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EXECUTIVE SUMMARY

PRIVATE-EQUITY FUNDING TO ENCOURAGE SMALL BUSINESS GROWTH

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About the Koret-Milken Institute Fellows Program

The Koret-Milken Institute Fellows Program accelerates Israel's economic growth through innovative, market-based solutions for long-term economic, social, and environmental issues. The program focuses on connecting government, philanthropic, and business resources that are vital to national growth and development.

Directed by the Milken Institute Israel Center, the Koret-Milken Institute Fellows Program awards annual fellowships to outstanding graduates of Israeli and international institutes of higher education. Fellows serve yearlong internships at the center of the nation's decision-making—the Knesset, government ministries, and other Israeli agencies—and aid policymakers by researching and developing solutions for various economic and social challenges.

In addition, fellows craft their own policy studies aimed at identifying barriers to economic and employment growth in Israel. The fellows' studies, carried out under the guidance of an experienced academic and professional staff, support legislators and regulators who shape the economic reality in Israel. The program offers the ultimate educational exercise, combining real-life work experience with applied research five days a week.

Throughout the year, fellows receive intensive training in economic policy, government processes, and research methods. They acquire tools for writing memorandums, presentations, and policy papers, and they develop management, marketing, and communication skills. The fellows participate in a weekly workshop, where they meet senior economic and government professionals, business leaders, and top academics from Israel and abroad. They also participate in an accredited MBA course that awards three graduate-level academic credits that are transferable to other universities in Israel. The course, which focuses on financial and economic innovations, is taught at the Hebrew University of Jerusalem's School of Business Administration by Professor Glenn Yago, Director of the Milken Institute Israel Center and Director of Capital Studies at the Milken Institute in California.

Fellows Program alumni can be found in senior positions in the public and private sectors. Some serve as advisers to government ministries while others work at private-sector companies or go on to advanced studies at leading universities in Israel, the United States, and Great Britain. Within the program's framework, more than 80 research papers have been published, catalyzing reforms, reducing barriers, bringing about economic growth, and improving the quality of life for Israeli citizens.

The Koret-Milken Institute Fellows Program is nonpolitical and nonpartisan. It is funded by the Koret Foundation, the Milken Institute, and other leading philanthropic organizations and individuals in the United States and Israel.

More about the program: www.kmifellows.org
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Executive Summary

Small businesses are commonly viewed as growth engines for economies. In Israel, small and medium enterprises (small enterprises) comprise more than 99% of businesses. Although measures to support and strengthen small enterprises in Israel have been in place for more than two decades, a significant turning point was the establishment of the Israel Small and Medium Business Authority (ISMEA) at the Ministry of Industry, Trade and Labor as a consequence of the State Comptroller's report for 2010.

Small and medium enterprises offer advantages such as innovation, entrepreneurship, minority employment, bridging demographic and social-economic gaps, and the ability to weather financial crises. Still, throughout the world, these businesses face considerable barriers in the forms of knowledge, bureaucracy, and financing.

1. **Knowledge** includes management expertise, marketing tools, dealing with changing regulations, and other aspects of business ownership. All of these pose a challenge to small enterprises where a small number of employees are responsible for a wide variety of fields in which they are not necessarily trained. The knowledge barrier impedes the development of the small enterprise and its chances of success. It also reduces the business's chances of receiving a bank loan because of the difficulty in assessing risks involved.

2. **Bureaucracy** means small enterprises often find it difficult to allocate the resources necessary to meet the demands imposed by changing regulations, differing standards, and dealing with authorities on various subjects, such as licensing.

3. **Financing** entails credit and capital. Where credit is concerned, loans tend to be more expensive and harder to come by for the small enterprise, mainly due to the difficulty in assessing risks. Where investment is concerned, a small enterprise is rarely considered to have the potential for high returns and, therefore, it has trouble raising investment capital.

ISMEA, which is in charge of the small-enterprises sector and the government strategies to strengthen them, endeavors to assist small enterprises with each of these barriers.

Knowledge is handled by two main channels. The first includes 25 field centers located throughout Israel where instructions, workshops, and counseling of entrepreneurs and business owners take place. The second is a counseling program under which small enterprises are entitled to receive subsidized individual counseling in a variety of fields including management, marketing, workplace, design, conforming to standards, technology, and export.

Bureaucracy is tackled by the Law for Encouraging Small Businesses, sponsored by ISMEA. The law features a uniform definition of small enterprises and mandates professional counseling prior to any consequential change in the regulation of this sector. Additionally, ISMEA espouses a policy of including small businesses in government procurement, streamlining business licensing and so forth.

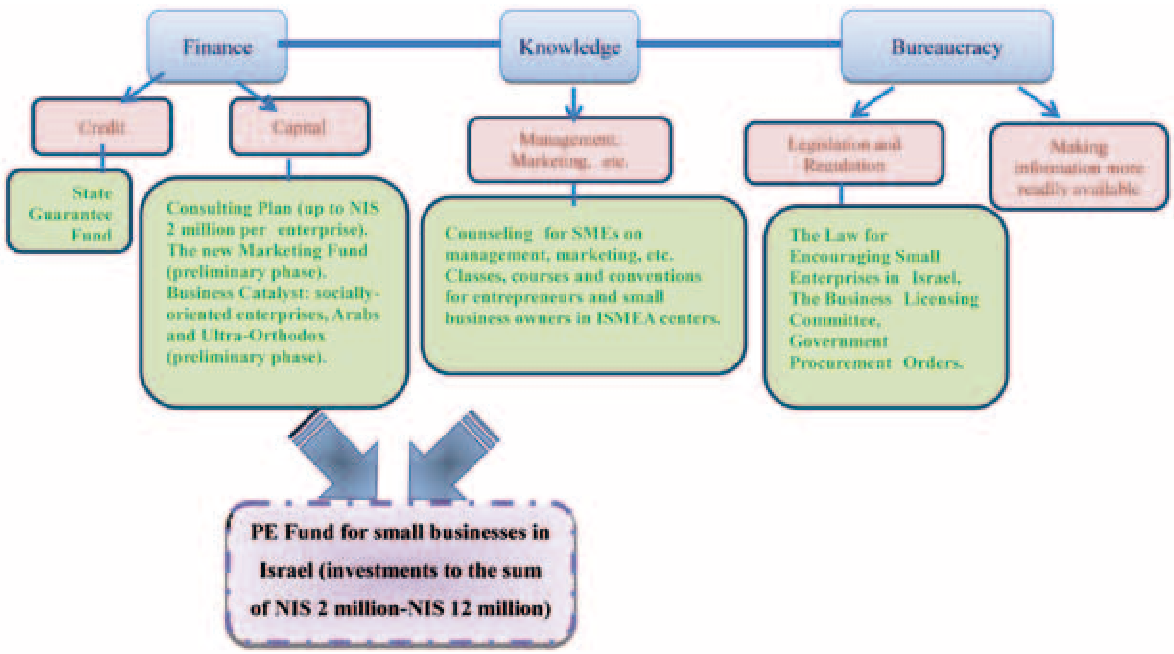
Financing, the focus of this study, is at the heart of several mechanisms, chief among them the state-guaranteed Small Business Fund. Other financing solutions include the Fund for Promoting Overseas Marketing. This includes the previously established consortium plan, which allows for a group of enterprises to receive funding for half of its export-related expenses, up to a sum of NIS 2 million. Lone exporters may receive similar financing, while enterprises with more than a certain volume of business are required to return the government's expenses by paying royalties. Under the Business Catalyst plan, the government spends hundreds of thousands of shekels to participate in the growth-related expenses of socially-oriented enterprises with Arab or Ultra-Orthodox employees. Both the Business Catalyst plan and the opening of the Marketing Fund to lone exporters are recent developments.

On the one hand, such plans signify a praiseworthy trend toward cooperation between the government and the private sector aimed at empowering small enterprises. On the other, their limited scope and experimental character point to the severe lack of financing sources for small enterprises based on investment (equity) rather than on credit (debt).

The role played by small enterprises in encouraging economic growth and the financing difficulties they face are not unique to Israel, and a comparison with other developed countries reveals a similarity between mechanisms for providing credit to small enterprises. There is, however, a substantial difference between mechanisms for providing small enterprises with access to investment capital such as in Finland, Holland, Italy, New Zealand, Italy, the US and the UK where the private sector is commonly involved.

Following the example set by these countries, this study advocates the establishment of a joint private-equity fund by the Israeli government, in cooperation with the private sector, with the goal of facilitating investment in small enterprises. Such a fund would create a new financing channel for small enterprises, allowing them to access growth and development capital. Within current support mechanisms, the proposed investment sums, ranging from NIS 2 million to NIS 12 million, are available only in the form of a loan. Another advantage is that these enterprises will enjoy improved management skills thanks to the supervision of the fund managers who can assist in the growth of an enterprise while improving its management, marketing, and operations. Thus, this support mechanism tackles two of the three major barriers by providing the small enterprise with significant investment capital and improving its business capabilities.

FIGURE 1. GOVERNMENTAL SUPPORT MECHANISMS FOR SMALL ENTERPRISES IN ISRAEL SORTED BY BARRIER



The current situation necessitates that the mechanisms be integrated into the proposed fund to encourage investment in the small-enterprises sector, which is assumed to yield low returns (i.e. compared to the IT sector) and to be characterized by an exceedingly high level of risk. Following a review of similar plans, we propose utilizing the model of a private-equity fund with the following features.

RFP for a joint private-equity fund. Aiming to establish a small-enterprise-oriented private-equity sector in Israel, RFP requirements should be set to choose candidates with proven and clearly defined professional experience, both in private equity and handling small enterprises. Additionally, the RFP would include mandatory investment rates in certain niches, such as export-oriented enterprises and service-sector enterprises catering to the needs of the elderly. Furthermore, the RFP would require a minimal leverage ratio of 1:4 in order to ensure that the joint fund can provide small enterprises with access to capital at a larger scale than is offered by current support mechanisms. Finally, the RFP will define enterprises eligible for investment as those with a yearly volume of NIS 5 million – NIS 30 million.

- **Upside** In order to increase investors' potential returns, the state would set a division of revenue to the benefit of the private investors, who also would be allowed to purchase the government's share at cost throughout the investment period. These features would increase the revenue yielded by private investors from their investment in small enterprises.

- **Downside** Mechanisms like this are meant to reduce risk to potential investors. A similar goal is achieved in the Life Sciences Fund (OrbiMed Israel). A certain rate of loss distribution between the government and private investors will be established based on the fund leverage ratio, ensuring that private investors do not lose their investment beyond a certain rate of negative returns. For private investors, this measure will serve to reduce risk.

Management fee. One of the major obstacles to operating a private-equity fund for small enterprises is that the usual rate of management fee (as a percentage of the invested sum) combined with the relatively small size of average investment in a small enterprise provides relatively little incentive for fund managers to actively oversee and optimize the investment. It is, therefore, recommended that the state fully or partially share the costs of management fees to provide small enterprises with the full benefit of being invested by a private-equity fund. The government will budget NIS 80 million toward the establishment of three different funds, each with capital of NIS 24 million (before leverage). Each fund will include NIS 500,000 to cover the government's share in the management fees of the recipient enterprises and for covering investment losses over a certain rate should they occur.

A joint private-equity fund through which the government and private sector are able invest in small enterprises in Israel would offer a financing solution to those enterprises that want to expand their business utilizing capital rather than loans. The size of the investments offered by the fund would complement the new financing support mechanisms currently in place. Moreover, the fund would allow the small enterprises receiving the investment to acquire administrative and professional skills. Using such a fund to support small enterprises increases their chances of growth and survival, thereby supporting the Israeli economy overall.

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