



Report of the State Comptroller of Israel | March 2022

The Government-Owned Defense
Companies

Approval Processes for the Establishment of Companies and Purchase of Shares in Existing Companies by the Government Defense Companies



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Background

Israel Aerospace Industries Ltd. (IAI), ELTA Systems Ltd. (ELTA), and Rafael Advanced Defense Systems Ltd. (Rafael) are government business, technology, and defense companies operating in dynamic, competitive markets in Israel and worldwide. The global aerospace and defense market is characterized by mergers and acquisitions of companies and joint ventures that must be carried out quickly and efficiently as part of their routine business activity. IAI, ELTA, and Rafael are subject to regulatory requirements on this matter, determined by both foreign and the Israeli governments, including the obligation to receive approval by the government or the Government Companies Authority (the Companies Authority) and the Ministry of Defense to establish companies or purchase shares in existing companies. In 2018–2020, there were 367 mergers and acquisitions in this sector worldwide, at a scope of approximately USD 268 billion.



Key figures

**10 and 9
companies
in Israel and
abroad**

in 2017–2020, IAI, ELTA, and their subsidiaries either established or purchased shares in 10 companies; Rafael and its subsidiaries in 9

**NIS 1.3
billion and
NIS 266
million**

the sums approved by the directorates of Rafael and IAI, respectively, to invest in the establishment of companies or purchase of shares in existing companies in 2017–2020

**6.5 months
and 4.5
months**

the average time elapsed from the approval date by the IAI and Rafael directorates, respectively, to establish companies or purchase shares in existing companies until approval by the Companies Authority

**10 months
and 7
months**

the average time elapsed from the approval date by the Rafael and IAI directorates, respectively, to establish or purchase shares in existing companies until government approval. The most extended period for approval was approx. 13.5 months

**NIS 195
million and
several
dozen
millions of
NIS**

depreciation of investments by Rafael and IAI, respectively, in companies purchased in 2017–2020

**34% of
the largest
defense
companies
in the world**

17 out of 50 of the largest defense companies in the world are under full, partial, direct, or indirect government ownership, most of them in China, Russia, France, and Israel

**hundreds
of millions of
USD**


the sum of investment in companies according to IAI's operative plan for the years 2019–2023

**dozens
of millions
of USD**

in 2019–2020, IAI management submitted to the directorate requests for investment in the sum of dozens of millions of USD, approx. 5.8%–9.2% of the sum planned for the years 2019–2023



Audit actions

 from September 2020 to August 2021, the State Comptroller's office examined the approval processes for establishing companies and purchasing shares in existing companies by IAI, ELTA, Rafael, and their subsidiaries. Completions audits were made by November 2021. The audit included mainly the normative foundation regarding the establishment of companies and purchase of shares, the Companies Authority activities to ease the existing regulation, mergers and acquisitions made by IAI and Rafael corresponding to their strategic plans, and changes in the value of IAI, ELTA and Rafael investments in companies established by them, and companies whose shares they purchased in 2017–2020. The audit was performed at IAI, Rafael, the Companies Authority, the Ministry of Defense, and the Ministry of Economy and Industry.


This report was presented to the Prime Minister and the State Control Committee of the Knesset on December 30, 2021.

By the authority under Section 17(c) of the State Comptroller Law 1958 [Consolidated Version] and after considering the government's arguments, consulting with the protection of national security information bodies and coordination with the Chairman of the Knesset, and since the subcommittee of the State Control Committee failed to convene, it was decided to publish this report while imposing confidentiality on sections of it. These sections shall not be submitted to the Knesset, nor shall they be published.






The findings of the audit report and its recommendations are valid as of the above date of its presentation.

Key findings



 **The establishment of companies and purchase of shares by IAI, ELTA, Rafael, and their subsidiaries** – the average time elapsed from the IAI Directorate approval to establish new companies or invest in existing ones until Companies Authority approval was approximately 4.5 months and until government approval about 16 months, and around seven months when disregarding three decisions that were not submitted to the Ministerial Committee for Social and Economic Issues. The average time lapsed from approval by the Rafael Directorate to establish a new company or invest in an existing one until approval by the Companies Authority was approximately 6.5 months, and until government approval, about ten months.








-  **Implementation of the government decision from December 2008 regarding the Green Track** – in addition to the lack of clear criteria for Ministry of Defense approval, the number of requests by the Ministry of Defense and Companies Authority for supplements or clarifications from the companies is not limited; hence, the overall duration for completion of the approval process for government companies to purchase shares through the Green Track is not limited. This process puts government companies at a disadvantage compare to non-government companies regarding the before-mentioned purchases. Therefore, although the Green Track has enhanced the approval process required for the purchase of shares in companies by IAI, ELTA, and Rafael, it still fails to give them a complete response to their needs, as opposed to the outlined provisions in the Government Companies Law.
-  **Implementation of the government decisions of May 2018 concerning the innovation program** – from the date of the government decision on the innovation program, May 2018, until the end of the audit, August 2021, IAI, ELTA, and Rafael did not purchase any shares in existing companies through the program. This was, among other things, in light of the limitations that the program imposes on them including a low purchase sum, low holding rates, and unlimited requests by the Ministry of Defense and Companies Authority for supplements or clarifications from the companies; hence, the approval process has no time limit and does not enable any quick response to market needs.
-  **Action by the Companies Authority to ease regulation** – although over a decade has passed since the Companies Authority and Ministry of Defense recognized the need to ease the regulation on IAI, ELTA, and Rafael, and despite the processes performed in this matter; as of the end of the audit, August 2021, the Companies Authority and Ministry of Defense still not succeeded in easing the regulation outlined in the Government Companies Law, and in government decisions regarding the Green Track and innovation program.
-  **Discussion in the directorates of the companies on the innovation circular** – in June 2019, the IAI Directorate discussed the innovation circular issued by the Companies Authority in September 2017, about a year and a half after it was required to. Rafael did not map out the obstructions to the execution of its innovation program and the limitations that could apply to it, nor did it present the Companies Authority details of the obstructions and limitations. As a result, Rafael failed to exhaust the opportunity to influence the content of the government decision of May 2018 regarding the innovation programs.
-  **The 2018 inter-ministerial steering committee for the removal of obstructions** – since its establishment in May 2018¹ until the end of the audit, August 2021, the inter-

1 Date of government decision.



ministerial steering committee (established by the Director-General of the Ministry of Economy and Industry) convened twice, in November 2018 and in July 2019. The committee did not report the government on its discussions and activity, nor did it consider ways to remove obstructions regarding innovative technologies adoption in government companies, nor did it invite any representatives of regulatory bodies and of IAI, ELTA, Rafael, and of the Ministry of Defense to its discussions.

-  **Approval to establish IAI subsidiaries** – from July 2019 until the audit end date, August 2021, for about a year and a half to two years, the Companies Authority failed to submit proposals to the Ministerial Committee for Social and Economic Issues to establish IAI subsidiaries in certain European and Asian countries. This precluded IAI from effectively realizing its business development strategy. For this reason, IAI has changed its business plans regarding these countries and is now establishing the companies through foreign corporations (indirect ownership). However, it initially planned to establish government (direct ownership) subsidiaries in them.
-  **Realization of business development strategy in IAI** – in 2017–2020, IAI failed to purchase a company in the USA, through which it could, among other things, expand IAI's presence in that market.
-  **Realization of business development strategy in Rafael** – in 2017–2020 (four out of six plan years), Rafael increased the sum of its sales in the USA from USD 136 million in 2016 to approximately USD 369 million in 2020, as opposed to an annual sales objective of USD 400 million.
-  **Depreciation of companies held by Rafael compared to the cost of their purchase** – in 2017–2020, Rafael purchased shares in three companies and established six companies. Six of these companies reported about NIS 51 million losses during this period. In addition, Rafael's investment in two companies, Aeronautics and Kanfit, depreciated by about NIS 74 million and substracted about NIS 70 million in its books surplus costs accrued by the purchases. Hence, the total losses accrued to Rafael from its holdings in these companies are about NIS 195 million. According to the financial statements of Rafael and the before-mentioned purchased or established companies, Rafael has not received dividends from them until 31.12.20.
-  **Depreciation of the companies held by IAI and ELTA as opposed to their purchase cost** – in 2017–2020, IAI and ELTA purchased shares in three main companies. In this period, IAI reported a loss of dozens of millions of NIS incurred by two companies in the initial stages of business development and several million NIS profit due to the purchase of one company. In addition, IAI substracted in its books extra costs due to those purchases of about NIS 0.75 million. According to the financial statements of IAI, it had not received dividends from any company from the day of purchase until 31.12.20.



Advancement of regulation designed to make the establishment of companies or purchase of shares in existing companies easier – in August 2021, the government decided to ease the regulation of government companies. According to the decision, the Government Companies Law will be amended regarding establishing or purchasing shares in existing companies. Changes will be made to the approvals mechanism and the length of time to receive them. The changes will improve the procedures of purchase and establishment and business flexibility, response times, and growth ability of the government companies.

Key recommendations



It is recommended that the Companies Authority and Ministry of Defense examine, according to the changing market conditions, the need to initiate another government decision regarding the establishment of companies and purchase of shares in existing companies or initiate further amendments to the Government Companies Law. Furthermore grant easing, define timetables and determine regulations for approval of requests by government defense companies according to the investment sum hierarchy.



The inter-ministerial steering committee on removing obstructions and limitations faced by government companies assimilating innovative technologies should renew its activity as required by the May 2018 government decision. It is recommended that the committee remove the above obstructions, including those connected with purchasing shares in existing companies.



In cooperation with the Ministry of Defense, it is recommended that the Companies Authority initiate decisions by the Ministerial Committee for Social and Economic Issues as early as possible, especially regarding the establishment of the three IAI subsidiaries in certain European and Asian countries.



It is recommended that the IAI Directorate consider implementing the company's policy regarding the establishment of companies and purchase of shares in existing companies, and the repercussions on its activity and its operative plan, given the apparent gap between the budget designated for this purpose and its execution. It is further recommended that the IAI Directorate hold a special meeting on the companies IAI has established or purchased shares in since 2017 and, among other things, discuss the added value IAI is supposed to derive from them regarding the companies' value and the reasons for their losses. This, among other things, to continue tracking these companies compared to the objectives determined.

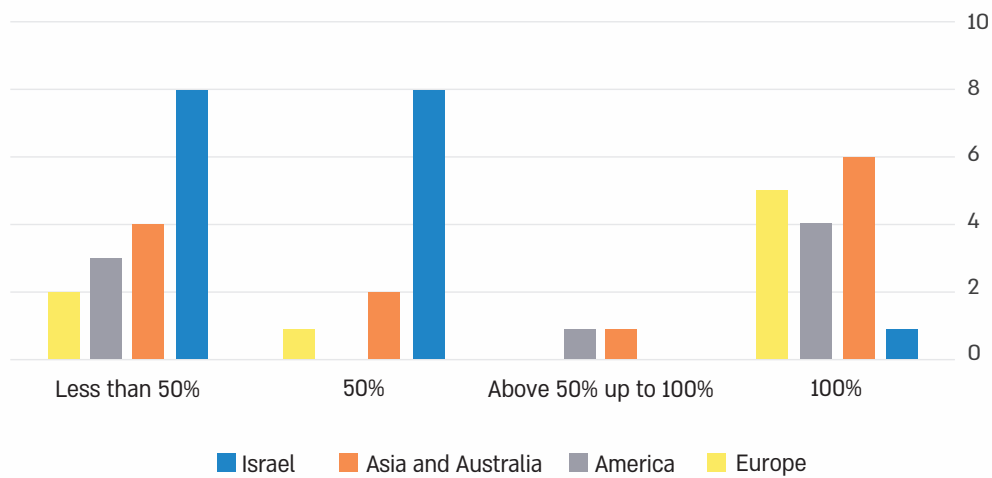


It is recommended that the Rafael Directorate discusses from time-to-time achieving goals outlined in the strategic plan for the company's sales in the USA, and their obstructions, particularly obstructions in the USA regarding companies establishment and company shares purchase and their contribution to the sales goals in the USA. It is further recommended that the directorate discuss the companies Rafael has established or purchased shares in since 2017, the reasons for the losses from these investments, the added value Rafael is supposed to derive from them, and the companies' targeted value. This is, among other things, to continue tracking these companies compared to the objectives determined.



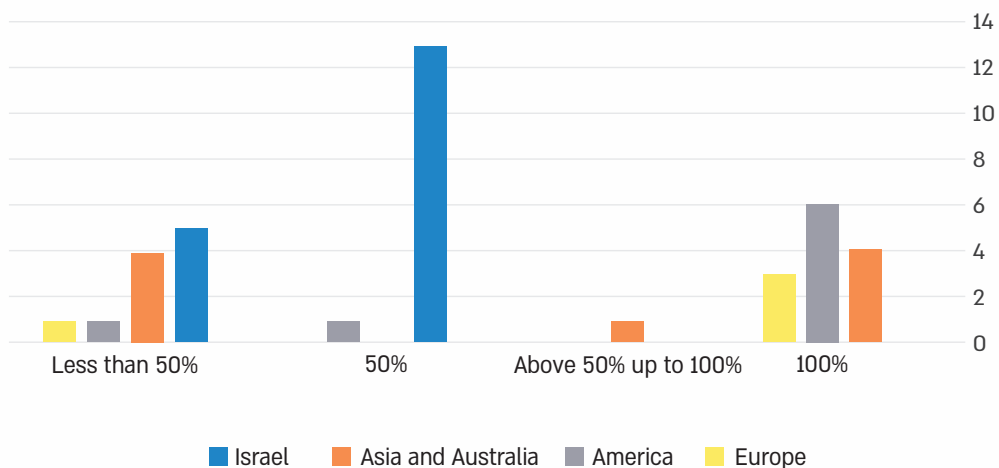
The holdings rates of IAI, ELTA and Rafael and their subsidiaries in active held companies, and their geographic location

IAI and ELTA



According to IAI documents arranged by the State Comptroller's office.

Rafael



According to Rafael's document arranged by the State Comptroller's office.



Summary

IAI, ELTA, and Rafael operate according to their strategic plans in both domestic and global markets. These dynamic and competitive markets are characterized by mergers, acquisitions, and joint ventures. These companies must carry out the mergers, acquisitions, and ventures efficiently and within short timetables according to market constraints, among other things, to penetrate new markets, purchase needed technologies, exploit size advantages, and even reduce competition. As opposed to non-governmental companies, IAI, ELTA, and Rafael must operate, regarding the establishment of new companies and purchase of shares of existing companies, according to rules and regulations determined in the Government Companies Law and government decisions. These rules also apply in cases of establishment or purchases of companies in small sums compared to their scope of activity. The companies claim that this regulation encumbers their ability to compete and causes them to miss business opportunities. The Government Companies Authority and Ministry of Defense are aware of this burden; however, they have not yet completed measures designed to ease it. It is recommended that the Government Companies Authority and the Ministry of Defense will finish examining the government defense companies' needs regarding the easing of burdensome regulation and, accordingly, ease regulation, including determining new approval orders for requests by government defense companies according to the investment sum hierarchy. This to improve their competitive ability and efficiency.