PLATFORMS FOR HIGH NET WORTH INVESTORS IN ISRAELI HIGH-TECH

DIY Investor

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Israeli hi-tech and its sources of funding have grown and diversified tremendously since the bubble burst in 2001 and over the last decade since the height of the financial crisis in 2007-2008.

Based on data from the IVC Research Center (see www.ivc-online.com), 96 Israeli hi-tech companies raised $341 million in Q3 2010, for an average investment round size of $3.55 million, while 144 Israeli hi-tech companies raised $1.44 billion in Q3 2017, for an average round size of $10 million.

In Q4 2017, 159 Israeli hi-tech companies raised an additional $1.44 billion, for an average round size of $9.1 million.

Venture capital investing

Raising sufficient amounts of capital to fund research and development and finance marketing efforts is obviously essential for a startup company to succeed, but is this investment a good one for the investor and what are the odds of a positive return?

Venture capital investing is not for the weak of heart.

Historically, a small number of deals provide a large portion of returns.

Over the last decade or so, the valuation of exit transactions has generally trended higher year by year.

Over the last three to four years, the picture is more nuanced as the valuation of exit transactions has continued to trend upwards, while the number of exit transaction has fallen slightly, suggested somewhat fewer exits at higher valuations per company.

The IVC Research Center reported $8.44 billion in exit transaction value in 2014, increasing to $8.87 billion in 2015, $9.96 billion in 2016 and $23 billion in 2017 (the 2017 amount includes the $15.3 billion sale of Mobileye to Intel, which skews the statistics dramatically).

Over the same period, the number of deals decreased from 132 deals in 2014, to 129 in 2015, to 120 in 2016 and 112 in 2017.

After deducting “mega-deals” with a value of over $1 billion, the picture is more normalised, although the numbers continue to show a drop in the number of companies exiting from 2014 to 2017, albeit after spiking sharply in 2014 from 108 deals in 2013.

While traditional venture capital firms, as well as angel investors remain very active in the market and command a large portion of the investment in this area, the investment platforms have also diversified and a multitude of other offering have been created to suit various types of investors.

Some of these offerings may be more suitable to the high net worth individual that is either reluctant or unable to invest the huge amounts required for an investment in a traditional venture capital fund or is reluctant or unable to go out "on his own" as an angel investor.

The multitude of investment platforms in the Israeli market today include:

- ✓ "Traditional" venture capital funds in various verticals
- ✓ Accredited Investor funding platforms
- ✓ Micro-funds
- ✓ Angel investors

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Venture Capital Funds

"Traditional" venture capital funds investing in Israeli hi-tech, include a wide variety of funds, some more international in nature, generally US based, often with an Israeli office (e.g., Lightspeed, Battery, Norwest) or with specific Israeli designated funds (e.g. OrbiMed), while others are solely Israeli based and focused, investing primarily into the Israeli market (e.g. Viola Ventures, Pitango, TLV Partners).

The size of the market opportunity and stiff competition has created increasing specialisation in specific verticals at the fund level, as some funds brand themselves as experts in specific fields, such as Cybertech (e.g. Glilot Capital) while other funds set up specific funds in specific verticals under the same fund umbrella (e.g. Viola Fintech).

Many funds stress the stage at which they invest, such as seed stage, prior to initial revenue after proof of concept and so on.

Despite the frequently reported death of venture capital funds, "traditional" venture capital funds have generally managed to retain standard venture capital fund economics of 2 and 20 (2-2.5% management fee per annum plus 20% of profits as "carried interest").

From the investors' perspective, "traditional" venture capital provides a dedicated investment team with a substantial track record, economically motivated primarily by a substantial share of the profits (in particular given that most funds in this space, with the exception of the large international funds, are not very large so that management fee, while very important, is not the "profit center" it often is in larger private equity and similar funds).

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With that said, the traditional model is predicated upon "big tickets", with investors generally required to commit a minimum of $500,000 to a $1,000,000, and often much more, over a period of 7 to 10 years.

The investor is entirely dependent on the fund's investment team, with no discretion of his or her own, there is generally no ability to leave the fund prior to its termination other than through a secondary sale (unlike hedge funds, venture capital funds do not allow redemption).

Accredited Investor funding platforms

Accredited Investor funding platforms have become a major source of funding for Israeli hi-tech over the last five or six years.

The most well-known are OurCrowd and iAngels. In a nutshell, these platforms source deal flow much as a venture capital fund would, perform due diligence on the companies and enter into term sheets with the target companies, but unlike venture capital funds that then call previously committed capital from their investors, who are obligated by contract to provide the committed capital for the investment, these platforms put the target company up on their internet website and begin to solicit investors (generally to avoid breaching securities laws only accredited investors may access these sites and make investments) and then aggregate the investors who opted to invest in the specific target company into a special purpose vehicle that makes the investment.

The platforms take their share of the economics of the deal, charging various fees, including set-up fees and management fees as well as a share of the profits. Terms vary from platform to platform.

From the investors' perspective, investing through an investor's platform would seem to blend investing through a venture capital fund with a choice, in the sense that the investor can choose his or her specific investments and is not committing a large chunk of capital, years in advance, on an unknown pool of investments.

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In addition, investments on accredited investors platforms require minimal investments of smaller chunks of capital, as little as $10,000 per investment, so risk can be mitigated and diversification increased.

With that said, as a venture capital fund would make 15 to 20 investments in typical venture capital fund, and an accredited investors platform would have a larger number of companies raising money on its website over the same period, the level of due diligence is likely lower.

In addition, the investors making the choices are not necessarily adequately knowledgeable in the technology or may not be privy to the same level of information as the investment team in a venture capital fund.

Also, depending on the governing documents in each case, a venture capital fund is in most cases, required to return all contributed capital to its investors prior to the managers taking a share of the profits.

This means that if a venture capital fund has made ten investments for example, the capital invested in those ten investments would need to be returned prior to the managers getting paid a share of profit.

In a special purpose vehicle that invests into one company, the platform receives a share of the profits once the amount invested in that one company is returned in full.

Assuming that a fair number of investments are not successful, it becomes clear that the venture capital fund is in a different position than the accredited investors platform, since the first needs to return the capital contributed to the fund as a whole, which includes "winners" that made a profit and "losers" that did not, while the accredited investor platform, since each investment is a separate investment unrelated from an economic perspective from the others, will receive a share of profit from the "winners", but will not need to offset this from any losers.

Micro-funds

Microfunds are similar to "traditional" venture capital funds, just with committed capital of a few tens of millions of dollars in total and sometimes as little as $5 million.

These are often first-time funds unable to raise larger amounts without creating a more substantial track record. The economics of these funds is generally similar to those of "traditional" venture capital funds, though often rather than set a management fee as a percentage of committed capital, these funds provide a budget for their operation that covers costs.

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Microfunds, due to their size, generally focus on seed-stage and early stage investments, where the risks and rewards are the greatest.

Microfunds differ from other venture capital funds in their relative inability to fund follow on investments in successful companies and protect their positions.

While larger venture capital funds will often be able to use their greater capital reserves to protect their positions, through the exercise of preemptive rights or otherwise, microfunds do not have these reserves and are, therefore, often in a mindset of protecting their "downside" and negotiating mechanisms that try and compensate for their relative lack of capital.

The most successful microfunds are very successful due to their efficient use of capital which provides for greater returns, while the least successful may suffer heavy losses due to their inability to protect their positions.

Angel investors

Angel investors are generally individuals investing directly into seed and early stage companies on their own.

Many angel investors in Israel are entrepreneurs themselves that began investing on an ad-hoc basis after becoming wealthy following an exit.

An angel investor does not enjoy the designated investment team of a venture capital fund or an accredited investors platform that sources investments and performs due diligence for him or her.

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Sourcing deals is probably the most difficult aspect of venture capital investing and requires a huge investment in time and networking. Investment through funds and micro-funds or through an accredited investor platform solves this issue.

On the other hand, there is no overhead of management fee and carried interest payable when investing as an angel and the decisions are all your own.

Angels, like Microfunds, often have a problem protecting their positions going forward and generally make their investments under the assumption that they will be greatly diluted until the company reaches an exit.

Angel investment is usually most suitable for individuals in their particular area of expertise, otherwise the risks may outweigh the rewards.

The Israeli hi-tech eco-system is full of opportunities for investment. There are various models for making such investments.

High net worth individuals contemplating such investments should consider, based on amount to be deployed, the ability to independently source and diligence investments and their personal risk-reward profile, which of the investments models is most suitable for them, bearing in mind that venture capital investing is always a very risky business.

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The online link to the article can be found here.