Our Approach to Israeli Technology Investing

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At Israel Investment Advisors, LLC (IIA) we do not invest in technology startups. Our parent company GHP Investment Advisors, Inc. (GHPIA) also does not invest in technology startups. GHPIA clients and prospective clients rarely ask us why we do not invest in technology startups. At IIA, however, we are constantly presented with this query. In fact, quite a few people familiar with Israel's reputation as the "Start-Up Nation" express surprise that we do not invest in technology startups, yet we call ourselves an Israel investment fund. We are equally mystified that so many people familiar with the uncertainties of technological innovation seem to assume that startup investing in Israel is somehow less risky than startup investing in the United States.

Venture Capital Can be an Excellent Business…Just Not for Us!

Venture capital can be an excellent business for funds that specialize in this type of investment. Startups are private companies, often lacking revenue or even well-defined business models. Good venture capital firms employ technologists and other appropriate personnel to evaluate, monitor, and engage with new products and management teams. Typically venture capital investors endure lengthy periods of illiquidity.

Most startups fail. Venture capital returns can be significant, however, they are often generated by only one or two big winners. One big winner can more than compensate for dozens of losers. Venture capital funds that lack one big winner can significantly underperform. Picking one or two huge winners amidst a plethora of failures is not our strategy. Fans of baseball understand that some of the best home run hitters tend to strike out more often. Our goal is fewer home runs and fewer strike outs, but more singles and doubles.

Since startup companies are mostly private, finding reliable failure data is difficult. Front-end data tracking capital investment is relatively easy to find. Several organizations publish quarterly statistics in both the United States and Israel. For example, a company called the IVC Research Center produces interesting and comprehensive statistics about Israeli startup investing each quarter. PwC Israel and Start-Up Nation Central also produce similar data. However, systematic reporting of more detailed data regarding revenues, net income, cash burn, and company closures is nearly impossible to find.

Roughly 1% of Startups Become "Unicorns"

An interesting study by the consulting firm CB Insights tracked 1,119 American technology startups that raised their initial "seed" round of venture capital investment between 2008 and 2010. They examined what happened to these companies through 2018. Of the companies tracked only 48% made it to a second round of funding and 15% raised a median $15 million by the fourth round. Of the original 1,119 companies, 12 achieved "unicorn" valuations of at least $1 billion by 2018 and another 40 exited through IPO or buy-out at valuations of $50 million or higher. In total 67% of the 1,119 companies either closed their operations or failed to produce investor returns. That's a lot of strike outs.
(See first chart on page 2, source: https://www.cbinsights.com/research/venture-capital-funnel-2/)

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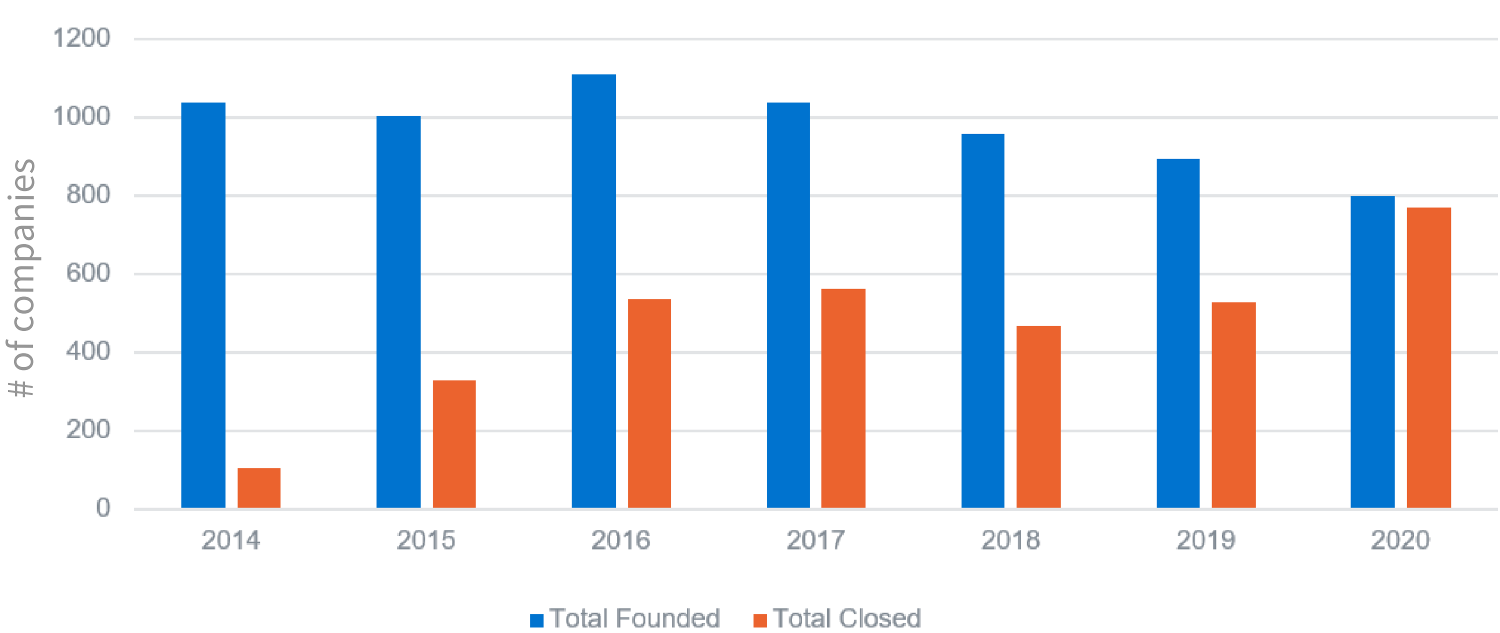
US Tech Companies That Raised a Seed Round in 2008, 2009, 2010

	Count	% of Previous Cohort	% of Original	Avg. Amnt. ($M)	Median Amnt. ($M)	Avg. Months in Between	Median Months in Between
Original Round	1119	***	***	0.67	0.35	***	***
2nd Round	534	48%	48%	4.27	3.09	20	16
3rd Round	335	63%	30%	11.09	7.30	20	18
4th Round	172	51%	15%	23.57	15.40	20	18
5th Round	96	56%	9%	56.85	25.00	20	19
6th Round	30	31%	3%	119.83	40.00	15	13

Start-Up Nation Central tracked the number of Israeli technology companies opened and closed each year between 2014 and 2020 (see their graph below, source: https://blog.startupnationcentral.org/general/what-does-the-increase-in-closures-of-israeli-start-ups-really-mean/). The Israeli startup scene is very robust with 800 or more companies opened each year. Startups often close their doors quietly, so the data below probably understates total closures each year.

Israeli Technology Companies - Opened and Closed



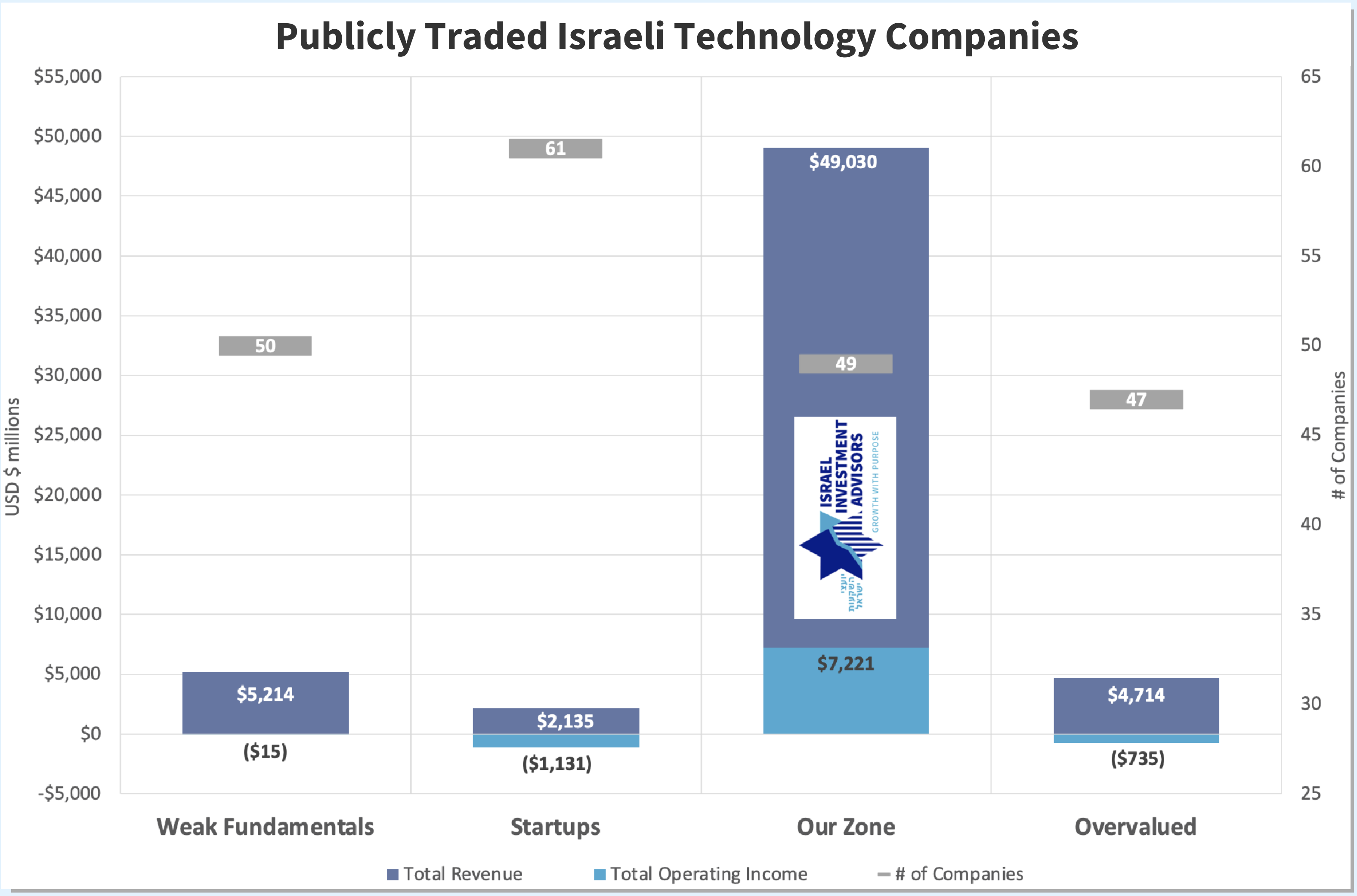
Israeli Technology Stocks

In the United States there are very few technology startups that trade on the stock exchange. A large percentage of these companies are in the life sciences or biotechnology industries, often with promising treatments already in clinical trials. Most publicly traded companies are more mature with significant revenues.

Israel is different. As the chart below shows there are 207 publicly traded technology companies in Israel. We separated these companies into four categories. We labeled 61 companies “Startups” because they are at an early stage of development with modest revenue, rapid growth, but negative cash flows. To compare company valuations, we use the Price-to-Sales (P/S) ratio since many of these companies are losing money and traditional Price-to-Earnings (P/E) or Price-to-Cash Flow (P/CF) ratios will not compute. For comparison, the Tel-Aviv 125 Index P/S ratio is 1.7 and the S & P 500 Index P/S ratio is 9.9 as of September 30, 2022.

As of Q3 2022 our Startups category traded at a median Price-to-Sales (P/S) ratio of 11.6. Fairly lofty, but in line with similar private venture capital valuations. Another 47 companies are also essentially startups but hot stocks. They tend to be somewhat larger and growing faster. We labeled these companies “Overvalued” because their median P/S ratio of 60.3 vastly exceeds our valuation tolerance.

Not all Israeli technology companies are startups. Quite a few were started decades ago, and some have brighter prospects than others. We labeled 50 companies with more difficult economics “Weak Fundamentals” and 49 companies with robust revenues and profits “Our Zone”. While we do sometimes identify turnaround opportunities in the “Weak Fundamentals” category, our technology investment strategy revolves around more mature companies with substantial revenues and profits.



Stocks are Volatile, but Liquid and Transparent

Investing in publicly traded stocks involves risks, of course, but the failure rate of profitable public companies is much lower than technology startups. Stock market investing can generate anxiety, particularly when prices are depressed as they are now. Public markets are indeed volatile, but they are also transparent. Private investments such as venture capital might seem less volatile since valuations are not quoted each day. Whether visible or not, however, startups are ultimately impacted by similar economic vicissitudes.

There are excellent venture capital funds focused on the "Start-Up Nation". The more they succeed the more public companies there will be in the future for us to invest. At Israel Investment Advisors, LLC. we invest in Israel as the "Scale-Up Nation". When startups succeed, they can graduate into global leaders. We look for the promising graduates when recruiting technology companies for the Israel Investment Fund, L.P.

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