

Private equity in Israel: market and regulatory overview

Barak Platt and Yarom Romem
Yigal Arnon & Co

global.practicallaw.com/5-561-8725

MARKET OVERVIEW

1. How do private equity funds typically obtain their funding?

Israeli private equity funds typically raise their funding from institutional investors, including pension funds and insurance companies as well as endowment funds, corporate investors and high net-worth individuals. In comparison to Israeli venture capital funds, Israeli private equity funds tend to receive a larger portion of their capital from Israeli institutional investors.

2. What are the current major trends in the private equity market?

Israel, unlike most developed markets, has an inverted private equity sector, with an unusually large venture capital segment and a relatively small private equity sector (when excluding venture capital). In the first three quarters of 2013:

- Israeli venture capital funds made aggregate investments of over US\$420 million, according to IVC (www.ivc-online.com/language/en-US/Home.aspx).
- Israeli based private equity funds (excluding venture capital) made aggregate investments of about US\$200 million (based on Vintage Investment Partners).

Overall venture capital investment (by all investors) reached US\$1.6 billion in the first three quarters of 2013, while private equity investment (by all investors) reached US\$2.2 billion for the entire year.

Private equity investment by Israeli private equity funds has dropped slightly each year from 2010 to 2013 (inclusive). Vintage Investment Partners believes that in 2013 "most Israeli PE funds opted to take a step back from doing deals this year due to pricier company valuations driven by strong capital markets".

Most private equity investment by volume is made by non-Israeli investors (see *Question 3*).

3. What has been the level of private equity activity in recent years?

Fundraising

Private equity investing took off in Israel in the late 1990s, when the first few Israeli private equity funds raised their initial funds.

According to Vintage Investment Partners, about US\$2 billion was raised by Israeli private equity funds between 2003 and 2007, and another approximate amount of US\$2.6 billion was raised until 2011. An additional US\$1.3 billion was raised in 2012 and 2013, for an overall steady pace of fundraising over the years.

Investment

The private equity market in Israel is essentially two tiered, with:

- Israeli private equity funds dominating the market in smaller private equity investments.
- Global players taking the larger deals, such as KKR's US\$500 million buyout of Alliance Tires in 2013, and Mobileye's buyout by a syndicate of non-Israeli investors for US\$400 million.

Transactions

The largest segment of the market by volume is buyout, which in 2013 accounted for 56% of all deal volume (down from 61% in 2012 and 70% in 2011, all according to IVC).

Straight equity is the second largest segment by volume, which in 2013 accounted for 40% of all deal volume (up from 34% in 2012 and 22% in 2011) (IVC).

Exits

2013 was a relatively weak year for exit activity, although this is likely due to fluctuations in a small market, where a few large deals can skew the results for the whole year substantially.

2013 included Tene Investment Fund's secondary sale of its holdings of Caesarstone on Nasdaq, at a company valuation of about US\$800 million for Caesarstone and a reported 5x return.

REFORM

4. What recent reforms or proposals for reform affect private equity in your jurisdiction?

A noteworthy recent reform in the area of corporate concentration is expected to substantially affect private equity investment in the coming years. In December 2013, the Knesset enacted the Law on Corporate Concentration 2013. This sets a limit on corporate pyramid structures to two tiers and limits cross ownership between industrial and financial companies. This legislation is generally expected to cause consolidation within the larger conglomerates in Israel, with many of them shedding assets in the process, potentially increasing private equity activity.

TAX INCENTIVE SCHEMES

5. What tax incentive or schemes exist to encourage investment in unlisted companies? At whom are the incentives or schemes directed? What conditions must be met?

Investments in Israeli companies (except for Israeli companies the primary assets of which are real estate holdings) by private equity funds with no permanent establishment in Israel are not subject to Israeli capital gains tax.

Private equity funds with a permanent establishment in Israel often receive tax rulings from the Israeli Tax Authority providing an exemption from capital gains tax on investments in Israeli hi-tech companies.

The Israeli Tax Authority has recently indicated a willingness to provide rulings exempting such funds from capital gains tax on the realisation of the fund's investments in non-high tech Israeli companies.

FUND STRUCTURING

6. What legal structure(s) are most commonly used as a vehicle for private equity funds in your jurisdiction?

Private equity funds are generally formed as one or more limited partnerships investing in parallel. The partnerships are generally registered in the Cayman Islands or in Israel.

7. Are these structures subject to entity level taxation, tax exempt or tax transparent (flow through structures) for domestic and foreign investors?

Partnerships, both Israeli and non-Israeli, are generally transparent flow through entities for Israeli tax purposes.

8. What (if any) structures commonly used for private equity funds in other jurisdictions are regarded in your jurisdiction as being tax inefficient (whether by not being recognised as tax transparent or otherwise)? What alternative structures are typically used in these circumstances?

Companies are generally tax inefficient as private equity funds in Israel, due to the taxation of income both in the company and on distribution of a dividend. Therefore, partnerships are generally used. The US form of limited liability company does not exist in Israel.

INVESTMENT OBJECTIVES

9. What are the most common investment objectives of private equity funds?

The most common investment objective of private equity funds is to achieve long term capital appreciation through the investment in, and exit from portfolio companies (generally through mergers, acquisitions and initial public offerings (IPOs)). Investments in private equity funds are long term commitments, with the term of the fund generally ten years at the outset with possible extensions

of the term. Distributions to investors are distributed only on the conversion of an investment into cash or tradable securities (that is, an exit).

FUND REGULATION AND LICENSING

10. Do a private equity fund's promoter, principals and manager require licences?

A private equity fund's promoter, manager or principals do not generally require a licence.

11. Are private equity funds regulated as investment companies or otherwise and, if so, what are the consequences? Are there any exemptions?

Regulation

Private equity funds are not regulated as investment companies or otherwise. As private equity funds are generally limited partnerships, the marketing and sale of interests in the partnerships is subject to applicable securities law.

Exemptions

The securities laws in Israel restrict the offering of limited partnership units to no more than 35 persons, excluding certain qualified investors. An exemption for very high net-worth individuals was recently enacted.

12. Are there any restrictions on investors in private equity funds?

There are no restrictions on investors in private equity funds other than those stemming from securities laws. The securities laws in Israel restrict the offering of limited partnership units to no more than 35 persons, excluding certain qualified investors. In practice, private equity funds generally do not accept investors that are not qualified investors.

13. Are there any statutory or other limits on maximum or minimum investment periods, amounts or transfers of investments in private equity funds?

There are no statutory requirements on investment periods, amounts or transfers of investment in private equity funds. However, the funds are usually closed-ended and do not allow redemption. Funds generally set minimum subscription amounts subject to general partner discretion to reduce such amounts.

The limited partnership agreement of the fund typically subjects transfers to the consent of the general partner in its sole discretion.

Tax rulings that may be applied for and received by the fund may set minimum holding periods, generally in the context of redeemable investments, such as in hedge funds.

INVESTOR PROTECTION

14. How is the relationship between the investor and the fund governed? What protections do investors in the fund typically seek?

The relationship between the investors and the fund is governed by the terms of the fund's limited partnership agreement (and subject to the law of the jurisdiction of the partnership). Investors typically

seek the same type of protections they would look for in a US-based fund, including:

- Confirmation of limited liability.
- Restrictions on use of proceeds.
- Restrictions on recourse borrowing.
- Clawback of overpaid carried interest.
- Financial reporting.
- Key man provisions.
- Non-competition restrictions, preventing the promoters from setting up a competing fund until certain time periods have passed.
- Provisions governing potential conflicts of interest.
- The term of the fund and its extension.

INTERESTS IN PORTFOLIO COMPANIES

15. What forms of equity and debt interest are commonly taken by a private equity fund in a portfolio company? Are there any restrictions on the issue or transfer of shares by law? Do any withholding taxes or capital gains taxes apply?

Most common form

Private equity funds commonly invest in equity (usually preferred, but sometimes ordinary shares) or in a combination of debt and equity. Investments by way of debt often include an equity kicker in the form of warrants. The level of debt to equity is driven by a mixture of the risk profile, the bank lending criteria and the funds mandate to leverage its portfolio investments.

The advantage of debt over equity is first and foremost tax efficiency, as repayment of principal of the debt is tax-free and the interest may be tax deductible for the portfolio company. In addition debt may be repaid when distributions of dividends may be prohibited due to a lack of distributable profits.

The equity component allows the investors to enjoy an upside on their investment, as well as greater control over the portfolio company that is not only reliant on contractual protective covenants.

Restrictions

Issuance of shares in a company that has only issued one class of shares is subject to statutory pre-emptive rights. The articles of association of the portfolio companies will generally include pre-emptive rights on new issuances of equity or debt, subject to customary exclusions and a right of first refusal on transfers of shares and notes. These rights are often limited only to certain major holders in the portfolio company.

Taxes

The sale of shares is a tax event (capital gains) borne by the selling shareholder. The buyer has a withholding tax liability unless satisfactory certificates of exemption from withholding tax are provided by the seller.

BUYOUTS

16. Is it common for buyouts of private companies to take place by auction? If so, which legislation and rules apply?

Buyouts of private companies do take place by auction, but auctions are in the minority of buyout transactions. If an auction does take place, it is controlled by the seller.

17. Are buyouts of listed companies (public-to-private transactions) common? If so, which legislation and rules apply?

Buyouts of listed companies generally take place as one of the following:

- A merger under the Companies Law 1999 (sections 314 to 327) and the Companies Regulations (Merger) 2000.
- A tender offer under the Companies Law 1999 (sections 336 to 340) and Securities Regulations (Tender Offer) 2000.
- A court approved merger under the Companies Law 1999 and the Companies Regulations (Application for Settlement or Arrangement) 2002.

Principal documentation

18. What are the principal documents produced in a buyout?

The principal documents produced in a buyout are:

- A purchase and sale agreement between the buyer and the seller or a merger agreement between the buyer and the target company.
- Articles of association of the portfolio company.
- Shareholders/investment agreement setting out ongoing commitments of the buyer, management and if applicable other shareholders. These include many options depending on the specifics of the deal, from voting agreements (if other shareholders remain) to bonus/retention arrangements for management.
- Employment agreements and related documents for senior management.
- Loan and security agreements, if leverage is involved.

Buyer protection

19. What forms of contractual buyer protection do private equity funds commonly request from sellers and/or management? Are these contractual protections different for buyouts of listed companies (public-to-private transactions)?

Private equity funds typically request:

- Representations and warranties and related indemnification provisions from the sellers in the purchase and sale agreement.
- Specific indemnities for issues identified in due diligence.

A purchase price adjustment based on cash at closing is a customary request. Protective provisions are a customary request in a private company, as could be a holdback or escrow on a portion of the purchase price.

20. What non-contractual duties do the portfolio company managers owe and to whom?

Statutory duties imposed on board members of portfolio companies (including portfolio company managers) include a

fiduciary duty to the company and a duty to act in good faith and for the good of the company, including without limitation:

- Avoiding any conflict of interest between his duty to the company and any duty relating to any other position held by him or his personal interests.
- Avoiding any activity competing with the company.
- Avoiding exploiting company opportunities for personal gain.
- Disclosing any information that comes in to his hands as a result of his position in the company.

In addition, the Companies Law 1999 requires shareholders to act in good faith towards the company and its shareholders and avoid misuse of the shareholder's power in the company. In addition, a shareholder with a controlling stake in the company or the power to decide on a certain issue is required to act towards the company in a fair manner.

21. What terms of employment are typically imposed on management by the private equity investor in an MBO?

Terms of employment typically imposed on management by a private equity investor include:

- Minimum periods of prior notice of resignation by the employee (that is, to provide sufficient lead time to find an appropriate replacement).
- Non-compete provisions (these are as a general rule not strictly enforceable, but are still standard practice).
- Non-solicitation.
- Confidentiality obligations.
- IP assignments.

Management are typically incentivised with options, with vesting of such options structured to maximise retention.

22. What measures are commonly used to give a private equity fund a level of management control over the activities of the portfolio company? Are such protections more likely to be given in the shareholders' agreement or company governance documents?

Private equity funds commonly influence the activities of the portfolio company through appointing one or more members of the company's board, and through various protective provisions requiring the consent of the private equity fund at shareholder level. The protective provisions may include:

- Control over authorisation and issuance of shares, that is, additional rounds of financing.
- Acquisitions and dispositions.
- Changes to the company's governing documents.
- Increase of the company's debt level.
- Payment of dividends.
- Interested party transactions.
- Material changes to the company's business.

To properly exercise influence in the company, private equity funds typically receive extensive information rights that include not only annual and quarterly financials, but also:

- Budgets and projections and inspection rights of the company's books and premises.

- A company covenant to notify the private equity fund of material changes to the company and its business.

DEBT FINANCING

23. What percentage of finance is typically provided by debt and what form does that debt financing usually take?

The percentage of finance typically provided by debt depends on the type of the deal and market conditions. Various forms of debt finance are used, including:

- Loan facilities of all types.
- Working capital and other revolving credit facilities.
- Asset secured loans.
- Debt instruments convertible into equity.

Lender protection

24. What forms of protection do debt providers typically use to protect their investments?

Security

Debt providers typically secure their investment through fixed charges (including pledges and mortgages) and floating charges on the borrower's assets and, if appropriate, guarantees of related entities.

Contractual and structural mechanisms

Debt providers often contractually agree on subordination of the debt through inter-creditor arrangements that set the seniority of the debt. Often payment of dividends is prohibited until the debt is paid.

Financial assistance

25. Are there rules preventing a company from giving financial assistance for the purpose of assisting a purchase of shares in the company? If so, how does this affect the ability of a target company in a buyout to give security to lenders? Are there exemptions and, if so, which are most commonly used in the context of private equity transactions?

Rules

A company can only purchase its own shares or provide assistance for financing the acquisition of its own shares, including by granting a security interest over a company's assets to secure the financing, if both:

- The company has profits available for distribution as dividends equal to or exceeding the purchase price of the shares.
- The company's board of directors declares that despite providing the financial assistance, the company will remain able to pay its debts as they become due.

Exemptions

These rules do not apply where a company assists in the purchase of shares of its subsidiary, but do apply where a subsidiary assists in the purchase of shares of its parent.

In general, directors must act to promote the company's interest. As the company will benefit from the successful results of its subsidiaries, a company's board can reasonably resolve that granting a security interest (or a guarantee) to secure debts of its subsidiary is in the company's interest.

Insolvent liquidation

26. What is the order of priority on insolvent liquidation?

In an insolvent liquidation the debt providers (the creditors) are given priority over other stakeholders by law. The order of priority among the creditors is as follows:

- Liquidation and receivership costs.
- First priority tax charges (primarily on real estate).
- Possessory liens.
- Perfected security interests (fixed charges, pledges and mortgages).
- Creditors with statutory preference (certain amounts of unpaid salary, certain debts to the tax authority, and certain debts to a landlord).
- Floating charge creditors.
- Unsecured creditors.
- Deferred creditors (shareholder creditors that a court has declared last in order of preference).

Equity appreciation

27. Can a debt holder achieve equity appreciation through conversion features such as rights, warrants or options?

A debt provider can seek to achieve equity appreciation through convertible debt instruments convertible into equity, or being granted warrants or options as an "equity kicker" when providing debt.

PORTFOLIO COMPANY MANAGEMENT

28. What management incentives are most commonly used to encourage portfolio company management to produce healthy income returns and facilitate a successful exit from a private equity transaction?

Portfolio company management is usually incentivised in the shorter term by annual or other bonuses based on pre-defined criteria aimed at meeting the portfolio company's broader goals.

Longer term alignment of interests between the private equity fund and management is usually achieved by providing management with a share of the equity in the company, usually in the form of tax benefited options in the Section 102 capital gains track.

In companies with an "overhang" of debt or preferred equity obligations that may prevent management from sharing in an exit through options to purchase ordinary shares, management carve outs are common. They provide an incentive for management to work towards an exit and stay on with the company long enough to see such an exit through to completion.

29. Are any tax reliefs or incentives available to portfolio company managers investing in their company?

There are no tax reliefs or incentives available to portfolio company managers investing in their company.

30. Are there any restrictions on dividends, interest payments and other payments by a portfolio company to its investors?

Payments of dividends or other payments by a portfolio company to its investors may be restricted by the terms of agreements between the company and its creditors, as well as inter-creditor agreements between its creditors that limit the payment of dividends, redemption of shares and other payments.

In addition, the Companies Law 1999 limits the ability of a portfolio company to pay dividends to amounts that are lawfully available for distribution (see *Question 15*).

31. What anti-corruption/anti-bribery protections are typically included in investment documents? What local law penalties apply to fund executives who are directors if the portfolio company or its agents are found guilty under applicable anti-corruption or anti-bribery laws?

The investment documents often include representations, warranties and covenants on the portfolio company's part regarding its past compliance with and undertaking to continue to comply with the US Foreign Corrupt Practices Act, or similar statutes in other jurisdictions.

Employment agreements of management often define acts that are materially detrimental to the company, as well as a conviction for a crime of moral turpitude, as acts that entitle the company to terminate such employee for cause.

Payment of bribes to non-Israeli officials is a criminal offence in Israel that carries a maximum penalty of seven years in prison.

EXIT STRATEGIES

32. What forms of exit are typically used to realise a private equity fund's investment in a successful company? What are the relative advantages and disadvantages of each?

Forms of exit

The typical forms of exit of a successful portfolio company, and the relative advantages and disadvantages, are:

- **Sale of the portfolio company's shares by all the portfolio company's shareholders.** Depending on the sales price, this is the most efficient and perhaps the most successful exit for a private equity fund, in that it involves a sale of all of the fund's shares in the company, typically in return for cash or tradable securities. A potential disadvantage is that, depending on how the transaction is structured, approval of the transaction may require class votes, giving certain shareholders the ability to complicate and occasionally frustrate the transaction.
- **Sale of the portfolio company's assets.** While a sale of the company's assets has the advantage of not requiring shareholder approval, it often has the disadvantage of being inefficient from a tax perspective. On a sale of its assets, the portfolio company is subject to capital gains tax, and when the resulting proceeds are distributed by the company to its shareholders, the distribution is often subject to a dividend tax.
- **IPO.** Flotation of a company's shares on a recognised stock exchange brings liquidity to the private equity fund, by enabling it to begin selling its shares on the public market. However, sales of shares on certain stock exchanges are subject to time and quantity restrictions, which limit a fund's ability to sell all its shares simultaneously. In addition, the share price is subject to volatility.

- **Sale of the portfolio company's shares in a private transaction by the private equity fund.** A private equity fund may sell its shares in a portfolio company to a third party. Often these sales are subject to a right of first refusal of other shareholders in the company. However, the price received by the private equity fund is likely to reflect a discount, as the third party is purchasing a minority interest in the company.

33. What forms of exit are typically used to end the private equity fund's investment in an unsuccessful/distressed company? What are the relative advantages and disadvantages of each?

Forms of exit

At this point the fund usually tries to limit its exposure as a dominant shareholder in the company and as a "deep pocket" and to reduce the exposure of its board members, whom it is usually required to indemnify for any claim in their capacity as directors. The private equity fund's appointed directors will often resign from the board.

The fund will usually look for a buyer for the portfolio company, even at a bargain or fire sale price, to prevent the shutdown of the company or it entering into bankruptcy. These deals tend to be with management who believe they can turn around the business or with competitors. They are often asset sales so that the company's liabilities are not assumed.

If a buyer is not found, the company will either go through a voluntary dissolution if it is insolvent, or go into bankruptcy or receivership if it is not solvent.

PRIVATE EQUITY/VENTURE CAPITAL ASSOCIATIONS

Israel Advanced Technology Industries

W www.iati.co.il

Status. The Israel Advanced Technology Industries (IATI) is a non-governmental organisation.

Membership. IATI members come from every level and aspect of the industry: Entrepreneurs, start-ups, incubators, accelerators, R&D centres, multinational companies, local and international venture capital funds, private investors, tech transfer companies and service providers.

Principal activities. IATI's mission is to strengthen the Israeli high tech and life science industries and create global, technological and innovational leadership. IATI researches, develops and advocates policies and actions that promote Israel's high tech industries, increasing awareness of its strengths and innovations worldwide.

Published guidelines. IATI has published best practices for entrepreneurs and start ups (*see website above*).

Information sources. IATI has published various resources (*see website above*).

Practical Law Contributor profiles



Barak Platt, Partner

Yigal Arnon & Co.
T +972 3 608 7777
F +972 3 608 7724
E barakp@arnon.co.il
W www.arnon.co.il



Yarom Romem, Partner

Yigal Arnon & Co.
T +972 2 623 9200
F +972 2 623 9236
E yaromr@arnon.co.il
W www.arnon.co.il

Professional qualifications. Member of the California Bar, 1987; Member of the Israel Bar, 1993; University of California (Boalt Hall), JD 1987; University of Pennsylvania, BA 1984

Areas of practice. Mergers and acquisitions; hi-tech; venture capital; private equity.

Professional qualifications. Member of the Israel Bar, 1997; Hebrew University, LLB 1996

Areas of practice. Venture capital; private equity; hi-tech; mergers and acquisitions.