יועצי השקעות ישראל | Israel Investment Advisors

Unlocking Even More Value in the Israeli Stock Market

Brian J. Friedman, CFA

December 31, 2013

Israeli stocks produced outstanding results in 2013. In the coming 10 to 15 years, we believe Israel could join the small club of countries whose stock market capitalization exceeds $1 trillion. Driving this growth will be ongoing success in the technology sector, as well as a major overhaul of the Israeli domestic economy. Legislation adopted by the Knesset in late December will require large conglomerates to separate their financial and non-financial holdings, reduce pyramid ownership structures, and open markets to greater competition. This restructuring – already underway even prior to the new legislation - is the third major wave of reform since Israel shifted away from Socialism in the 1990's.

In the 1990's Israel privatized companies owned by the Histadrut labor union and in the 2000's government holdings were also privatized. Most of these companies were acquired by politically connected tycoons who raised capital from banks they owned as well as from stock listings and bond issues (also distributed through the banks they owned). The new owners used the capital to revamp their businesses for much greater profitability and value. They also exploited their monopoly power. Privatization transferred ownership into private hands, but left the monopolistic nature of Socialist enterprise intact (for more detailed analyses of this phenomenon, please reference the materials on our web site at www.israelinvestmentadvisors.com/resources).

Transformative Legislation Adopted in December 2013

Massive street demonstrations in 2011 put the high cost of living in Israel on the top of the government's agenda. After forming two commissions to study the issue, the Knesset finally passed transformative legislation in December 2013. This legislation attacks the monopolistic structure of Israeli business and finance. The goal is to level the playing field. Capital will be better allocated according to business merit rather than privilege and monopolies will face greater competition. Over time, Israeli consumers will gain better choices at better prices.

The legislation to break up pyramids and unwind cross share-holdings of financial and non-financial businesses is actually just the latest in a series of important reforms in recent years. In the 2000's Israel broke the top three banks' control over the securities markets and asset management industry. As a result, new offering of stocks and bonds increased - at least until the global financial crisis - and are once again rebounding. The Israeli pension system was overhauled to allow for greater investment flexibility. Israelis are large savers through their pension plans, but for many years Israeli pension plans were forced to buy government bonds rather than other investments. These restrictions are being gradually lifted as the government reduces its debt as a percentage of Gross Domestic Product (GDP). Perhaps most important of all reforms, falling government debt allows the Israeli capital markets to flourish as ever more savings flows into stocks and bonds.

Reforms over the past decade facilitated the expansion of the Israeli stock market. Since 2003, the total capitalization of Israeli public companies doubled to approximately $190 billion. Nevertheless, Israeli stock valuations remain constrained by limited liquidity and geopolitical risk. The restructuring of business pyramids could lead to a large number of securities offerings, further boosting liquidity and company valuations. Perhaps even more importantly, a wide variety of enterprises heretofore locked out of the Israeli capital markets by the dominant monopolies should be able to list their stock in the coming years. As was mentioned above, the new legislation actually accelerated an ongoing process. Many tycoons gambled their empires on highly indebted real estate during the global boom and were forced to liquidate assets to remain solvent. Others discovered that the pieces of their conglomerates were more valuable when sold separately than when held together in their pyramids. More liquid markets and higher valuations will benefit the big players even as it erodes their monopoly power.

A Capital Markets Revolution is Already Underway in Israel

Most Americans do not yet appreciate the financial revolution already underway in Israel. There are now 564 listed Israeli companies, of which 464 trade on the Tel-Aviv Stock Exchange (TASE), 85 are exclusively listed in the United States and 15 on European exchanges. The total market capitalization of the TASE is about $157 billion while Israeli companies listed in the U.S. amount to $31.4 billion in total market value.

All of this growth came despite the last 10 years of global crisis which suppressed stock valuations and IPO (Initial Public Offering) activity. Most Israeli companies raised capital via merger or acquisition in recent years rather than by tapping the public markets. Extreme volatility limited the appetite among investors in Israel and around the world for new issues. However, the market dynamics are already shifting.

Several Israeli companies launched successful IPOs in 2013 and analysts predict 25 or so Israeli companies might go public in 2014. Adding further impetus to stock market liquidity and valuations will be a large number of offerings – both IPO and secondary stock sales of already listed companies – as new regulations take effect forcing Israeli tycoons to divest their concentrated holdings over the next four years.

Israel already excels at technological innovation; a trend we believe will continue and grow. As Israel improves business competition in its domestic economy and the freedom of its financial sector, we believe financial innovation will also accelerate. We are not waiting for this trend to begin. It is already here, but not yet globally significant. We think the world will take notice of the Israeli financial markets in the coming years and we are pleased to be among the first to participate.