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Venture Capital and High Tech in Palestine

By Laith Kassis

In the context of our nation's small size and geographical distance from many global commercial centers, with access further restricted by the Israeli occupation, and due to the limited natural resources available in Palestine, Palestinian leaders are well aware that the fostering of knowledge-based industries is vital to the nation's economy. The Palestinian Authority has issued a vision statement for the economic future of a Palestinian state that asserts, "Palestinian economy is open to other markets around the world, striving to produce competitive goods and services of high value, and aiming over the long term to establish a knowledge-based economy."[i] Knowledge-based economy and innovation are key to creating higher-paying jobs, new technologies, and better standards of living.

As thoroughly reported in TWiP's May 2016 issue themed Palestinian Startups, Palestine has developed incubation and acceleration programs that provide funding through development agencies in the very early stages of development. For small startups and up-and-coming businesses in emerging industries, seed funding and venture capital is generally provided by high-net-worth individuals (HNIs), also known as angel investors, by early-stage venture-capital (VC) firms, and by crowdfunding initiatives. The startup firms targeted usually promise future monetary value based on innovative technology or business models (intellectual property), frequently in high-technology industries such as information technology (IT), social media, or biotechnology.

Angel investors are wealthy individuals, the majority of whom are business executives or entrepreneurs themselves. Their investment in startups follows or overlaps with the incubation and acceleration stages and involves not only monetary support but also mentoring time during which these experts share their wealth of knowledge on business strategies and markets. Angel investors provide moneys via convertible notes and SAFEs (simple agreements for future equity, equity constituting shares that form an ownership stake). They do so primarily in order to reduce legal costs, cut transaction overhead, and save time in closing a deal, because such agreements transfer equity in the company to the investor only at a later date – and sometimes, in the case of a failed startup, not at all.

> Convertible notes and SAFEs are ideal structures to be used for seed and VC funding in Palestine to accelerate more companies as friction-free mechanisms.

VC firms or funds invest in early-stage companies in exchange for equity in the companies in which they invest. They target entrepreneurial startups and small businesses that are believed to have long-term growth potential. VC is generally used only in high-growth industries, where risk is much higher.

But these investors take on these risks in the hopes that some of the businesses they support will bring in high returns. For the startups, venture capital is an essential source of funds because there are generally no physical assets or personal guarantees from the entrepreneur that could qualify as collateral to secure debt financing from banks. The VC fund normally takes an active role, granting strategic advice and expert knowledge in areas from financing to business models and marketing. Importantly, it aims to exit the company after a period of time – typically four to six years after the initial investment – which can be accomplished through a merger, acquisition, or initial public offering (IPO). Hence, part of the selection at the outset is to have an exit plan for the venture.

Crowdfunding is similar to VC in that it is ready to take on a high-risk idea, even when there is a probability that the startup may fail. Crowdfunding investors may lose their investment if a pre-order product, promised by the startup, cannot be delivered in case a business fails.

A financial wizard with a banking background will not necessarily be suitable to manage venture capital and seed funds. Venture capitalists (like incubator and accelerator managers) are expected not just to manage financial assets but also to create new venture value. Risk tolerance and people skills are essential to manage entrepreneurs' behavior during the

different rounds of financing: seed, early stage, and growth stages. Venture capitalists are generally passionate about growing high-growth companies.

In Palestine, above all there is the challenge of assisting startups in developing market traction in regional and global markets since Palestine's market does not substantiate the growth patterns needed by most startups. The challenge is to link Palestinian startups with global value chains and to secure follow-on investment with overseas VC funds or investors.

According to Ernst & Young, about two-thirds of all VC in the world is concentrated in the United States, specifically in the Silicon Valley where a VC fund there is typically not used for seed stages or early funding. These rounds include funding from the 3 Fs: Family, Friends, and "Fools." However, hoping for high returns on their investments, some of these fools may get lucky! Seed financing can also be secured from angel investors, seed-stage financing syndicates, and firms, as well as from incubators and accelerators. Hence, incubators and accelerator programs are taking an ultra-high risk on their portfolio of companies, and failures are the norm in the industry.

The Palestinian eco-system supports startups in their very early stages with incubation and acceleration programs that provide seed funding, but this support alone does not "save" startups in the valley of death (see chart). Here, the startup is still at pre-revenue stages, focusing on improving its minimum viable product and preparing to go to early-stage markets. It may secure some early sales, but not enough to sustain it. Since Palestine does not have an angel-investor network that is engaged in supporting startups and willing to take on the necessary risks, VC funds here fill in the vacuum and have become essential in helping entrepreneurs with follow-on investment during their startup lifecycle – but entrepreneurs miss out on the mentoring provided by angel investors. For the benefit of Palestinian startups, VC funds play well because from day one on they act as global players, linking emerging businesses with the world's markets, resources, talent, ideas, and opportunities. The fund is typically staffed by a team with experience in global relationships and transactions, frequently introducing a global advisory board that draws talent and expertise from the Palestinian diaspora. Funds focus on helping startups achieve success by leveraging international value chains, the diaspora, and a global network of advisers, mentors, and partners.

It is important to note here, however, that not all startups are VC or seed-capital backed. For example, I am currently "bootstrapping" a secure unified telephone communication

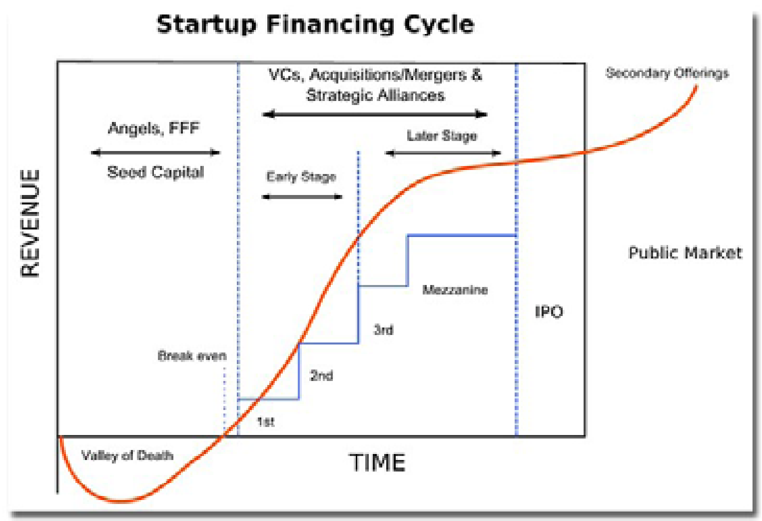
application for Android and HTML5 that combines audio, video conferencing, and chatting, and runs on open-source framework that provides communication networks for private branch exchange (PBX). Bootstrapping is a way of self-funding a startup in which limited resources make the sustaining and commercialization of an operation much more challenging. However, it allows entrepreneurs to retain the full share of equity on their investments.

In the United States, typical funding amounts in angel and seed-investing stages range from a couple thousand US$ all the way to one million US$, whereas venture capital usually amounts to millions, tens of millions, or even hundreds of millions of dollars. Promising Palestinian startups can apply for $40,000 seed investments from Ibtikar and in the next stage aim to gain access to a follow-on investment in the US$ 200,000 range, as was the case with Mashvisor[ii] during its startup and early-stage development.

Palestinian entrepreneurs are advised to exercise due diligence and inform themselves regarding the reputation of the VC funds with which they engage, inquiring about their capabilities and what they can offer, other than money, by comparing term sheets and percentage of equity share in exchange for funding. Some members of the entrepreneurial community argue that entrepreneurs should not be restricted to a few VC funds but have more options to choose from. This would allow for more flexible term sheets and might enable entrepreneurs to negotiate lower equity shares in exchange for investment funding.

> Look for venture-capital funds that are more empathetic to entrepreneurs. Startups are difficult to grow. Entrepreneurs need support and help from their investors – not the other way around.

In some cases, VC funds have invested in Palestinians who live in Israel but engage in the occupied territories and strive to be part of the Palestinian entrepreneurship and innovation eco-system in the West Bank. They



Startup Financing Cycle. Image courtesy of Wikipedia.[iii]

have also assisted entrepreneurs in raising considerable follow-on funding from foreign VC funds. For example, the European investment fund Global Founders Capital has invested $3.5 million in the Middle East hotel-booking startup Yamsafer, working in cooperation with Sadara Ventures, which had been supporting the startup in earlier stages, along with some undisclosed US-based investors.[iv] Other Palestinian success stories were reported on Wamda website, focusing on eight Palestinian incubation programs and highlighting their successful portfolio of incubation startups[v] such as Edunation accelerated at Arabreneur, or Shoobiddak incubated at PICTI, or Pinchpoint backed by Sadara Ventures, or Indiepush and Redcrow accelerated at Fast Forward.

The startup eco-system needs to reflect on what it is trying to accomplish with these investment vehicles, and whether the design and business models of the current funding structures fit that purpose – albeit all VC funds in Palestine are foreign registered. Do we want to grow companies to make headlines, or use VC funds to collaborate with the Israeli technology industry and link them to Arabic-speaking markets, or to invest in Israeli entrepreneurs who would hire Palestinians in the hundreds as back office developers – and not in business positions. Do we strive to become globally viable high-tech competitors in deal structuring, or focus on content and e-commerce-oriented business models, or do we want to invest in existing IT companies to spin off new products through new startup ventures? Have we been effective in using these investment vehicles to tempt competent members of the Palestinian diaspora to return home and launch a startup?

On a similar note, do we want VC fund managers who can work well with other funds on co-investments, or just be concerned with maximizing their own fund returns?

As the VC industry continues to evolve from its nascent stage, all these points are relevant topics that can affect the behavior of the Palestinian high-growth technology entrepreneurship sector, its future culture, and its engrained "DNA."

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i "Building a Palestinian State: Towards peace and prosperity," Palestinian National Authority, Paris, December 2007, available at http://www.undp.ps/en/aboutundp/Prdp.pdf.

ii http://www.forbes.com/sites/elizabethmacbride/2016/07/31/a-palestinian-entrepreneur-pivots-starts-succeeding-and-then-feels-the-pressure/#1154a9742134.

iii Kmuehmel, VC20, https://commons.wikimedia.org/wiki/File:Startup_financing_cycle.svg.

iv Natasha Lomas, *Gobal Funders Capital Invests in Middle East Hotel Booking Startup Yamsafer*, TechCrunch, June 2015, available at https://techcrunch.com/2015/06/03/global-founders-capital-invests-in-middle-east-hotel-booking-startup-yamsafer/.

v Rafat Abushaban, *Palestine's to 8 incubators*, Wamda, September 2015, available at http://www.wamda.com/2015/09/palestine-s-top-8-incubators.