

Israel

Aerospace

Rating **Neutral 1**
Prior: Buy 1

Price target **US\$23.35**
Prior: US\$22.00

Price **US\$21.71**

RIC: ESLT.O BBG: ESLT US

12 July 2004

UBS Investment Research

Elbit Systems
Limited Upside Despite Potential Tadiran Deal; Downgrade to Neutral-1
Downgrading to Neutral-1

With the news that Tadiran (TDCM.TA-Not Rated) intends to buy a 20% stake in Elbit (at a 22% premium) lifting the shares, we no longer see enough upside to maintain our Buy-1 rating. We are not sellers of the stock although given peer valuations, growth potential and limited opportunity for margin expansion, we find it difficult to add new money to the name at this point.

Tadiran's potential stake doesn't change the fundamentals

Tadiran Communications, has agreed to pay \$197m for 20% of Elbit, pending approval of the Federmann group, Elbit's largest shareholder (30%), which has first right of refusal on the stake. It is tempting to believe that the premium implies an ability to unlock some hidden value in Elbit and create synergies, but we are cautious for now.

Estimates unchanged

We are forecasting sales growth of 7% and 5% in 2004 and 2005 to \$961m and \$1,012m and EPS growth of 18% and 10% to \$1.34 and \$1.48 respectively.

Valuation: Raising PT to \$23.35

Our previous \$22 PT valued Elbit at a discount to its global peers. With the potential deal removing the need for a discount, we raise our PT to \$23.35, which values Elbit at 15.8x '05e EPS, in-line with the sector. While we would not be surprised by some upward momentum as the deal nears completion, with less than 10% upside to our PT we move to a Neutral-1.

Highlights (US\$m)	12/02	12/03	12/04E	12/05E	12/06E
Revenues	828	898	961	1,012	-
EBIT	58	53	67	74	-
Net income (UBS)	45	46	53	62	-
EPS (UBS, US\$)	1.13	1.14	1.34	1.48	-
Net DPS (UBS, US\$)	0.08	0.08	0.08	0.09	-

Profitability & Valuation	5-yr hist. av.	12/03	12/04E	12/05E	12/06E
EBIT margin %	7.8	6.0	7.0	7.3	-
ROIC (EBIT) %	21.8	14.9	18.4	20.2	-
EV/EBITDA x	7.5	8.0	9.0	8.0	-
PE (UBS) x	6.6	15.1	16.2	14.7	-
Net dividend yield %	0.4	0.5	0.4	0.4	-

Source: Company accounts, Thomson Financial, UBS estimates. UBS EPS is stated before goodwill, exceptionals and other special items.

Valuations: based on an average share price that year, (E): based on a share price of US\$21.71 on 09 Jul 2004

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Trading data

52-wk. range	US\$21.78-15.42
Market cap.	US\$0.90bn
Shares o/s	41.5m
Free float	45%
Avg. daily volume ('000)	8
Avg. daily value (US\$m)	0.2

Balance sheet data 12/04E

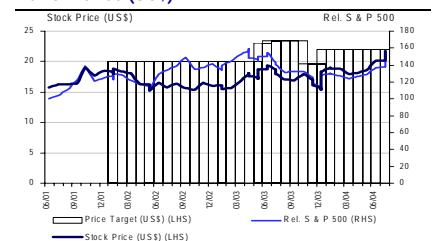
Shareholders' equity	US\$0.51bn
P/BV (UBS)	1.8x
Net cash (debt)	US\$0.03bn

Forecast returns

Forecast price appreciation	+7.6%
Forecast dividend yield	0.5%
Forecast stock return	+8.1%
Market return assumption	7.5%
Forecast excess return	+0.6%

EPS (UBS, US\$)

	12/04E			12/03
	From	To	Cons.	Actual
Q1	-	0.31	0.33	0.31
Q2	-	0.32	0.32	0.23
Q3	-	0.34	0.33	0.30
Q4	-	0.36	0.37	0.31
12/04E	-	1.34	1.35	-
12/05E	-	1.48	1.46	-

Performance (US\$)


Source: UBS

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ANALYST CERTIFICATION AND REQUIRED DISCLOSURES BEGIN ON PAGE 4

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Tadiran Communications deal

Tadiran Communications (Tadiran), an Israeli company that specializes in defence and civilian wireless communication systems has agreed to pay Elron \$197m, a 22% premium to Wednesday night's (July 7th) close, for their 19.6% Elbit share. The deal still has to be approved by the Federmann group, Elbit's largest shareholder (30.1%) and controlling interest, which also has first right of refusal on the sale. Federmann has less than three weeks (until July 29th) to exercise that right.

Should they not exercise, Tadiran and the Federmann group will jointly control the company. Elron and Federmann have a joint management agreement that hasn't been implemented in full by the former, such that Federmann holds the reins at Elbit. If Tadiran completes the purchase of the Elbit shares, it intends to put the joint management agreement into practice and become much more involved in the management of Elbit. Under the agreement, Tadiran would be able to appoint a CEO at Elbit on its behalf, while Federmann would appoint the chairman. In addition, all decisions regarding the company would be taken in agreement between the partners.

Tadiran rationale...

At a 22% premium to market or 16x our 2005e EPS, the deal is not a cheap one valuing the company at a slight premium to Elbit's defence electronics and avionics peer group (see Table 1 below). We note that the company was trading close to its all-time highs before the deal was announced.

From a strategic viewpoint, however, the deal may make sense to Tadiran for one or more of the following reasons:

- **Margin improvement.** Margins have been a real sticking point at Elbit in recent years. GM's fell for the third successive year in 2003 to 25%. We are forecasting for around 26% in 2004. Tadiran management told analysts on Thursday morning (July 8th) that they would achieve margins of 35%+ within two years by focusing more on profit and being more selective in choosing contracts.
- **Strategic alliance and associated synergies.** An alliance with Elbit would likely improve Tadiran's ability to win key contracts. Tadiran would also gain access to Elbit's more extensive technology, people and client base.
- **Industry consolidation.** The first shot. We remind investors of the fragmented nature of the local industry where comparatively small companies often find themselves competing against each other for key contracts. Industry consolidation involving the government-owned (Rafael, IAI Elta and IMI) and the non-government-owned companies (Elbit, Elisra and Tadiran Communications) is widely expected in the near-to-medium term future.

What about Elbit?

While the deal is certainly interesting to us and hints that Tadiran may see potential that we do not, we do not yet view the deal as unlocking any hidden

value in Elbit apart maybe from a strategic alliance with Tadiran and the ability to increase their product offering. We are therefore wary about rerating our Elbit investment case, and in extending our valuation parameters before seeing clearer evidence of the potential positive impact on the underlying business.

Our Elbit estimates remain unchanged pending any details from the companies that would cause us to reassess our view on revenue and margin opportunities. We are forecasting for YE sales in 2004 and 2005 of \$961m and \$1,012m representing annual growth of 7% and 5% respectively. Our EPS forecasts of \$1.34 for 2004 and \$1.48 in 2005 represent annual growth of 18% and 10% respectively. We remind investors that EPS growth was flat last year. At the current time and without any change to our fundamental thesis, these growth rates seem reasonable. Our forecast for the global defence industry is in-line with the UBS defence teams view on the sector.

Raising PT to \$23.35; lowering rating to Neutral-1

Table 1: Defence electronics and avionics peer group multiples

	MV (\$m)	EV (\$m)	P/E		EV/Sales		EV/Ebitda	
			04	05	04	05	04	05
CAE Inc	1,108	1,465	17.3	17.5	2.1	1.9	11.5	9.1
Meggitt	1,381	1,684	13.9	12.8	2.3	2.1	10.2	9.2
Rockwell Collins	5,967	5,888	20.4	18.2	2.1	1.9	11.4	10.3
Smiths Group	7,434	7,496	17.5	16.1	1.5	1.5	10.1	9.3
Thales	6,225	7,868	13.2	10.8	0.6	0.6	6.3	5.6
Harris Corp*	3,204	NA	22.6	19.4	NA	NA	NA	NA
L3 Comm.*	6,783	NA	18.8	16.6	NA	NA	NA	NA
Average			17.7	15.9	1.7	1.6	9.9	8.7
Elbit Sys. (Current)	832	837	16.2	14.7	0.9	0.8	8.9	7.9
Elbit Sys. (Tad. Deal)	1,005	982	18.0	16.0	1.0	1.0	9.8	9.2

Source: UBS Estimates, * Bloomberg

Following a price appreciation of 13.5% over the last six weeks and a further 7% rise since Wednesday's close (July 7th) on the back of the Tadiran news, Elbit is now trading at 14.7x our 2005e EPS estimate of \$1.48.

Our previous PT of \$22 valued Elbit at 15x 2005e PE, a small discount to the defence electronics and avionics sector shown above. In our view the potential deal removes the need for this discount.

Our new PT of \$23.35 values Elbit at 15.8x 2005e EPS and in-line with the sector. While we do still see the potential for a couple more upward moves in the stock towards the deal value as deal completion with either Tadiran or the Federmann's draws closer, given that there is less than 10% upside to our PT, we lower our rating from a Buy-1 to a Neutral-1. We are hardly sellers of the stock as our valuation indicates, but we are reluctant to add to positions here in the absence of detailed synergies that can be achieved by Tadiran with its 20% stake in the company.

■ **Elbit Systems**

Elbit Systems develops, manufactures and integrates advanced, high performance defence electronic systems for customers throughout the world.

■ **Statement of Risk**

Failure to maintain gross and operating margins at these levels could lead us to dramatically reduce our 04 and 05 EPS forecasts.

■ **Analyst Certification**

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UBS rating	Definition	UBS rating	Definition	Rating category	Coverage ¹	IB services ²
Buy 1	FSR is > 10% above the MRA, higher degree of predictability	Buy 2	FSR is > 10% above the MRA, lower degree of predictability	Buy	44%	33%
Neutral 1	FSR is between -10% and 10% of the MRA, higher degree of predictability	Neutral 2	FSR is between -10% and 10% of the MRA, lower degree of predictability	Hold/Neutral	48%	31%
Reduce 1	FSR is > 10% below the MRA, higher degree of predictability	Reduce 2	FSR is > 10% below the MRA, lower degree of predictability	Sell	7%	28%

1: Percentage of companies under coverage globally within this rating category.

2: Percentage of companies within this rating category for which investment banking (IB) services were provided within the past 12 months.

Source: UBS; as of 30 June 2004.

KEY DEFINITIONS

Forecast Stock Return (FSR) is defined as expected percentage price appreciation plus gross dividend yield over the next 12 months.

Market Return Assumption (MRA) is defined as the one-year local market interest rate plus 5% (an approximation of the equity risk premium).

Predictability Level The predictability level indicates an analyst's conviction in the FSR. A predictability level of '1' means that the analyst's estimate of FSR is in the middle of a narrower, or smaller, range of possibilities. A predictability level of '2' means that the analyst's estimate of FSR is in the middle of a broader, or larger, range of possibilities.

Under Review (UR) Stocks may be flagged as UR by the analyst, indicating that the stock's price target and/or rating are subject to possible change in the near term, usually in response to an event that may affect the investment case or valuation.

Rating/Return Divergence (RRD) This qualifier is automatically appended to the rating when stock price movement has caused the prevailing rating to differ from that which would be assigned according to the rating system and will be removed when there is no longer a divergence, either through market movement or analyst intervention.

EXCEPTIONS AND SPECIAL CASES

US Closed-End Fund ratings and definitions are: Buy: Higher stability of principal and higher stability of dividends; Neutral: Potential loss of principal, stability of dividend; Reduce: High potential for loss of principal and dividend risk.

UK and European Investment Fund ratings and definitions are: Buy: Positive on factors such as structure, management, performance record, discount; Neutral: Neutral on factors such as structure, management, performance record, discount; Reduce: Negative on factors such as structure, management, performance record, discount.

Core Banding Exceptions (CBE): Exceptions to the standard +/-10% bands may be granted by the Investment Review Committee (IRC). Factors considered by the IRC include the stock's volatility and the credit spread of the respective company's debt. As a result, stocks deemed to be very high or low risk may be subject to higher or lower bands as they relate to the rating. When such exceptions apply, they will be identified in the Companies Mentioned table in the relevant research piece.

Companies mentioned

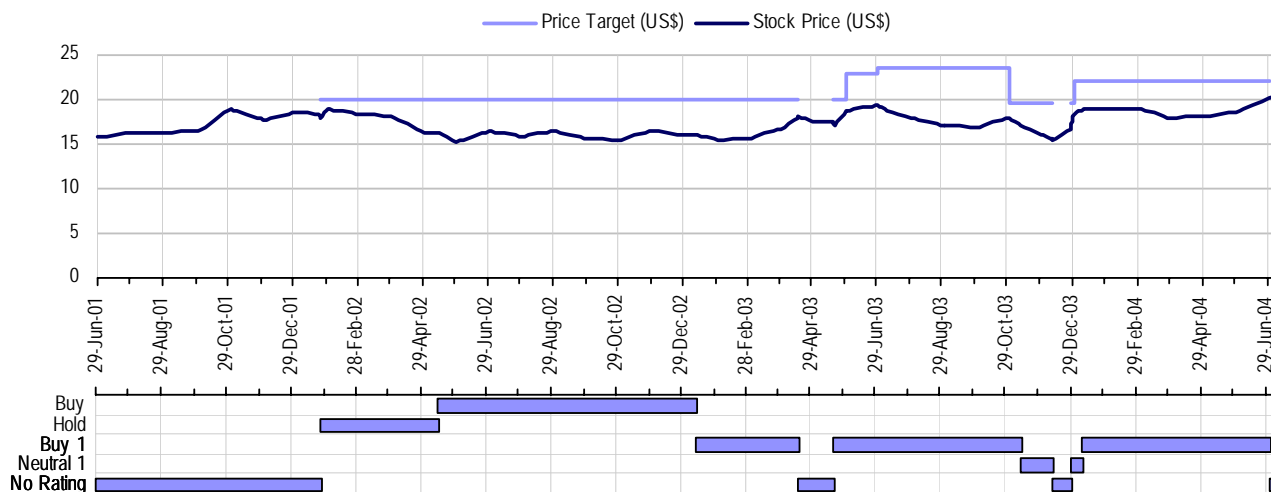
Company Name	Reuters	Rating	Price
Elbit Systems ¹⁶	ESLT.O	Neutral 1	US\$21.71

Price(s) as of 9 July 2004. Source: UBS.

16. UBS Securities LLC makes a market in the securities and/or ADRs of this company.

Unless otherwise indicated, please refer to the Valuation and Risk sections within the body of this report.

Elbit Systems (US\$)



Source: UBS; as of 9 July 2004.

Note: On October 13, 2003, UBS adopted new definition criteria for its rating system. (See 'UBS Investment Research: Global Equity Ratings Definitions and Allocations' table for details.) Between January 11 and October 12, 2003, the UBS ratings and their definitions were: Buy 1: Excess return potential > 15%, smaller range around price target; Buy 2: Excess return potential > 15%, larger range around price target; Neutral 1: Excess return potential between -15% and 15%, smaller range around price target; Neutral 2: Excess return potential between -15% and 15%, larger range around price target; Reduce 1: Excess return potential < -15%, smaller range around price target; Reduce 2: Excess return potential < -15%, larger range around price target. Prior to January 11, 2003, the UBS ratings and definitions were: Strong Buy: Greater than 20% excess return potential, high degree of confidence; Buy: Positive excess return potential; Hold: Low excess return potential, low degree of confidence; Reduce: Negative excess return potential; Sell: Greater than 20% negative excess return potential, high degree of confidence. Under both ratings systems, excess return is defined as the difference between the FSR and the one-year local market interest rate.

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