

## ISRAEL



## Israel's Growing Pains

Despite robust growth through industrial advances, inbound investment remains the name of the game.

By Howard Stock

**W**hile Israel's economy is slowing down a bit from its breakneck pace in 2015, business still remains strong, with continued interest by strategic investors and joint venture partners in innovative Israeli companies, Israeli lawyers report.

"In the technology world, we have already seen almost half a dozen substantial exits, including sales of companies to Oracle and Cisco in the first two months of 2016," says Barry Levenfeld, a partner at Yigal Arnon & Co. "Certainty finally appears to be just around the corner for the natural gas regulations, unemployment is down, and the forecast, although not as rosy as 2015, remains strong. China has become a

key player in inbound investment, and not just in technology, and we expect that trend to continue."

Joey Shabot, partner and shareholder at Greenberg Traurig P.A., adds that in addition to Chinese investment, Israel is also seeing inbound capital flowing from Japanese and Latin American investors. "Israelis are as open as ever to doing business with the world and the Israeli government is continuing to take steps to encourage research and development (R&D) and inbound investment."

Historically low borrowing rates are helping Israel's economy maintain a decent momentum in 2016. "Low interest rates cause institutional investors and investment funds to pursue alternative Investments from the one side, and the companies to pursue new

opportunities, both business development and capital raising,” says Yoav Caspi, a partner at AYR—Amar, Reiter, Jeanne, Shochatovitch & Co., adding that “Israeli law is in an ongoing process of improving and tightening, which may keep investors away due to certain uncertainty, but as well, improves their position by protecting their investments and by outline a standard of business behavior.”

However, despite the pizzazz of high-profile exits from the technology sector, and private equity funds and global technology giants’ perpetual angling for the next big thing in Israeli technology, sluggish fundamental growth is cause for concern, says Hanan Haviv, head of Herzog Fox & Neeman’s technology practice. “Although GDP continues to grow, the pace of growth is slower than previously expected,” he says. “The Bank of Israel projected in its last report that the GDP would grow at the rate of 2.6% in 2015, instead of the projected growth of 3.0%, and 3.3% in 2016, down from 3.7% previously projected.”

Despite significant success in the Israeli technology sector, a recent report of the Ministry of Finance found that since 2010, the pace at which the technology sector has grown is only half the pace of the growth in the overall market. “Despite Israel’s highly educated and motivated workforce, the lack of a sufficient number of skilled employees remains a challenge facing the technology sector,” Haviv says. “Nevertheless, despite this challenge, Israel remains an important research and development center for many of the world’s leading multinational companies.”

## OUTBOUND INVESTMENT

A positive development over the last few years has been the rise in outbound investment from Israel. This trend is particularly evident in sectors such as real estate and gaming, and to some extent also in technology, Haviv says. The forces that drive this trend are different in each sector. For example, the limited number of opportunities in real estate in Israel, and the local regulatory regime for gaming, have forced Israeli entrepreneurs to look overseas.

Increasingly, Israel’s technology sector has used acquisitions as part of its growth strategy, although Israel is still primarily an inbound investment destination, and will likely remain so for the foreseeable future. “What is particularly interesting in the technology sector is that in a significant portion of the transactions where an Israeli company is the acquirer, the target is also an Israeli company,” Haviv says. “The fact that Israeli tech companies are making acquisitions, both in Israel and overseas, rather than pursuing an early exit, is a welcome sign of maturity for the Israeli technology sector.”

However, inbound investment remains by far

greater than outbound, and there are obvious reasons for this, says Levenfeld. “Israel is small and far away from its natural markets, and the odds are stacked against an Israel-based firm being a world power, gobbling up companies outside of Israel,” he says. “There are notable exceptions, such as Teva, Amdocs, Checkpoint and Tower, and some more recent companies like

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Mellanox and Mobileye, but while outbound investment may be increasing, inbound investment is still the name of the game.”

Indeed, the majority of Israeli businesses are still focused on grooming themselves to be acquisition targets, adds Shabot. “Even those Israeli businesses that have a strategy of remaining independent, are not especially acquisitive,” again, with some significant exceptions, especially in the homeland defense and security markets.

One exception to this rule is an increasing number of outbound real estate transactions. Israeli pension and insurance funds continue to aggressively invest in U.S. and European commercial and residential real estate, closing several billion dollars in deals in the last year. “The outsized assets under management of Israeli institutions practically forces them to look outside of Israel, and they tend to favor real estate investments,” Shabot says.

“Outbound individual and corporate-level investment in foreign real estate is an area to observe,” agrees Jan Wimpfheimer, a partner at Schwell Wimpfheimer & Associates. “I expect to see growth in this area in the coming year.”

The largest recent inbound M&A deals include China’s Bright Food Group’s \$1.75 billion acquisition of a 56.7% stake in Tnuva; the \$1.25 billion acquisition of Fundtech by Canada’s D+H; and the \$929 million acquisition of Valtech by Heartware. Smaller but still significant, Sichuan Hebang acquired a controlling interest of the Stockton Group, a transaction valued at

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\$180 million; Pro-Quest acquired Ex-Libris for \$500 million; and the Intercontinental Exchange Group acquired SuperDerivatives for \$350 million.

By comparison, the largest recent outbound deals include Bezeq's purchase of the remaining 50.2% of DBS Satellite Services Ltd. (Yes) from Eurocom Communications Ltd. for \$571.3 million; Teva's \$2.3 billion acquisition of Mexico's Rimsa; and Migdal and Menora's \$500 million acquisition of a portfolio of 22 shopping centers in Dallas and Houston, Texas.

Currently, many of Israel's largest financial companies are for sale, the driving force being the government's push to decentralize the financial sector in Israel. "We will see many transactions in this sector in the coming years," Haviv says. "The same will apply in the natural gas sector, once again driven by the government's attempt to introduce competition into a closely held market."

To that end, the government is ramping up its efforts to introduce competition to what was essentially a duopoly of Israel's two big banks. "The Competition Law of 2014 means that any group owning both a substantial financial entity and a substantial non-financial

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(real) entity must divest itself of control of one or other of the corporations involved," Haviv says.

A major part of his platform has been to ensure that the big banks sell off their profitable credit card operations, as well as to increase opportunities for smaller banks and other financial institutions to penetrate the credit sector for small business and domestic borrowers.

There have been a few bumps in the road, Shabot says. Delek Group's contract to sell the Phoenix Insurance company (at a value of approximately \$1 billion) to China's Fosun was recently terminated, as a result of the Israeli insurance regulator's failure to grant Fosun regulatory approval. "We do, however, eventually expect to see divestment transactions resulting from the mandatory sale regulations, especially in the financial and energy industries," he says.

Additionally, the long-expected approval of the new natural gas regulations is likely to spur financing activity to develop Israel's recently discovered tremen-



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dous offshore gas fields, Levenfeld says. In response to popular protest, "the government has shown similar—though often erratic—resolve to introduce competition into the natural gas sector, requiring the current monopoly players to sell off significant interests in their offshore Mediterranean gas finds," Haviv adds.

Each of these different initiatives will generate significant M&A activity with the buyers almost inevitably, coming from overseas. "There are few Israeli buyers capable of acquiring any of the large corporations or enterprises that will have to be sold off, and the Israeli candidates strong enough to buy these assets are themselves prevented from making acquisitions as a result of the government's anti-concentration measures," Haviv says.

#### NO OIL SLIDE

Given Israel's geographic location, one might expect it to have felt the pinch of the oil slump, but that's not the case, says Haviv. "It is hard to see any direct and immediate effect in Israel of the slump in oil prices. Unlike many of our neighbors, the Israeli economy is not dependent on oil production or oil prices." The effects of the oil slump are real, he says, but are largely indirect. Somewhat fortunately in hindsight, the development of Israel's massive offshore gas discoveries has been delayed by the government's inability to introduce a clear and consistent set of guidelines governing issues such as competition, pricing, royalty levels, export quotas and so on. "While the delays in developing the Mediterranean gas fields have dragged on, energy prices around the world have crashed, and this has clearly affected the economics of developing the offshore gas fields," Haviv says. "On the other hand, lower energy prices have meant savings for Israeli businesses, allowing them to be more competitive. The slump in oil prices has affected markets around the world, and this has an effect on both inbound investment into Israel and outward investment, as investment activity slows generally."

Wimpfheimer adds that the slump hasn't taken much of a bite out of transaction workflow for the



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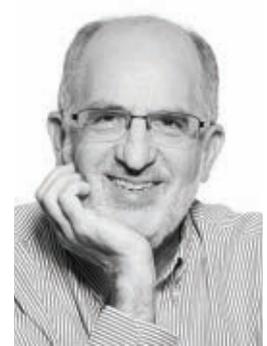
legal profession, either. “The larger firms as well as those smaller firms operating on the highest level of the profession will continue to see strong opportunities for deals,” he says. “We don’t anticipate the changes in the oil market will adversely affect the outlook for Israel.”

If anything, lower oil and gas prices have been beneficial to consumers, who have found themselves with more disposable income as a result. “I do not see any material effect on Israel or Israelis by the oil slump,” Shabot says. “A marginal effect is a reduction in gas prices at the pump, putting some extra spending money in consumers’ pockets.”

Generally, though, outside these event-based opportunities, Israeli lawyers expect more of the same from overseas buyers and investors, albeit for different reasons. “For China, it is an understanding that they cannot meet their declared growth projections without leveraging technology to accelerate growth in traditional non-tech and low-tech industries,” Shabot says. “In the U.S. and Europe, it is the continued understanding by strategic players in many different lines of business, including low-tech businesses such as finance, that innovation is likely to disrupt their business models, and that the best way to stay alert and on top of potentially disruptive trends, is to participate in the innovation marketplace. Government incentives allow Israeli companies to develop products and



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concepts more effectively than directly through major international companies.”

For their part, Levenfeld says Israeli businesses tend to be innovators and risk takers, and being “trapped” in a small country, need to expand globally if they want to survive. “As a result, there will always be a drive for Israeli companies, especially technology companies, to look abroad for markets, suppliers and manufacturers,” he says. “We can expect to see established Israeli technology companies seeking these benefits from foreign acquisitions.”

The main factor that makes Israeli businesses and investors attractive as inbound investment targets and outbound buyers is the entrepreneurial spirit. “Israeli entrepreneurs know how to navigate uncharted territories and find creative solutions for solving problems or creating new markets,” Haviv says. “Israeli entrepreneurs know how to identify hidden opportunities and take the risks to develop them, for good or bad, without knowing how everything will play out.”

Additionally, as Levenfeld says, Israel retains the same strong draws it has demonstrated over recent years: unbeatable technological innovation, savvy product development to meet the needs of the latest “hot” industries, a skilled and creative workforce and a relatively (but not completely) friendly regulatory environment. “Add to this: fair courts and economic stability, and the attractions are clear,” he says. ■

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# THE RISE OF THE STRATEGIC INVESTOR IN ISRAEL

By Yair Geva and  
Michal Herzfeld



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Israel's reputation as a global technological powerhouse is now well-established. The country's reputation for outstanding intellectual capital and entrepreneurial drive led to its branding as the "Start-Up Nation". Attorneys and academics alike focus on the year-on-year increase in M&A activity and foreign investment in Israel. Less attention has been paid, however, to the more subtle shifts in the sources and timing of investment activity in Israel, and how this is affecting Israel's high-tech scene.

## TRADITIONAL FINANCIAL INVESTMENTS VS. EARLY STRATEGIC INVESTMENTS

Over the last decade, Israel has seen a steep increase in investment by foreign investors, by both venture capital firms and multinational corporations, in C-rounds and later. Recently however, foreign corporations have begun to establish their own investment funds that invest directly and at earlier stages of a target's existence. By investing early and directly, these companies get an inside view on the market and a foot in the door to acquire new technology before competitors. Israeli tech companies, in turn, benefit from the imprimatur of high-profile strategic investments, indicating an informed vote of confidence from a major market player.

From the perspective of the lawyers involved in such transactions, strategic investments differ markedly from financial investments. On the investor side, the client's objectives for a purely financial investment are to protect the investment, potentially to attract high-profile co-investors, and to aim for a quick exit at a high valuation. These objectives lead the client to place emphasis on strong representations and warranties, indemnification against risks, and shareholder vetoes over major transactions, exits, and issuances of shares and options that would dilute the investor's holdings. For its part, the company's objective is to bring in the investment as quickly as possible, at a high valuation, and to retain as much freedom to operate as possible—in other words, to push back on all of the types of managerial and operational control that the financial investor seeks.

## LEGAL ASPECTS OF STRATEGIC INVESTMENTS

With a strategic investment, the investor would naturally like to see its investment succeed, but the focus is often the investor's access to the target company's intellectual property and products, for both the short and long term. Thus, from the very outset of negotiations, the investor and the company's management discuss issues that much more rarely come up in negotiations for financial investments, such as influence over the company's rights to enter into exclusive or preferential commercial relationships and other strategic alliances and the right of the investor to take over the target company. The company naturally welcomes the investment and the investor's expertise in the industry, but is wary of these substantial limitations.

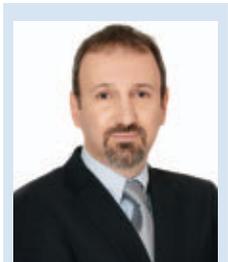
This change in the client's focus has a significant impact on the structure of the deal and on the area of focus of the lawyers accompanying the deal. For example, in a financial investment, the lawyers may spend comparatively more time on due diligence, cleaning up any regulatory and compliance issues at the company, and researching and protecting against potential exposures. In a strategic investment, the lawyers often spend a significant amount of time drafting side commercial agreements and negotiating the language of the investor's shareholder rights. The delicate dance between the investor and target can also lengthen the time it takes to reach signing and closing.

## BUSINESS CONSIDERATIONS FOR STRATEGIC INVESTORS

Although a strategic investor will tend to seek significant control over the target company and to prevent the target company from engaging with the investor's competitors, it is wise to keep in mind that these restrictions may depress the company's value and isolate the company from its industry network. Disagreements between management and shareholders are not helpful to the development of a young company, and often distract key personnel from their primary focus of completing the development of the company's product. Strategic investors should keep in mind that the mere existence of



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a strong, long-term relationship with the target can provide many of the benefits sought. The lawyers can assist by discussing these issues both with their own clients and in negotiations, and by tailoring the investor's control over the target company in order to reach a solution that will satisfy the needs of both sides.

### FROM START-UP NATION TO HIGH-TECH NATION

The shift toward earlier stage investment by strategic investors is creating opportunities for Israeli companies, particularly those in industries such as biotech, that require significant capital and long development periods. Whereas a financial investor cannot accept the risk of a company that requires massive investment and many years to market

its product, a strategic investor is an operating company that can pay more, wait longer, and expect additional "returns" in the form of state-of-the-art technologies. Increasing early stage investments by strategic investors permit Israeli entrepreneurs to expand into a wider range of technologies, and to benefit from the knowledge of investors with experience and knowledge beyond Israel's borders. These developments will lead to more transactional activity on the part of Israeli companies, which will increase the demand for domestic legal services and strengthen the position of Israeli lawyers within the global legal network.

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firms and mature companies in the hi-tech industry, and concentrates his practice on M&A, private equity, venture capital transactions and related corporate matters. He is a recognized leader in his field and has acted on some of the largest hi-tech transactions in Israel. Prior to joining HFN, Yair spent six years working in leading U.S. law firms. Yair also serves as the head of HFN's China Desk.

**Michal Herzfeld** is a member of HFN's Hi-Tech Department. Her practice focuses on representation of domestic and foreign venture capital and private equity firms, as well as both start-up and established Israeli companies in investment rounds, mergers and acquisitions, joint ventures, and ongoing corporate and commercial activities.

## TRANSFER PRICING IN ISRAEL; AN INTEGRAL PART OF ANY CROSS-BORDER M&A TRANSACTION

By Eyal Bar-Zvi

A number of recent developments – two Israeli court rulings on transfer pricing, the recent adoption of the OECD BEPS Rules (actions against Base Erosion and Profit Shifting), and the growing number of transfer pricing audits in Israel for both inbound and outbound businesses – mean that transfer pricing issues must now be considered an important component of any due diligence examination prior to any investment or M&A transaction.

The correct transfer pricing strategy can lawfully save a corporate group significant amounts of tax, while the wrong strategy can trigger penalties even greater than the original tax "saved". Ill-regulated transfer pricing can lead to adverse purchase price adjustments, while proper transfer pricing structuring can result in significant advantages. In matters of transfer pricing, it is the economic substance of the transaction or an arrangement that will determine the outcome, not the legal form of the arrangements. The legal documentation may well purport to determine the place or the pricing of the activities of a corporate

group in a manner not in line with actual value creation, or where the relevant "people" are present, which is the basis on which the Israeli Revenue Authorities tend to interpret the BEPS rules. This is important especially when taking into account the tax benefits and grants (from the office of the Chief Scientist at Israel's Ministry of the Economy) that Israeli companies are often awarded.

In the context of the corporate acquisition, the purchaser must consider three principal transfer pricing issues:

- (a) Verifying that the transfer pricing documentation of the target company is in accordance with applicable law. Equally important is to ensure that the transfer pricing arrangement as documented is in fact being implemented;
- (b) Integrating the operations of the company within the acquiring group without invoking a challenge on the part of the Israeli Revenue Authorities regarding the shifting of intellectual property (IP); and
- (c) How to efficiently "export" the IP of the Israeli company to the acquiring group.

Two recent Israeli District Court decisions have ruled that an Israeli subsidiary working on the "cost plus basis" (i.e. utilizing the TNMM/CPM methods) should include within the "cost plus" model expenses associated with employees' social security payments, as well as options granted by the parent corporation. The rules regarding these particular issues may be different in the USA, and these rulings may be subject to challenge in Israel, but until these cases (or the basis of the decisions) are appealed and decided upon by Israel's Supreme Court, these rulings must be taken into consideration.

**Eyal Bar-Zvi** is an attorney and an economist, and serves as Co-Head of HFN's Transfer Pricing Department. Eyal advises Israeli and foreign multi-national corporations on inbound and outbound transfer pricing and supply chain management. HFN is the only law firm in Israel which provides full-scope transfer pricing services, including transfer pricing studies and transfer pricing policies, as well as representing clients in front of the Israeli Revenue Authorities and the courts.