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Regional Instability Keeps Israeli Stock Valuations Low

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Perceptions about the Israeli economy and financial markets continue to suffer from regional political instability in the Arab and Islamic world. The misnamed “Arab Spring” is rapidly turning into a bitter winter in Syria, Lebanon and perhaps now Egypt. Some of the problems are indeed spilling over into Israel. The Israeli military returned fire from the Gaza strip into Syrian territory and bombed a shipment of weapons bound for Hezbollah in Lebanon. In recent months Hezbollah sent its forces into Syria to fight on behalf of Bashar Assad’s brutal regime.

While Israel is most often discussed in the context of conflicts in the region it is important to remember that Israel is a modern, democratic and increasingly wealthy society - a unique phenomenon in the Middle East. Israel’s primary security goal is to protect its “island” from the troubled seas surrounding it. So while Israel made headlines over the past decade for its Second Lebanon War with Hezbollah in 2006 and Operation Cast Lead in the Gaza strip in 2009, as well as numerous other episodes and security actions, its economy grew at the remarkable pace of 6% per annum. Public company profits increased 10% per year during the same period of time.

Perhaps security concerns will always keep Israel’s foreign investment inflows well below their potential, but for any investor willing to look beneath the seemingly troubled surface many opportunities abound. Despite robust growth Israeli stocks sell for fairly low valuations. The Price-to-Earnings (P/E) ratio for the Tel-Aviv 100 Index is 11.8 based on 2013 earnings estimates, and the Price-to-Cash Flow (P/CF) ratio is 6.4. In other words, for each dollar of cash pocketed by a company investors are only paying \$6.40 or an owner’s yield of 15.6%.

Analyzing data from a newly introduced stock index called the Bluestar Israel Global Index tells a similar story. The Bluestar Index better captures many of the higher growth technology companies that are listed on global stock exchanges but not the Tel-Aviv Stock Exchange. Even including these global listings valuations remain low with an estimated P/E ratio of 13.1 and a P/CF ratio of 7.5.

Security Needs Motivate Aggressive Economic Reform

The inherent security concerns in Israel contribute to attractive valuations, making their stock market a bargain for global investors. Perhaps also underappreciated is the fact that Israel's security situation motivates policy makers to implement reforms that prove impossible in more secure countries. Take for example the opposition in Europe to far more modest reform proposals. Unlike troubled European countries such as Greece, Spain or Italy, Israel requires economic growth to protect itself from acute threats.

Over the past two decades Israel radically restructured its formerly Socialist economy into a technologically advanced capitalist society. However, a great deal of the transformation remains incomplete. Privatization marked the initial phase of the transformation, but the monopolistic structure of the Socialist economy was left largely intact. The next phase will be a more aggressive shift away from monopoly toward greater business competition.

In 2012, the Israeli government adopted policies to break up concentrated financial and corporate pyramids over a four year period. The clock is ticking while Israeli tycoons prepare to divest their financial holdings from their non-financial holdings. Over time this will greatly increase competition and transparency in the financial sector. This economy-wide reform came on top of a major shift in the telecommunications sector when the Israeli government licensed three new mobile phone operators to compete with the three incumbents.

During the second quarter Prime Minister Netanyahu announced a new initiative to increase competition for Israel's ports and airlines. The government will submit a tender for private companies to bid on the construction and operation of two new port facilities in Ashdod and Haifa. The goal is to break the current port monopoly, reduce shipping costs and facilitate much higher volumes of trade. If successful the effects could ripple throughout the economy, boosting retailers, manufacturers and consumers. Similarly, greater competition in the airline sector should lead to lower fares and wider choices. All of these reforms are in addition to the major labor market reforms designed to encourage the Haredim (Ultra-Orthodox) and Arab women to enter the work force in much larger numbers (see our 2013:Q1 letter).

In any other country where security and conflict did not occupy so much ink and thought, these developments would dominate headlines. Eurozone countries are rocking world markets with their political inertia and relatively timid economic reforms. Meanwhile Israel is engaged in wholesale economic restructuring despite loud protest from the political opposition and labor unions. We believe the economy and stock market will continue to respond very positively in the long run to Israel's pro-growth policies, despite ongoing revolutions, civil wars, terrorism and other conflicts in Israel's very troubled neighborhood.