How to Become the Target Firm: Analyzing Israeli Startups Successful Exits

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Abstract
Ideas is what any startup begins from, but only these with a practical application. While entrepreneurship refers to all new businesses, startups relates to the new businesses that intend to grow large beyond the solo founder. That makes them possible for being commercialized. Some startups become unicorns, privately held startup companies valued at over US$1 billion. Then, every company was at one time a startup. The aim behind the foundation of a startup is a successful exit, therefore we must always proceed taking in count to become the most desirable target firm, in order to be acquired by one of the worldwide large companies in each industry.

In the last years, tech giants have collectively made over 800 acquisitions, even amid the Covid-19 pandemic. Acquirers' current and potential stockholders reward listed corporations after each Hi-tech startup acquisition (contrasting the uncertain results of general M&As) as they believe this is one of the best available ways to achieve new technologies.
This research aim is to identify the variables, factors, characteristics and circumstances that allow Israeli startups to become the desired target firm for bidding companies.
As a result of his personal expertise and as extended as updated available data, the author focused this project in several Israeli startups acquired by listed foreign firms in the last decade, hoping to allow a generalization of the findings, providing to new entrepreneurs around the world several tools toward a succesful exit starting from the very foundation of their own company.

The previous, using (among others) The Worldwide Business Evaluation Model for M&A, since it is as general as possible, tries to list all the involved parameters, and assesses the variables according to its grade of impact in each case, allowing the startups to obtain the highest qualification for each potential acquirer in every industry and country, in order to become the most suitable target firm.

Keywords: *Entrepreneurship, Startups, Exit success.*

JEL Code: M13, L26 & L32 *(2019 Classification)*

1. Introduction

Organizations made up by humans are living beings, not as static nor rigid as it may appear. In the case of a profit company, is able to indentify several stages. Let's start from the very beginning: newborn (*foundation*), childhood (*consolidation*), growth (*development*), seeking for a boy/girlfriend (*alliances, associations*), to engage (*agreements and contracts*), to marry (*M&A*), sons (*split, spin-off*), maturity (*no increasing profits*), eventual separation (*desinvestiture, exit*) and passing away (*hostil M&A, bankrupcy*).

A company rationale, since it is managed by people, is similar to the logic basis of any human organization. For instance, there are a lot of similarities between Political Parties and private companies. Their main aim is to spread its ideas (*products & services*), to conquer as many voters as possible (*market share*), there is a constant internal struggle to exercise leadership (*managers & Directors*), coexistence of people with very different positions *(among the Board*), alliances with rivals are permanently evaluated, in order to increase the size (*M&A*), members' personal interest is not always totally aligned with party objectives (*Agency problem*), frequently splits and spin-offs occur (divestitures, reorganizations), the outgoing sometimes founds competing parties (*former CEO´s entrepreneurship)* and there is a dominant inertia for subsisting, although it would be more convenient to desist.

Intrapreneurship is innovative activity that happens within a company whereas entrepreneurship is innovative activity that is pursued through a new firm established primarily for that purpose. Sharing the argument of Ibrahim (2016), an intrapreneur is commonly thought of as an employee inside a large corporation who stays in-house to pursue her idea rather than leaving to create a startup.

An intrapreneurial venture can start from the very scratch, but when the company were you are an employee has the required resources to purchase it ready, making the decision to purchase an existing firm.

While entrepreneurship refers to all new businesses, including self-employment and businesses that never intend to grow big or become registered, startups refer to the new businesses that intend to grow large beyond the solo founder. That makes them possible for being commercialized.

Some startups become unicorns, privately held startup companies valued at over US$1 billion.
Startups are founded by one or more entrepreneurs who want to develop a product or service for which they believe there is a demand. These companies generally start with high costs and limited revenue which is why they look for capital from a variety of sources such as venture capitalist.
One of the most frequent issues that startup founders face in the very early steps (even before crossing the *Valley of Death*) is their lack of commercial background.
The founders might be great genius in their field, but not precisely in making business.
As a result of the previous, Angel Capitals commonly take a large slice of their firm, direct consequence of their lack of management strategy and expertise.
University accelerators and incubators (where available) may supply an expert and independent support for these entrepreneurs.

2. Why large companies engage in M&A

The literature suggests that the underlying motivation to merge is motivated by a series of rationales and drivers. For example, a strategic rationale is when one company acquires the other due to its over-capacity in the market sector where both operate. The underlying driver for acquiring the company is the desire to control a larger capacity in this sector.

Now more than ever, companies must sustain their competitive advantages. It is well known that every firm must design its own strategy to face the threats of competition in an everlasting changing environment. In our global village, substitute products may be available in each market after less than twenty days of navigation, even faster in the case of services.

Synergy is when the combined power of working two companies together is greater than the sum of the powers of each one operating separately.
This explains the notable increase in the volume of M&A, not just as another inorganic growth way. When a firm (like a startup) does not have enough capital, the needed knowledge and network, its infrastructure is inefficient or due to any other limitation, to be acquired by a large company seems as a desired and valid alternative.
Thus, the largest company integrates the smallest, becoming a unit.
The firms may win in tax aspects, synergies, financial benefits, savings in salaries, rents, administrative expenses and competitiveness, to name just a few.

This bounty or premium is a direct result of the combination of both firms' synergies. The value of synergy can be calculated in 3 steps: Firstly, for instance, we value the companies separately by discounting each expected cash flow at its weighted average cost of capital. Second, we estimate the value of the combined firm, with no synergy. Then, as a third step, we consider the effects of synergy into the expected growth rates and cash flows

and proceed to revalue the resulting blend. The difference between the value of the combined firm with synergy and the company without synergy provides the value for synergy.

As per Weston and Weaver (2007), although each M&A case is different, it is always true that the previous evaluation indicates that the combination of both companies is a good business decision, at least from the acquirer point of view.
Be aware that many acquisitions are frequently presented to the market as mergers, due commercial and prestige reasons, mainly referred to the acquired firm.
When the target firm is a startup, by the opposite, an acquisition means a successful exit.
Despite the previous, some adverse effects must be considered, such as culture shock, different procedures, among others.

Once a large company Board of Directors decides to engage in M&A, the next step for the managers is to look for the target company that better suits with the firm strategy in order to be purchased (and with their own interest as well, as per Agency problem).

Usually, a M&A between a foreign listed corporation and an Israeli startup is: private ownership, related, mainly vertical integration (but sometimes even horizontal in order to block a potential future competence), full acquisition, cross border and friendly.



Table 1: Israeli High-Tech Investments 2019-21. © Meitar (2021)

One of the crucial acquirers' aim is to retain the target firm management, as they represent (working as a team) a great source of added value. It should be properly highlighted that acquired firm management level of integration (assessed using payroll and R&D budget, among other measures), is one of the key variables that predict better the post-acquisition grade of success.
This kind of acquisition avoids waisting time, trial and errors costs and personal risks.The previous, as the market (stockholders, customers and suppliers) usualy rewards a good evaluated M&A when is announced, since it represents a threat for current competitors as well a barrier for potential ones.
Take note that proposals for new deals/ventures are often presented directly to the Board of Directors or to the CEO by external brokers, and later analyzed by managers, what is called a descendent path.
The way is ascendent, when the idea is presented by an employee and later assigned to the Business Development Department. The Chieff Development Officer firstly will request a deep evaluation, but later, in case he/she shares the project, will endorse and recommend the new business opportunity.
The Board of Directors have to decide if to commence the new venture from scratch or to seek for a target company which fits. The task can be assigned to an external broker, or to expert employees.

3. Determinants variables in target firm selection.

There are many factors involved at target firm selection process. To identify them from the very foundational stage allow the entrepreneur to design his startup as much suitable as possible for the potential bidden company.

A skema describing the Israeli ecosystem of innovation seems helpful to understand its singularity that explains the high level of success of recent years startups exits.



Figure 1: Israeli Innovation Ecosystem © StartupNation (2021)

Gavious and Schwartz (2009) sustain that investors may perceive firms with a continuous increase in sales as those that are able to transfer through the technology adoption lifecycle, which the main factor affecting value-relevance is a firm's degree of market penetration.

As per Cohen (2011), sometimes as a part of the integration process the buyer nominates the acquired team management to take control over its own business. Carbone (2011) sustains that not all deals deliver the anticipated benefits, mostly due to an unfruitful integration process. Moreover, Cohen (2012) studied in depth Israeli Hi-tech startups acquisitions by foreign corporations finding that acquired company and its technologies were fully integrated into the buyer core business within a short period of time started to generate a positive cash flow.

Almor, Tarba and Margalit (2013) research findings show that maturing technology-based global corporations can increase their chances of survival by acquiring other firms, allowing them to continue increasing their sales and to expand and upgrade their product line.

The study by Brueller, Ellis, Sege and Carmelli (2015) examined the effects of timing in high-tech acquisitions by analyzing how deviation from routines affects the value captured by the acquirer as well as the price paid. They examined the context of information and communication technology acquisitions in which multinational technology incumbents are known to habitually acquire product-related capabilities to facilitate their entry into new product domains. The paper highlighted the role of routines in managing technology acquisitions of multinationals and tests the hypothesis that smaller deviations in terms of target-maturity and acquisition-timing lead to superior outcomes for acquirers. Their findings indicate positive relationships between stricter iterations of routines and superior outcomes.

According to Kelly and Ma (2016), post-acquisition key talent retention describes what startup talent values most.

Zaks (2016) claims that is necessary to differentiate the M&As involving technology startups acquisition. As a result of the combination of the drive, the dynamic process and the human capital capabilities, is expected to result in a more successful outcome than was reported.

As per Getz and Goldberg (2016), the main reason behind the current acquisition wave of US listed companies in Israel is that many successful startups in the Hi-tech industry sector have been established, creating a large pool of people who understand the field well, which strengthens the flow of ideas.

Biazzo (2017) sustain that the main exit strategy for a startup is to sell the company to a larger company for profit, generally leaving their business standing without affecting the work of executives and employees.

Trapczynski, Zaks and Polowcyk's (2018) research conclude that trust from acquired firm managers positively increase post-acquisition success, although trust from the acquiring company (expressed with the autonomy that it leaves to the acquired firm) is not a significant predictor.Polowcyk and Trapczynsky (2018) argue that the communication climate is a crucial performance factor. They also found that effective knowledge transfer to the acquired company is an essential determinant of post-acquiaition success.

Dashti and Schwartz (2018) empirical study, based on 402 Israeli startups M&A between 2002–2009, conclude that foreign shareholders increase the likelihood of success of the startupexit via overseas acquisitions.

Zaks, Polowcyk and Trapczynski (2018) sustain that when foreign listed companies acquires Israeli Hi-tech startups investing in strategic thinking were more appreciated by the stockholder (current and potential) than when focused on the technology alone. Several determinant factors are considered when large US listed companies purchase Israeli Hi-tech startups, as stated in theirInvestors Relations brochures. There might be also undisclosed strategic objectives, for instance to impede future competition.

Some acquirer's firm independent variables are for example: same core business industry of the target company, overseas M&A, an independent and professional Board of Directors decided the M&A, R&D, acquirer firm size is much larger than the target one, among many others.

Acquired firm characteristics are for instance: foundation year, Industry subsector, local or international revenues, just to list a few.

4. Using the Worldwide Business Evaluation Model

The as useful and general as possible proposed *Worldwide Business Evaluation Model for M&A*, describes the criteria behind acquirer firms decision-making process, trying to list all the variables involved, and estimating them according to their degree of impact in each case analyzed, so that the Model can be applied in any industry, market and country.

This Model is intended for legal & formal accountancy large companies, mainly listed.

The Model is divided into 3 stages:

The first is the country level, where the analysis should not be influenced by the managers' point of view, as it is not related to the involved companies. For our research, Israel (at the moment of the analysis) must be suitable for this kind of investment, mainly when the idea is to maintain the acquired firm as a division.

It should be remarked that for corporations very prone to risk and high returns, a low percentage obtained at the national level in this Model may mean just the opposite: a very attractive place.

The second step refers exclusively to the target company characteristics.

The third step is to evaluate the possible combination between the two companies. This is why the second and third steps are calculated together: they both refer to the companies involved in the M&A transaction. The two last steps are added in a grand total percentage since the pros and cons of each candidate company depend solely on the point of view of the buyers.

The positive impact range varies from 5% to + 10%, the negative ranges from -5% to -10%, and a neutral variable is considered 0%. The basic assumption is that the first 3 columns of the grid would be evaluated in a very similar way by any analyst at the same time in the study.

Nevertheless, being comparative, an analyst may consider a variable as low/medium, but there would be no discrepancies between low or high incidence. The last 4 columns depend exclusively on acquirer firm managers' point of view, since, for example, a highly concentrated market can be seen as a great business opportunity, not a disincentive.

When the entrepreneur founds a startup is crucial to decide where to base it, as the characteristics of the place where he locates the firm cannot be changed by him nor in the short term. The potential buyer will start his analysis from the national stage. The first factors an acquirer will consider when selects a target firm are the characteristics of the country where is the startup established.

Some of the most relevant factors are: clear and stable commercial rules, technological, communications and infrastructural level of development, justice courts independence grade, national political and economy stability, local corruption level, protective laws and importation barriers, unemployment rate, local currency stability , rigid labor rules, investment trend, incentives for foreign investment, free access to foreign currency exchange, dividends taxation and limitations for foreign firms, among others.

	A WORLDWIDE BUSINESS EVALUATION MODEL FOR M&A							
	ISRAEL	Low	Med	High	Positive	Neutro	Negative	Relevance
1	***Variable***							
	Clear and stable commercial rules		x		x			5
	Technological development (higher Education, patents, copyrights, startups, etc)			x	x			10
	Communications development (internet coverage and speed, equipments, etc)		x		x			5
	Infraestructural development (roads, ports, buildings, etc)		x		x			5
	Justice courts independence level and stability			x	x			5
	National political stability		x		x			5
	Macroeconomic stability			x	x			5
	Local corruption level	x			x			5
	Protective laws and/or importation barriers		x		x			5
	Unemployment rate	x				x		0
	Local currency stability			x	x			5
	Rigid labour rules		x			x		0
	Investment trend			x	x			10
	Incentives for foreign investment		x		x			5
	Free access to foreign currency exchange			x	x			5
	Dividends taxation or limitations for foreign firms		x		x			5
	SUBTOTAL 1							**80%**

Table 2: Israel National Evaluation © Moskovicz (2020)

This amazing outcome of 80% explains the current foreign investment wave in Israel. As per the Worldwide Business Evaluation Model, once the country stage got a percentage above 65%, is time to proceed analyzing the potential target firm characteristics, by assesing each factor according to its relevance from the acquirer point of view, therefore this evaluation stage depends totally on bidden company strategy, that reflects its culture and interests.

When an entrepreneur founds a startups he/she must to design the company taking in count the leaders firms in his own industry, as they are the potential future acquirers.

A foreign bidden company Board will decide to engage in an M&A process with a selected firm only after analyzing and assesing several related factors, and how they may impact the post-acquisition performance.

There are many variables, such as: its eco-sustainability, the level of dependence on imported raw goods , the use of very specific supplies, the dependence grade on limited natural resources, patents or royalty payments, the level of dependence on expert staff, customers concentration grade, product concentration level, suppliers concentration grade, the relevance of the exportations in the total revenues, the feasibility to import its procurements, local industry maturity grade, capital requeriments, local market size and potential access to new markets, the level of accurate data availability, accounting formality grade, competitors formality level, cost dependence level on foreign currencies, reliable statistical records availability, target firm market atomization grade, the kind of ownership (public, private, one partner, a few, a familiar company) , the global situation of its industry subsector , industry regional growth and if the managers can be retained, among many others.

The result depends on acquirer's analysis, as what seems negative for some bidden companies might be the opposite for anothers. The same regarding the relevance of each factor, reflected by the percentage range between -10% to +10%.

Acquirer company managers main task is to predict as much as possible post-acquisition performance, evaluating the expected level of success once both firms synergies are combined. This is the reason why it seems absolutely crucial to consider the folowing variables by the entrepreneur when decides to found a startup: presence of acquirer global competitors in the region, organizational culture similarity, company size, the potential incremental profits once in buyer's hands, to create the conditions that allow a plug & play post-acquisition, organigram similarity, Horizontal or vertical integration, are there indirect additional benefits for the acquirer, is the acquirer already in the region, is the potentially acquirer company currently in this industry, an eventual acquisition impedes acquirer competitors strategy, are there some acquirer corporate reasons (even unveiled) for this acquisition, the distance to acquirer headquarters, language and cultural gaps, just to mention a few.

The Marker magazine published some unexpected findings related Israeli unicorns:

A. 39% started with two founders, 33% three, 15% four or more, and just 13% solo founder.
B. Related founder ages: 31% were between 31-34 years old and 30% between 35-39, 14% between 40-44, 12% above 45 and just 12% between 25-29.
C. Regarding founders' network: 35% knew the partners from the industry, 21% were introduced, 16% from the army, 11% were friends, 10% from the university (against to the myth) and 7% were relatives.
D. 58% of the founders had already created or invested in other startups in the past.
E. 83% of them have an academic degree, 61% in engineering or computer sciences.

In order to help to startup founder to identify a future potential acquirer, the author found in recent research that: 1) the acquirer is mostly an US listed firm, 2) the CEO is not the acquirer´s Board chair, 3) the acquirer company is leaded by a Board of Directors as independentas professional, 4) the acquirer engaged in an overseas M&A process, 5) target firm is much smaller than the acquirer's size, 6) both firms' core business is related to the Hi-Tech industry, 7)acquirer's goal was to purchase new patents, products and/or to integrate target´s firm staff, 8) the deal is part of a M&A wave such as the current one in Israel, 9) the startup at least had 2 years of revenues.

5. Limitations, conclusions and recommendations.

Further research is required as well a more extended list of worldwide cases where a large company acquires a startup, to provide a stronger base to validate a generalization and as a tool to analyze each case study particularities. There may be many other variables that explain target firm selection. This work is just the commence, the research should be improved and continued.

The founder must catch the hunter, designing the strategy andr adapting the startup to the potential buyer. Once decided the field of activity and defined the strategy, it is trongly recommended to seek who are the worldwide leaders in the industry which may be interested in a future purchase and proceed accordingly in order to obtain the highest qualification.

Usually, a car that does not have a "For Sale" signal will get a higher price. This, as the buyer does not ask himself the reasons why the car owner wants to sell it. That detracts from its value and bargaining power. Even if you want to sale the vehicle, the smart strategy is to display the car in the right ic places, always in excellent condition and hopefully brilliant. When is the buyer who is interested, for his own reasons in acquiring that kind of car like yours, it only can increase its price.

Although is well known every startup aim is to be purchased, the potential acquirer doesn´t know your timing or your red borders regarding price and conditions.

Don´t show your cards prematurely, let your counterpart to see the tasty bread you can deliver, but keep the recipe for the exit stage.

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