

An Un-Leveraged Approach to Innovation

Tapping into Israel's growth economy requires a fundamental shift in philosophy for U.S. dealmakers

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Israel is abuzz with innovation. Even as the nation faces political turmoil at home and abroad, its economy continues to generate long-term value at a truly staggering pace. From 2002 until 2007, the run-up to the global financial crisis, Israeli gross domestic product grew at an average rate of 5.2 % annually, with exports of technology growing by 72%. This made Israel the last among 29 economies surveyed by the Organization for Economic Cooperation and Development to enter into a recession and among the first to exit it.

Having weathered the economic storm so comfortably, Israel's innovation economy — unlike its counterparts in Silicon Valley or elsewhere in the world — continued to gain momentum throughout the recession. Investors have taken note. Among OECD countries, Israel's venture capital sector is by far the largest in relation to its economy. In 2008, venture investment came to just under \$1.4 billion, or 0.69% of gross domestic product, compared with 0.2% to 0.3% for the next highest-ranking countries (Denmark, Finland and the U.K.) and 0.12% for the U.S.

This is a telling statistic that has been misinterpreted by many market-watchers and deal-hungry investors who have been flocking to the region. While the opportunity for investing in innovation in Israel is substantial, it is the investor's method — more than their money — that is most attractive to Israeli start-ups.

A key factor that is making the start-up sector successful in Israel is its lack of leverage. Venture capital firms do not use leverage in same way that private-equity firms and bankers do. That is very attractive to Israeli entrepreneurs who have a fundamentally different philosophy on leverage than most American dealmakers.

In our last three deals to secure expansion capital for Israeli companies, as well as for our current clients, equity has been the main funding source and leverage has been off the table. This comes as a shock to most American investors who have made their fortunes on the back of leverage. But it is an essential philosophical difference to understand for investors looking to tap into Israel's booming innovation economy.

With roots in the cultural, societal and emotional backgrounds of most Israeli entrepreneurs, this un-levered approach to growth is evident in many aspects of Israeli finance. Consider Israel's mortgage market. The main sources for financing mortgages are direct loans by banks; there is no secondary mortgage market and practically no collateralization of mortgages. Moreover, a mortgage carries personal recourse to the entire mortgage amount. If a borrower defaults on his mortgage in Israel, the bank can go after any other asset that individual has. As a result, down payments are much higher than in the U.S. (usually at least 30%-40% of the property value) and mortgages represent only 25% of GDP versus more than 75% in the U.S.

This is much bigger than a sociological aversion to debt — it is the foundation of a culture that believes one needs to create something tangible in order to build value. Doubling-down through the use of derivatives is not an option in the Israeli economy. The only way to increase consumption power is through entrepreneurship. Growth, therefore, comes not from a hyper-developed financial sector but from technological innovation.

It is essential for investors in Israel to appreciate this core philosophical orientation and its impact on nearly every decision made in the country if they are

to successfully tap into this market. What is the ideal formula for foreign venture capitalists and other investors looking to engage with Israeli companies? Of course not all deals are created equal, but we found attributes that resonate based on our experience working with companies in the region:

- Finance with Equity, Not Debt: Debt financing, the hallmark of the American private-equity economy, is the exception rather than the rule in Israeli venture capital. Due in part to the country's ingrained aversion to excessive personal debt and its growth-oriented culture, successful business relationships hinge on future equity performance.
- Embrace the Risks You Know: Perhaps more so than in other countries, Israeli entrepreneurs are willing to take extraordinary risks on new ventures when they know and understand the potential outcomes. Murky, black-swan style risks that hide in a highly levered transaction are an anathema that will doom any deal.
- Israel's Capital is Human Capital: The driving force behind the expansive technological innovation in Israel is a deep-rooted human desire to increase consumption power by building, developing and growing something new, rather than by collateralizing existing assets. Successful partnerships in Israel are focused on expansion, not an exit strategy.

Israel does not have large fixed assets that can be extensively leveraged. In more mature economies with mineral resources, large amounts of land and longer histories of wealth, the impulse to "create" illusory wealth by developing new ways to reshuffle the existing pie is almost too tempting for its elite. We have seen the best and the brightest of Western societies migrate to Wall Street, where math and science PhDs were paid inordinate amounts for repackaging, securitizing and trading existing assets. Israel cannot indulge itself in this.

Entire books, such as "Start Up Nation," have been devoted to other elements of Israeli society that drive the innovation economy — strong networks resulting from compulsory military service and the active support of the government in fostering venture incubators and venture capital. But the underlying importance of deeply ingrained notions of what constitutes real value and self-reliance cannot be ignored.

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