Israel's High-Energy Economy

The recent discovery of huge reserves of natural gas could help Israel's famous start-up economy take the next step.

By Howard Stock

While oil tends to dominate the economic headlines of Israel's neighbors in the region, falling oil prices have not had as much impact on Israel's economy as the future prospects for Israel's recent-and massive-offshore gas discoveries.

"For many decades, Israel was an energy importer. Now it faces the prospect of being a significant energy exporter," says Alan Sacks, a partner at Herzog Fox & Neeman.

But it isn't all good news, and that's where Israel's legal sector comes into play. For one, the development of Israel's offshore gas discoveries is being hampered by a lack of clear leadership from Israel's regulators and the special interest of just a handful of energy companies. "The Anti-trust Commissioner has indicated his intention to break up this cartel and to generate competition within the offshore gas economy," Sacks says. "We have yet to see how this issue will play itself out. One consequence may well be the forced disposal of significant interests in offshore gas fields with significant corporate and financing work for any lawyers involved."

On the other side of the table, "The ability of companies such as Nobel Energy and Delek to develop the Leviathan gas reservoir has been severely impacted by regulatory uncertainty and changes in government policy," says Jonathan Finklestone, a partner at Tadmor & Co. "We continue to assist leading companies and lenders in the energy sector as they steer a path through the regulatory challenges currently being encountered."

Part of the delay is undoubtedly due to the sheer size of the opportunity. Not only does the gas promise to lower the energy bills of all Israelis, Gadi Ouzan, a partner at Shibolet & Co., says that more than 50% of the gas produced can be exported. "The price of the natural gas is not pegged to the price of crude oil and in fact is significantly less than the comparable calorific price of crude oil," he says. "This has reduced the cost of energy to Israel and thereby the price of electricity to consumers as well as the cost of electricity to most industries, thereby enabling export oriented industry to be more competitive."

The tax levied on the profits of the gas producers and the royalties payable to the State of Israel are creating windfall profits that will be invested in a reserve fund, similar to what Norway has done with its profits from the North Sea, Ouzan explains.

Jan S. Wimpfheimer, partner at Schwell Wimpfheimer & Associates, adds that newly discovered energy resources mean that Israel's dependence on foreign oil is abating. And Finklestone says that if anything, falling prices have helped Israel's economy offset the effects of the global economic slowdown and weaker export demand from Europe and North America.

The other side of the coin, in this case the ruble, is that the negative impact of falling oil prices on Russia's economy has resulted in a significant hit to Israeli agricultural exports and also to inbound tourism from Russia, according to Sacks.

STABLE BUSINESS ENVIRONMENT

However, in the eyes of international investors, Israel remains an attractive business destination, says Tal Tirosh, head of S. Friedman & Co.'s high-tech practice group, a point underscored by International credit agency S&P, which recently reaffirmed Israel's A+ rating with a stable forecast. Despite recent regional discord, "Our firm was involved in a few cross-border M&A transactions during Operation Protective Edge, and while a number of conference calls had to end abruptly due to sirens in Tel-Aviv, the war did not halt the negotiation process nor deter foreign acquirers from moving forward with their acquisitions in Israel."

Indeed, in terms of international deals, 2014 was deemed the "year of exit," Ouzan says, with purchases of Israeli companies by large international corporations announced weekly and sometimes even daily. The first quarter of 2015 seems to be carrying on where 2014 finished off. "Valuations in both the high-tech fields and in traditional industries—with control in Tnuva, Israel's largest dairy manufacturer, purchased at a gross company valuation, including debt, of NIS8.6b being a prime example—seem to be as high as ever," he says.

While the majority of foreign investment in Israel continues to come from the U.S. and Europe, Ran Ben-Ari, a partner at Gross, Kleinhendler, Hodak, Halevy, Greenberg & Co., says investors are increasingly coming from Asia, and not just from China but also Japan, Singapore, Korea, India and other Asian nations.

China remains the dominant Asian investor in Israel though, Sacks says. The largest of these investments has been the state-owned Bright Food's, Tnuvas acquirer. "Why the interest from overseas? For the technological giants this is obvious. Israel is a leader in technology, particularly in the cyber, internet and e-commerce spheres. The technological giants from overseas are looking to buy the latest and best technology to incorporate into their operations," he says.

In the last few years, "Israel has witnessed a soar in direct investments by Chinese venture capitalists (VCs) and corporations in Israeli high-tech companies, and a growth in acquisition of Israeli companies by Chinese strategic partners, acquiring large positions in key Israeli industries, and lately an increase in Chinese investments in Israeli venture capital funds," adds Tirosh. The prevailing motivation for their investments in Israeli companies, he says, at least for some of these Chinese companies, is their perception that those investments are a necessary layover on their way to their ultimate destination, which is investments in U.S. companies and U.S. VC funds.

Chinese companies are also making significant investments in insurance and infrastructure, Finklestone says. Recent examples include investments by Chinese companies in the construction and operation of new ports and in the acquisition of large insurance companies.

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However, their influence is felt most strongly in the high-tech field, with large Chinese strategic partners involved in a significant number of investments in some of Israel's most promising start ups, says Gadi Graus, another partner at Shibolet & Co. "A combination of Israel's cutting edge technology and global outlook seems to be very enticing to Chinese businesses and investors of all sorts."

BARRIERS TO ENTRY

Is all this action enough to attract international law firms? Sort of, but Israel—the country famous for having the highest number of lawyers per capita—doesn't make it easy. In August 2012, the 33rd Amendment to the Israeli Bar Association 1961 was passed, allowing foreign lawyers to practice law in Israel and permitting collaboration between Israeli and foreign law firms. Tirosh explains that according to the amendment, foreign lawyers are now allowed to provide legal advice with respect to the law in the jurisdiction in which they are licensed. The ban on foreign lawyers to represent clients before the Israeli courts remains.

While the amendment represents a significant development in the Israeli legal market, the two years that have passed since it was enacted have not yet seen a dramatic surge in foreign law firms opening offices in Israel or merging with Israeli law firms. "A few reasons come to mind," Tirosh says. "First, there are considerable tax issues relating to the recognition of the revenues of these firms in Israel that have not yet been fully addressed or resolved. Second, lawyers in Israel are proscribed from sharing profits with individuals who are not lawyers by profession. And third, Israeli lawyers are prohibited from incorporating as a limited company. The heightened liability will certainly be a deterring factor for partners in U.S. or U.K. law firms having to decide whether to open an Israeli office or not."

The offices that have been opened in Israel serve, on the whole, as liaison and business development offices and are not significant players in the local market, Graus says, though they can play significant parts in some of the largest transactions.

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International firms can register with the Israel Bar Association and openly practice foreign law from within Israel, but other than Greenberg Traurig, few international law firms have taken advantage of this opportunity, preferring for the moment to work from afar or to employ one or two local marketing scouts that do not actually practice law but instead source the opportunities to other offices of the law firm, says Joey Shabot, a partner at Greenberg Traurig.

Due to the discovery of natural gas, plus Israel's ongoing commitment to developing alternative sources of energy, energy law is one of the fastest-growing areas of new business for Israeli law firms, but the more established practice areas remain strong. Shabot says his firm is picking up a lot of new work in litigation-related services and compliance, while Ben-Ari says a significantly more active Israeli Antitrust Commissioner and the Antitrust Authority in recent years, as well as the recently enacted Centralization Law, plus an increase in environmental law due to the increasing awareness, and increased legislation and enforcement have been becoming more and more significant in the recent past.

Tirosh adds that while it's not a new practice area, dramatic changes undergoing the Israeli employment law field are worth noting. In the last few years, due to a

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surge in legislation that expanded employers' liabilities toward their employees and shifted the burden of proof onto the employers' shoulders, coupled with a significant increase in the number of enforcers employed by the Ministry of Economy, the Israeli employment law jurisprudence has been evolving at an unprecedented pace and has become more sophisticated and comprehensive than ever before. In addition, "the Israeli labor courts have upheld a few initial attempts by workers' committees to organize as labor unions at their respective companies—two of these companies were high-tech companies—reviving an area of Israeli labor law that was dormant for years," he says.

Both Ouzan and Finklestone note a growing phenomenon of U.S.-based real estate companies raising debt in the public markets in Israel, and international transactions with China are on the rise.

While Israeli companies have long been associated with serving developed markets, particularly in the fields of technology and medical devices, Ben-Ari says appetite for these kinds of products and services is also growing in Asia and Africa.

This global ambition presents an opportunity for law firms, Shabot says. "Teaming up with an international law firm can open a lot of doors for a growing Israeli company, as its law firm's client base—strategic partners, investment banks, and others—become more accessible."

Global law firms have a breadth and depth of experience that purely domestic law firms cannot match, Sacks adds. "Israeli entrepreneurs, in particular in the e-commerce, and internet fields are spreading internationally. The global reach of major international law firms can be of invaluable support in the field of M&A, regulatory issues, and so on."

DRIVING OPPORTUNITIES

Law firms are not only active in helping their corporate clients find those opportunities, but also in providing ongoing legal support as their businesses expand, Finklestone says.

A case in point, Shibolet has maintained a Chinese desk for almost 10 years, helping Israeli companies

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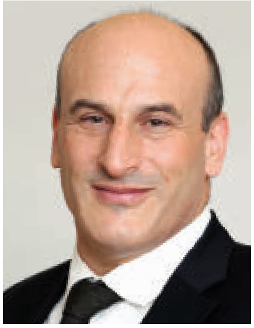

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bridge the cultural gap, providing the specialized negotiating skills required and helping lay out the legal and business roadmap up front for any cross-border ventures. And he says Israeli companies aren't just targeting China.

"There appears to be no region in the world in which Israeli companies are not active in mining, infrastructure, water, alternative energy, gaming, internet, medical devices, high-tech and almost any other field imaginable," Graus says. "This aggressive risk appetite often requires a highly business oriented, hands-on, multi-disciplinary legal advice. Those firms that are able to provide such advice, bring much added value to the table."

Lawyers are somewhat split on the direction of Israel's future growth. Shabot says that while Israel's business scene is famous for attracting major international buyers, early-stage businesses are now starting to resist those offers in order to remain independent and to compete on the global stage on their own terms.

However, Sacks predicts that Israel will continue to be an attractive market for a wide array of potential acquirers, largely as a result of a combination of high-quality technology and reasonable valuation of many Israeli companies, particularly for foreign private equity firms. He says those reasonable valuations—and a subsequent surge in M&A activity in Israel—will be driven by a combination of companies' need to sell assets to finance debt and recent legislation in Israel prohibiting ownership of the substantial financial entities and substantial "real" entities. In addition, "Israel has just held a general election, and the economic policy of the new government is yet to be determined, but the outlook for economic activity—and particularly the legal profession—looks bright," Sacks says.

Ouzan agrees. "The uncertainty of the last few months has receded now that the elections are over and a new government will be formed over the next few weeks," he says. "The government will have to deal with a variety of social issues, including soaring house prices and income and wealth inequality. Notwithstanding, it would seem that the Israeli economy is strong and that the high-tech and other internationally oriented businesses will continue to grow." ■

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