ISRAELI HIGH-TECH IN THE SHADOW OF SIX MONTHS OF WAR

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Introduction

The first quarter of 2024 marks six months since the launch of the "Iron Swords" war, a year since the beginning of instability in Israel over the judicial reform, and nearly two years since the beginning of the global economic slowdown. Against this backdrop, the data from the first quarter and the half-year mark of the war, highlight several key trends:

- Investment in Israeli startups has remained stable at a low level. While the average quarterly investment in the first three quarters of 2023 stood at about $2 billion, during the war period it dropped to an average of $1.6 billion per quarter, a level not seen since 2017.
- Total investment is increasingly reliant on a limited number of mega-rounds (fundraisings of $100 million or more). Aside from a few companies that are able to raise mega-rounds, investment has dropped dramatically, and for the first time in many years, total investment without the mega-rounds is less than $1 billion per quarter.
- Particularly concerning is the continuous decline in the number of active investors in Israel, both Israeli and foreigners, which appears to have worsened because of the war.

Yet, it is important to note that weak investment data is not unique to Israel. In the first quarter of 2024, the global tech sector had not yet recovered from the 2023 slump, and total investment had decreased in both the United States and Europe.

Upon reaching the six-month mark, we included in this report a section on its effects on Kiryat Shmona's tech ecosystem. Beyond the obvious interest in the war's impact, this section raises questions about the Israeli government's plan for developing non-software-based ecosystem in the periphery.

Unless specified otherwise, the data in this report about Israeli high-tech is based on IVC database. Data for other countries is based on PitchBook database.

Naturally, a report published immediately at the end of the quarter is partly based on provisional data; hence, some of the figures shown in this review may be updated in the months ahead. Where a significant update to the data is expected, we expressly state so.

Recent Publications

- The State of Women in Israeli High-Tech 2024
- Israel Lags Behind US and Europe in Female Founders
- What Characterizes Israeli Tech Companies That Raised Money in 2023?
- The Israeli High-Tech in 2023 | Annual Report

1. Investment in Israeli Companies

Having peaked at $9 billion in Q4 2021, venture capital (VC) investment in Israeli companies has declined almost every quarterly since. This trend aligns with the global post-2021 investment normalization observed in early 2022, which later coincided with a broader economic slowdown throughout the latter half of the year. In 2023, additional factors specific to Israel contributed to the decline. Domestic political instability arising from legal reforms, coupled with the outbreak of war in Gaza in Q4 2023, have exacerbated the negative investment trend.

Quarterly and half-yearly data

Figure 1 presents the total investment in Israeli companies since Q1 2021. The amounts for the last two quarters, affected by the ongoing war in Gaza, suggest stabilization at approximately $1.6 billion quarterly. While an end to the decline is welcome news, investment has leveled off at pre-2018 rates. However, this is if we just compare the rates in nominal terms. **Adjusted for inflation, the current capital-raising rate is the lowest recorded since 2015.**

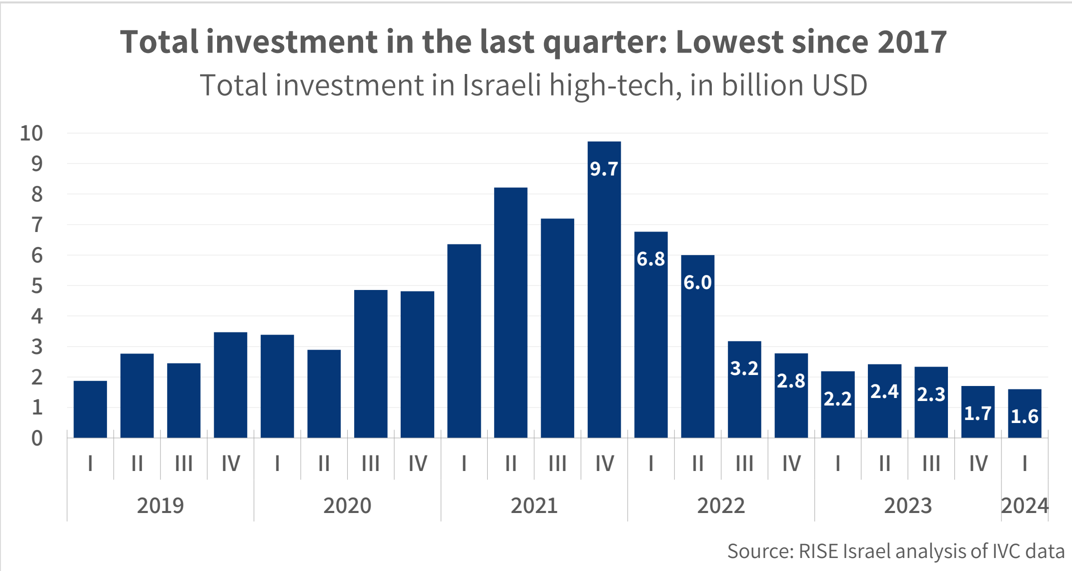


Figure 1

Figure 2 presents the same, but combining quarters into half-year periods, in order to compare the periods before and following the beginning of the Gaza War. Investment in the last half-year period has declined 31% compared to the previous half-year, and 34% compared to the corresponding period in the prior year.

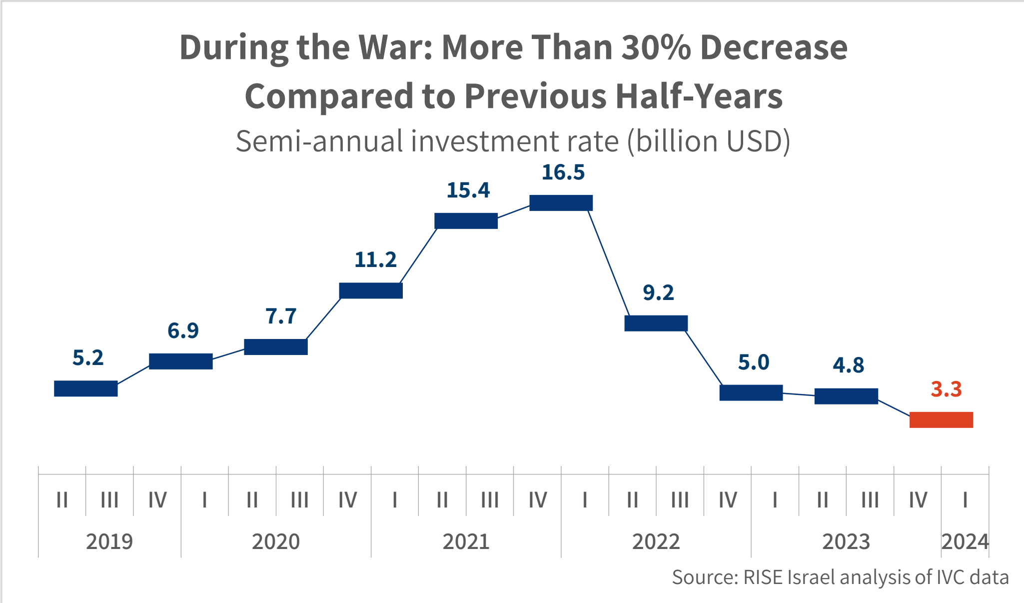


Figure 2

Figure 3 depicts the total quarterly deal count (number of investment rounds) in Israeli companies since Q1 2019. It is important to note that rounds are often discovered with a substantial delay, and consequently, the data presented here is likely to be revised upwards in the future.

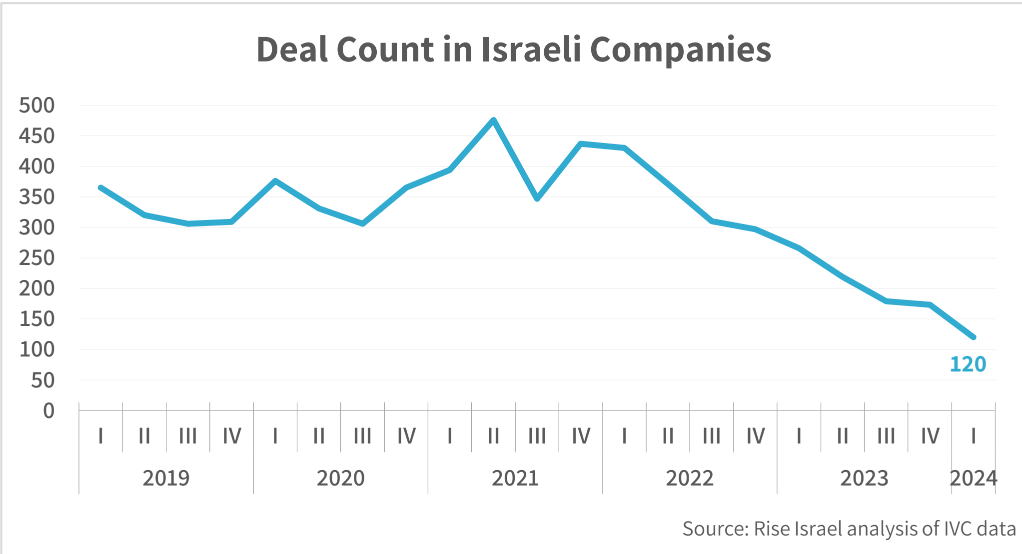


Figure 3

Additionally, the recent difficulty in raising capital drives many startups, particularly in early stages, to utilize Simple Agreements for Future Equity (SAFE) for fundraising. These agreements, which allow companies to secure capital without pre-determined valuations, as well as other forms of fundraising (e.g. internal rounds), are seldom reported publicly, and may lead to underestimation of the investment figures. However, this underestimation is likely consistent with previous quarters.

Figure 4 presents a comparison of total investment in Israel, the United States (US), and Europe, normalized to Q1 2019. The data indicates a decline in total investment for both the US and Europe during Q1 2024, suggesting a continuation of the global slowdown in the tech industry.

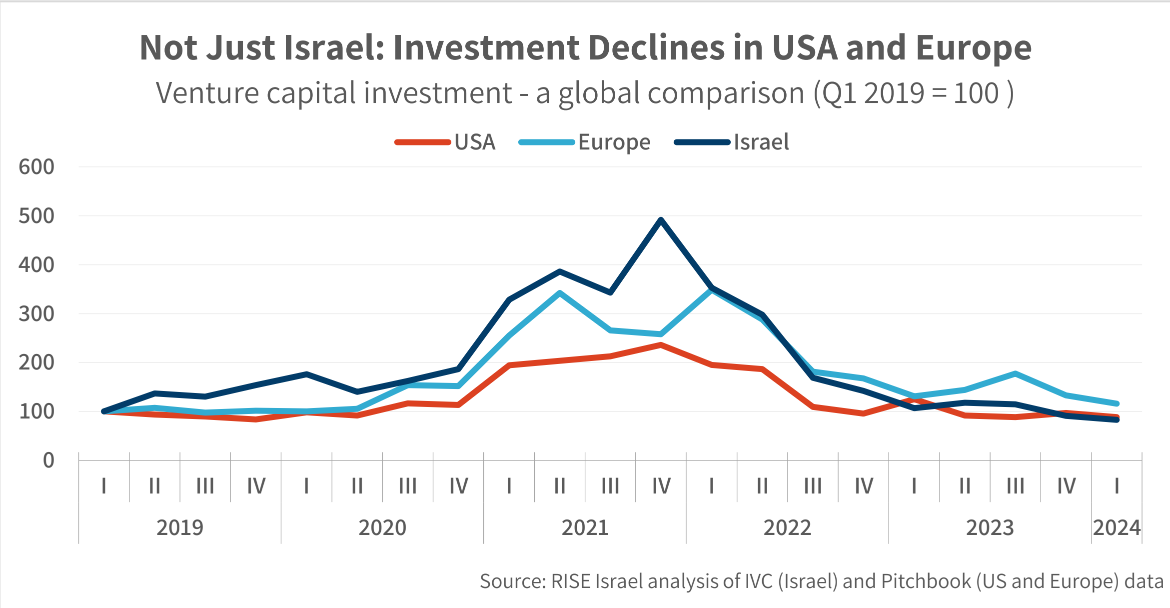


Figure 4

While all three regions experienced investment decline, the impact **has been most severe in Israel** – a 31% decrease in the last half-year compared to the previous half year (23Q2+3). This is in contrast to Europe, which experienced a 22% decline in the same period, and the United States, which saw a modest 3% increase.

Some additional insights:

- The funding rounds of 22 companies (20%) included no venture capital investor (neither Israeli no foreign), but included only individual investors, corporate investors, and incubators.
- In nine of the rounds, the only participants were the “emergency” relief funds that were established during the war.
- Hence, only 80 companies have managed to raise capital from “traditional” venture-capital funds in the first quarter.
- **Increasing dependence on “Mega-Rounds”** (rounds of $100 million or more): Q1 2024 witnessed six mega-round investments totaling $736 million, representing 46% of the quarter's total investment amount. Excluding these mega-rounds, total investment would have been only $864 million. Paradoxically, this increase in the dependence on mega-rounds comes as the number of such rounds has decreased from roughly 15 mega-round per-quarter during the peak period to only 3-6 per quarter since mid-2022 (the last four quarters saw 5, 4, 4, and 6 respectively; see figures 5 & 6). This trend might indicate increased difficulties in capital acquisition for a broader range of Israeli companies, with the exception of a select few high-performing firms.

- **Of the six companies that raised mega-rounds in 24Q1:**
  - Three are in cybersecurity, one in fintech, one in digital media, and one in medical devices.
  - The headquarters of two of them are in Israel and four in the USA.

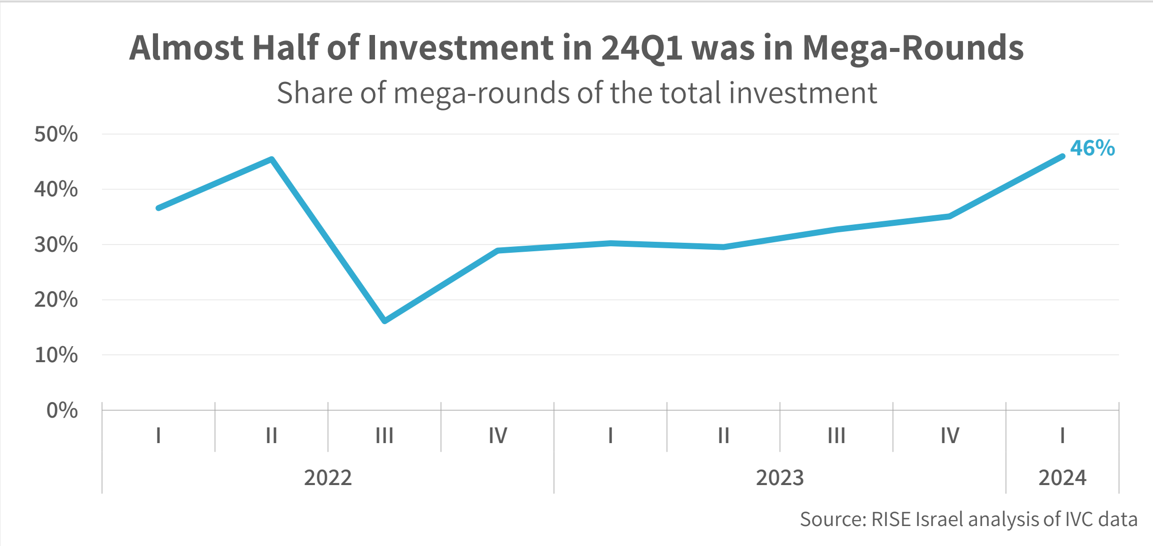


Figure 5

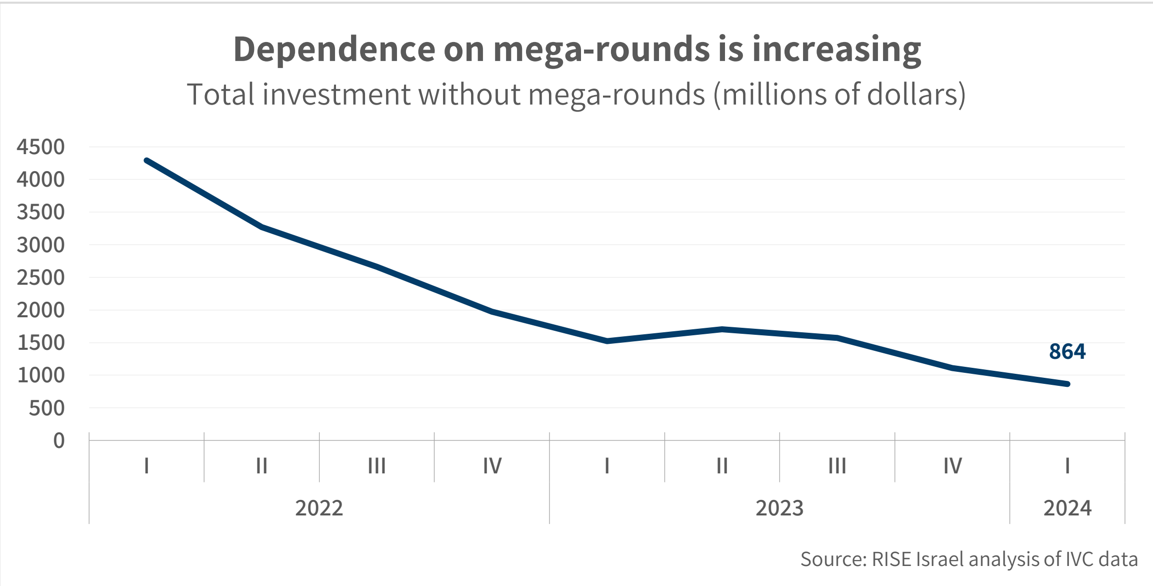


Figure 6

Implications

Investment in the Israeli high-tech sector appears to have stabilized at approximately $1.6 billion per quarter, representing the lowest level since 2017. Additionally, there is a concerning trend of increased dependence on a limited number of large-scale funding rounds (mega-rounds). While the continued emergence of such high-performing companies could potentially sustain this level, a growing challenge in capital acquisition is evident for most companies.

2. Investors in Israeli Companies

In our recent reports, we highlighted a concerning decline in the number of active investment entities in Israel, both local and foreign. As can be seen below, this trend continued into the first quarter of 2024. Since the decrease in the number of active investment entities began in 2022, it is unclear how much of it stems from the global slowdown that started in that year, how much was influenced by the internal instability and the war that characterized 2023, as well as the worsening sentiment towards the State of Israel in various countries at the beginning of 2024. Additionally, it is plausible that at least part of the decline in activity of local entities is due to their own difficulties in raising capital.

Figure 7 compares the number of active investment entities (i.e., those that made at least one investment and are not private individuals) - venture capital funds (VC), corporate venture capital funds (CVC), institutional investors, and corporations – in a half-year breakdown, separating foreigners and Israelis. During the half year of the war, there was a decline of 23% in the number of active foreign investment entities in Israel compared to the six months prior, and a similar decline compared to the corresponding period last year. As for Israeli investment entities, the decline in the last six months was 30% compared to the previous half-year.

Figure 7

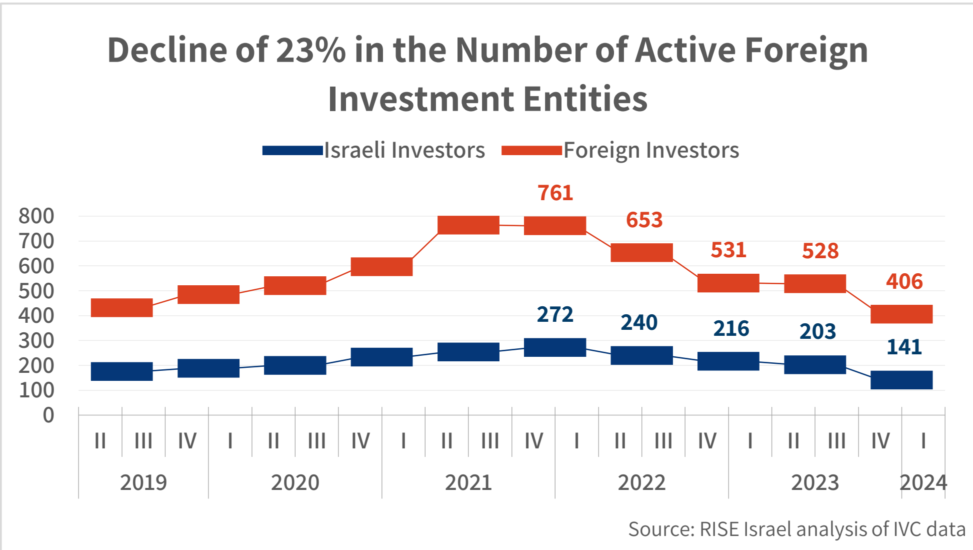


Figure 8 compares the number of active venture capital funds in a half-year breakdown, separating Israeli and foreign funds. The data show that during the half year of the war, the number of active foreign funds in Israel decreased by 20% compared to the previous six months, and a similar rate compared to the corresponding period last year, while the number of Israeli funds decreased by 25% in relation to those periods.

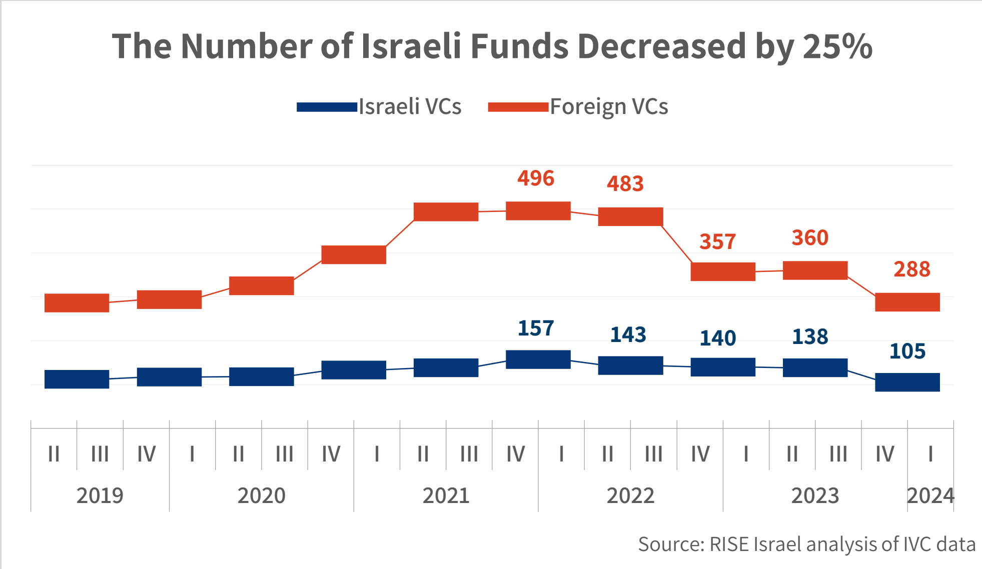


Figure 8

Implications

As mentioned above, it is unclear what exactly caused such a significant decrease in the number of active investing organizations in Israel. Among the possibilities:

- Some investors reduced their activity due to the global economic slowdown.
- Some funds themselves are struggling to raise capital, affecting their investment activity.
- Fewer attractive companies for investors are being established or are operational in Israel.
- Some investors invested only in internal rounds, which were not reported publicly .
- Some investors have stopped investing in Israeli companies due to reasons related to the political and security situation in Israel, or due to a deterioration in sentiment towards Israel.

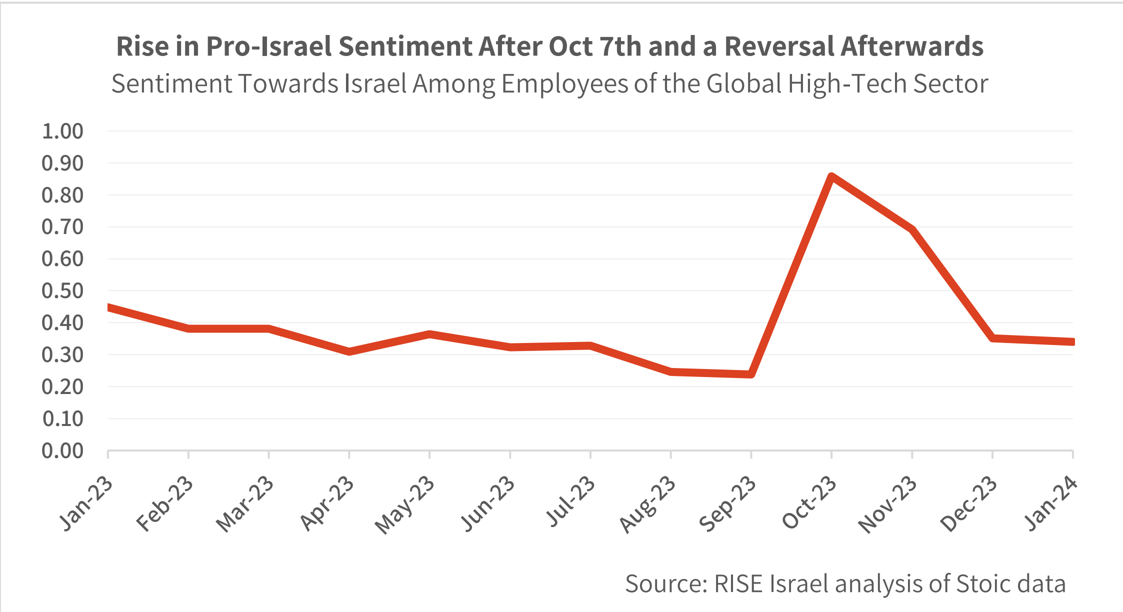
Regardless of the reasons for this decline, **the phenomenon is extremely concerning.** The Israeli high-tech sector needs both the establishment of new startups and the opportunity for growth and expansion of more mature companies, requiring an active ecosystem of investment entities, both local and foreign. The decline in the number of foreign investors is very worrying, as it may indicate a trend of distancing from Israel due to recent events. The same goes for Israeli VC funds, as it may indicate their difficulty in raising capital. **Since most of the money for Israeli funds comes from foreign sources, their difficulties in raising capital could also indicate a distancing of foreign investors from Israel.**

3. Global High-Tech Sector Sentiment Towards Israel

In our annual report we highlighted that about half of Israel's R&D funding comes from foreign sources, marking a significant contrast with the OECD average of less than 10%. This funding comes through R&D centers of Multi-National Corporations, direct investment by foreign investors in Israeli start-ups, or investment in Israeli VC funds which subsequently invest in Israeli start-ups. Due to this reliance on foreign funding, global sentiment of the high-tech sector towards Israel is very important. That sentiment was obviously affected by the brutal Hamas attach on October 7th, and the ensuing Iron Swords War.

Realizing the importance of this sentiment, we launched a research project with Stoic, a company that specializes in monitoring and analyzing social networks. The project objective is to monitor the sentiment of employees of high-tech companies and of foreign investment funds towards Israel. We use an AI model that identifies posts of these employees about topics related to Israel, and translates them to a sentiment score. At the time of this report, the data covers the time period until January 2024.

The research is in its early phase, and we present here initial findings. Figure 9 illustrates the average sentiment towards Israel among non-Israel based employees of over 500 global technology companies. A higher score in the figure indicates a more favorable sentiment towards Israel. It shows **a notable increase in pro-Israel sentiment immediately after October 7th followed by a decline in the two subsequent months**. However, it is noteworthy that **sentiment levels measured in January 2024 were higher than those measured before October 7th.**



4. War Impact on Technology Companies in Kiryat Shmona

The challenges faced by technology companies from Kiryat Shmona represent a small part of the broader social and economic challenges in the North. However, as we mark the six month anniversary of the War, we decided to put a spotlight on the impact of the war on these companies. Although Kiryat Shmona is not a big technology hub in terms of the number of companies or employees, it holds strategic importance. While Israeli high-tech is dominated by software companies, of approximately 15 technology companies that operated in Kiryat Shmona prior to the war, only two are software companies. 11 are in the life sciences, agri-tech/food-tech, and clean-tech sectors. Companies in these sectors are vital for Israel's economy and society. They typically employ more women that the broad high-tech industry, and offer opportunities for people with backgrounds in areas like chemistry, biology, and food engineering, while the broader high-tech primarily employs graduates of computer science and software engineering.

The presence of companies in these sectors in Kiryat Shmona is not coincidental. Rather, it is the result of the proximity of relevant academia and research institutions (Tel Hai College, Migal), as well as governmental policies aimed at fostering the development of such a hub, such as through the establishment of the Fresh Start technology incubator in 2020 by Tnuva and Tempo, with funding support by the Israel Innovation Authority. About half of the Kiryat Shmona technology companies are part of this incubator.

Therefore, the challenges of technology companies from Kiryat Shmona, and their ability to overcome them, hold national importance.

Beyond the challenges faced by many start-ups, such as the recruitment of a high percentage of employees or of key people to reserve duty, data we collected from companies in Kiryat Shmona revealed the following unique challenges:

- **High unexpected expenses resulting from the need to relocate the company**. Unlike software companies, where it is relatively easy to relocate people and computers, companies in the life sciences, agriculture and food sectors also have labs, and sometime a production facility. As a result, the unexpected expenses included rental of an alternative place, transportation, rental or procurement of equipment (that either could not be moved or was shared by several companies), conversion of office spaces to labs, travel arrangements for employees to the new and more remote locations, etc. Some of these unexpected expenses were exceptionally high. For example, space rental in the new locations is much higher (as high as 8x) compared to rental in Kiryat Shmona. Some companies had to relocate different functions to different locations, which adversely affected both expenses and efficiency.
- **Most employees live in the Kiryat Shmona area**. As a result, employees and their families had to relocate frequently and did not have a suitable arrangement for their children. This impacted their ability to focus on their work. In addition, some employees who stayed in their homes in the North now have to spend more time travelling to and from work, and this led some of them to quit work.

- **Delays or forced changes in collaboration plans with other Israeli companies** in areas such as validation, pilots, etc. as many of those companies were also impacted by the war.
- **Loss of in-process material and long delivery times of imported materials and equipment.**
- The above-mentioned challenges caused **major delays in technology and product development**. These often impact the company ability to reach a significant milestone that would allow it to raise money. The combination of increased expenses and delays in reaching key milestones adversely impacts the ability of these companies to raise money, and hence their survivability.
- Many Israeli start-ups face difficulties in raising money at this period of time. However, as described above, companies from Kiryat Shmona face unique challenges, yet there is no dedicated assistance program for them, and they need to compete with other companies for funding by the Israel Innovation authority or by the emergency funds that were established by the private sector.
- As of now, different companies have managed to deal with these challenges at different levels of success. **No company reported it has returned to the pre-war activity level.** Moreover, they still don't know what governmental assistance they will get and when, nor when they will be able to return to normal operation in Kiryat Shmona.

Summary and Recommendations

Needless to say, the most important things for Israeli high-tech are returning to a security and political stability, rehabilitation of Israel's image where it was damaged, and in general – reestablishing Israel's image as an attractive place for investors.

The government should put special emphasis on assisting companies most impacted by the war, such as the technology companies from Kiryat Shmona, to whom we dedicated a chapter in this report. Preserving such companies, in sectors like life sciences, food and agriculture, and helping them return to normal operation as quickly as possible, are critical to Israeli high-tech, especially if the government wants to have technology hubs in the periphery in the future. Preserving these companies necessitates financial assistance to cover their unexpected expenses, and support in fund raising so they can continue their operations.