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Israel: Much More Than Just a Start-Up Nation

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There is a vast difference in potential risk and return with start-ups vs. established companies. Start-ups typically bleed money while they are getting off the ground. Venture capitalists expect to lose their entire capital investment in the majority of companies they finance. To offset the many losses, they hope for a few gigantic wins. The big wins usually take a number of years before early investors can liquefy their holdings.

Stock markets certainly fluctuate, often wildly, but they reward patient investors who buy solid companies at reasonable valuations. Israel offers many such opportunities without the substantial risks associated with start-ups. The rags-to-riches stories of many high-tech entrepreneurs are certainly enticing and the story of Israel as a "Start-Up Nation" is both true and something of which to be proud.

Authors Dan Senor and Saul Singer effectively outline the underlying reasons for Israel's growing high-tech prowess in their bestselling book *Start-Up Nation: The Story of Israel's Economic Miracle*. Some of the key factors cited include military necessity since Israel needed to fight smarter to compensate for its numerical disadvantages in troops and materials. Ancient Jewish values of questioning and debate merged with a diverse immigrant population brimming with intellectual ferment. Another important factor was Israel's pioneer heritage which fostered an egalitarian culture often disrespectful of hierarchy or received wisdom. Mixed in were supportive government policies, strong science and technology education and appropriate legal institutions, all of which promoted and financed high-tech entrepreneurs.

This excellent book, however, leaves out many important aspects of the story – both positive and negative. One of the most obvious positives is that some "start-ups" were so successful that they became large companies. Most of these larger companies continue to grow and innovate despite the fact that they are no longer start-ups. One of the negatives is that Israelis often create niche products in narrow market categories. This reflects the very same forces outlined in the Start-Up Nation book. Israel often needs to adapt other "platform" technologies such as Oracle databases, Cisco Systems routers, Apple smartphones or the Google search engine to its particular defense or business applications. As a small country, with a small market, it is very difficult for Israeli companies to develop platform products of their own. The economies of scale are simply not available.

Given these constraints Israeli start-ups fail at a very high rate and even successful companies often are forced to sell at a very early stage in their lifecycle. Add-on or niche technologies tend to have shorter lifecycles or create more economic value when integrated into a larger technological platform. The Israeli business press frequently laments this phenomenon. Fortunately Israel is enriched with innovative ferment that pushes its high-tech sector to overcome these disadvantages. When examined from a hard-nosed point of view as investment analysts, however, there is a great deal of activity that does not meet our investment criteria.

We do not want to be misunderstood. Israel's rise as a global technological power is genuinely astonishing and we believe it will continue. We merely think the huge risks associated with start-ups are better borne by the venture capitalists equipped to handle them. In this regard Israel is also blessed with a large and well developed venture capital industry.

From humble beginnings in the 1980's, Israel's high-tech sector is now quite well organized. Last year venture capitalists invested $2.1 billion into 546 start-up companies. To put things into perspective, California received $14.5 billion in venture capital funding followed by Massachusetts with $3.0 billion and New York with $2.2 billion. If it were a U.S. state, Israel would be one of the largest technology hubs in America! Similarly, Israel hits well above its weight on a global scale. Last year venture capital investments totaled approximately $5.0 billion in Europe, $5.0 billion in China and $1.5 billion in India. For a country of 7.5 million people it is remarkable to be in the top tier of the world's technological innovators. Obviously Europe with 400 million people, or China and India each in excess of 1 billion people should be expected to garner much larger venture capital dollars than Israel, but the gap is not very wide.

Israeli high-tech start-ups are most definitely "on the map." Interesting companies often receive rich valuations comparable to venture capital investments in Silicon Valley. Ironically, the same cannot be said for many mature companies traded on the stock exchange, particularly the Tel-Aviv Stock Exchange (TASE). Israeli finance is somewhat inverted relative to other countries. In most countries, start-up investment is almost a rounding error relative to investment in mature companies. In Israel, however, start-ups are a very significant percentage of total capital flows.

We believe Israel will converge with the global pattern over time as more Israeli technology companies mature. Despite the lack of media attention on mature technology companies relative to the exciting start-up stories, we believe there are good return prospects for investors with significantly less risk. Israel is an amazing country in many ways, and its high-tech flowering is certainly admirable. As pragmatic investors, however, we remain focused on basic fundamentals. We buy profitable companies with good balance sheets and solid growth prospects that sell for reasonable prices. We believe we will be rewarded over time for our efforts as will the State of Israel.