# Pre-Seed and Early Investment: Methodology

DATA
AND
INSIGHTS

# OVERVIEW

There has been a sea change in the financing of early-stage start-up companies over the past decade. Previously, there was a clear differentiation between an enterprise that consisted of an idea and perhaps a basic prototype and a company that had a product, strategy, and corresponding marketing plan. Seed funding was the appropriate model for the former and A round for the latter. There was a marked difference between these types of financing characterized by amount, type of investor, and the operative status of the company.

Traditionally, Seed rounds differentiated from A rounds according to their timing in the life cycle of the company: if the operation comprised less than ten employees, without a working product and no sales, funding would most likely fall into a Seed Round. Now, much more frequently than before, companies much further on in their life cycle, with multiple employees, working products, and even sales, often claiming these are Seed Rounds. So, how are we to redefine what constitutes each round of funding in this new age?

These changes are not relevant to Israel alone, but many territories with start-up ecosystems and corresponding investment infrastructure. Several research companies, from diverse geographic locations, decided to define rounds by the characteristics of the funding, generally by investor type. Others try to distinguish between Pre-Seed and Seed based on the overall ‘weight’ of a company’s operational status.

Due to a range of factors, these changes were less marked in Israel than in other markets. Over the years, IVC has stayed with the traditional tech funding divisions: Seed, A round, B round, etc. Since the significant information source is a formal publication of the companies, IVC collects the Seed funding data into the Seed Round’s bucket. This helped create a clear benchmark concerning the industry dynamics and avoid analysis that can bias the real trends due to fewer funding events.

In 2020, the appearance of early-stage investments is quite different. The amounts for Israeli Seed rounds resemble those that were typically only found in A Rounds in 2010-2011. More importantly, the nature of investors in Seed Rounds has changed dramatically. Up until 2015-16, the early and mid-funding rounds (Seed, A, B) rarely included Private Equity Funds, Family Offices, Institutional funds, strategic investors, and similar. Now it is prevalent.

# PRE-SEED CHARACTERISTICS

To differentiate between Seed and A rounds, we introduced two new categories: Pre-Seed and Early Investments encompassing all the previous Seed rounds. Early Investments refer to funding rounds whose characteristics were more akin to companies typically seeking A rounds. How do we define Pre-Seed investments, and how do we allocate them? IVC deals with quantitative data, so taking a numerical methodology to create quantitative boundaries between the Pre-Seed and other kind of early rounds, is straightforward. The two main features of this approach are the sums raised and the investors' type.

For the Pre-Seed investor types, we thought about the more traditional early investors: Technology Transfer Companies, Angels, Angel Groups/ Crowdfunding investments platforms, Incubators, Innovation Labs, Corporate Accelerators, General Accelerators, Academic Accelerators, Impact Accelerators, Co-Working Spaces and Grants from the Israeli Innovation Authority. However, in this large vessel, there are outliers. Not all Angels are created equal. Out of nearly 1400 Angel investors active in Israel over the last decade, (both foreign and local), several dozens of them act more like fund investors, in the meaning of fortune and investments types. The most active Angel investors in 2018-2020 are included in this exclusive list and treated as Early-stage investors and not Pre-Seed (although you might find them repeatedly engaging in deals for companies in the Pre-Seed stage).

One can apply the same logic to the Angel Groups and Crowdfunding investments platforms. Of approximately 70 investment groups active in the Israeli tech market since 2015, only about four of them, on average, took part in deals of $1M or less each. The rest are presumed to invest and target companies more like Micro-VC than traditional angels. The overall depiction considers not just the investors' behaviour but also the companies' operation. Pre-Seed companies are assumed to be an exciting opportunity but not yet a company with employees, products, or even a specific market. When a more sophisticated investor joins a company at this stage, we might assume that the operational level is more advanced than Pre-Seed. Hence the importance of the investor type.

Notwithstanding all of the above, the more important feature is the invested amount. We see the dollar amounts as a sign of faith in the founders' visions. Undoubtedly, many irrational decisions are made on this path. A charismatic founder could attract a seven-figure investment without any operational proof of concept for his or her ideas. Yet, these are anomalies. In most cases, you need more than just ideas and charm to attract large amounts. We took the mid-point in Seed rounds for the last few years as a good place to draw the line between the Pre-Seed and the rest. In 2015-2019, the median amount in Seed rounds was nearly $0.9 Million. While the standard deviation in Seed Rounds almost doubled in this period – as indication for higher amounts - there are just a few occurrences (investments deals) that fall in the far-right edge of the normalized distribution curve of the Seed deals.

# TECHNICAL PROCEDURES

The quantitative boundaries can take you up to a certain point but cannot cover everything. Each year there are multiple deals where the indicators are not sufficiently precise. Sometimes a more sophisticated investor had been involved in rounds with low amounts or traditional Pre-Seed investors have taken part in high amount deals. In these cases, how could we decide if those are Pre-Seed deals or Early-Stage deals?

The differentiation could have been decided in an interesting, yet endless, philosophical debate. So, as is more common to our times, we used a mathematical procedure as the lead, employing a clustering algorithm (KMeans) to help us draw the boundaries. The main feature was on the amount of each deal, and adjusted weights for each deal were mainly based upon the investor types. The analysis includes more than 4300 Seed Rounds that took place in 2012 – 2020.

| | Early Investments Median $m | Pre-Seed Median $m |
|---|---|---|
| **2012** | 1.5 | 0.1 |
| **2013** | 1.725 | 0.1 |
| **2014** | 1.62 | 0.1 |
| **2015** | 1.8 | 0.1 |
| **2016** | 2 | 0.105 |
| **2017** | 2 | 0.1 |
| **2018** | 2.1 | 0.1 |
| **2019** | 2.5 | 0.1 |

The results give new recognition to investments in early-stage companies. The separated groups that were created from the Seed Rounds, helped us better understand how they affect the overall local tech investment landscape. In the period between 2012-2019 (some of the data for 2020 is not available yet), the median amounts for Early investments increased by 66% while the Pre-Seed median didn't change (see table). This underscores the transformation in the funding dynamics over the decade.

# SUMMERY

Overall, the shifts in early rounds seem like a symptom for a more systematic change. In some manners, the only differentiation of Seed from A Rounds in the last years, is the standard deviation of the amounts. In more mature stages we can find similarities with other types of funding.

The traditional understanding of start-ups' funding seems to be losing its relevance. Understanding it is more a long-run effort, not a sprint. Accordingly, frequent adaptations to the methodology might be needed in the future to reflect the fluid transformation of the funding mechanisms.

# THANK YOU

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