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October 28, 2009

Mr. Roy Vermus  
Chief Executive Officer  
Psagot  
By E-mail

Dear Mr. Vermus,

I am writing in response to your request that I review the reorganization proposal (“the Plan”) that Africa Israel Investments Ltd. (“Africa”) made on October 22, 2009 to its bondholders, as well as the report of Professor Barnea on which Africa’s proposal relies, and that I analyze whether the Plan provides adequate protection to the interests and contractual rights of Africa’s bondholders. Given the importance of Africa’s reorganization for Israeli investors, and the possibility that this reorganization might affect the structure of other reorganizations of financially distressed firms in Israel, I have carried out my review and analysis on a *pro bono* basis.

As I explained in the attached report, I have concluded that the Plan fails to provide adequate protection of the bondholders’ rights and interests. The attached report also discusses how the premises underlying Africa’s proposal, and the structure of the Plan, should be revised to provide bondholders with adequate protection.

Sincerely,

A handwritten signature in black ink, appearing to read "Lucian Arye Bebchuk". The signature is fluid and cursive, with a long horizontal stroke at the end.

Lucian Arye Bebchuk

October 28, 2009

## REPORT

Professor Lucian Arye Bebchuk

### I. INTRODUCTION AND SUMMARY

I was asked by Psagot to provide an independent assessment of the reorganization plan (“the Plan”) that Africa Israel Investments Ltd. (“Africa”) proposed on October 22, 2009 to Africa’s bondholders, as well as of the report written by Professor Barnea (“the Report”) on which Africa relies in proposing the Plan. In particular, I was asked to examine whether the design of the Plan adequately takes into account the interests and contractual rights of bondholders, and whether the Plan, if implemented, would adequately protect these interests and rights. Given the importance of Africa's reorganization for Israeli investors, and the possibility that the reorganization of Africa might affect the structure of other reorganizations of financially distressed firms in the Israeli economy, I have carried out my review and analysis on a *pro bono* basis.

In conducting my analysis, I have take as given the facts stated in Africa’s Plan and in the Report. For the reasons explained below, my analysis concludes that the Plan would not adequately protect the interests and rights of bondholders, and that, for such protection to be provided, the premises underlying the Plan and its structure need to be revised along the lines suggested in the analysis below.

### I. QUALIFICATIONS

I serve as the William J. Friedman and Alicia Townsend Friedman Professor of Law, Economics, and Finance, and the director of the Program on Corporate Governance, at Harvard Law School. I am also a Research Associate of the National Bureau of Economic Research and a Fellow of the American Academy of Arts and Sciences. The views expressed in this report should not be attributed to any of the institutions and organizations with which I am affiliated.

I am recognized as one of the world's leading researchers working at the intersection of law and finance. In recognition of my contributions, I served as a President of the American law and Economics association, and was elected as member of the American Academy of Arts and Sciences and as Inaugural fellow of the European Corporate Governance Institute. The citation accompanying my induction to the American Academy of Arts and Sciences described me as “[o]ne of the nation’s leading scholars of law and economics, [who] has made major contributions to the study of corporate control, governance and insolvency.”

I am the author or co-author of more than seventy-five studies. My work has appeared in top journals in law, economics, and finance including the *Harvard Law Review*, the *Yale Law Journal*, the *Quarterly Journal of Economics*, the *Journal of Financial Economics*, and the *Journal of Finance*. One of the areas on which I have done writing and research over the years concerns the reorganization of companies in financial distress. A full list of my writings is included in my curriculum vitae available on my homepage (<http://www.law.harvard.edu/faculty/bebchuk>).

### III. ANALYSIS

#### *1. The Premise that Africa’s Going Concern Value would be Lost if Africa and its Bondholders Fail to Reach Agreement*

A critical premise of the Report and the Plan is that, in the event Africa and its bondholders fail now to agree on a plan of reorganization, Africa’s going concern value would be lost and the bondholders would share a liquidation value falling greatly below Africa’s going concern value. In particular, the Report assumes that failure to reach agreement would result in a wholesale liquidation of Africa’s shares in its subsidiaries at market prices falling substantially below the subsidiaries’ fundamental economic values.

The above premise plays critical role in the Report’s conclusion that the package offered to the bondholders would make the bondholders better off – and by a large margin – compared to the alternatives available to them in the absence of an agreement. Furthermore, the assumption that, but for the consent of Africa under its current management, the going concern value would

be lost, is used as support for the Plan's providing Africa's shareholders with a substantial value after the reorganization.

The Plan and the Report, however, do not provide a basis for this critical premise. It is far from clear that failure to reach an agreement between Africa and its bondholders now would necessarily lead to liquidation that would destroy Africa's going concern value, thereby denying bondholders the ability to benefit from it. In the absence of agreement, and given that Africa has announced that it cannot meet its obligations, Africa could be expected in such a case to enter later this year into a reorganization process subject to court supervision under the applicable provisions of Israel's Companies Act of 1999. Such a reorganization process should not require a fire sale liquidation when doing so would destroy Africa's going concern value. Rather, when there is a substantial going concern value at stake, a possible and indeed likely outcome of such a process would be a court-approved plan to keep Africa as a going concern and to distribute shares in the reorganized company to the company's bondholders. And if the going concern value is not enough to compensate the bondholders in full, the bondholders may end up with all of the securities of the reorganized Africa.

## *2. The Premise that Africa's Controller should Remain in Control after the Reorganization*

In designing a plan of reorganization, the Report appears to take it as given that Africa's current controlling shareholder ("the Controller") should remain in control of Africa after the reorganization. The Report takes the view that the Controller would be able to provide "value added" in connection with investments in Russia and Eastern Europe, and that Africa's going concern value would thus be higher with the Controller's involvement than without it.

Under the analysis in the Report, the Controller is expected to be left with no value in the event Africa and its bondholders do not reach an agreement, but to end up with a very large block of shares (which would further increase to a majority of Africa's outstanding shares with the addition of shares issued for the Controller's additional infusion of funds). Providing the controller with such a large block appears to be partly motivated by the premise that having the Controller remain in control would be important to the realizing Africa's full going concern value.

This analysis raises several significant questions from the perspective of protecting bondholders' interests and rights. To begin, assuming that the Controller can provide "value added," the Report does not attempt to provide any quantification of this value added or explain why the value added is considered to be so substantial as to make it worthwhile for bondholders to leave the Controller with such a large block of shares.

Furthermore, and importantly, even assuming that the "value added" is quite large and that it would be beneficial for Africa to have the Controller continue to play a leading role in guiding investments in Russia and Eastern Europe, providing the Controller with a very large block of shares in Africa is neither sufficient nor necessary for producing such value added.

Leaving the Controller with such a large block would not be sufficient to secure the Controller's involvement because the Plan does not condition the Controller's retaining the large blocks of shares on such involvement. Under the Plan, the Controller would be free to sell the control block in the future (or might be forced to sell it to satisfy the Controller's outside debtholders); in such a case, the Controller would presumably not continue to play a role in Africa's business efforts, but the Controller (or its outside creditors) would be able to obtain value from the Controller's sale of shares that the Plan provided partly to induce the Controller's continued involvement.

Moreover, it is far from clear that Controller's continued involvement could not be secured with arrangements and incentives that would be significantly less costly to bondholders than providing the Controller with a large block of Africa's shares. In considering this issue, bondholders should take into account that the Controller is assumed to have value added with respect to investments in Russia and Eastern Europe, and that such investments are the focus of AFI Development but not of Africa's other subsidiaries; thus, providing the Controller with incentives to improve AFI Development's value using shares in Africa could be an inefficient and excessively costly way to provide such incentives. Bondholders should also take into account that providing the Controller with shares in AFI Development (or Africa) would provide the Controller with value even in the event that those shares were to decline in value; incentives to enhance AFI Development's value could be provided instead by awarding the Controller, if he continues his involvement with AFI Development, with a significant share of any appreciation in the value of AFI Development's shares from their current levels.

Bondholders should also take into account that, even though providing the Controller with incentives to increase the value of AFI Development could be beneficial, locking control of Africa for a long time in the hands of the Controller might produce certain counterproductive incentives. Even after the conversion of some of Africa's debt into equity, Africa would have substantial debt outstanding, with additional debt outstanding at the level of Africa's subsidiaries. Given the substantial level of leverage, the Controller would have incentives to pursue riskier strategies than would be in the interest of Africa's debtholders.

In sum, the bondholders' examination of alternative reorganization plans should not proceed from the premise, which underlies the Plan and the Report, that the Controller should remain in control of Africa after the reorganization. Indeed, the above analysis indicates that the protection of bondholders' interests could well be best served by a reorganization plan that would not lock control over Africa in the hands of the Controller.

### *3. The Prediction that the Proposal would Provide Bondholders with the Value Due to them*

The Plan and the Report note predictions that, assuming the Plan is implemented, the market value of the securities given to the bondholders will be such that the value of the total package awarded to them would make them "whole." In particular, the Report estimates that the package would have a value of 7.4 billion NIS and thereby provide the bondholders with the full value owed to them. While the prediction concerning the value with which the bondholders would end up in the event of no agreement between them and Africa might be too pessimistic, the bondholders should be concerned about the possibility that the estimate of 7.4 billion NIS is too optimistic. The Report does not provide sufficient information about the estimated future cash flows of Africa and the reliability of such estimates to enable the bondholders to verify that this prediction is likely to materialize. Thus, the reorganization plan should take into account and address the possibility that the package of securities initially awarded to bondholders out to fail to provide them with the value due to them.

One way of addressing such a concern would be to include a mechanism that would provide the bondholders with rights to get additional shares in the event that, once the reorganization plan is implemented and market prices settle, it turns out that the package

received by the bondholders -- without the provision of such additional shares -- would have a value falling significantly short of the value owed to the bondholders. As the Report indicates, there is now substantial uncertainty, and given this uncertainty there is substantial difficulty to predict with confidence the value of any package of securities that bondholders would get in a plan of reorganization. Accordingly, to protect the interests of the bondholders, such a protective mechanism could well be worthwhile including even if the package of securities offered to bondholders were to be improved relative to the package offered in the Plan.

#### IV. CONCLUSION

Based on the above analysis, I conclude that adoption of the Plan would not adequately protect bondholders' interests and contractual rights. The protection of bondholders' interests and rights would be served by reconsidering the premises and structure of the Plan in the ways discussed in the above analysis.