Globalization of Technology Ventures: Lessons from Israel

BME CAPITAL MANAGEMENT

By Dr. Gideon Tolkowsky

Technology is universal, and technology markets are relatively culture-insensitive. Still, the fact remains that surprisingly few high-tech startups that were conceived outside the U.S. or the world's primary technology markets have evolved into global companies. Why is that so? In this opinion piece, Gideon Tolkowsky, principal of Israel-based BME Capital Management, who has been involved in venture capital in the U.S. and Israel for more than 25 years, offers some lessons from Israeli high-tech startups.

Globalization has become a cliché, and in no other field of business has it become more worn out than in technology. After all, technology is universal and its markets are relatively culture-insensitive. Technology businesses should therefore be the easiest to globalize, and high-tech startups should be natural candidates for global expansion. Still, the fact remains that surprisingly few high-tech startups that were conceived outside the U.S. or, more broadly, outside the world's primary technology markets, have evolved into global companies, even of medium size. Why is this so?

Several yardsticks can be used to measure the so-called global presence of a technology company. Each of these is likely to be debatable to some extent. One simple measure might be the number of non-U.S. companies traded on the NASDAQ exchange. Presumably, NASDAQ trading reflects a non-U.S. technology company's ability to break through regional barriers and gain international recognition.

Consider these numbers: As of August 5, seven companies that are registered in Australia are traded on NASDAQ; six that are registered in Japan, five in the UK, four in Singapore, two in France, three in Germany, two in South Korea, three in India, three in Argentina, one in Brazil, one in Spain and one in Sweden. In contrast, one figure stands out: 63 companies registered in Israel are traded on NASDAQ.

How can a country with a population of a little more than seven million -- approximately the population of New Jersey -- located 9,000 km from the U.S. -- breed dozens of technology companies that have succeeded in going international? An even more interesting issue is whether the lessons learned in Israel pertaining to the globalization of technology ventures can apply to other economies. And, if so, is their applicability limited to small economies only or are the lessons size-independent?

One might argue that the country's small size forces Israeli companies to go international quickly, and that the lessons learned there are limited to small economies. Yet, one can find far larger economies struggling with similar challenges. Take, for instance, India's thriving technology industry that is making huge and not always successful efforts to evolve beyond technology services (e.g., software subcontracting) to product-based models. Brazil may be a second example. Apparently, a large domestic market does not necessarily rid local technology companies of the hurdles to globalization that plague small economies. Lessons learned from the latter may therefore be relevant to the former too.

Globalize or Go Bust

The question of size-independence warrants particular attention. Technology ventures, primarily those that are product-based rather than service-based, cannot remain local. They must either globalize fast or they fade away. A high-tech startup must be able to effectively compete with the market leaders in its field on their own turf, i.e., in major world markets. Otherwise, the large players will beat the startup across the board, including on *its own* turf, its native country. While it is possible to successfully market, say, a Turkish brand of beer in Turkey, it is far more difficult to succeed in local marketing of a Turkish-made computer modem. The product either needs to gain global market acceptance or it will gain none at all, not even in Turkey.

This is the meaning of the worn-out statement that the business of technology is global. A technology company either competes globally or does not compete at all. This applies to technology startups that are born in Israel just as much as it does to those born in substantially larger economies.

This realization implies that product-based technology ventures face the huge challenge of going international early in their life cycle, normally when their capital base is slim and their management team is spread thin. Going international in this case means setting foot in the world's primary technology markets, primary in terms of both size and sophistication. For most technology products, primary market means, first and foremost, the U.S. Yet, this is not always the case. For instance, in the business of selling components on an OEM basis to manufacturers of consumer electronics, Japan and South Korea are just as primary as the U.S., if not more so.

The point here is that simply setting foot in a neighboring country will not do the trick. It will not fit the description of "going international." True globalization for a technology firm implies competing with its fiercest rivals in primary markets. This is a gargantuan challenge. It means the company must enter the lion's den and prevail, or be gobbled by the lion, whether inside or outside its den.

This is where the lessons learned by Israel's high-tech startups should be relevant to other entrepreneurial high-tech ventures in other non-primary economies. The lessons, in this respect, are independent of the size of the company, or of other national features of the country in which the high-tech startup originates.

It Begins with a Plan

A business plan for a high-tech startup must adopt global horizons from its very first page. No matter where the venture is located, the underlying operating assumption must be that the young company will face the challenge of competing in the most competitive markets from Day One. The theory by which being located in a protected market provides the startup with a shelter within which to bud is illusory. The reason is that if the budding company lacks the qualities necessary to compete with its best established rivals right from the day it launches its first product, then its product launch is likely to fail. Technology markets are global. If you cannot beat the lions in their den, they will prevent you from standing on your feet even in your own den.

For this reason, the business plan of a high-tech startup that is located outside the world's primary markets should assume a global perspective from the very start. Chapters that deal with product specs, distribution channels, manufacturing, costing and pricing, competition, intellectual property strategy, regulatory strategy, financing and -- most importantly -- management; these business planning elements should all be geared toward penetrating the primary world markets quickly. The more product-oriented a company is, as opposed to service-oriented, the more apparent this requirement is.

The most a technology startup located in a secondary market can afford to do domestically is to alpha-test its product, as there is an advantage in alpha-testing close to the R&D team. However, from beta-testing onward, the advantages -- in fact, the necessity -- of being close to competitors in their own markets far outweigh the advantages of staying in a sheltered environment. In the business of technology products, operating in a protected, less-competitive market, may be a short-term relief but is a longer-term death sentence.

Indeed, most of the 63 NASDAQ-traded Israeli companies, as well as numerous other Israeli technology companies, generated their first sales outside Israel, more often than not in the U.S. Typically, it was only after they had acquired satisfied customers in primary markets that they began to sell in Israel. This was not because of market size. After all, as small as the Israeli market is, it still has buying power. But then, why would even a single Israeli hospital buy a diagnostic imaging software package from a local startup before the hospital administrator can rationalize the purchase decision based on successful installations in the U.S., or in Germany? One may rest assured that GE Healthcare's or Siemens Medical's local sales force will see to it that the administrator will be unwilling to assume the risk of buying domestic without the product having strong references from primary markets. Apparently, the lion dominates all dens, domestic and others. That is why the beast must be confronted on its own turf.

Customers/Shareholders Synergy

For a growth-oriented business, distinct synergy exists between its client base and shareholder base. When the business has international ambitions, this synergy is particularly pronounced. Shareholders that can assist the company in crossing cultural borders -- who can give it credibility in foreign markets, whose reputation is woven into the business fabric of the target market -- are priceless. They bring clients just as much as they bring capital.

Similarly, having a respectable list of reference clients in an overseas market helps remove the natural hesitation of investors based there to bet their money on a small entity headquartered in a remote country. This is true for private financing, and is even truer when the company attempts to go public. For example, going public on an American exchange is exceedingly difficult when a company has no U.S. clients. Similarly, closing strategic deals with U.S. clients is smoother when the company is publicly traded in the U.S., due to increased transparency and reputational added value.

For these reasons, a high-tech startup that is based in a secondary market would do well to recruit primary market shareholders as early as possible in its life cycle. These could be professional institutional investors, such as venture funds, or value adding private investors, such as successful entrepreneurs. While the company may initially have to sell more of its equity to raise such capital, at the end of the day this approach will pay off. Growth is likely to be faster, capital will become more accessible, and successful emergence out of the startup phase is more likely to occur.

One story that comes to mind, which has its light side and which illustrates the customer/shareholder synergy, is that of the wife of a U.S. venture capitalist who walked into the clinic of a Los Angeles dermatologist and discovered a miraculous machine for hair removal. To be sure, the next thing that happened was that her husband's VC firm invested in the budding Israeli startup that had developed the machine. The rest is history -- NASDAQ trading, global spread and so on.

Shadow Marketing

High-tech startups often turn to indirect distribution channels for market penetration. Companies that are located far from their main markets, physically and culturally, are all the more inclined to do so, and for good reasons. Yet there are risks involved. Indirect distribution channels tend to isolate the company from its market. An invisible wall is erected between the company and its clients, competitors and general winds of change in the market, which are so important for gaining insight into fast moving trends in technology markets. For a company based out of and away from the market it attempts to penetrate, this isolation becomes particularly burdensome.

One important lesson in this respect is that, as effective as a company's indirect distribution channels may be, it should never succumb to a 'shoot and forget' modus operandi. While the company deposits its products in the hands of an independent distributor, representative, system integrator or OEM, it should continue to orbit around the channel's marketing and sales force, day in and day out. Differently put, the company should engage in what might be referred to as "shadow marketing". This means that, to the extent possible, and even against its distribution channel's preference, the company would do well to stick to its indirect channel like a shadow. Company personnel should accompany the channel's representatives on sales calls, join the channel's in-house marketing meetings and closely interact with the channel's customer support team.

Occasionally, a high-tech startup yields to the temptation of putting its fate in the hands of a potent distribution channel, such as a leading OEM, in the hope that "things will be okay." Management convinces itself that "such a major market leader must know what it is doing and surely has what it takes to sell our product." While this wishful assumption may well be correct, it nevertheless leads to isolation from the market. Needless to say, this lesson, about the acute need for "shadow marketing", is particularly valid for companies that are remote from their market, geographically and culturally.

Here, a case in point might be an Israeli startup that launched an organization-wide satellite communication system. This was clearly a "big player" line of business. The company just had to go the OEM route for initial market penetration, and it did. But then, it made a point of being intimately involved in the end applications, from design to installation to service. It did not let its OEM shield it from end users. The company consequently succeeded in gaining invaluable direct market insight. Several years later, it acquired its OEM.

Mix R&D with Sales

It is a truism that in technology companies, sales people tend to treat R&D as a necessary evil ("Unfortunately, without them there is no product to sell"), while R&D tends to treat the sales team as ignorant simpletons ("What do *they* know about our product?"). Sales people are frustrated with R&D's commercially unjustifiable striving for product perfection, while R&D is constantly at loggerheads with sales peoples' promises to clients about product features that do not exist or delivery schedules that are unrealistic. An eternal, hardly bridgeable cultural abyss yawns between these two groups.

In high-tech startups that are located far from their primary markets, this gap widens ten-fold. Engineers by and large do not excel at communication, while sales people normally have little patience -- including for collaboration hiccoughs that stem from distance and cultural differences. The physical and cultural barriers between the two groups become particularly wide and threatening to group coherence.

What should be done? The inevitable answer is that R&D and sales people should mix. Under normal circumstances, mingling between the two groups, particularly in a small company, is easy and natural. They share the same corridors and coffee machine. But when it comes to a company whose R&D and sales teams are separated by an ocean, or by something far wider and deeper than an ocean -- such as a language barrier or a diametrically different cultural taste in sports -- mingling becomes a true challenge.

For this reason, small technology companies that are spread across the world should pro-actively create mingling opportunities. They would do well to send an R&D person from Stockholm to spend a couple of weeks in the Palo Alto sales office, and to encourage a sales person from Tokyo to spend several days at the R&D facility in Bangalore, São Paulo or Jerusalem. It may add to costs, but at the end of the day it will save chasm-bridging money and will boost revenues.

Illustrating this approach was an Israeli startup that developed high-end memory devices based on novel solid state technology. The company made a point of sending its engineers to customer visits. The goal was not just to provide technical support, but also to expose the engineers to the challenges faced by the company's sales force in trying to convince a large manufacturer of defense electronic systems to bet its product's reliability on a novel technology originating from an obscure, tiny company located on the other side of the ocean. There was nothing like this experience to nurture engineering's respect for sales -- and vice versa.

Management Structure

By far the most challenging task for a technology startup, while forming a bridgehead in a remote market, is management. How can the company build a management structure that will function and will deliver growth while retaining entrepreneurial spirit and making the best of it, rather than just paying the price of cultural diversity?

In a nutshell, the Israeli experience has been that various management structures have been tried by high-tech startups; all have had their failures and all have had their successes. Differently put, no textbook solution has emerged and company shareholders and boards of directors have been left with the challenge of tailoring ad-hoc managerial solutions. When the dust settles -- and this is a subject that typically raises *much* dust in the air -- the 'right' management structure hinges on personalities. These, alas, rarely lend themselves to cataloguing and standard formulas.

Diverse formulas have been tried. These have included sending one of the local (Israeli) founders of the company to the target market (e.g., the U.S.) to set up a marketing and sales bridgehead; or recruiting a U.S. (or other primary market) professional manager to head the marketing and sales operation there, and having that person report to management in the company's homeland, or the other way around. Alternately, some companies have tried a hybrid solution -- sending one of the company founders overseas *and* recruiting a local manager there, while having the latter report to the former or vice versa.

One successful example that comes to mind is an Israeli startup founded by an entrepreneur with outstanding leadership qualities and unparalleled technological talent in his field, yet with little business experience, let alone in an international framework. The Israel-based VC who agreed to seed the company introduced the entrepreneur to an ex-Israeli person who had been living in the U.S. for many years and had an outstanding salesmanship record. The two teamed together, with the original entrepreneur running the company from Israel and the experienced salesman running its marketing and sales beach head in the U.S. It was a winning combination. Clearly, both persons' Israeli origin turned the geographical and professional-background gaps between them bridgeable, while making good use of the valuable skills both individuals brought to the table. The VC who initiated this marriage reaped a very good return on his investment.

Notably, though, while no recommended structure has emerged, one structure has had a distinctly lower rate of success than others: Recruiting an experienced, professional U.S. (or other primary market) CEO to manage the entire company, including the Israeli R&D operation, without placing one of the original Israeli founders shoulder-to-shoulder with the U.S. CEO, even if reporting to the CEO. In our desire to refrain here from elaborate sociological or psychological analysis, we will leave it at this, at the simple empirical result: This latter structure tends not to work. In fact, the graveyards of Israeli technology startups are filled with companies whose professional investors tried to impose such management structure on their investees.

One example of a disastrous management structure is that of a non-destructive electronics testing company founded and seed-financed in Israel, where the second round U.S. investors forced the CEO to recruit a U.S.-based CFO. They simply wanted to control cash management. However, they neglected to recognize that the one person a CEO needs closest to him or her is the CFO. The CFO is the CEO's most trusted and most intimate lieutenant. Placing the CFO thousands of kilometers away from the CEO is a sure recipe for failure, as sure as can be, which is indeed what happened.

International Corporate Culture

All the above lessons regarding international high-tech entrepreneurship may be summarized in a single bullet point, which is abstract yet profoundly relevant: It is vital to build an international culture within the company from Day One. This translates into many different action items, large and small. It includes recruiting people who speak various languages and, preferably, have spent time overseas and developed cultural sensitivity. It also includes putting emphasis on in-company, "over the chasm" communication -- by phone, email, videoconference and trips abroad -- even to the extent of over-communication. It gets down to very simple things, such as always using English for inter-company communication and encouraging employees to use English in email correspondence even when the corresponding parties are both, say, Hebrew, or Chinese or Spanish speakers.

At the end of the day, perhaps contrary to intuition and certainly contrary to common practice, it is the successful formation of an international corporate culture that is the paramount pre-requisite for success for a high-tech startup. The company must think and act globally from Day One, and it can only do so if it actively nurtures an international corporate culture.

Corporate culture is like the scent that is in the carpet. You can vacuum the carpet day in and day out; you can send it to the cleaners again and again; the scent remains. Therefore, it had better be the right scent -- the right corporate culture -- from the beginning. Companies that cultivate a global culture, from the day their founders write the first page of their business plan and from the day they recruit their first employee, have the best chance of growing in today's global economy.