To exit or not to exit

That's the billion-dollar question. Israel prides itself on being the start-up nation, but many contend that it would be better off creating its own homegrown multinationals.

By Ora Coren | 02:50 29.09.12 | 0

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All of Israel was aflutter in July 1998 when Mirabilis, a start-up company founded barely two years earlier, was sold for the then outrageous sum of $407 million to AOL. The deal turned Mirabilis founders Arik Vardi, Yair Goldfinger, Sefi Vigiser and Amnon Amir, all in their late 20s, into celebrities.

The torrent of start-up exits that followed earned Israel the moniker "start-up nation" and turned it into a model for other countries trying to copy its formula for innovation and success.

But from the get-go, the acclaim was accompanied by increasingly sharp criticism, warning about the long-term consequences for Israel's business culture and insisting that high-tech needs large, stable companies to provide it with a competitive edge – not start-ups that are quickly sold to foreign concerns and vanish from Israel's economic landscape in the interests of making a fast buck.

Fourteen years have passed since that momentous exit and the debate still rages on. Even the government has been kicking around the question of which is better for the economy, but more current findings on the overall benefit resulting from large high-tech companies as opposed to medium-sized or small ones are not available.

Aside from a desire for an Israeli Nokia to sprout up (more on this later), an intuitive perception suggests that larger business concerns make a greater contribution to the national economy since they employ a broader range of workers – not just programmers and engineers but also administrators, marketers and salespeople that are spread out at various locations, some in outlying areas.

They also generate more sales and pay more taxes, and the know-how spillover effect to the rest of the industry is larger and more varied. The State Revenue Administration's 2007 report surveying all businesses, not just those in high-tech, pointed out a clear advantage for large businesses over smaller ones.

Israel has a few large homegrown enterprises, both in high-tech and other fields, including Teva Pharmaceutical Industries, Iscar, Netafim and Keter Plastic, but almost everyone agrees the economy needs more.

Why are these enterprises so rare? Some point to a lack of managerial capabilities needed to run large companies, explaining that the local entrepreneurial disposition is more suited to the creative stages of a start-up than to managing major international corporations. So is it fair to conclude, therefore, that the Israeli economy is not built for growing large international companies? And is the relative scarcity of such companies in Israel necessarily a bad thing?

Economies of scale

We tried investigating these questions through the eyes of entrepreneurs, workers and economists who are very familiar with local industry and high-tech in an attempt to put together the optimal "fleet" of Israeli companies, combining lean and agile start-ups with midsize concerns and sturdy flagships that support thousands of families.

Most of those who are critical of the start-up-and-sell-fast phenomenon point to the structure of Israeli industry to back up their view. Big companies account for employment and contribute more to gross domestic product, so policy makers should encourage more large firms rather than start-ups.

This assertion was corroborated by data compiled by a team of senior officials from the academic, private and government sectors and led by the Samuel Neaman Institute for the 2009 Caesarea Economic Policy Planning Forum. It showed that high-tech companies employing over 450 people, roughly 1% of the total number, accounted for about 25% of all high-tech workers in Israel – not including those employed at the research and development centers of foreign companies. The next largest 9% of companies, classified as midsized, aggregately employed another 30%, while the remaining 90% – small incubator companies and start-ups – employed only 45% of Israeli's high-tech workforce.

Figures obtained by TheMarker show that this claim does have a basis. On the assumption that the businesses that contribute the most to the economy are those that export, you can look at the Israeli manufacturing sector as a pyramid.

At the bottom are thousands of small businesses and hundreds of medium-sized enterprises that each exports an average of about $50 million annually. In the middle are about 50 medium-plus-sized companies that export between $50 million and $100 million a year. Further up are about 40 large exporters, each of which sells between $100 million and $250 million annually overseas.

At the top are a dozen companies whose exports exceed $250 million annually and seven mega-exporters whose foreign sales exceed $1 billion each.

Figures from the Israel Export Institute provide even more evidence for the contribution of big companies. The data show that larger firms – those with revenues in excess of $50 million – account for $17.8 billion of GDP and employ 268,000 people. By comparison, small firms – defined as businesses whose sales do not exceed $2 million – contribute NIS 1 billion to GDP and provide jobs for 14,000 people.

Moreover, the institute also found that start-ups don't necessarily grow any further after being acquired by foreign companies, and in most cases are even shut down. The data show that an average of 606 start-ups a year were established from 2005 to 2007 in Israel, while 244 closed down. Over the same period, 240 start-up mergers and acquisitions occurred, 160 by foreign companies and 80 by Israeli companies.

"Most of the start-up companies taken over by foreign companies didn't survive," says Shauli Katznelson, the institute's economic department director. "Of the 160 start-ups bought by foreign companies, 89 of them 56%]] had their operations suspended while the other 71 44%]] continue to be active – 48 as R&D centers for their foreign purchasers and 23 as independent but privately owned companies. In contrast, most of the start-ups bought by Israeli companies were merged into the purchasing entity and only one continues as an independent operation."

The bottom line: Exits through mergers and acquisitions are good for investors and entrepreneurs, but not necessarily for the economy or the company that gets bought.

The tough implications of easy money

It is therefore not particularly surprising that some of the most outspoken critics of the exit phenomenon come from the ranks of traditional industry, such as Giora Shalgi, former CEO of Rafael Advanced Defense Systems Ltd.

“Exits are dangerous, but easy to get caught up in,” he says. “The country needs to wake up from this dream. Anyone buying a start-up doesn’t intend to leave anything valuable behind. What remains is a small stratum of people who are enriched by their talents, while the other 95% are left holding the bag. No real industrial capacity is built when talented ex-soldiers lacking any business know-how prepare an exit strategy. The country can’t be maintained by Google and Facebook alone.

“In a healthy industry, there is an element of start-up companies side by side with classical industry,” Shalgi continues. “Even in the United States they are starting to bring back industry. The Germans have preserved their industrial base and Germany, relative to other countries, is in a good position ... We have a large collection of small manufacturers that need to be pushed to turn them into larger ones. The barrier now is quality of management. Israel should aspire to turn ‘Made in Israel’ products into a brand.”

Shmuel Barkan, joint GM of Freescale Israel, a branch of the multinational semiconductor maker Freescale, contends that Israel needs another 10 to 15 large companies more than it needs more start-ups.

“Israeli high-tech is very dispersed, with some 2,500 companies each with an annual turnover of less than $20 million, as opposed to having only a few hundred companies that each have a higher turnover. There’s a lot of innovation and a few big exits, but half the country’s research and development engineers work for large, stable foreign companies,” he says.

“The bottom line is lots of attempts to turn intellectual property into a lot of money quickly by forming start-ups or by working for R&D centers run by foreign multinationals,” says Barkan.

“We have to end the strong connection between managers and the groups that invest in companies and want to cash out on their investment quickly,” he adds. “This works against quality management and gives priority to investors rather than the companies.”

‘We are a greenhouse’

On the other side of the debate, of course, are the investors and entrepreneurs of the start-up industry, among them Yossi Vardi. He sees the phenomenon as an Israeli asset of which the entire world is jealous and is adamant that it be carefully nurtured.

“Yes, we have big companies in Israel. We call them ‘something Israel’ – Intel Israel, Google Israel,” he says.

Experience shows that big Israeli companies do not provide stable employment, maintains Vardi. Many of them never stood the test of time.

“When you’re building a big company, you run into problems involving management, marketing and IPOs. Plus, you need to ride the waves of the global market, and the question is how you build a stable entity despite all of this. When a big foreign company comes and buys an Israeli company with an idea, it doesn’t just take the brains and leave. It often builds its factory here, brings management and financial know-how and an international distribution network,” says Vardi.

“We Israelis excel at taking an idea and growing it. We are a greenhouse, which is a risky business and requires determination, stubbornness and dedication to your goal. We excel at this. We talk with entrepreneurs in Spain who say they want steady work, no risk. The same goes for Germany and Japan – they fear risk.”

Ultimately, Vardi says, exits are a good thing. “I object to attempts to present Israel’s exit culture as something unpatriotic. When you have an exit, a big company takes a smaller company and does something better with it,” he says.

Room for everyone

Haim Shani, former CEO of NICE Systems as well as a former treasury director-general, tempers Vardi’s enthusiasm, noting that the country has room for both start-ups and large corporations.

“In the debate over high-tech and exits, the key question is the proportion,” he says. “In a country where technology accounts for a significant percentage of the GDP and an even more significant percentage of exports, it seems there’s room for everyone, and all the companies in the chain offer value.”

Shani points to two kinds of multinational operations here – pure R&D operations like Microsoft and Google, and those that encompass R&D and production, like Hewlett Packard and Applied Materials.

In the first instance, the company promises steady employment to its Israeli workers but keeps the innovations they generate. The economy profits from the employment they create and the intellectual property they produce. In the second, the economy benefits from the employment as well as the wide range of jobs created, including in manufacturing and business.
Big Israeli companies do the same, but offer an even wider range of jobs as development, management, sales and other operations are all conducted in Israel.

“Exit” is not a dirty word, but it’s also not necessarily a blessing – not for the company or for the country, Shani says. “Of course there are companies that are sold at a relatively early stage for very high sums, and this certainly holds financial logic for the investors, but since the average price for an Israeli company in the last decade was $44 million, I presume there were many cases where companies had the potential to grow and make an exit at a higher price,” he says. “If companies were to wait a few more years before selling out, the return to the founders, investors and the economy would be higher.”

Shlomo Markel, vice president of the multinational company Broadcom, says big-company advocates have to take into account the risk of their strategy.

“If a start-up aspires to become a very big company, the odds are that it will eventually shut down or go bankrupt. To make yourself into a large company requires a managerial-creative and operational-creative perspective,” he says. “There’s nothing you can do about it – Israelis are very creative but they don’t know anything about efficient manufacturing, corporate management or marketing.”

‘Israeli firms need Israeli CEOs’

Management quality at Israeli companies is the subject of intense debate. Prof. Eugene Kandel, head of the National Economic Council in the Prime Minister’s Office, says management problems that afflict Israeli start-ups stunt their growth.

“Unlike the U.S., we have few managers experienced in running high-tech companies, and this hampers our short-term ability to create large companies,” he says. “That doesn’t mean there aren’t companies launched with the goal of becoming large, but this usually happens when there are investors and entrepreneurs who already made their first exit and now have more patience.”

The key lies in developing a framework that allows the growing company to remain Israeli, says Kandel, including the development of growth-oriented human capital through training of Israelis returning from abroad.

Eyal Waldman, CEO at Mellanox Technologies, is among the minority that doesn't agree homegrown management is the problem. He claims an Israeli chief executive can run an expanding Israeli company better than a foreigner.

"Hiring a foreign CEO for an Israeli company seldom works out because of cultural differences," he says. "Just like most Japanese companies hire Japanese CEOs, an Israeli company needs an Israeli CEO."

Avi Hasson, chief scientist at the Industry, Trade and Employment Ministry, wants to see companies joining forces. In a recent brainstorming session with the Finance Ministry, one of the ideas under consideration was developing tools to encourage cooperation or mergers between companies in the same field.

"Companies in Israel working in very similar areas could create a critical mass by joining together," says Hasson. "Investment funds need to identify such opportunities and initiate mergers ... or state guarantees could be given for merger financing through bank loans."

Rather than wondering about the lack of huge companies in the economy, Hasson suggests looking at the half-full glass with companies such as Given Imaging, Mellanox and Conduit – each of which has hundreds of millions of dollars in sales.

"Keep in mind the mitigating factors, one being that the high-tech industry is very young," he says. "We like to move forward fast, but building large companies takes time. There are funds around the world that, for financial reasons, would rather postpone selling off a company with $100 million in revenues and wait until it triples in sales three years down the line. There are now more seasoned entrepreneurs who have already made exits, and this relieves pressure for quick sell-offs."

Export innovation

Saul Singer, who wrote the best seller "Start-up Nation" with Dan Senor, offers a different perspective. Like Vardi, he thinks the debate over quick sell-offs misses the point. "It shows we haven't begun to fathom the significance of being a start-up nation and that people don't understand the real value of Israeliness," Singer says. "The world envies Israel's ability to sprout so many start-ups and tries to copy the phenomenon. If everyone wants to be like Israel then things probably aren't too bad, even if companies exit quickly."

The start-up craze presents a fantastic opportunity, maintains Singer, but Israel's unique advantage could wither away if we don't learn to take advantage of it. "We have a 10- to 20-year window of opportunity," he says. "Innovation will take root throughout the world as it has in Silicon Valley and Israel, which lead in the size and number of companies, but just for the time being."

Singer claims other countries like India, Brazil and China will soon be catching up and that we need to be there to help them. "Better that innovation in such countries develops with our cooperation than without it," he says.

Foreign companies also help

So which side is right? It seems that, to create a winning formula, the Israeli economy needs to generate more large companies, with hundreds of product developers and engineers, which will evolve into mega-exporters and fill the country's coffers with tax revenues.

But as we set out to fulfill this vision, here are a couple of things to bear in mind: First, Israel's pool of talent is finite, and large companies don't appear out of the blue. They depend on local labor and resources, which are functions of population size and investment in technology training.

A delicate balance must be maintained between the number of R&D people working in large companies and at the start-ups providing Israel with its competitive edge. Start-ups need to be carefully safeguarded: Any global high-tech company emerging here will likely come from their ranks.

Also, the importance of hosting foreign corporations' operations should not be downplayed. True, Israeli companies have a greater immediate impact on the economy: Their local activities are broader and they generate more tax revenues, while some international companies only do development here. However, foreign companies keep their Israeli R&D staffs at the cutting edge of global developments and introduce sorely lacking advanced administrative and marketing capabilities into the local business environment.