

ISRAELI M&A

Israel has embraced venture capital during the last decade as the rise of the high technology and green-tech industries has meant a need for investment.

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VC money has allowed start-ups to flourish in the country and provided countless targets ripe for acquisition by private equity players and existing trade buyers. The lack of IPO activity since the start of the credit crunch last August has only made the M&A sector in Israel hotter.

Israeli Venture Capital – the story so far

Venture capital in Israel sprang up on the back of the Israeli Government's Yozma Program in 1993. The program encouraged the development of a viable venture capital industry. Prior to 1993 there was only one VC fund in the country but the program precipitated a dramatic, positive change in the perception of foreign VC investors and their attitude towards investing in Israel. Under the Yozma Program 10 new venture capital funds were formed, managing \$20 million each, of which Yozma's share was 40%, with foreign investors holding 60%. In the years since 1993, the Israeli VC industry has flourished and gained a leading position in the world, with the total capital raised to date in excess of \$10 billion.

The program attracted major international venture investors including Advent, MVP, CMS and Walden from the US, Daimler-Benz, DEG, Van Leer Group and TVM from Europe and Oxtion, AVX, Kyocera and Vertex from the Far East.

Today there are about 80 venture capital funds operating in Israel, with the total capital raised at \$10.6 billion and investments made in more than 1000 Israeli start-up companies. Many of these start-ups went through successful IPOs and, according to the IVA, there are presently more than 70 Israeli companies traded on NASDAQ and around 30 traded on various European exchanges, including AIM. Israel is ranked second, after Canada, in terms of the number of non-US companies traded on NASDAQ.

Since 1993, the average size of the leading Israeli VCs fund has jumped from \$20 million in 1993 to more than \$250 million today.

The Israel Venture Association (IVA) was set up in 1996 as a national body designed to encourage the flow of foreign capital into the country, as well as investment from domestic sources.

It represents all players in the VC industry in Israel, including the major VC funds and other venture investors. It also liaises with service providers, technological incubators, investment and commercial banks, private investors and private equity firms. It is active in exchanging information between venture capital associations in Europe, North America and Asia.

Orna Berry is venture partner at Gemini Israel Funds and chairperson of the IVA. She is also a former Chief Scientist and Director

of the Industrial R&D Administration of the Ministry of Industry, Trade & Labor of the Government of Israel. She believes that the US VC model has been adopted to great effect in Israel, but that the industry is still growing and developing, with the help of foreign capital.

She said: "US financial advisers provided significant assistance when the VC industry was being set up in Israel, with American VCs very involved in creating the model for the Israeli finds and in syndicating with them. For foreign investors in general, the regulatory environment is very friendly, while they are also attracted by the openness of the hi-tech and VC sectors."

She added: "To encourage local financial institutions to invest in Israeli VCs, the IVA is continuously engaged with the authorities to ease regulation."

Dr Berry says that the high-tech industries are the major benefactors of venture capital and, in turn, private equity backing, but is keen to emphasise the growing popularity of other industries.

She added: "The relationship between VCs and the high-tech sector persists and grows, while new relationships are also being formed with alternative energy and water companies. Multinational corporations from around the world are involved too. Private equity has been well received in Israel as a vehicle for supporting venture-backed companies prior to their exits, especially in the run up to a public offering of these firms."

Why is the High Tech sector so successful in Israel?

The high tech sector has been the driving force behind Israel's economic success. In 2007 alone, firms in industries such as communications, life sciences, internet and semiconductors raised around \$1.76 billion from local and foreign investors.

In 2007, 27 Israeli high-tech companies raised \$701 million through IPOs on US, European and Israeli stock exchanges.

Israel is considered to be one of the most technologically advanced countries in the world.

A high standard of education mixed with an influx of technologically skilled people during the last 20 years has contributed to the boom.

High defence spending and a lack of raw materials such as oil, coal and metal has also combined to create a country that is on a par with Silicon Valley in California for high tech expertise.

Many of the global leading technology companies like IBM, Motorola, Intel, Microsoft, Cisco, HP, BMP, SAC, Sandisk, Sun Microsystems, Applied Materials and many more have established R&D centers in the country.

Figures from the IVA show that there are 135 professionals with engineering degrees per 10,000 people and 24% of the workforce holds university degrees.

Israel has a stable and mature economy with an annual inflation rate of about 4.5%, a growth rate of around 4%, \$19,000 GDP per capita and a modern infrastructure suitable for technological developments.

Just two examples of successful high tech firms funded by VCs include Intel Israel and DSP Group.

Lior Aviram, senior partner and head of the high tech practice at law firm Shibolet & Co, said high tech firms play a large part in Israel's economy and are attractive to foreign investors.

He said: "Around 80% of M&A activity in Israel takes place in the high tech sector. It's a sector of start-ups that are being funded by VCs from Israel and around the world, but mainly from the US. Many of these have teams on the ground in Israel, firms such as Sequoia Capital, Benchmark Capital and Battery Ventures. Many of these are on their third or fourth funds in Israel and are backed by pension funds and institutional investors."

Barry P Levenfeld, from law firm Yigal Arnon & Co, has acted on several high tech transactions in recent times and says they are an attractive target for foreign acquirers.

He said: "Acquirers from outside Israel have shown sustained interest in purchasing Israeli high tech businesses over recent years. Our office alone has handled acquisitions on behalf of IBM, France Telecom, Oracle, Sun Microsystems, Symantec, Red Hat and eBay, just to name a few.

In Q1 of 2008 alone we closed or signed over \$1 billion of deals. Israeli technology has been and remains very 'hot'."

Foreign Investment in Israel

Foreign investment in Israel is welcomed by the country and there is a good acceptance that foreign capital can help the economy grow and become more prosperous.

M&A activity involving Israeli companies acquired or merged totaled \$3.2 billion in 2007, in 75 deals. The most noteworthy deals involved big American acquirers, for example IBM's acquisition of XIV for around \$300 million and AOL's \$363 million acquisition of Quigo.

J. David Chertok, head of the private equity practice at Meitar Liguornik Geva & Leshem Brandwein, believes there is no shortage of international companies vying to acquire Israeli companies, particularly in the High Tech sector.

He said: "We have seen acquirers from North America, such as strategic players like HP, Microsoft, eBay, Yahoo, Applied Materials, AOL and EMC. There are also private equity players such as Berkshire-Hathaway, Texas Pacific, Cerberus and Fox Paine. From Europe we have seen strategic players like STMicro, DeutschePost and Siemens. From India we have seen Sun Pharmaceuticals, from Korea there is Samsung Electronics as well as players from Taiwan and Russia."

Heather Stone, co-head of the Technology and International Practice Group at Gross, Kleinhendler, Hodak, Halevy, Greenberg & Co (GHK) in Tel Aviv, says Israel has been an attractive market for acquirers from outside the country for many years.

She said: "The burgeoning technology sector produces many novel businesses that ripen into targets for foreign acquirers, particularly from the United States, but also from the United Kingdom, Europe and the Far East. For example Yahoo!, AOL, Red Hat and ICAP have all been active in acquiring Israeli businesses in the last year or so. As a small country, it is difficult for many of these technology-

based companies to reach the critical mass, in terms of size and market cap, to become global competitors in their own right."

She says technology firms are actively trying to attract foreign investment.

She added: "Israeli businesses are very welcoming to suitors from overseas. It is often part of the business strategy of technology based start-ups, from all fields, including in the life sciences. And even in the sphere of "old economy" businesses. Israelis value the strategic partnership of world market leaders."

Nimrod Rosenblum, partner at law firm Epstein Rosenblum Maoz (ERM), said there has been much interest in Israeli companies from international buyers, despite the credit crunch.

He said: "We have seen much interest in Israeli companies from international buyers, both trade and financial (including private equity houses). Originally, most of the interest came from the US (mainly venture capital funds or large high-tech companies) and was focused on high-tech. However, during the last year we have worked on various acquisitions by European buyers (mainly from the UK, Germany and France) in the 'clean-tech' (mainly alternative energy), homeland-security, 'traditional' industry and infrastructure sectors."

He added: "The turning point in relation to investment in many non-high-tech Israeli businesses was probably the multi billion dollar acquisition of Iscar by Berkshire-Hathaway, and since then new sectors have come under the international investors' spotlight. Despite the recent global events, our firm is currently involved in several acquisitions of Israeli businesses by international private equity houses and trade buyers, and we estimate that strategic acquisitions will continue in the next year."

The case for foreign acquisition - a long term view

It is well known that VCs firms often sell investments to PE firms as they try to crystallise a return on equity, in order to get a healthy return for their fund.

The tightening of available capital in the debt markets around the world is shifting the focus of Israeli M&A activity to trade buyers, especially in the high tech sectors.

While many Israeli companies are keen to attract the interest of VCs, it does mean they are under

pressure to provide an exit for that VC in a short timescale, usually around 2-3 years. Many times this means bringing in another VC fund for a financing round or selling to a PE house, setting in place another exit strategy a few years down the line. A trade acquisition will provide a more long term and settled future for the firm.

Mr Aviram, from Shibolet & Co, says the shift to an emphasis on trade buyers will reduce the amount of exits in the high tech sector and may reduce company valuations.

He said: "The window for IPOs has been closed for a year so the other avenue is an acquisition. We are clearly going to see less and less of the situation where a VC fund sells to another VC fund or PE company. In the next year or two we will certainly be left with M&As by industry players like IBM, CISCO, Microsoft or Google. This will also mean that company valuations will be lower because demand from acquirers will be lower."

Miss Stone noted that examples of trade deals include the recent acquisition of Qumranet, a firm that makes visualization software, by Red Hat a US firm that provides open source solutions for use with the Linux platform. This deal, worth \$115 million, is typical of the cutting edge technological trade deals happening in Israel at the moment.

While much activity is with US-based firms, there are also plenty of UK/Israel transactions. As Ms Stone noted, London-based inter-dealer broker ICAP PLC recently acquired Traiana Inc, a privately owned provider of automated post-trade processing services to financial institutions.

Legal issues for M&A in Israel

The Israeli legal landscape has become much more merger and acquisition friendly, particularly for foreign investors.

Mr Levenfeld believes that much has been done to level the playing field in Israel in terms of M&A friendly laws. He believes the acquisition of Israeli companies has become very similar to acquisitions of U.S. or U.K. companies.

He said: "Publicly-traded Israeli companies can be acquired by a familiar reverse triangular merger structure. There are no currency control issues. For the most part, there are no securities law issues, however

in some cases acquirers using their stock to purchase Israeli companies may require court approval. Some tax issues do arise in acquiring Israeli companies, but in general they can be solved by getting an advance ruling from the Israel Tax Authority. In short, with proper local counsel, all the legal challenges can be anticipated and dealt with."

There are still legal challenges to overcome though, despite this willingness to facilitate acquisitions.

Mr Rosenblum said: "Having to liaise with several independent regulators, unlike the UK's centralised FSA-based model, is a challenge as is the unique combination of common and civil laws principles in Israeli law. In addition, some of the most sophisticated forms of acquisition-finance (e.g. various aspects of LBOs such as financial assistance) have not yet been duly tested by the Israeli courts."

He added: "Having worked both in London and Israel, I strongly believe that Israeli law and regulation offer significant flexibility for foreign buyers to structure, finance and execute their acquisitions in Israel."

Ms Stone points out that it can often be difficult to squeeze out a minority shareholder following a tender offer.

She added: "Local laws relating to labour, tax, government grants for research and development and tax breaks for industrial activity in certain regions of the country, can also make acquisitions more difficult. However, with proper structuring, most of these challenges can be mitigated."

Foreign acquirers should also be aware of the common practice in Israel of setting up Delaware corporations with Israeli subsidiaries.

Mimi Zemah, managing partner at law firm Zemah Schneider, believes the use of Delaware companies is no longer relevant for tax purposes, but does have its uses in specific circumstances.

She said: "Israel is not that bad tax-wise for companies any more, corporate tax has been reduced substantially. The only reason investors set up a parent company in Delaware, is simply because they are used to it, or because some companies have technology and products to be sold in Arab countries or for the defence arena. In such cases, the department of defence (DoD) doesn't want to deal with an Israeli company, it has to be a US company."

She added: "From a cost perspective, there is a

great value to doing all legal work from Israel. Israeli lawyers have good knowledge of client sensitivities and they are cheaper than US law firms."

Security issues – Hizbollah, the Palestinians and Lebanon

Security issues have been a problem in Israel since its inception as a nation in the 1940s. Despite constant troubles around its borders, the economy has remained relatively untroubled and still presents attractive opportunities for foreign investors.

Ms Stone, believes the M&A market is unscathed by recent tensions.

She said: "Security issues do not generally affect the M&A market in Israel. Even during the last war in Lebanon, while some Israeli businesses in Northern Israel had to consider evacuation and disaster recovery plans, M&A activity continued. The state of world markets seems to be a much more relevant factor than any security concerns."

Mr Aviram is keen to dispel the myth that security issues have affected the economic health of Israel, pointing to the fact that most hotels in Tel Aviv are full of businessmen.

He said: "Israel has never been a safe place, trouble has always been in the air. Once investors decide to come here, the security issues do not matter. It sounds ridiculous, but regional crises don't matter. Investors are here visiting Israel, the hotels are mainly full of business people."

Mr Levenfeld was surprised how many calls he was getting about investment in Israel during the Second Lebanon War.

He said: "International businesses understand that the local military-political situation is essentially irrelevant. Israeli high tech businesses are based primarily on brain power, and are not affected by the security situation. During the Second Lebanon War, when Hizbollah missiles were raining down on the North of Israel, I kept getting calls from acquirers looking for Israeli counsel. Sometimes, after the calls in which we discussed possible acquisitions, I would say to myself 'Don't these guys watch television?' But actually, they understood that the underlying fundamentals supporting the acquisitions were not affected by passing security considerations."

Ms Zemah, from Zemah Schneider, agrees that investors are unconcerned about the security situation.

She said: "People expected there to be a slow down after the war in the north, but that didn't happen. The main challenge that we saw, from a legal perspective, was that foreign investors wanted to include a material adverse change

clause in contracts about The State of Israel. VC investments in Israel are high tech-based, so you can always relocate people from here. Most high tech companies look to relocate people to the USA or Europe, so the security situation is not so important."

She added: "We see that the globalisation factor makes the investment in Israel more cost effective, in a global way, and the local security concerns are less relevant. The volatility of the financial markets is much more relevant than the local security issues and we need to address such factors to assist our clients."

Acquisition Opportunities Abroad for Israeli Firms

Many bigger Israeli firms are keen to reverse the tables and make acquisitions abroad. This is mainly true of the Israeli firms that are already listed on foreign exchanges such as AIM or Nasdaq.

Israeli companies were on the acquiring side in 60 deals during 2007, with almost 40 acquisitions of foreign companies. \$1.96 billion was spent on foreign acquisitions.

On example of a recent deal is the UK media and broadcasting company Well Trade Services, which was recently sold to the Tel Aviv Stock Exchange (TASE) listed Taya Communications,

Ms Stone believes the credit crunch has made this more likely, as Western businesses have lost value.

She said: "The recent credit crunch, in the United States especially, has made businesses from the hardest hit areas more attractive to Israeli businesses as acquisition opportunities. The New Israeli Shekel has been strong relative to the US dollar and Euro, while Israeli institutions seem not to be as hard hit as their US and European counterparts, by the credit crunch. This has made it somewhat easier for Israeli companies to pursue foreign acquisitions."

Mr Rosenblum agrees with her about weakened firms being attractive to Israeli acquirers.

He said: "In light of the current low valuations of companies and assets in many jurisdictions, we see an increasing interest from many of our clients in the potential acquisition of competing or complementary overseas businesses. In addition, some of the Israeli financial institutions are relatively more liquid than their international competitors and we believe that following the initial shock of the credit crunch, and the recent developments in the US, they will undoubtedly take advantage of the global situation."

Mr Chertok believes there are many world class Israeli firms making acquisitions abroad.

He said: "Many Israeli business groups have been very active in real estate and infrastructure opportunities worldwide. In addition some of Israel's companies are the world's leaders in their field of expertise, such as Teva Pharmaceuticals in generics, Amdocs in billing software, Iscar (the Berkshire Hathaway company) in precision tooling, and Makhteshim-Agan in pesticides. They have been active in acquisitions throughout the world, most recently Iscar and Teva have made significant acquisitions in Japan."

Ms Zemah, believes Israeli firms are definitely more acquisitive abroad, but says the same cannot be said of Israeli VCs.

She said: "Israeli companies are definitely looking to acquire foreign companies, whether it be a manufacturing company looking to buy a distributor, or just to buy a competitor. The expectation for firms to encounter difficulties due to the credit crunch lowers their valuations and makes them more attractive to Israeli acquirers."

She added: "Foreign acquisitions are less common with Israeli VCs because they have tax rulings whereby they can only invest a certain percentage of the funds in foreign entities, maybe 10 or 20%. Their basic interest is in the Israeli market, but there is a good deal flow here so the potential is great."

Conclusion

Israel has fared better than many other Western countries with regard to the credit crunch. Its high tech sector is vibrant and is supported by new emerging sectors such as clean tech. This is attracting the attention of foreign VCs and private equity houses as well as strategic industry multinationals, looking for acquisition opportunities.

Behind all this is a healthy economy, largely unaffected by disputes with the Palestinians and Hizbollah in Lebanon, which has developed its own VC industry, is relaxing company law and producing some world class companies in the process.