EUROPE & MIDDLE EAST outlook

Evolutions in the Israeli High-Tech Ecosystem

Partners David Osborne and Simon Weintraub of Israel-based law firm Yigal Arnon & Co examine Israel's resilient tech scene

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Israelis in all fields – from medicine to Fintech, cyber-security to gaming – are constantly developing new devices and inventing new formulae and methods. High-tech and innovation have become an intrinsic part of Israel's genetic makeup, with the start-up culture reaching into every sector of the economy. At a time when investors around the world are bemoaning a slowdown in the tech sector, Israel's sector is on the rise: while venture capital investments fell globally by 30 percent to US$27.3 billion in the last quarter of 2015, Israeli technology start-ups raised a record US$1.2 billion, totalling US$4 billion for the year.

In 2016 there is no sign of a slow-down as Israeli start-ups have raised US$1 billion in the first quarter alone. It is an exciting time to be innovating in Israel, and the country's forward-thinking legislators have harnessed this enthusiasm by reforming the state's tech-sector legislation and regulations, resulting in increased productivity and economic expansion. This is best demonstrated by two recent legal developments: an amendment to Israel's Office of the Chief Scientist and corresponding Law for Encouragement of Research and Development in the Industry 5744-1984 (the R&D Law), and its opening of the tech sector doors to equity crowd funding; a new avenue for investment aimed at expanding the investor pool for early stage companies.

Office of the chief scientist

In 1974, Israel established the Office of the Chief Scientist (OCS), a Governmental body charged with providing financial development and R&D resources to private sector entrepreneurs, to stimulate the economy's civil sector. The Government has regularly reformed this body since its creation, intending to increase efficiency and keep pace with new trends in the country's high tech sector. Most recently, in July, 2015, the Knesset (Israel's Parliament) enacted Amendment Number 7 to the R&D Law increasing its flexibility to adapt to a rapidly changing and demanding international market.

This amendment, among other important changes, created the National Authority for Technological Innovation (the Authority) to improve and supplement the OCS's activities and to implement the Government's technological innovation policies. To achieve this, the Authority is empowered to track companies and set unique and track-appropriate rules for determining the type and scope of benefits made available to them, as well as the conditions for receiving and methods for allocating those benefits. A multiplicity of benefits is available under this new regime, including granting funds directly to companies, giving loans, exemptions, discounts, and guarantees and subsidies. Although restricted from purchasing shares directly, the Authority can finance the recipient company activities with a Government-granted budget, with repayment obligations from royalty payments from sales, and with capital raised through debt instruments. In short, the amendment offers a new and efficient way for capital seeking entrepreneurs focused on R&D to receive aid in a meaningful and timely manner.

Equity funding

In addition to amending its R&D Law, the Knesset recently embraced a regulated form of equity funding in an effort to widen further the scope of investment avenues available to start-up companies. This fundraising method has, of late, been in vogue in the global tech scene since it makes capital raising channels increasingly accessible to companies planning seed financing rounds. Equity funding is not devoid of risk however, and many of its potential pitfalls parallel to those posed by public offerings generally. Public groups of investors are less equipped to directly negotiate investment terms and anti-dilution protection measures with investment companies and are likewise less capable of conducting effective corporate governance.

Moreover, when investing as part of a public group, investors have less financial incentive to follow their investments carefully and exercise their minority rights. Section 15 of the Securities Law 5728-1968 nominally protects these investors from such dangers by preventing companies from making public offerings without publishing prospectuses approved by the Israel Securities Authority. However, this regulatory regime has encumbered the practice of equity funding due to its low threshold for meeting the definition of “public offering”.

But this is all about to change.

In 2015, the Knesset passed Amendment Number 58 making equity funding feasible, while maintaining minimal and effective regulations to provide protection for the public. Companies that have never made a public offering may now raise capital by selling securities to the public through online platforms, as long as they publish a disclosure statement; and they may actively involve a lead investor with no business connection to the company in the financing round, and ensure that the amount of capital raised during the round (both in total and per investor) is capped at a specified amount. This new regime offers new opportunities both for investors and start-up companies, since it increases the ability for companies to raise capital and at the same time, it is opening the tech world to a new class of investors in a relatively safe and regulated environment.

China: A new frontier?

Israel’s chief trading partners and the primary beneficiaries of these investment-friendly laws have traditionally been located in the North America and Europe. Recently however, emerging markets in the Far East have become increasingly attracted to Israel's booming start-up scene, resulting in rapidly intensifying trade relationships and economic ties between the regions. The main player in this burgeoning trade is China.

It was reported that in 2015 alone, the two-way trade volume between Israel and China reached US$11.4 billion. As of late, there are numerous high profile M&A transactions between Israeli companies and Chinese acquiring parties, including China’s

Bright Food Group's acquisition of the controlling interest in Israel's Tnuva Food Industries in 2015, a company valued at NIS 8.6 billion, and the Chinese Conglomerate Fosun's recent acquisition of Ahava, Israel's distinguished Dead Sea cosmetics company, for approximately NIS 290 million.

Yigal Arnon & Co. has recognized this budding trade relationship and we have developed our own China practice group. This group has represented numerous Israeli companies in transactions with Chinese entities, including Oramed Pharmaceuticals in a licensing transaction with China's Hefei Tianhui Incubator of Technologies, for $50 million, which closed in the fourth quarter of 2015.

And this is just the beginning.

Israel is currently in talks with China regarding the creation of a 10-year multi-visit visa to further facilitate business and tourism, and has already signed seven academic cooperation agreements with Chinese universities to establish joint Israeli-Chinese study institutes and further invest in student exchange programs. The academic program will likely cost around US$68 million over nine years and is expected to increase the number of Chinese students studying in Israel from 800 (currently) to 3,000 within five years. On January 11, 2016, following approval of the Finance Committee of the Israeli Knesset, a new law called The Treaty Law of the Asian Infrastructure Investment Bank 2016 was formally adopted. The initial letter of application to become a member of the Bank was signed by Prime Minister Netanyahu in his capacity as acting Finance Minister in March 2015, and now Israel can formally become a member of the Asian Infrastructure Investment Bank. This is a major milestone in Israeli economic relations with Asia in general and particularly with China, as Israel is becoming a formal member in a significant Asian financial institution together with 56 other nations. Israel will hold a 0.75 percent position in the Bank, while the largest stakeholder is China with a 30 percent stake. Most recently, it was announced that Israel and China are negotiating a free trade agreement that has the potential to double the trade volume between the two countries.

Israel's tech sector continues to defy global trends; it is flourishing in its existing markets and shows no sign of slowing down. Moreover, its future remains bright as Israel's legislators continue to reform the regulatory system to be more investment friendly and increase market productivity, all while expanding the sector's borders into new frontiers around the globe. In short, there has never been a better time to jump on the bandwagon.

This article was originally published in **Europe and Middle East Outlook.**

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