How Does Stock Market Investing Benefit Israel?

Brian J. Friedman, CFA
June 30, 2015

Many prospective investors at Israel Investment Advisors, LLC understand the personal benefits of investing in the Israeli stock market, but underestimate the benefit to Israel. In contrast, many people intuitively grasp the benefits of start-up investing for Israel while recognizing the substantial risk of financial loss for their personal assets. A well-functioning stock market brings many benefits to Israel. Stock markets channel capital to companies seeking larger economies of scale. They spread corporate ownership more widely throughout society, and promote greater transparency and liquidity. They boost pension plans and offer competitive advantages for companies pursuing acquisitions. Israel is now the proud "Startup Nation." A growing stock market will facilitate Israel's emergence as a "Scale-up Nation" as well.

As we discussed in our 2013:Q3 newsletter[1] the Israeli stock market suffered a significant blow in 2010 when stock indexes reclassified Israel from "emerging market" to "developed market" status. When designated an emerging market, Israel was a nice sized fish in a small pond. As a developed market, however, Israel moved into a vast ocean of capital where it remains a very small fish. In the process, emerging market mutual funds and ETFs sold their Israeli equities, but developed country funds did not replace the lost investment. Chart 1 shows the impact on Israeli stock market liquidity and Chart 2 highlights the impact on valuations since 2010. We launched Israel Investment Advisors, LLC to capitalize on and help rectify this situation.

[1] *OECD Membership: A Milestone for Israel, but Troublesome for the Stock Market* is available on our website at: http://www.israelinvestmentadvisors.com/wp-content/uploads/2013/10/OECD-Membership-A-Milestone-for-Israel-but-Troublesome-for-the-Stock-Market.pdf

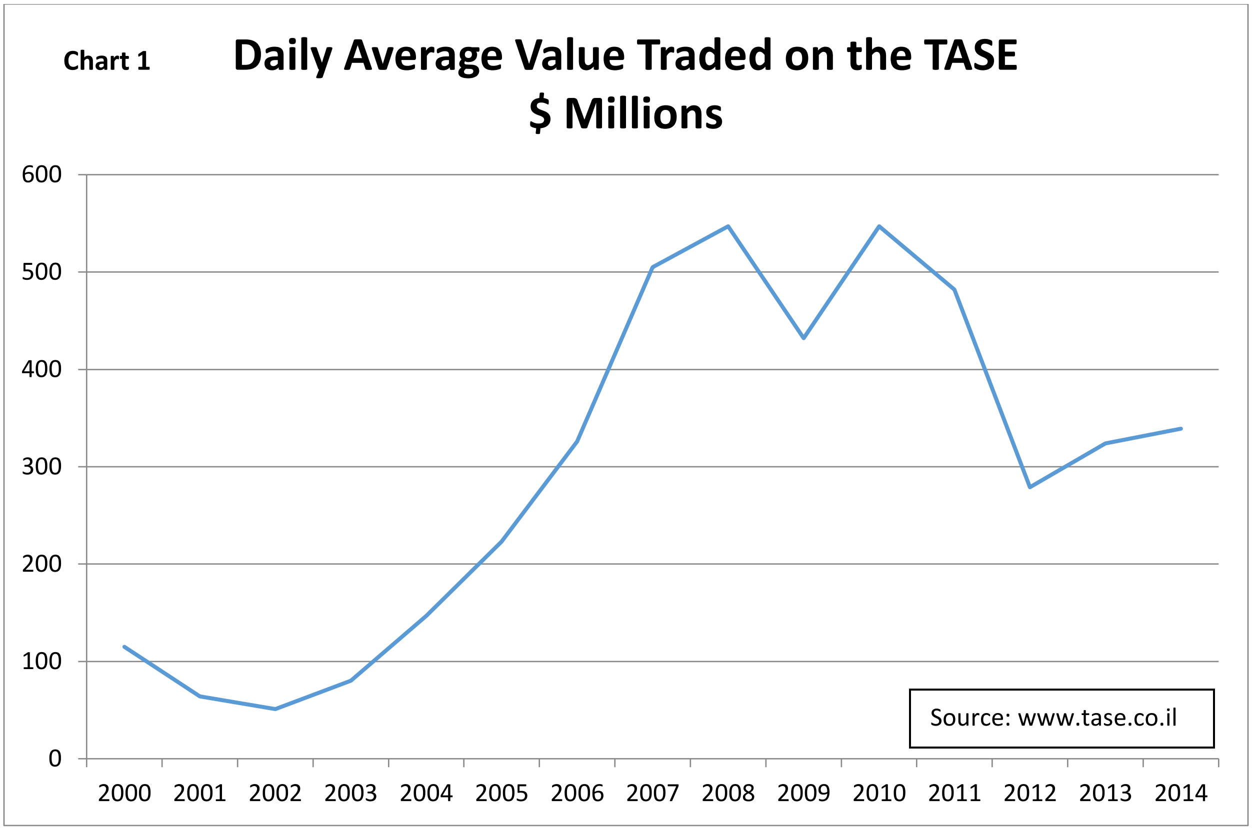
Chart 1
Daily Average Value Traded on the TASE
$ Millions
600
500
400
300
200
100
0
2000
2001
2002
2003
2004
2005
2006
2007
2008
2009
2010
2011
2012
2013
2014
Source: www.tase.co.il

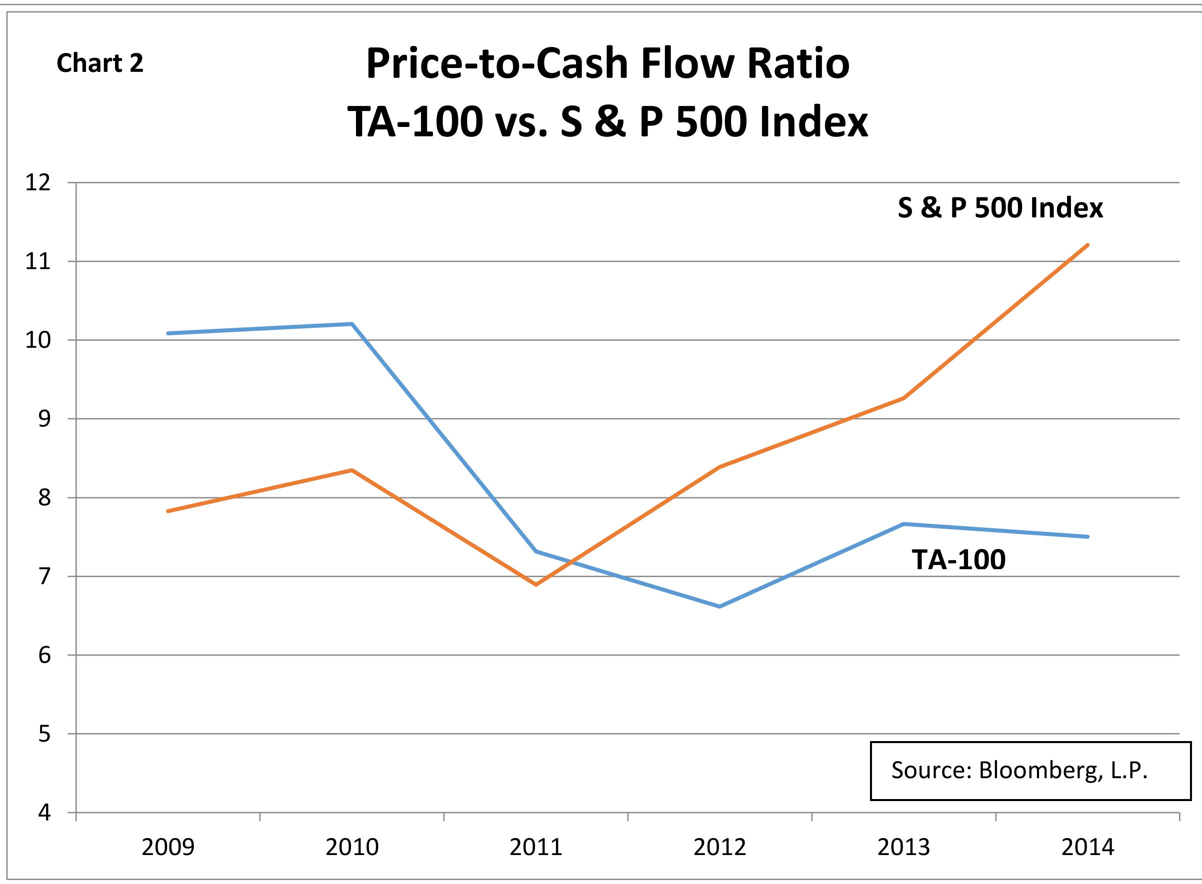
Chart 2
Price-to-Cash Flow Ratio
TA-100 vs. S & P 500 Index
12
11
10
9
8
7
6
5
4
S & P 500 Index
TA-100
2009
2010
2011
2012
2013
2014
Source: Bloomberg, L.P.

From Startup to Scale-up

Israel is a widely recognized global hub for venture capital investment. According to an analysis by IVC Research Center and KPMG, 688 Israeli startups raised $3.4 billion in Venture Capital funding in 2014. While there are 5,400 technology startup companies active in Israel today, the failure rate is quite high. The IVC Research Center analyzed 10,000 high-tech companies founded between 1999 and 2014. They found that 46% ceased operations, while only 139 companies exceeded $100 million in annual revenues or employed more than 100 people. A total of 350 companies achieved a minimum valuation of $50 million and 102 are publicly traded.

The stock market's role begins where venture capital typically ends, helping the 350 successful companies scale into global enterprises. As the Israeli stock market attracts more investment the venture capital success rate will also improve. In the United States a liquid and well capitalized stock market is the venture capitalists' partner, not their competitor. The stock market also funnels capital to all sectors of the economy, not just the technology sector.

Last year Israeli companies only raised $2.1 billion through stock offerings on the Tel-Aviv Stock Exchange (TASE), about $1.3 billion less than Israeli startups raised from venture capitalists. This is a very unusual situation in the world of finance. By way of comparison, American companies raised $247 billion from stock offerings in 2014 vs. $48 billion raised by startups from venture capitalists. Moreover, IPOs and other offerings are still recovering from the financial crisis while the venture capital total benefitted from a few very large investments into companies like Uber, Snapchat and Airbnb (PriceWaterhouse Coopers and the National Venture Capital Association - NVCA).

The stock market channels savings from millions of individuals, providing much larger amounts of equity capital than other institutions can muster. Alibaba raised $25 billion from its IPO, something that could only be accomplished through a stock offering. Moreover, successful technology companies typically achieve vastly greater scale and scope following their IPO than they did as startups. For example, eBay had 139 employees when it went public in the 1990's, at the end of 2014 it employed 34,600. Facebook had 3,200 employees when it went public vs. 9,199 in 2014. Google went from 3,021 people prior to its IPO vs. 53,600 today. (NVCA 2015 Yearbook) Venture capital is often required to nurse a company to viability, but the stock market allows it scale up.

Toward a $500 Billion Market

Israeli startups could be even more successful with a better capitalized stock market. Unlike the United States, Israel attracts more money for startups than publicly traded companies. This is a very unusual situation. Relative to startups, stock market investing is less risky and typically attracts more capital. Capital raised from stock offerings in America is fivefold larger than venture capital funding. We believe this situation will normalize over time with the help of firms like Israel Investment Advisors, LLC. Based on the current trajectory of the Israeli economy, Israel could support a $500 billion stock market in a decade's time. This growth will benefit our investors while also benefiting Israel.