

Chapman *Insights*

OPPORTUNITIES FOR OUR CLIENTS

September 18, 2013

Israel: The Next Big Distressed M&A Opportunity?

The market for distressed investment opportunities in the U.S. has shrunk considerably over the last few years. As a result, U.S. hedge funds have looked to Europe, but they have been disappointed by the minimal and highly selective opportunities.

It's time for investors to look at Israel, which is experiencing an upswing in distressed opportunities in many areas including real estate, telecoms, the financial sector, medical technology, retail and hospitality. This upswing is due to Israel's economic climate, regulatory restructuring, and the unique capital structure of many of its companies. The market for distressed M&A in Israel is beginning to resemble that of the U.S. in the late 1980s, when investors had no trouble finding solid companies with a need to restructure bad balance sheets.

The Israeli economy is not in distress. In fact, the country has continued on a pace of steady growth since 2010. These conditions support a quicker turnaround for companies that are able to restructure. In addition, the capital structure of Israeli companies is being redefined, resulting in unique new opportunities for investors.

Many of Israel's largest companies are part of a pyramid in which the operating companies at the bottom are owned by multiple layers of holding companies ultimately controlled by a tycoon.

These tycoons have, until recently, had an easy time borrowing funds and overleveraging their companies by issuing multiple layers of public bonds at the parent or intermediate holding company level. Many Israeli companies now experiencing distress are otherwise healthy, but their holding entities are saddled with bad balance sheets as a result of public bonds issued at the holding company level.

When restructuring was needed, it typically involved bondholders agreeing to a haircut as part of an agreement in which the tycoon retained control of the equity of the combined enterprise.

There are signs that this is changing. The public and politicians have begun to protest restructurings in which bondholders – including institutions investing in public pensions and retirement funds – take significant haircuts while tycoons get control of companies at an unfair price.



In addition, the Israeli Ministry of Finance intends to implement new rules prohibiting banks and institutions from concentrating too many investments in companies held by a tycoon under a single holding company.

These rules – which were recommended by the Hodak Committee, tasked by the Israeli Finance Minister to determine whether and how to regulate institutional investors – are intended to limit an institutional investor's ability to invest in a single group of related companies.

The new rules will severely restrict the ability of many existing companies to raise new funds through bond issuance. They will also favor direct investment by distressed funds in lieu of raising capital from public markets. And the new rules require the appointment of an examiner to review the terms of any proposed restructuring involving public bonds.

Meanwhile, Israel's judiciary system – based on Western legal principles of applying legal precedent and recognition of secured creditor rights – should provide confidence that existing rights and remedies can be transferred from original holders and will be enforced in Israeli courts with some predictability. Although Israel does not have a bankruptcy code, many of the basic principles of U.S.-style Chapter 11 reorganizations are being applied through common law precedent.

These policy changes – coupled with Israel's growing economy and predictable judicial system – create new opportunities for distressed investors with capital and management expertise who have a demonstrated ability to execute successful corporate turnarounds.

However, with opportunity comes risk.

First, banks and institutions have shown a reluctance to sell distressed loans.

Second, institutional investors have been very wary of converting distressed loans to equity and have attributed little value to the reorganized companies' shares. As a result, some restructurings have left reorganized companies with too much debt, hampering their chances for successful reorganization.

Finally, while the Israeli judiciary is slowly adopting western reorganizational principles, there is still little precedent and experience in applying these new principles.

Although the distressed market in Israel is relatively unexplored, a few U.S. hedge funds have recently dipped their toes in. In the fourth quarter of 2012, York Capital Management purchased a significant stake of bonds issued by IDB Group, a collection of Israeli holding companies with operating assets in diverse sectors.

Although ongoing, the restructuring of IDB Group will likely encompass some form of equity control transfer to bondholders unless bondholders are repaid, and may very well set a precedent for future debt transactions in the country.

Similarly, two U.S. hedge funds recently purchased public bonds issued by Elbit Imaging, a group of holding companies with operating assets in the real estate, retail and medical technology sectors. The firm is in the process of negotiating a restructuring involving a significant conversion of bonds into equity of Elbit Imaging.

Overleveraged companies in Israel now face an evolving and inhospitable regulatory environment, an angry public that is demanding accountability and fairness in restructurings and limited access to Israeli institutional investor capital. All of this appears to set the stage for significant new opportunities for U.S. hedge funds ready to overcome the challenges and purchase solid and performing companies in need of balance sheet restructurings.

This document has been prepared by Chapman and Cutler LLP for informational purposes only. It is general in nature and based on authorities that are subject to change. It is not intended as legal advice. Accordingly, readers should consult with, and seek the advice of, their own counsel with respect to any individual situation that involves the material contained in this document, the application of such material to their specific circumstances, or any questions relating to their own affairs that may be raised by such material. © Michael Friedman, 2013. All Rights Reserved.

Originally published September 3, 2013 in Bloomberg Brief.



Michael Friedman
Partner

Chapman and Cutler LLP
1270 Avenue of the Americas, 30th Floor
New York, New York 10020
212.655.2508
friedman@chapman.com