

Investing in semiconductors poses challenges to Israel's VCs

Some VCs are finding it increasingly difficult to make investment decisions in favor of semiconductor firms. Zeev Holtzman, founder and chairman of Giza Venture Capital, examines the changes in the industry that in the past produced numerous "winners" for Israeli venture capital investors.

Israel's semiconductor industry has been among the most active and successful sectors in Israel over the past two decades. It has experienced many successful exits. Some companies went public, while others were acquired – and several of these exits have had handsome valuations.

New challenges arise

Fundamentals in the industry have changed in recent years, raising certain obstacles to investment. These impediments are by no means deal killers and certainly do not mean that VCs should look to other areas of investment, but they do present challenges that must be addressed. Here are some of the issues that the industry and its investors face:

- Competition has grown much stronger, especially from the Far East. Although new developments and state-of-the-art technologies are still coming from the US, Israel and Europe, the powerhouses of China and Japan are becoming more innovative in their approach to new start-ups.
- The amount of capital that must be invested in semiconductor start-ups is much greater today than it was only a few years ago. Most industry

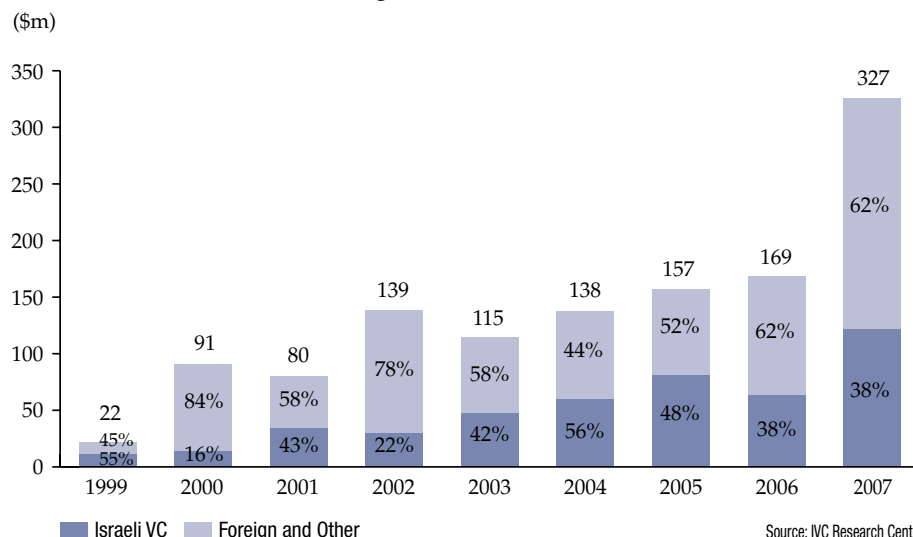
analysts believe that \$40-\$50 million or even up to \$80 million is sometimes required to finance a company to the point that it reaches sizable revenues and is attractive to acquirers.

- VC funds must carefully consider a potential portfolio company's capital requirements in follow-on rounds, especially if the VCs want to avoid substantial dilution down the road. Generally, VCs want to maintain a 20-25 percent interest in their portfolio companies, which often means that VCs must allocate as much as \$20-\$30 million for follow-ons over the life of an investment in order to reach the point when an acquisition of the portfolio company is feasible.
- The exchange rate between the dollar and the shekel is putting the squeeze on semiconductor firms. Salaries constitute the largest single expenditure for early stage semiconductor firms. The devaluation of the dollar against the shekel means that the cost of engineers in Israel is no longer relatively inexpensive. Another way of looking at the situation is that a new start-up needs 30 percent more than in did previously to finance the same activity level. Capital efficiency has long been among the principal advantages of local technology development. Now this particular advantage has been eroded.
- Potential acquirers are more cautious when making acquisition decisions. They're willing to wait longer and are less inclined to pay hefty sums that characterized acquisitions in this field in the past.



Zeev Holtzman

Capital Invested in Israeli Semiconductor Companies by Israeli VC, Foreign and Other Investors



Source: IVC Research Center

VCs respond to the new playing field

- VC funds are continuing to consider investments in the semiconductor sector, but they are trying to form syndicates from day one. It is common to see two or three funds make joint investments in round A in order to ensure future support of a company.
- VCs are focused on semiconductor firms that have the potential to be leading players in a specialized, but substantial niche.
- VCs have learned to be patient and not rush to exit. VCs nowadays prefer to wait until a portfolio company reaches its potential at the commercialization stage in order to increase exit valuations.

From my perspective, semiconductor investments must still be viewed favorably. Israeli entrepreneurs continue to exhibit remarkable innovation, with their know-how benefiting from global companies that operate in Israel as well from their military experience. In terms of management capabilities, managers in the semiconductor sector have shown strong competence and proficiency – more so than managers of other sectors. There is a substantial pipeline of attractive semiconductor companies headed by second and third time entrepreneurs, preparing to impact the industry with their latest technological ideas and advances. VCs, in my opinion, would be wise to consider backing them. ■