

Emerging Nations: New Sources for Capital Funds; Israeli Experience

Aharon Shapiro, Ph. D. St. John's University, New York City.

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Abstract:

In most emerging nations, the domestic stock exchanges are too small and too volatile for efficient provision of financial capital for the development of new industrial firms. In the Mideast, only Israel has been able to create a flourishing economy with new industrial development. Much of the success is due to the ability of Israeli firms to raise capital in the larger world capital markets, particularly New York.

Finding Capital Funds.

Raising capital funds for new or growing enterprises has always been a problem for an emerging economy. Almost by definition, the local capital markets are not particularly attractive to both domestic and foreign investors. The local markets tend to be too small, too volatile and too restrictive for successful flotations.

Israel's response.

In Israel, the Tel Aviv Stock Exchange (TASE) suffered from the same disabilities of depressed prices and erratic behavior of most small local exchanges. Consequently, very few Initial Public Offerings (IPO's) are placed on the TASE. Most have been shifted to New York for placement. (1)

In 1995, only 18 Israeli companies offered new issues on the local TASE and raised a mere \$71.5 million. In contrast, Israeli IPO's or new additional issues raised almost 8 times that amount, or about \$565 million in New York that same year. Of that \$565 million, some \$500 million were mainly for hi-tech companies. (2) Israeli firms then proceeded to raise \$1 billion more each year in New York in both 1996 and 1997. (3)

Israeli Economy

This performance is amazing, considering that Israel is such a small country. It is a parliamentary democracy presently celebrating its short 50 years of statehood since 1948. The country is no larger than the State of New Jersey USA or Krugerland Park in South Africa. Also, It has a small population of less than 6 million. It has few natural resources. One-third of the country is arid desert. Nevertheless, the country is an economic success story. It boasts a GDP of about US\$100 billion and a

per capita income of more than \$17,000, about the same as Ireland and the United Kingdom. (4)

Israel has moved considerably into a more complete industrialized free market economy. This may come as a disappointment to the successors of the original socialist and agricultural minded pioneers who struggled to colonize the country in the early 1900's. The country has managed to reduce the inflation generated by the once powerful Histadrut Labor Union. Swallowing some bitter monetary policy medicine the government plans to reduce the rate of inflation to an unmatched low of 5% for 1998. This is expected to come with a penalty of 8.3% unemployment and some slowdown in economic growth.

Privatization of government monopolies (e.g. banking, utilities) has also made considerable progress.

Major exports are no longer oranges but hi-tech electronics and software.

The kibbutz (collectives) another symbol of Israel's socialist past has changed. Kibbutz population is declining. It has shifted from agriculture to manufacturing and services. Two kibbutzim even committed the heresy of listing themselves on the TASE.

The free market LIKUD party controls the new government. Prime Minister Benjamin Netanyahu holds an MBA from Massachusetts Institute of Technology.

Trade with Israel has become acceptable to most Asian and European countries. They now disregard the Arab boycott prohibiting trade with Israel.

Israel on Wall Street

In seeking extra-territorial capital sources, it is indeed remarkable that little Israel, today has some 100 firms traded on USA exchanges. This surpasses all other foreign countries with the exception of considerably larger Canada. (5) American investors have become enamored with the profit potential of Israeli firms, particularly hi-tech.

Why the flourishing hi-tech industry in Israel.

Some explanations for the shift to hi-tech include the recent large immigration of Russian Jews with engineering skills. Total engineers in Israel now number 15,000. This has created some 2,000 hi-tech companies in Israel and about 300 "incubator projects begun each year.

Although partially subsidized by the Office of the Chief Scientist, most startups are initially undercapitalized. After about 3 years about 45% fail. Survivors may receive aid from venture capital funds or are merged with another larger, more

prosperous entity. Eventually they turn to Wall Street to solve cash problems. Today, some 100 companies are now listed on the exchanges as regular stocks or as American depository receipts.

By 1996 more than 80 Israeli firms with a total capitalization of \$15 billion were already traded in New York. This averages out to \$188 million per firm. TASE that has been operating since the 1930's and has 657 listings for a total capitalization of \$73 billion has an average value of only \$111 million per firm.

In each year of 1996 and 1997, 25 Israeli firms raised about \$1 billion in capital funds. (6) However 70% went to the more established firms of Checkpoint, Gilat, Teledata, Nice, Tecnomatix, Tefron, Esc and Supersol. It is interesting that Supersol and Formula also traded simultaneously on the TASE. Their stock prices are arbitrated between New York and Tel Aviv and thus kept in line.

A company called Crystal dealing with solving the millennial year 2,000 problem for computers has become the most successful Israeli flotation for 1997. Crystal returned to investors a 290% yield. Average yield for 1997 for Israeli stocks was also a commendable 54%. (7)

Despite American enchantment with Israeli stocks, Israeli stocks were rated in July 1997 as among the more risky countries for stock exchange investment.

Ranking criteria were : market risk, volatility in volume and value in local currency, information available , investor protection, securities trading supervision and administration and taxation.

Israel was ranked in the fourth of five high-risk groups, which include China, Columbia, Czech Republic, Hungary, India, Indonesia, Poland, Sri Lanka, Taiwan and Venezuela. (8)

Weakness of Tel Aviv Stock Exchange and Shift to Wall St.

TASE volume is too small. Frequently offers are not matched by any bids. Many days find numerous individual stocks not traded at all. Starting with 1994 the TASE turned bearish.

This may possibly be attributed to:

- 1) Sharp rise in inflation and interest rates
- 2) Downturns in company earnings
- 3) Fluctuations in New York hi-tech prices affecting Israeli stocks
- 4) Investigations by the Israel Security Authority (equivalent to the USA Securities Exchange Commission) investigation of possible stock manipulation

- 5) The new Likud Government may have produced uncertainties of the direction of the Arab Israeli peace process, which may have discouraged capital inflows.
- 6) The banks that are holders of vast retirement funds, have been dismal failures in providing real positive returns to the pension holders. Savers had abandoned the banks and their mutual stock funds and turned instead to secure government bonds or short term fixed returns.
- 7) Finally, some blamed Jacob Frenkel, the monetarist from the University of Chicago and now Director of the Central Bank of Israel who has kept interest rates high because of inflation concerns.

The above might explain why from January 1, 1994 to September 1, 1997, foreign investment directly in TASE stocks totaled only \$1.77 billion compared to \$2.77 billion invested in Israeli shares on Wall St. during that same period. (9)

Israel Hi-tech

Hi-tech is now Israel's largest industry. Electronics and Software compose about \$7 billion in annual sales for 1996. This is some 8 – 9 % of the GDP. The key areas are imaging, data compression, communications , data security and semi-conduction design and equipment. Because many allied industries such as healthcare, use expertise in these interrelated fields it is not easy to define the borders of the hi-tech industry. A full account must also allow for the local impact of the Israeli subsidiaries of American firms such as Intel, Microsoft, Motorola, and IBM. About 70% of this output is exported. (10)

Some Hi-tech success stories include:

Point of Sales Inc. providing software for checkout counters
Checkpoint which provides computer security software
Vocal- tech and computer telephony

Clal Electronics, a large holding company was capitalized on NASDAQ at \$463 million but in contrast had only \$388 million worth of shares outstanding in Tel Aviv.

Some Recent Israeli Offerings

Formula systems Ltd. Is a venture capital firm that invests in young Israeli startup software concerns. Formula had tripled in price on the TASE is expected to float an \$80 to 100 million issue on the NASDAQ shortly. (11)

The following are the five largest Israeli high-tech offerings on Wall Street as of March 10, 1998 (12)

Company Name	Market Value at Issue (\$millions)	Sum Raised (\$millions)	Activity
Amdocs	4,000	350	programming and billing Systems for line and Cellular phones
Indigo	1,000	100	Digital off-set color print
Check-Point	460	59	Internet data security (firewalls)
Galileo	330	51	complex digital semiconductor Devices
Tadiran	290	101	Communications equipment Electronics

Reasons for the Israeli success with implications for other emerging countries

- a) **The Peace dividend.** Since its statehood in 1948, Israel has had to survive four major wars. The last major war concluded with the Egypt/Israel treaty of 1973. While Israel still devotes a good portion of its budget to defense, more resources are now available for peaceful development. Of itself however, the treaty with Egypt has been of very little direct economic benefit to Israel since Egypt still has neither the inclination nor the income to buy Israeli products.

It may be said that Israel has also enjoyed a “war” dividend. The country has had to defend itself again against hostile neighbors numbering perhaps 20 times the population of Israel. It could do so only by excelling in military electronics and engineering. Many skills and technology have since been transferred to civilian use.

- b) **Israel's college educated are about 28% of its population. This matches the hi-tech areas of the Silicon Valley in California and Boston. (13)**

With the collapse of the Soviet Union, Large scale Russian Jewish immigration brought a host of university educated technicians and scientists.

Israel claims a higher ratio of engineers per 10,000 population, 135, compared to the USA which has only 85. Every third family has a computer which exceeds the ratio for every country except the USA. Three out of ten families have cellular phones. (14)

- c) **Israeli startups are subsidized by the government.**
- d) **Startups have received the support of 36 foreign and domestic venture capital funds. They chose Israel because its economy still has relatively low post-development manufacturing costs and is producing products usable throughout the entire globe.**

Implications of this study for Other Emerging countries

Israel has grown from a backward farming and sheep raising land to a modern democratic industrial power in the space of 50 years. Unfortunately, this progress has resulted in the envy and the continued hostility of its neighbors.

Most other Mideast citizens languish in poverty and for the most part are dominated by non-democratic governments. How to improve their lot?

This study would recommend:

A shifting from agriculture to small scale industry as the major source of national income.

Emphasis on industries using cheaper labor.

Emphasis on education, engineering, and computers and finding niches in the global markets.

Reduction in defense budgets that misallocate resources.

Of course the rub is that the escape from poverty requires huge sources of capital funds. The local stock exchanges in all Mideast countries are practically defunct. Ultimately, firms must be encouraged to find rich uncles in the land of Uncle Sam or for that matter in the other large world exchanges such as London, Paris, Germany, Japan, Hong Kong.

Endnotes

- (1) For more complete description of Israel Capital Markets see this writer, Aharon Shapiro, *Journal of Emerging Markets*, Vol. 1, #3, Fall /Winter, 1996, pp. 57-71**
- 2) *Link Magazine, Israel*, “Tour of New Israel Economy” 1997**
- (3) Ami Ginsburg, *Arena/Globus, (Israel’s Business Newspaper)* Feb. 26, 1998.**
- (4) *Dow Jones News Wires*, April 28, 1998**
- (5) *Ibid.***
- (6) Ginsburg, *Arena*, Feb. 26, 1998**
- (7) Ginsburg, *Arena* Sept. 11, 1997**
- (8) Yaakov Shragai, *Arena* Jul 1, 1997 and *Wall St. Journal* June 27, 1997.**
- (9) *Arena* Oct. 13, 1997.**
- (10) *Link*, “Tour of New Israel Economy 1997) [www. Link.co.il](http://www.Link.co.il)**
- (11) *Dow Jones Newswires*, April 29, 1997**
- (12) Shlomo Greenberg, *Arena* Dec. 16, 1997.**
- (13) Peter Passell, *New York Times*, June 5, 1997**
- (14) Joel Greenberg, *New York Times on the Web* , Aug. 18, 1997**