Global Investor Spotlight

Israel: Finding Stability in an Uncertain Environment

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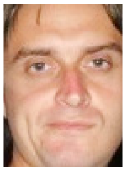

Despite the wider downturn that has been seen for equity values in recent months, there are some pockets of productivity that can be found if regional markets are isolated and analyzed. One of these examples can be seen in Israel, where the benchmark index (the TA-100 Index) posted gains for the month of April even with the negative risk sentiment that has come as a result of weak economic data out of the U.S. and China, as well as the seemingly continual debt concerns that are present in the Eurozone.

Assessing the Economic Data

While this performance might seem surprising, or perhaps unsustainable, a quick look at the economic releases in the country will provide a supportive view. In the fourth-quarter of 2011, the national economy in Israel grew by 3.4% on a yearly basis despite the fact that consumer sentiment globally was hitting multi-year lows and stock measures such as the S&P 500 Index were caught in significant downtrends. According to International Monetary Fund (IMF) estimates, the Israel economy is expected to grow by 2.8% in 2012 so even though the total performance is expected to moderate, it is likely to remain at healthy levels for the remainder of the year.

In addition to these broader signs of strength, inflation figures have also moved higher, showing that consumer demand is reversing its previous weakness, as this is the first time in five months that consumer prices have exhibited upside pressures. Relative to the consumer, there are some short-term concerns, however, as an increase in gas prices have been seen as a result of the cancellation of Egypt's state-owned gas company program to supply energy products to Israel. But this supply disruption is likely to be temporary in duration, so the higher prices coming from gas shortages are likely to be resolved by the end of the year.

Selections in the Israel Fund

Investors looking to gain exposure to the region have a wide variety of options but perhaps the most well-positioned can be seen with the Israel Fund (NYSE: ISL), which is a closed-end fund run by Aberdeen Asset Management.

With the domestic view in Israel remaining supportive for continued consumer strength and productivity growth, there are also many company-specific developments that have also lent to the argument that prospects are positive for holdings within the Fund. One example can be seen in Check Point Software, as the tech firm was propelled higher on strong fourth-quarter earnings numbers. The increase in profits came as a result of larger product sales and subscription revenues.

Positives were also seen in Teva Pharmaceuticals which was able to successfully raise $3 billion to refinance borrowing and extend debt maturities, taking some pressure off of the company's balance sheet. This was particularly encouraging because Teva also introduced new drugs into the market, creating potentially strong rivals to the high blood pressure medicines that are currently being offered by Sanofi Avantis. In other Fund-related news, Pelephone (a mobile subsidiary of Bezeq Telecommunications) also released new product offerings, with monthly package offerings aimed at overcoming competition from new industry participants.

Some recent changes in the Fund included the addition of Rami Levi, a discount retailer with a strong balance sheet, a low-cost operating model, and inexpensive valuation. To account for this addition, the Fund's position in the fragrance company Frutarom was reduced on concerns that the company's acquisition strategy is becoming overly aggressive.

Attractive Valuations

Because of some of these recent additions, price to earnings ratios in the Israel Fund, relative to Israel's benchmark index, present some attractive valuation opportunities as well, with the Israel Fund trading at a price to earnings ratio of 12.51 in the month of May versus the 13.29 price to earnings ratio seen in the Tel Aviv 100 index. So, for investors looking to capitalize on the stable growth seen in the region, the Israel Fund presents some interesting and attractive opportunities relative to its major counterparts.

More specifically, the Fund sees some industry sectors as being excessively cheap given the recent political events that have added to downside pressure in stock prices. Last summer, a wave of political protests was seen as public disapproval of food prices led to some key policy changes in the food and consumer staples retail sector. "As a result of the protests, which were sparked by outcry over the price of cottage cheese, the government set up several committees to look into different issues of concern. Food producers and retailers are one of the sectors under particular scrutiny," explains Devan Kaloo, Head of Global Emerging Markets Equities for Aberdeen Asset Management.

Since uncertainty over future profitability in food and consumer staples has caused the sector to be one of the weaker performers over last 12 months, there will be some scope for upside in stock prices once government policy initiatives are implemented and uncertainty in the sector is reduced. At the moment, the Fund is looking to set itself in a favorable position once this rebound occurs.

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Two Key Themes for Israel's Economy

Looking at which factors will affect the performance of the Israeli

economy as a whole, two key themes emerge. On the domestic level, there will still need to be a proper assessment of the outcomes that came as a result of last year's consumer protests. On the global front, Israel will continue to deal with the potential contagion effects that remain a possibility given the relative weakness seen in the economies of neighboring countries.

Short term, the overall element of uncertainty that has been created by these events (both internal and external) could continue to weigh on profitability prospects for certain companies. But when looking at longer term time horizons, the recent declines are likely to provide new buying opportunities as growth trends resume: "As stock pickers, our focus remains on finding good quality companies trading at attractive valuations. The recent protests against food price inflation have triggered sell-offs in the stocks of otherwise good businesses," says Devan Kaloo. Clearly, the strategy of the Israel Fund is one that looks to capitalize on any downside overreactions in these markets, showing a balanced approach to longer term time horizons.

Potential Areas of Weakness

When looking at potential areas of weakness in the Israeli economy, one area of concern can be seen in holding companies, which have come under heightened scrutiny since last year's protests focused on the issue of concentration of wealth and corporate ownership in Israel: "The government is seeking to pass regulations to limit cross-holdings and also to limit the number of layers in the holding structures, which are typically pyramidal," says Kaloo.

Since holding companies typically are highly leveraged, many of these companies have borrowed against the value of their investments in declining subsidiaries. This tendency has undermined the strength of these companies and limited profitability performance. In light of this, the Israel Fund elects to hold direct positions in the operating subsidiaries themselves, rather than to increase exposure in companies with dangerous levels of open leverage.

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Rising Energy Costs

Another area that is potentially problematic for the Israeli economy is rising energy costs. Before last year's political upheaval in Egypt created trade disruptions, Israel was able to secure a stable supply of gas from Egypt to supplement its own offshore reserves. But when the Egyptian government unilaterally elected to cancel the trading agreement earlier this year, Israel began to face gas shortages which are expected to continue until recently discovered offshore gas reserves can be brought into production.

Rising energy costs are seen as a negative for Israeli companies as a whole, and in the manufacturing sector in particular. The Israel Fund, however, has no exposure to the energy sector, as even gas producers have failed to benefit from these seemingly-positive market dynamics given the intense level of government scrutiny that has been placed on Israel's gas supply monopoly.

Another negative for Israel's energy supply companies comes from the fact that gas production is still in the exploration and early development phase for these suppliers, and this is seen as limiting potential sales and short-term cash flow. At this stage, while it is still unclear how Israel's gas reserves will be commercialized, the Israel Fund is taking the prudent move approach by waiting to see how the industry develops before committing to new investments in the sector.

The Broader Economic View

Since the Israeli economy is driven by exports, and the US and Eurozone are Israel's largest trading partners, some assessment should be made of Israel's ability to recover from the recent financial turmoil seen in these areas. One significant positive can be seen in the trade relationship that is building between Israel and emerging Asia, where a greater number of exports are being sold. Exports to Asia rose by 45% in 2011 (on a yearly basis), and this region now makes up for 20% of total exports sales for Israeli companies. With Asia seeing limited contagion effects from the debt problems in Europe, this is an encouraging trend and suggests that any negative impact from the global growth slowdown will have only limited effects for Israeli exporters.

While official growth forecasts for the Israeli economy have been revised lower, the Bank of Israel is still expecting the economy to expand by a strong and relatively stable 3.2% in 2011. Helping to support longer term growth forecasts is the young and burgeoning population, which is seen underpinning private lending and consumer spending on the domestic level for years to come: "As a general point, Israel's economy has been very resilient. It weathered the global financial crisis well thanks to its sound economic fundamentals, stable banks and prudent policies. We see this continuing going forward," explains Devan Kallo.

With average growth annual rates of 5% from 2005 and 2008, Israel's resilience can be seen in its economic performance in troubled environments. The country was one of the few examples of growth expansion in 2009 (after the Lehman Brothers collapse in the US) and those growth prospects are forecast by most analysts to continue this year as well.

Investment prospects in Israel tend to be overlooked, as many think of Israel as a country as limited in terms of natural resources and population size. But at the same time, it must be remembered that recent natural gas discoveries (two of the largest exploration discoveries in recent years) are likely to reverse some of these expectations and be a supportive element in the country's economy for years to come. Sound economic fundamentals, a stable banking sector and prudent policy initiatives make Israel a strong choice to achieve consistent growth returns in an otherwise uncertain economic environment. ■