

# DAVID T. MORGENTHALER'S SPEECH TO

**Baldwin Wallace College**

**March 23, 2006**

Thank you, Peter –

Like many things in life, this all started out very quietly. At a Blue Ribbon Commission meeting for the County Commissioners where we were trying to advise on Regional Economic development, Peter Rea and I got to talking about business ethics – his field. He asked if I'd come out and speak to the students on the subject. At first I demurred, because at my age, I'm trying to avoid any work I can. I only work 7 hours a day now – you know – ½ time. I mention that to my full-time partners, but they don't seem to get the message. They think 10-12 hours per day is enough.

Anyway, Peter suggested I add in some Regional Economics, and then when I get the announcement, I am shocked to find I am giving the Kamm Lecture, and a lot of high-priced business executives are invited. Worst of all, several of our own people at Morgenthaler are taking advanced courses at Baldwin-Wallace and might be here. This could be embarrassing! I can't just shoot the bull with this group. Peter has out-witted me, and I have to do some work.

So, what can we talk about that makes up for your missing a good evening in your easy chair in front of the TV? I understand your Center has to do with business, science, and ethics. Those are critical elements of the venture capital world I live in, and let's touch on them in that order.

First, about the business of the economic development of this region, which is of vital interest to everybody who lives here. The newspapers have been full of our problems – stagnant population growth, loss of good manufacturing jobs, bad weather, a brain drain of bright students, aging infrastructure and housing, a poor K-12 education system, etc. All these problems are true and real. But, is the cause that, as a lot of people in our region have said, “Oh, if only the river had not caught on fire.” or, “We just need a good advertising slogan.” or, “Why doesn't The Plain Dealer stop writing those critical articles? Everything would be all right then.” I don't think so. I very much don't think so! I think The Plain Dealer is calling the situation as it sees it, and that its call is just about right.

47 years ago I moved a company to Cleveland, and the city was a world-class manufacturing center. It isn't today, and it is moving toward being a nice regional distribution center with significant manufacturing activities. That isn't all bad – such centers can be very nice places to live with lots of amenities that make life pleasant. But, with that approach, you don't stay world class – so we have to decide what we want to do, what we need to do, and how to implement it.

Some think the arts, our orchestra, drama and other culturally enriching things will save us. Some think amenities will bring the creative people flocking here, and they will innovate ideas that will rejuvenate this region – like coffee houses – just line up 50 Starbucks on Euclid Avenue, and you will revitalize downtown. Try reading Richard Florida’s “The Rise of the Creative Class.” He’s a friend – I helped him with his first book, and he says nice things about me on national TV, but I don’t agree with the conclusions people are drawing from his work. 50 Starbucks – even if you COULD get them – will NOT save us. Only high class jobs for creative people will bring them here.

Let’s learn a lesson from history. In the past, economic growth of a region in a free market society has seemed haphazard – a result of a seemingly accidental coming together of a variety of factors at a particular point in time.

We call these factors economic drivers and growth does not happen without them.

The factors that came together to drive North Eastern Ohio, as we all now know, were cheap water transportation, ready availability of the raw materials for metal-making, and the immigration of some people who knew the technology of metal. These factors enabled everything that happened. The demand that used these metal-making capabilities came from the development of first the steam engines that enabled railroads, and then the gasoline engines that enabled



automobiles. The gasoline engines were made possible by the discovery of petroleum in Western Pennsylvania about 1857. This was originally used to build the kerosene lighting empire that became Standard Oil. Originally the demand was strictly for kerosene, which made John D. Rockefeller rich. Gasoline was a dangerous and unwanted by-product. But technology advanced, and the gasoline engine enabled 2000 buggy-makers across the country to become automobile manufacturers – with only three now left, plus the foreigners. All the supporting industries of rubber, glass, machine tools, and nearly everything made out of metal arose to take care of the demand created by automobiles. Polymers followed later.

People moved into the region to fill the jobs all this created. Retail businesses, banks, lawyers, services, hospitals, and entertainment were set up to service these people. The wealth brought into the region founded and supported cultural institutions. Colleges to teach the people and train engineers were funded. Surrounding farms fed everybody.

In the end, it is the growth of attractive jobs that drives population growth in a region, and it is the export of goods and services from the region bringing back money that stays in the region – that builds up the wealth of the area. If the region does not export more of something – goods or services – for which it gets paid more than it imports, it will inevitably get poorer. It is as simple as that.



In Northern Ohio we lived on metal making and metal fabrication for over 100 years – we were fat, dumb and happy, and now these industries have leveled off or are actually declining as happens in any mature industry. We have done far too little to replace them. Beyond these two, we never got the critical mass to be world class in any significant industry sectors – it didn't seem important to the regional leadership. The good businessmen did what they had to do to make their own businesses grow, and those who didn't, declined or failed. No one planned remotely adequately for the region.

When young people graduated from high school, there were good paying jobs available in these mechanical industries that didn't require college educations, so there was less of a drive to get higher educations for children. Our unionized labor forces were probably the best paid in the world, but the costs made us less and less competitive.

We know from Russia and other state dominated societies that centrally planned economies do not work well, but in our region we have gone overboard in the other direction. While growing areas like Austin, Texas and the Research Triangle of North Carolina put in regional development plans 45 to 50 years ago, Northern Ohio started one last year. Silicon Valley started trying to improve its economy in the late 1930's, and got great impetus in 1957 when the semi-conductor industry moved in. Boston got its economic driving forces with the

industries born after WWII. Northern Ohio effectively missed the electronics boom – the economic driver of the economy for the last 40 years.

What went wrong? Our poor climate? Nonsense. I visited Palo Alto – what is now the heart of Silicon Valley – in 1949. I was a young engineer from Erie, PA, giving technical lectures to the power plant people up and down the West coast. Palo Alto housing was cheaper then than in Cleveland – today it is 3-5 times as much. Stanford was turning out bright electrical engineers, but there was a brain drain. Why? They all moved east, to lovely climates like Schenectady, Pittsburgh and Northern New Jersey for the good electrical engineering jobs at GE, Westinghouse, RCA, and the other electrical companies. So much for climate. I thought of moving my family to Palo Alto in 1949, but I didn't want to pick fruit or raise vegetables for a living.

What changed things? Stanford University was desperately trying to build local industry firms from the 1930's on, and got some small ones started. But the real break came in 1957, when Bill Shockley moved from Bell Laboratories in New Jersey back to Silicon Valley, bringing the semi conductor (which he had co-invented in 1947) with him. The semi-conductor is the story of the 2<sup>nd</sup> half of the 20<sup>th</sup> century. It enabled computers, telecommunications, mass television, and facilitated almost every device we use today. Cleveland, Buffalo and the other so-called Rust Belt cities missed practically all of it, and didn't realize what was



happening. Then the San Francisco area did another good thing. The nature of DNA was discovered at Cambridge University in England in 1953, but in the 1970's at Stanford and UCSF, came the discovery of how to do something useful with this information, and the biotech industry was born in the San Francisco area. Effectively the Rust Belt cities missed this also.

Industries mature. When they do, innovations that make people want more of their products slow down. If the new and growing industries go elsewhere, a region's growth slows down. As industries age, their costs rise, and a region becomes less competitive. Lower cost regions get the new plants. Now with modern transportation and telecommunications, most regions have to fight global competition. Like it or not, that is the reality, and it won't go away.

A few facts about institutional venture capital firms like ours. When Ohio was great 100 years ago, there were no such firms. Individuals, companies, and banks financed growth. Institutional venture capital began at the end of WW II in New York and Boston, and was small until the late 1970's; California had none until the semi conductor came. The money that financed the original semi-conductor activity came out of New York and Los Angeles. The reality is venture capital follows innovation; it does not cause it.

I founded my firm 36 years ago in Cleveland, and today we are one of the most national firms with offices in 5 cities where we believe most of the



innovation will take place. We have a large early stage venture capital office in Silicon Valley in the center of a 2-mile cluster of the greatest venture capital firms in the world. In this center of competition we get more opportunities than in any other city of the world, because the area still has the leading cluster of new industries, and produces more innovation than anywhere else on earth. Fifty years ago, when Cleveland was probably near its peak, there was no Silicon Valley, housing in Palo Alto was cheap, traffic was light so the climate was even better – just few good jobs. I repeat – they are the economic drivers.

A few words about venture capital. There are about 700,000 new companies formed every year, counting all the 1 or 2 person small companies. Institutional venture capitalists fund only about 1000 new companies, or 1 in 700. The number is not very precise, but whether it is 1 in 500 or 1 in 1000 is not the key. Venture capitalists look for opportunities they believe can become big – so a disproportionate share of the high growth companies is funded from our industry.

What can our region do to improve things? Obviously, like all older regions, we have a whole variety of human and neighborhood problems that our governmental organizations have to deal with every day. I am not trying to talk about those, but I don't think they are the cause of our decline.. There is only time for me to touch on creating new jobs by trying to develop the new high growth industries, as many other regions are trying to do.

As we said, in 1957 Austin, Texas put together a plan for growth. Today, they have become a dynamic center for new industry, several times the size they were then. The Research Triangle in North Carolina did the same, and a strong growth followed.

Northern Ohio is belatedly getting its act together. Many are beginning to realize we cannot keep riding on the past.

No one knows for sure what will be the high growth industries of the future, but it seems clear that technology will drive most of them.

We must support and strengthen our research universities, and also demand they keep improving on technology transfer. They cannot afford to think like dreamy ivy covered colleges out in the woods – they must get into the 21<sup>st</sup> century as economic drivers, like M.I.T. and Stanford.

We must improve our schools and demand our children study and behave better. The public schools I went to 75 years ago would not have tolerated today's behavior for a minute. This is a major problem for parents as well as teachers, and the school system cannot do it all. Our society must demand its children behave and perform better – or the Asiatics will beat us in high technology as well as low-cost manufacturing.

We must think regionally – not municipality against municipality. We must realize the enemy is not the next suburb or Akron, but rather is Boston, San

Francisco, Baltimore and the newer cities, and we must unite to fight them for the research dollars that come out of Washington.

We must quit fragmenting into so many small organizations that never get to critical mass, and unite into larger effectively run organizations. The Cleveland area is known for its many small firms – that is partly good, but some things require larger mass. The consolidation of organizations into the Greater Cleveland Partnership is long overdue and gives me hope. Nortech is the first step I have seen toward a technology plan for the region, and it must be supported. JumpStart is the most promising incubator we have seen in the region.

What action steps do I recommend? A lot is starting to happen – carry it out. Make sure the following is accomplished:

- A regional organization is in place charged with preparing a Regional Economic Development Plan – Is NEO or GCP it? Quit competing locally – the outside globe is the challenge. Unite.
- A Technology Development Plan is prepared. Nortech is a start. Who is responsible for a plan?
- Everybody is responsible for thinking regionally. There is no such thing as only leaking in your end of the boat. Foundations (thank God) are now paying major attention to economic development.
- Strengthen education at all levels – and be dead serious about it.



- Make sure the research universities feel a duty to innovate, and have strong technology transfer functions. Then support them.
- Do what we can to hold existing businesses and attract new ones – and realize this is limited. Businesses will do what they must do to survive in a competitive global market.
- Promote health care services and medical products. This is where we have a relative advantage. Follow up on nanotechnology, MEMS, fuel cells, alternative energy and any other new technologies as they emerge and try to develop a comparative advantage.
- Most growth in the future will be technology driven because that is where innovation will come from. The key to industrial growth is innovation – real innovation – not climate and not just amenities. If we can produce really exciting new technology or concepts, venture capital will be there. I repeat – a misconception is that venture capital causes innovation – it doesn't, it follows it – anywhere and everywhere.

What about science? It teaches us to understand how the universe works. It enables technology – which is the application of science to provide something mankind wants. Then innovation is the process of thinking up something NEW mankind wants, or will want and can pay for when he sees it. Innovation may be technology based, or it may not, but in the future increasing amounts will come

from technology. The wheel, the paper clip, the tin can, the mold board plow, the ballpoint pen, and the many other simpler innovations you use everyday have already been invented, and most of the new things we are buying come from – or are enabled by-technology.

So, we'd better all pay more attention to science and technology – it's our hope to maintain our leadership in living standards, and China and India have started to train a frightening number of engineers and scientists.

Our 3<sup>rd</sup> Point – Business Ethics. What advice should we give to college students about ethics?

This is the point of view of a venture capitalist whose firm has invested in more than 225 companies and experienced only about 6 lapses (at least that we know about). So, we picked ethical people to manage our companies about 97% of the time. We must be good judges of character. That's a pretty high grade – an A in any course. But – and it's a Big BUT – the ethic lapses of those managements cost our firm over \$100 million in profits attained, but not yet cashed in. I may be a slow learner, but losing \$100 million will teach even me something.

All managers were, of course, fired. Some were censured by the SEC, some went to jail (shockingly a couple were PhD's) and one died. I was asked if I had him killed. My flippant answer was NO – he died from natural causes before I could arrange it.

So, how should we advise our young people about business ethics in a world where the press is playing up sensational stories of the people who have profited from illegal or highly unethical business practices, or made huge money in sports while using banned drugs, or made improper political contributions to land government contracts? When we tell our young people to play life straight, are we being realistic? Are we being fair to them about what they are going to find? I think we are, and in a minute I will try to tell you WHY.

I have lived in the world of entrepreneurship and venture capital continuously for the last 61 years. Before that, it was school, big corporations, and the Army. An entrepreneur must see unfulfilled opportunities that others have not seen, find ways to fill them, believe that he or she can accomplish this, and then go and DO IT! Without energetic execution, nothing gets accomplished. A venture capitalist must be an optimist, or he will never make the risky investments he undertakes and persist in the face of the losses he sustains. But, the venture capitalist must temper his optimism with a strong dose of realism, or he will NOT survive. The world has many impractical dreamers, wildly over-optimistic entrepreneurs, and a number of just plain charlatans that are out to cheat anybody they can.



Our young people must see realistically the kind of people they are dealing with and be guided accordingly, just as a venture capitalist must judge the people he is considering investing in.

Now probably some of you are thinking to yourselves “What kind of baloney is this old guy trying to hand me? Does he think I’ll believe that venture capitalists are a bunch of goody two-shoes? Then why are they sometimes called *vulture capitalists*? Everybody knows they’re a tough-minded bunch that are just out to make money!”

Out to make money? You bet we are!

The pension funds and endowments whose money we manage are counting on the profits we make for them to help pay the salaries of professors, the scholarships for students, and the pensions of retired employees; and if we don’t perform, they’ll fire us the first chance they get. Mercy is not a word in their vocabularies, and their alphabet has only 3 letters – IRR. For non-finance people, that means Internal Rate of Return, which measures how much profit you’re making on your money. These are our customers, and every single one of them knows how to figure IRR’s. And, every quarter we have to submit figures that are our report cards on how we’re doing for them.

Venture capitalists have to take risks on technology, markets, and the skill of honest, well-meaning managements. They know enough not to knowingly add

character risks – they lose often enough, backing honest, well-meaning people who are doing their level best and working really hard. If your character is judged doubtful, your chances of getting any financial backing from any good professional venture capitalist is usually No Way in Hell – no matter how good your deal sounds. And, the fact you seem really smart won't help if he doesn't trust you. The venture capitalist knows the chances are all too good you'll use those brains to cheat him at some point.

This isn't a new idea. Old J.P. Morgan, whom God knows was tough, realistic and smart, was testifying before Congress in the early 1900's. Somebody asked what was the important factor in getting credit, implying Morgan lent only on security and didn't really care whom he lent to. Morgan thundered his answer. "Not all the bonds in Christendom are enough to get me to lend to a man whose character I don't trust." And I, for one, believe Morgan meant it. The bad guy will find some way to cheat you. Life is too short to fool with such people. I've known several of the great financiers of our time – and a couple of the worse charlatans. I'm glad I can honestly say that I've never known any of the great ones to be involved in anything bad. They're smart, yes, they're tough-minded – don't let me mislead you – I don't want to be buying when they are selling – but they are legal and ethical. As to the charlatans, I just learned last month that one of the biggest ones I've ever known finally ended up in one of the most unpleasant jails in the



world (not in the U.S.) after cheating a lot of people and even looking smart enough to get away with it for a long time. The mills of the gods grind slowly, but they can grind exceedingly fine.

So, where does this leave our advice to young people? My answer is to try to work for people whose ethical values match or exceed yours. If you misjudge an employer or find yourself in a situation where you're pressed to compromise sensible ethical values – much less laws, try to change the situation. If you can't – and often you won't be able to – get out as quickly as you can. It may be hard in the short run to give up an attractive or well-paying job just because you're suspicious of your company's legality or ethics, but if the situation smells bad, and you can't fix it, GET OUT. Whether to be a whistle blower is too complicated a subject to deal with in a speech, but in any case, don't stick around to get mud on yourself – or maybe much worse. In the long run, you'll usually be very sorry.

Now how does all this ethical talk fit with the real world?

My experience as an Army company commander for more than 4 years in WWII in the United States, Africa and Italy taught me some lessons. In the course of commanding over 1000 men in 2 companies in Africa and Italy, as well as in the U.S. – all draftees who didn't want to be there – not a volunteer among them, I made it my business to try to get to know each man personally and study them carefully as individuals. To generalize from what I found, about 75% of people are



essentially good and want to be constructive and stay out of trouble. They make some mistakes and get off track, but mostly they are pretty good humans.

About 20% of people don't start trouble but are easily led into it. They are willing to believe "Everybody cheats – it's OK. You're not really doing anything bad." And, so they can be led into bad practices.

About 2-3% were real criminals. Their brains were just wired differently. Their value systems just told them to do anything they thought they could get away with. Fear was the only way to control them, and their promises meant absolutely nothing.

I haven't found civilian life too different from this experience, though I've never seen formal studies of any such groupings of people. There are a few people that think anything you can get away with is OK. If we can believe the press, one of the Enron executives said in school that it was up to the regulators to enforce the laws – he'd do anything he thought he could get away with. If true – and I can't guarantee that, though I have also heard it from others – is it a surprise that Enron happened? And, how many people today bitterly regret having anything to do with that set of values? If my firm thought a person felt that way, he'd never get hired, and we would never invest a dime with him.

The word "integrity" gets used a lot. What do we mean by it? To me, it means that you have what most of us would agree is a good set of principles, and

you can be counted on to live up to them, no matter what the temptations are, or how tough the situation is. You won't lie, cheat, steal, break laws, do insider trading, or act unethically, no matter what. You may make mistakes, but you will never knowingly give us a bad fact or wrong number. Your word is gold. We write contracts down so there is no misunderstanding, and because perhaps others will have to implement them, but we don't have to worry about your going back on an agreement – and we would never do it to you. Those are the kind of people we want as partners and employees.

Is this emphasis on integrity and trustworthiness actually worth anything in the real world? Or will we just sleep well now and have to wait for our other rewards in Heaven, while others get richer here on earth?

We have anonymous surveys done from time to time to see how our firm is viewed in the industry. Happily, we've always been in the top 25 overall, usually in the top 10, in some categories in the top 3 or 4. We're still struggling to make No. 1.

But in one category we are always one of the top 2 or 3 – that is in trustworthiness and honesty. And, has that meant any money to us? You bet it has. Millions! How? In 2001, after the dot.com crash, we were able to raise a very large fund, \$850 million. After the crash, many venture firms were asked to give back large parts of the funds they had raised, reducing their fees by many

millions. We were merely asked whether we honestly believed we could still find opportunities to invest that much money profitably. When we told our investors we believed we could, no one asked for his money back. That's about as practical a demonstration of the value of honesty and being trusted as I have ever seen.

Further, advice to college students – Big article in the NY Times recently – over 50% of the people lie on their resumes. Don't do it. Some of us check.

It is one more place where we can tell whether you will lie to us, and if we think you will, even on little things that don't matter much, you are a lot more likely to lie to us when really bad things threaten. Business problems are often like a small leak in a boat – easily fixed if you catch them early and can practice damage control, but disastrous if somebody denies them, and you don't learn about them until the boat is full of water.

We knocked out a candidate with a great resume for president of an exciting company recently because he said he graduated from a college he had only attended. Our recruiter we were paying over \$100,000 missed it – but we didn't. Probably it would have made no difference, but showed he will lie to us. What will he tell us when bad news comes in on a clinical trial of a new drug? Trust is critical. Many people are sloppy about checking references – the best firms aren't. I ask a lot of questions I already know the answers to, just to see if the interviewee will lie or bluff.



I've found the hardest thing in life is getting good advice. Why do you have trouble getting good business advice? Because those that love you usually do not know, and those few who really know do not usually love you. Nobody wanted good things for me more than my Mother – bless her Sainted Heart, but her business advice was terrible, and fortunately I ignored it.

So what do we take away from all this?

If the region (and America for that matter) is to maintain its economic edge, it must innovate products, services, and ways of doing things. The poorer parts of the world are studying us, emulating us, and mean to catch us and pass us up economically if they can. They have no reason to feel it is our God-given right to be richer and superior. We are not paying enough attention to this danger to our future.

Most of the future desirable innovations will probably be technology driven. Most of the things we have bought recently are technology enabled – Computers, I-Pods, cell phones, games, cable and satellite – you name it. We must stay ahead in technology and innovativeness, or our living standard will not progress. This takes motivation of our children, education, research funds, sensible laws and tax structures.

Remember, our soldiers are brave and well-trained, but it is the technology advantage that has made the huge difference in army to army combat in both Gulf wars.

One of America's great commercial and investment advantages has been the relative transparency and honesty of our markets and business institutions. We should punish severely those relatively few who abuse this, while leaving the system as free as possible to adjust to the demands of consumers and business buyers.

The U.S. faces great challenges, but oh how I wish I were a middle aged man of 60, a young man of 40, or a boy of 30 to live in what is coming. And, to be younger than that, the world ought to be your oyster.

Thank you.