

Meeting challenges to ensure future growth

Maintaining the positive momentum in Israel's venture capital and technology industries is crucial, maintains Zeev Holtzman, Chairman and founder of Giza Venture Capital. He discusses Israel's past achievements and the factors that sparked its success.

In Israel we have a double celebration this year. We are marking 60 years since the establishment of the modern State of Israel. At the same time, it is the 15th year since the rise of Israel's venture capital industry, which, like the State of Israel, has had extraordinary accomplishments in its short history.

The VC industry cannot afford to lower its guard. The current economic slowdown could, for example, impact high-tech industry. We might also expect high-tech investment in 2008 to slip somewhat, perhaps to \$1.5 billion, although that is still a respectable level. I remain cautiously optimistic that fund managers, entrepreneurs and overseas investors will use their experience and insights gained from the 2000/01 crisis to face any potential obstacles. Dealing wisely with developments, will enable the venture capital and technology industries to continue their growth and development over the long term.

So, as Israel's venture capital industry moves on to its next phase with new challenges and opportunities on the horizon, it is appropriate to examine how we reached this point and look at the factors that have characterized the industry's success.

In the beginning...

In 1993, the Israeli government sponsored a program called Yozma – which translates into the word "initiative" – to encourage private investors to establish venture capital funds. With \$100 million, a government-supported investment company was set up with 10 "drop down" funds that each had capital of \$20-\$25 million. Investors in these drop down funds partnered with the government, but were granted the right to purchase the government's interest within five years at pre-determined conditions. Most did buy out the government stake, effectively jumpstarting a venture industry that today is regarded as one of the most successful in providing young vibrant companies with their required start-up capital.

Past decade scores major achievements

Let's look at some of the results, which to my mind are truly incredible. In the last decade, Israeli venture firms raised some \$12 billion. In the same period, Israeli technology companies attracted \$15

billion, which includes funds raised from both local and foreign investors. Venture capital-backed companies raised \$4 billion through initial public offerings on the world's stock exchanges and attracted a whopping \$27 billion in merger and acquisition activity.

Israeli companies have become especially familiar to NASDAQ investors. In fact, today on NASDAQ, there are more Israeli companies trading than firms from any other country outside of the United States and Canada.

Emergence of industry leaders

Many global technology leaders have originated in Israel. For example, Israel has produced Amdocs, Check Point, ICQ and Mercury in the information technology and Internet areas; DSP, M-Systems, Orbotech and Zoran in semiconductors; Comverse and Verint in communications; and Given Imaging, Teva Pharmaceutical and Medinol in the life sciences. Some of these companies have been acquired and now continue to operate in a different form and shape under their new corporate parents.

Israel compares favorably with US, Europe

While Israel is relatively small in terms of its population of seven million, there is no denying that it packs a strong investment punch. In 2007, total venture capital investment in Israeli companies reached more than \$1.7 billion. In the United States, the venture powerhouse of the world, with a population of about 45 times that of Israel, total venture investment was \$30.3 billion. Another way of looking at it is that Israel has just two percent of the population of the United States but has received venture investment equal to 5.6 percent of that of the United States.

Comparisons with individual states are also of interest. Israel ranks third in venture capital after California and Massachusetts and ahead of states such as New York, Texas and New Jersey. Set against European countries, Israel ranks a close second to Great Britain and far outpaces other countries including France, Germany, Sweden, Denmark and Switzerland.

Foreign investors take to Israeli innovation

Why did Israel's venture capital industry develop so rapidly and successfully? The answer of course is that it had a good product – Israeli technological innovation – in which to invest. As more and more success stories began to emerge from Israeli industry, increasing numbers of overseas investors wanted to be part of process,



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making it easier for new venture funds to be formed and for the existing funds to raise follow-on funds. Foreign institutional investors are the main shareholders in Israeli venture funds. Traditionally, there has been little participation from Israeli institutional investors, partly due to structural reasons and partly due to a slow-moving, built-in conservative approach to investing. While this has begun to change in recent years, foreign investors continue to supply the bulk of funds to all of Israel's leading venture capital funds.

Numerous factors spark success

Israel's technology industries developed rapidly with venture capital-supplied funds, but their success has been due to more than just available funds. Several factors converged over the past 15 years to account for the strong performance of Israeli companies:

- High quality human resources must be ranked at the top of the list. Israel's leading universities and research institutes have turned out top flight engineers and entrepreneurs in a variety of key disciplines. The influx of well-educated technically oriented immigrants from the former Soviet Union that began in the early 1990s and continued throughout that decade added to the pool of talent. Many of Israel's entrepreneurs got their start in the military, which permitted young researchers to acquire knowledge and hone their skills early and in a real-life setting. Israel ranks number one among the world's leading economies with 135 engineers per 10,000 employees. This compares with the US which follows with 70, Japan with 65 and the Netherlands with 53.

- Also key to the development of industry was the entrepreneurial culture that developed, patterned after that in the West, principally the United States. The fact that this spirit could develop from a socialistic oriented society, which dominated the early years of the State, is particularly remarkable.

- In the 1970s and 1980s, the only technology of prominence in Israel emanated from the defense industry. A strong push to convert and transfer defense-related technologies to commercial applications was unusually successful. The success of Israeli companies in the communications and software fields, for example, has resulted from adapting a wide array of military expertise and products to civilian uses.

- Global technology companies have recognized the advantages of Israeli human resources and innovation, leading many multinational technology firms to establish operations in Israel. Motorola, Intel and Applied Materials are among the world leaders to establish major corporate research centers in the country. Not only have these companies benefited from Israeli brainpower, but these companies have contributed strongly to the Israeli economy, bringing in management expertise, market knowledge and the business perspective of highly accomplished firms.

- The successes of the past have enabled in Israel a critical mass of capital, investors, VC funds and start-ups – all the ingredients needed to maintain the strong flow of financing for the establishment and growth of new companies.

- The Israeli government has taken a positive approach to research initiatives. It has several programs to encourage industrial research that generally include the sharing of research expenses for approved projects. Moreover, it supports binational research and development programs and participates in cooperative inter-nation programs, such as Eureka, that help keep Israeli R&D moving into new frontiers. Company R&D spending has been a prime factor in generating advanced technology.

- Government support has also been present in other ways. Israel maintains modern legal and financial systems. Its

favorable tax regime with zero tax for foreign investors in VC funds and export-oriented industries holds important appeal.

- Some venture funds in Israel have been reluctant to fund seed stage companies, preferring the lesser risk of investing in companies that have reached several milestones or have attracted customers or partners. One means by which the deal flow of young companies has been maintained is through a government-supported incubator program, which has provided new entrepreneurs with administrative help and handholding and has enabled budding entrepreneurs to focus their efforts on developing their ideas, before emerging into a competitive commercial environment. From the program emerged many firms that eventually went on to attract venture capital and become commercial successes.

- In recent years, the original government-supported incubator program has, in part, given way to the private sector. Many of the incubators have been sold to private investors or funds that have greater resources than the government and the ability to provide a wider range of services to incubated companies. Some of the incubators have been floated on the Tel Aviv Stock Exchange in share offerings that helped raise required development stage capital. This phenomenon has helped increase high-quality deal flow.

- Overseas venture capital firms have made direct investments in Israeli companies. Attracted by the high level of innovation and opportunities in Israel, foreign VC firms have taken one of several investment approaches to Israel. Some, such as Benchmark, Sequoia and Greylock, have established Israeli dedicated funds with domestic Israeli management and have led investments or have co-invested along with Israeli funds. Others, such as Accel Europe, Partech and Bessemer, have made allocations to Israel from their general funds and have opened an Israeli office or use Israel-based representatives to advance their investment program. Typically, these co-invest with Israeli funds. Foreign venture funds have accounted for more than 50 percent of investment in Israeli technology companies for the past several years. Generally, foreign fund investment is viewed as complementary to Israeli fund investments, not competitive.

- Corporate VCs have made important strategic investments. Intel Capital, Motorola, Siemens and Johnson & Johnson have been among the more active investors in this category, making investments based on their own corporate requirements and visions for the future.

- Israeli opportunities have emerged in a variety of sectors, keeping pace with the demands of global markets. While Israel had been at the forefront of Internet technologies, for example, the bursting of the Internet bubble in the 1999-2000 period resulted in subsequent investor reluctance in all technology areas. When investors returned to the market, Israel was able to present appealing opportunities in other sectors such as the life sciences. Today, as the Internet has reemerged as a favored sector and as cleantech has attracted a rush of attention, Israel has scores of interesting, innovative candidates that are ripe for investment.

Savvy investors will still choose Israel

I believe we will continue to see favorable development of Israel's venture capital industry. Leading Israeli VCs have raised, or are in the process of raising, a fifth generation of funds. While some investors are eyeing Asia for new opportunities, many experienced investors understand that leapfrog technologies won't be found there. They are instead interested in the potential of the huge Asian markets. Savvy investors – those wanting to find the next technology megastar – will assuredly be keeping Israel squarely on their radar. ■