I also serve as a Lecturer in Management at Stanford Graduate School of Business where I teach a class called "Startup Garage". I am testifying in my capacity as a board member of the National Venture Capital Association, our industry's trade association that advocates for public policy to help high-growth startups thrive.

Venture capital and its importance to the U.S. economy

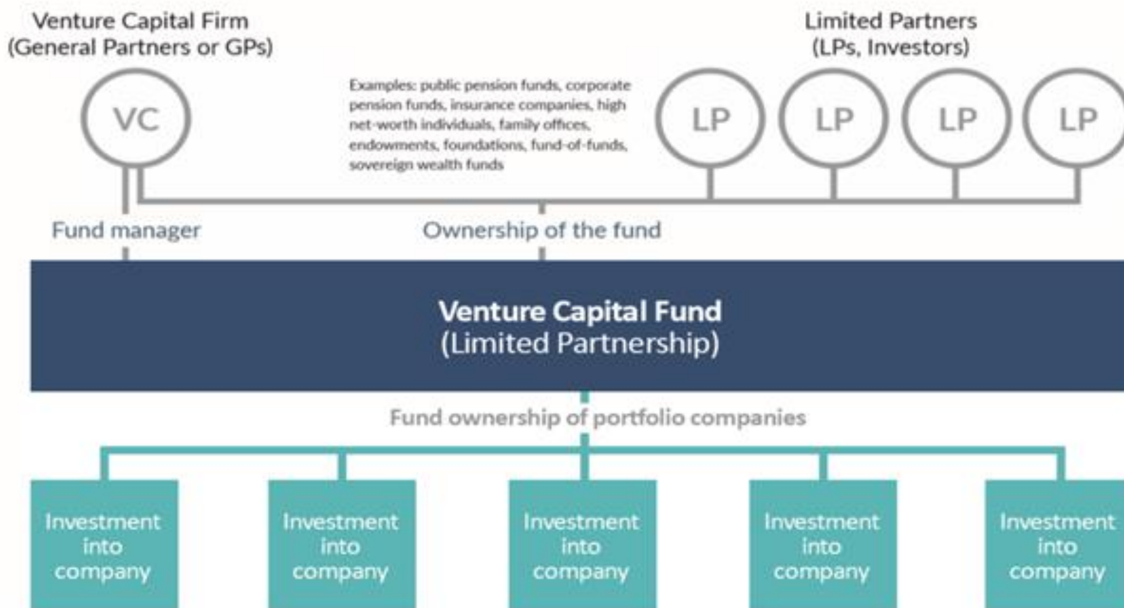
Venture-backed companies have had an outsized positive impact on the U.S. economy. According to a 2015 study by Ilya Strebulaev of Stanford University and Will Gornall of the University of British Columbia, 42 percent of all U.S. company initial public offerings (IPOs) from 1974 to 2015 were venture-backed.[1] Collectively, those venture-backed companies have invested $115 billion in research and development (R&D), accounting for 85 percent of all R&D spending, and created $4.3 trillion dollars in market capitalization and 63 percent of the total market capitalization of public companies formed since 1974.[2] Furthermore, a 2010 study from the Kauffman Foundation found that young startups, most venture-backed, were responsible for almost all of the 25 million net jobs created since 1977.[3]

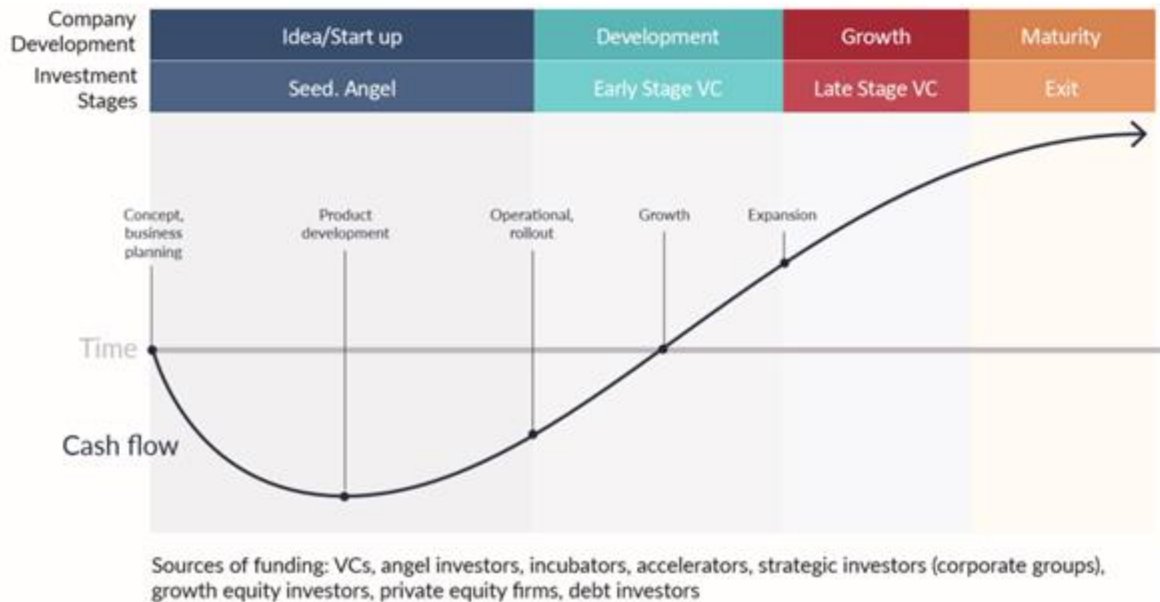
[1] "The Economic Impact of Venture Capital: Evidence from Public Companies," Stanford University Graduate School of Business Research Paper No. 15-55, *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2681841.
[2] Id.
[3] "The Importance of Startups in Job Creation and Job Destruction," Kauffman Foundation Research Series: Firm Foundation and Economic Growth," (July 2010), *available at* http://www.kauffman.org/~/media/kauffman_org/research%20reports%20and%20covers/2010/07/firm_formation_importance_of_startups.pdf.

American economic growth is dependent on the economic activity that comes from young firms scaling into successful companies. The rapid hiring, the innovative product development, the increasing sales and distribution needs, and the downstream effects all serve to drive the U.S. economy forward. It is imperative that policymakers, entrepreneurs, and VCs work together to encourage entrepreneurship in our country.

Venture capitalists like myself raise investment funds from a broad range of limited partners (LPs) – *e.g.* pension funds, endowments, foundations, family offices, fund-of-funds—and invest in amazing entrepreneurs with breakthrough ideas. Venture capitalists invest anywhere from the very early stage, where the startup has little more than an idea and a few people willing to take the risk of their lifetimes to bring that idea to fruition, to growth-stage companies, which have achieved product market fit and are generating revenue, and the focus is on effectively scaling the business on its way to profitability. A company leaves the venture ecosystem generally through an initial public offering (IPO), a merger or acquisition (M&A), or as is sometimes unfortunately the case in the startup world: bankruptcy.

The VC Fund Structure





Venture capitalists seek out exciting startup companies and invest in them in exchange for equity. But the job of a VC is so much more than writing a check. We roll up our sleeves and work with startups to help entrepreneurs turn their ideas into successful, enduring companies. For example, I typically serve on their boards, and work closely with them to identify and recruit talented executives, develop partnerships and craft strategy. Making the decision to invest is just an initial stop on the journey we share with founders. We support our companies over a long period of time, generally around five to ten years.

Failure is a common reality in venture capital and the startup ecosystem. Failure can occur for many reasons: the technology may not work as envisioned, the product or service does not fulfill a compelling customer need, the unit economics of the business may not work, or management execution may be poor. But VCs and entrepreneurs accept the significant risk of failure because the economic and societal rewards of success can be meaningful. This delicate balance between the risk of a startup and its potential rewards is an essential ingredient to fostering innovation.

One concern I have is that some policymakers presume that just because the United States has been the historical leader in startup activity that our country will always be in the top position. To the contrary, the share of global venture capital invested in the U.S. has fallen from 90 percent to 51 percent in only 20 years.[4] Other countries have seen how entrepreneurship has benefited the American economy and are now racing to compete with us and are using a number of different policy mechanisms to do so, such as immigration policy that welcomes immigrant entrepreneurs and tax policy that supports young, pre-revenue companies. At the same time, our country has not prioritized making the United States the best place in the world to launch a high-

[4] NVCA 2019 Yearbook, Data provided by PitchBook, *available at* https://nvca.org/wp-content/uploads/2019/08/NVCA-2019-Yearbook.pdf

growth startup. In recent years, the U.S. venture capital community has been confronted with policy challenges, such as immigration policy that does not facilitate immigrant entrepreneurship and foreign investment scrutiny that has caused the Committee on Foreign Investment in the United States (CFIUS) to be highly relevant in many startup financings. It is time policymakers endeavor to establish the best possible policy framework for high-growth startups.

Venture capitalists must assess whether a company can compete against incumbents

When VCs are contemplating a potential investment in a startup, they typically consider a number of factors, including the size of the market opportunity, whether the product or service is significantly better than existing offerings in the market for at least some customers, the defensibility of the business (in other words, how easily could other companies create similar offerings), the growth rate and likely ultimate profitability of the business, and the strength of the management and technology teams. With regards to defensibility, startups can create competitive moats most commonly through unique technology but also by scaling fast enough to achieve network effects (where the product or service gains additional value as more people use it) or build significant brand equity.

When evaluating a startup looking to compete directly against a large incumbent, VCs will seek to understand whether the founder has a unique and important insight into the market which is driving the development of a differentiated product or service, whether she has crafted a marketing and sales strategy that will enable the startup to grow quickly, and whether the leadership team of the startup can execute nimbly against larger competitors. Startups building products that serve customers only marginally better than large incumbents will likely find it challenging to secure VC investment. Similarly, startups building superior products but competing in markets where incumbents are nimble and deep-pocketed may also find it difficult to secure VC investment.

The venture capital industry has diverse views on using antitrust against digital platforms

The venture capital industry has closely observed the increased scrutiny that large technology companies have received in recent years. Whether a company is large or small, these companies exist in the same ecosystem and impact each other in many ways. In fact, today's large technology incumbents were at one-point venture capital-backed companies and many of them now have their own venture capital investing efforts.

Recent inquiries by the Federal Trade Commission and the Department of Justice have been noticed by venture capitalists like myself, though there are diverse views about how applying antitrust law to technology platforms might help, hurt, or hold harmless innovative startups.

Certainly, there are some venture capitalists who have grown frustrated by practices of large technology companies that can have an outsized negative impact on startups. For example, through periodic changes to their algorithms, large technology companies that have significant consumer reach can dramatically affect overnight the traffic flowing to startup websites and mobile apps.

At the same time, other venture capitalists believe the startup ecosystem benefits in many ways from large technology incumbents. For example, these VCs point out that startups often view larger companies as potential customers or distribution channels, and that talented employees at these incumbents sometimes go on to start their own companies in pursuit of their entrepreneurial dream. Finally, M&A activity has always been an important avenue for liquidity for risk-taking entrepreneurs and investors, and as discussed below, it has become even more so in recent years, with technology incumbents the most active acquirers of technology startups.

Venture capitalists are not necessarily in one or the other of the two camps I have described. In my experience, the vast majority of VCs see both sides of this argument: we are passionate about the startups we invest in and want them to get a fair shake in the marketplace as they take on incredible challenges; at the same time we recognize that large incumbents sit adjacent to startups in the tech ecosystem and that action against these companies could have adverse and unforeseen consequences for young companies.

It is certainly appropriate for policymakers to pose questions about market power and examine abuses and, of course, to periodically ask whether various laws must be modernized for our times. In undertaking examination of this policy area, I encourage policymakers to recognize that the public markets are not nearly as welcoming to small companies as they once were, and indeed that many young companies cannot realistically achieve the scale necessary to become standalone public companies, which means that often M&A is the most viable pathway for a startup. If the government makes it more challenging for incumbents to acquire these companies, this will have the devastating effect of making it less attractive to launch a new enterprise and for people like myself to fund and partner with those companies. The end result will be harm to the American innovation economy.

In the majority of acquisitions the larger company is seeking to acquire a startup to complement an existing business or offer new services to its customer base. This activity has been commonplace in the U.S. since before the dawn of the modern venture capital industry. It is likely a minority of cases where an incumbent is engaging in an acquisition to directly stifle a future competitor—whether the incumbent is *currently* in that business line or intends to be in the future. Furthermore, at times, smaller competitors will merge in an effort to take on a larger competitor, and it is important not to stifle that activity either as these smaller market participants do not have the resources to participate in exhaustive government proceedings.

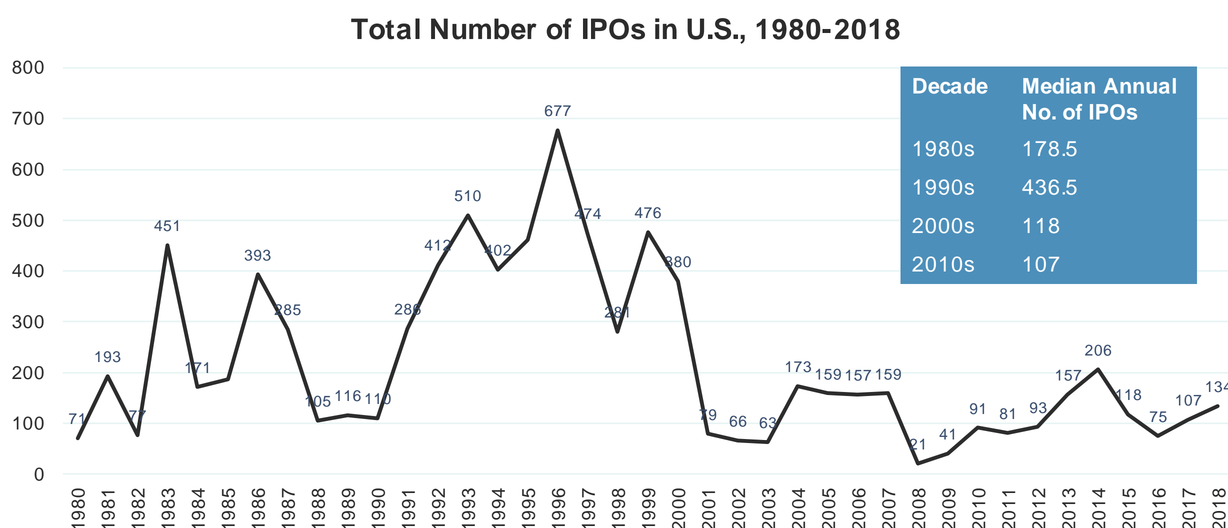
IPOs have declined as an exit option for startups; M&A activity is the dominant exit

The venture capital industry invests in less than one percent of all new businesses but invests in nearly *half* the companies that go public, thus closely linking our industry to the IPO market. From a public policy perspective, it is important that companies access the public markets because it allows companies to grow further as mature enterprises and gives Americans an opportunity to invest in these companies as they save for retirement and other purposes. Prior to 2000, it was frequently the case that more small companies (defined as those with less than

$50 million in sales) went public than large ones.[5] But this changed starting in about 2001, and since then most companies going public have been larger sized issuers.[6]

It has become more expensive and significantly more challenging to manage public companies; much of the infrastructure that supported small companies going public has disappeared, and the markets have become more short-term in nature. A 2017 presentation by Cowen showed that 61% of U.S. listed companies below $100 million in market capitalization did not have any research coverage.[7] The result is alarming: the United States now averages *less than half* the number of IPOs per year than in either decade before 2000. The lack of IPOs has been particularly glaring for companies attempting to go public with market capitalizations under $1 billion. As a result, there are now roughly half the total number of public companies than there were twenty years ago.[8]

The number of annual IPOs in 2000s & 2010s well below 1980s & 1990s



Source: Professor Jay R. Ritter, University of Florida

But this data does not tell the whole story. Technology startups have experienced the brunt of the harm to the IPO market. Tech IPOs experienced a steep drop off in 1999-2001 and have not never truly recovered; whereas biotechnology has remained fairly steady in the last twenty years and has seen an uptick since 2012.[9]

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[5] *Initial Public Offerings,* Professor Jay Ritter, University of Florida, April 2019, *available at* https://site.warrington.ufl.edu/ritter/ipo-data/
[6] Id.
[7] *Capital Formation, Smaller Companies, and the Declining Number of Initial Public Offerings,* Jeffrey M. Solomon, https://www.sec.gov/spotlight/investor-advisory-committee-2012/jeffrey-solomon-presentation.pdf (June 2017).
[8] Id.
[9] NVCA 2019 Yearbook, Data provided by PitchBook, *available at* https://nvca.org/wp-content/uploads/2019/08/NVCA-2019-Yearbook.pdf

Despite the shock to American IPOs, the amount of capital invested by the venture capital industry has grown steadily over time, from $37 billion in 2008 to $130 billion last year. M&A activity has become more important to the health of the startup ecosystem and the predominant venture-backed exit, with 779 M&As last year and the median M&A deal value reaching a 15-year high of $105 million.[10]

Recommendations for policymakers

As policymakers consider focusing antitrust law on digital platforms, I recommend they carefully consider three points.

•Policymakers should educate themselves on the broader aspects of new company creation. This incredibly unique and productive economic model is fragile and reliant on a number of factors for success. One small change can have huge ripple effects, and it is critical that policymakers consider the broader picture of the economics of the startup ecosystem before taking significant measures. I recognize that inviting me to testify at this important hearing is a sign of your interest in this area of the economy. I strongly encourage you to continue in this vein going forward.

•It is critical that policymakers understand that not all M&A is the same. As I stated above, often times an incumbent will acquire a company for its technical talent, for a new product that it can sell to existing customers, or to enter an entirely new business. In these situations, the government should not seek to stifle or slow those transactions. In other situations, an incumbent may acquire nascent competitors (that may or may not have been on a trajectory to become successful standalone companies) in order to foreclose future competition. These situations may merit closer review but could have the unintended consequence of dampening the creation of and investment in companies that seek to directly challenge incumbents.

•As changes to antitrust laws are contemplated, I encourage policymakers to act deliberately, as changes could produce many unforeseen consequences. As discussed above, the reduction in IPO activity is an alarming trend and I hope that Congress, as well as executive branch agencies, will take action to help reverse the trend. I commend Securities and Exchange Commission (SEC) Chairman Jay Clayton for his focus on this topic. But even the best of efforts will not open up in the short-term. This means that for the time being the venture and startup ecosystem must rely heavily upon M&A activity for exits. Without this option, investment into startups will suffer and cause a massive drag on innovation and new company formation.

In closing, I thank the Committee for its attention to this important topic and hope I have helped to educate policymakers on important distinctions as it considers action.

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[10] Id.