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Early-Stage Venture as an Attractive Asset Class for a World Recovering from COVID-19

Abby Flamholz[1] and **Aaron Zucker**[2]

Executive Summary

1. The economic downturn will create new opportunities for value creation by privately held companies, both by existing companies as well as by newly founded companies.
2. Seed-stage opportunities will require even less capital to get started but significant support to grow long-term, both in follow-on capital as well as hands-on mentorship and guidance.
3. Due to the longer-term horizon for exit, the timing for investing at the beginning of a new economic cycle positions these companies to further capitalize on the anticipated upswing of the markets.
4. Substantive and lasting value creation through innovation of "deep-tech" vs other innovative "business" opportunities provides the potential for greater returns even in mediocre outcomes.
5 Israeli innovation continues to flourish with over 1,000 new companies formed each year and an estimated 6,000 startup companies based in Israel alone.
6. Bottom line: Seed stage VC should be considered as an attractive long-term investment strategy, especially when focused on deep-tech value creation led by Israeli innovators.

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The world is bravely at work to bring the COVID-19 pandemic under control. Countries and states have taken different approaches to stem the spread of the virus. As of the writing of this paper, it seems that those who have taken more aggressive actions – locking down their citizens early – seem to have better positioned themselves as far as containing the pandemic. But these actions have come at a great cost to the global economy which was only just completing a cycle of recovery since the downturn of 2008 (subprime crisis).

Expert opinion regarding the depth of the current downturn, as well as the time to recovery, ranges from 10 years, in the pessimistic view, to 6 months in the most optimistic reports we have seen. Not surprisingly, this differing analysis can be explained, in part, by the location and personal experience of those conducting the analysis. That being said, the current easing of restrictions is being met by improvement in the markets, even though consumers are still being cautious.

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[1] ***Abby Flamholz*** is the Chief Investment Officer of Worth Venture Partners, an SEC-registered investment advisor providing diversified alternative emerging manager solutions. For more information: wvpem.com.
*Note that being an SEC-registered investment advisor does not imply a certain level of skill or training.

[2] ***Aaron Zucker*** is the Managing Partner of Sapir Venture Partners, a Seed-stage micro venture capital firm empowering Israeli founders commercializing deep-tech and cutting-edge science.
For more information: sapirvp.com.

It will take time to fully assess the damage to consumption and production caused by this pandemic and the rate of future economic growth. The strategic considerations of venture capital (VC) as an asset class in a portfolio have been argued at length by others.[i] [ii]

Considering the current economic outlook, it seems that the very aspects of the VC asset class which were used to argue against it, are now what make it attractive. Amongst these, consider the long-term horizon of VC returns and anti-correlation with market performance. Investments being made today by a VC investor will be positioned to ride the wave of renewed growth during the recovery.[iii]

This assumes that these portfolio companies survive the downturn. There may still be further dips before we bottom out. VC investors account for this by applying strategies of diversification – multiple companies in a portfolio, at multiple stages of development, and even across different industries. Some of the greatest returns in VC are generated by funds with vintages around periods of economic decline. (Of course, this is also true of funds with vintages solidly within positive growth periods in the market).[iv]

There is data to support the argument that early-stage investments generally outperform later-stage investments as far as return multiples go.[v] This is in part due to the longer "time-to-market" for these companies during which they can create sustainable value. Furthermore, we believe that there is the potential for higher returns for smaller funds versus larger funds stemming mostly from the fact that you need multiple $B exits to return multiples on $B funds, and most exits are not that large.[vi]

We also believe that there should be a clear preference to invest in portfolio companies which are driving innovation based on cutting-edge science and deep technology. The value being created through this type of innovation should create a longer lasting impact on an industry, resulting in appreciation of the portfolio company. This is in contrast to companies leveraging innovative business models alone, such as marketplaces and social networks. This is especially important to keep in mind regarding companies that identify a limited scope of market need which may have evaporated with the shift in economic stability or which are based on current market conditions. Neither are permanent. But overall, it would seem that the crisis will strengthen the need for new technologies and quicker adoption rates.

The strength of Israeli innovation is well known.[vii] Our focus on Israeli founders was driven in part due to their resilience and ability to adapt so as to overcome challenges. This is especially important today where every company needs to prioritize survival and then growth. As we evaluate the overall economic environment, we identify different timelines for potential recovery in geographic markets as a result of their actions to contain the virus and its economic impact. Israel's economy is expected to "absorb the shock" of the coronavirus pandemic as indicated by S&P Global Ratings[viii] reaffirming Israel's AA- sovereign credit rating last week. Israeli founders are uniquely positioned to engage with any market around the globe and can further adapt their strategies to align with recovery schedules in each geographic region.

To allow countries and states to emerge from the lock-down, they are creating new guidelines to protect us. It is within the confines of this "new normal" that we will need to begin the economic recovery process. As such, early-stage companies are arguably better positioned to adapt. For this stage in the life of the company it is necessary to dedicate more resources to R&D, rather than teams of sales and marketing professionals limited by air travel restrictions. During uncertain times these companies can cut costs and focus on internal development to ride out the storm, essentially increasing their long-term value creation.

Before March 1, 2020 we were already witnessing a shift within venture capital. Despite record amounts of capital in the industry, the number of deals getting done in 2019 was smaller than in 2018.[ix] This trend toward larger deals is most relevant at the Series A stage and the later stages pre-IPO. These rounds were becoming larger but fewer. We expect this trend to continue and even expand in the near term. Funds will look to increase the reserves set aside for their existing portfolio companies to overcome the effects of the pandemic, thus reducing the available capital for new investments. Furthermore, while many of the larger funds have either raised capital recently or will have the brand power to continue doing so, we expect funding for the venture capital industry overall to shrink in the near-term as institutional investors rebalance their allocations.

Considering all of the above, we have renewed conviction in our focus to back Israeli founders at the early stages of commercializing deep-tech and science. In our opinion, the "correction" in pre-money valuations due to the downturn has made these opportunities even more attractive at the Seed stage while prices have become excessive at the Series A stage. Furthermore, with an established portfolio and key relationships in place across the ecosystem, we are seeing great companies at the stage and time most exciting to be investing in VC.

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[i] For context see Paul Kedrosky, "Right-Sizing the U.S. Venture Capital Industry," June 10, 2009, https://www.kauffman.org/wp-content/uploads/2009/06/USVentCap061009r1.pdf.

[ii] See also the more recent report: Samir Kaji, "A data driven view on what Emerging Manager LPs are thinking today," May 12, 2019, https://medium.com/@Samirkaji/a-data-driven-view-on-what-emerging-manager-lps-are-thinking-today-ee75b2dcbc27.

[iii] This is covered in depth by Adam Fisher, "Letter to a Young Investor," April 13, 2020, https://medium.com/@AdamRFisher/letter-to-a-young-investor-39cb6d24c5e1.

[iv] Cambridge Associates, "US Venture Capital Index and Selected Benchmark Statistics," December 31, 2017, https://www.cambridgeassociates.com/wp-content/uploads/2018/05/WEB-2017-Q4-USVC-Benchmark-Book.pdf.

[v] Abe Othman, "Startup Growth and Venture Returns: What We Found When We Analyzed Thousands of VC Deals," December 11, 2019, https://angel.co/blog/venture-returns.

[vi] See Kedrosky.

[vii] See more at Start-Up Nation Central, www.startupnationcentral.org, or you can find the book, Dan Senor, Saul Singer, START-UP NATION on Amazon.

[viii] See Eytan Halon, "S&P: Israeli economy expected to 'absorb' coronavirus shock," Jerusalem Post, May 17, 2020.

[ix] "Preqin and First Republic Update: US Venture Capital in 2019," https://www.firstrepublic.com/-/media/frb/documents/pdfs/innovators/Preqin-and-First-Republic-Update-US-Venture-Capital-in-2019.