Trends and Developments

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SPACs, Unicorns, Holdbacks and Other Exotic Features of the Contemporary Israeli M&A Market

The year 2021 will be remembered as the year of the "unicorns", special purpose acquisition companies (SPACs), secondary deals and talent mobility, all of which had a substantial impact on 2021 M&A transactions. In addition to these phenomena, increased use of representation and warranty insurance (RWI) policies in cross-border Israeli transactions has been a clear trend, as well as, at times, the difficulties in procuring such insurance when insurers struggle with the concept of insuring the acquirer of an Israeli target. The one thing that did not appear to have a significant impact on the M&A scene in Israel was COVID-19.

The year 2021 showed, yet again, that the perceived value of acquiring or investing in Israeli companies overcomes possible geopolitical concerns. In May of 2021, rockets were fired from Gaza into the Gush Dan area, where Tel Aviv and the majority of Israeli start-ups are located. Not even rocket attacks that resulted in a temporary disruption of air traffic at Ben Gurion international airport slowed down the pace of investments in Israeli tech companies. Foreign investors continued to shower Israel with funds from venture capital firms, growth capital funds and private equity firms, as well as proceeds from IPO, SPAC and M&A transactions.

The numbers for Israel were phenomenal, eclipsing any previous year. Over USD25 billion were invested in Israeli start-ups, in over 770 financing rounds. There were 75 IPOs, including SPAC transactions, and over 160 M&A deals totalling some USD12 billion. All this for a country the size of Rhode Island.

In short, 2021 was a whirlwind. This article will attempt to highlight certain transactional trends that became more prevalent over this past year.

SPACs

The "SPAC craze" did not skip over the Israeli hi-tech industry. A number of quite prominent companies went public through a merger (a "de-SPAC" transaction) with a SPAC, with the target company surviving as a publicly traded entity. The merger or share acquisition was typically accompanied by substantial private investment in public equity into the now publicly-traded operating company. SPACs have a variety of advantages for the target company, including greater certainty of price, and in general greater certainty of getting the deal done. Over a dozen Israeli companies went public in 2021 via a SPAC, most of the deals in Q2. The SPAC craze has slowed down, but is far from over. Unfortunately, six months to a year after these SPAC IPOs, many of them – as well as companies which went public with more traditional IPOs – were trading at significantly below their IPO value, disappointing investors, and perhaps more importantly, disappointing employees who found their options significantly underwater.

Unicorns

The year 2021 also distinguished itself as one during which a significant number of private Israeli companies enjoyed successful financing rounds, raising hundreds of millions of dollars at valuations exceeding a billion dollars. There were over 85 such "unicorns" in Israel by the end

of 2021. These fantastically high valuations bring with them some unique problems.

Growth pressures

Unicorns are subject to relentless pressures from their investors to sustain rapid growth to justify their high valuations. In order to meet these growth expectations some unicorns began turning their attention to acquiring other private companies, achieving growth through acquisition, and not organically. Accordingly, if prior to 2021 acquisition transactions typically involved global players seeking to get their hands on new technologies by acquiring technology-savvy companies in Israel, in 2021 we witnessed a rise in acquisitions of Israeli companies by other (relatively) young private or public Israeli companies, which were flush with cash or able to use highly valued shares as acquisition currency.

Tax issues with stock consideration

Since the new unicorns do not have the same cash reserves as the global giants, an increase in transactions where the buyers, public or private, used their stock as all or a part of the acquisition consideration was evident. These stock deals trigger unique Israeli tax consequences. In general, and unlike some other jurisdictions, the sale of shares in return for shares – a stock for stock deal – is taxable in Israel for the party selling its shares. When a public acquirer uses its shares to acquire a target, the Israeli Income Tax Ordinance permits, under certain conditions and subject to receipt of a ruling from the Israeli Tax Authority (ITA), payment of the associated tax to be deferred for a period of up to four years. However, if the acquiring company is private, the same tax event is triggered but a tax deferral may be obtained only if the parties comply with various complex requirements, including post-closing obligations and restrictions that impact the acquirers and the surviving company post-acquisition. In short, stock deals in Israel are subject to tax complexities not always present in other jurisdictions.

Global workforce changes

Access to talent and a skilled workforce is one of the prime attractions for potential buyers of Israeli companies. The year 2021 was characterised by global labour shortages, increases in wages, and an across-the-board upgrading of employment-related benefits in the hi-tech sector. Frequent employment moves and talent mobility are the 2021 trend that employers have come to dread. The desire to retain a skilled workforce and talent following an acquisition became a staple post-acquisition concern, with many transactions including a negotiated holdback and retention components.

Retaining founders

Aside from cushy post-acquisition compensation packages, retention of founders is typically achieved through application of a holdback arrangement: part of the consideration payable to the founder in consideration for their shares is held back, and paid over time subject to the continued employment of the founder. The main issues relating to these holdback arrangements in Israel are tax-related. The big concern is that the “held back” consideration, which is now subject to continued employment of the founder, will be characterised by the ITA as employment income, and taxed accordingly. In this case, the ITA has published guidelines that clarify which holdback arrangements will preserve capital gains treatment for the held back consideration (a tax rate of approximately 25%) and which arrangements would trigger ordinary income taxation (a tax rate of approximately 50%). In order for the selling founder to enjoy the lower tax rates, the holdback needs to comply with certain conditions, including (i) that the per share consideration to be paid to the founder is the same as that paid to other shareholders holding ordinary shares, and (ii) that the considera-

tion subject to the holdback does not exceed 50% of the aggregate consideration payable to the founder for the sale of their stake in the company. Under Israeli law, the tax on the held back consideration is payable at closing, before such funds are actually released to the founder. As such, when determining deal economics the parties will need to make sure that the founder receives enough cash consideration at closing to allow them to be able to pay these taxes. If, ultimately, all or part of the held back consideration does not end up being paid, the founder will receive a refund from the tax authorities on any excess tax paid.

Retaining employees

Buyers are not only interested in retaining founders after the deal, but they are also concerned to retain, to the extent possible, the skilled workforce. These retention mechanisms included post-closing retention bonuses released over time subject to the employee's continued engagement, and use of customary equity compensation arrangements (stock options, restricted stock units, etc). Retention payments are treated as bonuses for tax purposes and subject to tax at ordinary income rates, so if an acquirer wishes to further incentivise the employees the retention can be structured through the grant of options and other equity incentives that afford their holder, under certain conditions, capital gains treatment on the subsequent gains. In order to qualify for these benefits the acquirer will need to adopt an Israeli equity incentive plan, either as a standalone plan or as a country-specific sub-plan of the acquirer's existing equity incentive plan. The Israeli plan will need to comply with certain filings and other procedural requirements dictated by the Income Tax Ordinance and its regulations. These involve the filing of the Israeli plan with the ITA, appointment of a designated trustee (an Israeli firm which the ITA recognises as an authorised trustee for purposes of compliance with the applicable tax requirements), a two year holding period, and other technical and substantive requirements that must be adhered to in order for income derived from sale of the equity incentives to be taxed at capital gains rates.

Secondary transactions

Prior to 2018, secondary transactions involving sales of equity by the founders and employees of private companies were seldom seen, and even frowned upon. The conventional wisdom was that founders and employees needed to stay with the company and lead it to greatness (or at least try), and that sale of equity by the founders signalled to investors that the founders were doubting the rosy future of their companies. These days, and especially in 2021, secondary transactions whereby founders and employees sell a portion of their holdings in the company in parallel to or in conjunction with primary investment rounds, are much more common. The reasons for this vary, but in an interest-based world an investor would be willing to allow the founder to enjoy a "mini-exit" at an earlier stage of the company's development. That way the founder is under less financial strain, and is incentivised to seek out an exit that will yield the investors a higher return, instead of settling for any offer because the founder needs the money or wants to have an "exit" under their belt. It has been known for companies to receive acquisition offers ranging in the nine figures where the founders do not insist on selling if there is a reasonable expectation of further increases in the value of the company, because these founders already have their mortgage paid out and can live the rest of their lives comfortably. Typically, outside of Israel, these deals are done by having the corporation purchase some of the founder's common stock, while at the same time issuing new preferred stock to the investor. However, unlike Delaware corporations, the ability of an Israeli company to purchase the ordinary shares of the founder (and in parallel sell the investor

preferred shares) is limited, as the Israeli company needs to comply with certain profitability and solvency requirements in order to be able to buy back its shares. This type of transaction also needs to be structured in a manner that does not trigger adverse consequences to the buyer or seller. This gets more complicated if the buyer wants the ordinary shares purchased in the secondary to be converted into preferred shares as a condition for the transaction. That conversion may be seen as a tax event for the selling founder, if not properly structured.

MAC/force majeure

Unfortunately, Israel experiences periods of conflict with its neighbours every few years. This was the case in May 2021, when Israel's skies were dotted with missiles and counter-missile rockets, while our legal teams kept working around the clock to enable and close mega-financing deals and acquisitions which were indifferent to the daily pyrotechnic displays and did not slow down at all. Surrealism at its best – feelings of sorrow and concern over the political issues mixed with satisfaction as the hi-tech sector continued to make progress. The main take here is that though these conflicts need to be taken into account when transacting with Israeli companies, these events have not had a material adverse effect on the Israeli hi-tech sector. As such, careful thought should be put into "material adverse change" termination and force majeure provisions to ensure that they are balanced when addressing these types of political-military unrest.

RWI for Israeli deals

Use of RWI in Israeli acquisitions became significantly more common in 2021, starting to catch up with the situation in Europe and the USA. Nevertheless, the fact that the premiums sought by the insurers were often substantially higher than those that would have been quoted had the transaction not involved an Israeli target cannot be ignored; as insurers who are not familiar with Israel or the Middle East automatically increase their premium to make up for the potential risk of the "unknown". Accordingly, when considering a RWI component in an Israel-focused transaction, it is always best to work with brokers who are familiar with the Israeli market (and there are a few who have developed such a specialty), who can reduce the insurers' concerns, get various insurers interested and mitigate the cost of the increased premium. Working with professionals that have a familiarity with the Israeli market a makes a big difference.

Conclusion

It is highly probable that some of the trends identified above will continue to be relevant in 2022. So far, the year has started out strong, but things can change in a heartbeat. The recent stock market fluctuations, and the situation in Ukraine, are putting a strain on valuations, and in particular have dramatically reduced the marked prices of the Israeli companies that recently went public. Lower prices, however, do not mean fewer M&A deals, just that the deals are done at lower valuation. The Israeli M&A market has shown that it is able to adapt when the economy is at a low point. Here's hoping next year's article will end on a positive note as well.

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Yigal Arnon & Co. has an M&A practice that is widely recognised as a market leader in Israel. It specialises in representing Israeli and foreign companies, both private and publicly traded, in important, complex and large transactions in the Israeli M&A space of virtually every possible structure and size, and in almost all fields and industries, including biotech, hi-tech and in the infrastructure sector; global mega acquisitions; complex investments deals; as well as purely Israeli transactions. Tapping into lawyers in both its Tel Aviv and Jerusalem offices – rare in Israel – the firm has specialty teams in all areas related to complex M&A. This includes corporate structuring, Israeli and US securities laws, all types of regulation (environmental, financial and technology, including the latest fintech, cyber and encryption regulations) as well as labour, tax, antitrust, real estate, IP, and litigation.

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