20 February 2002

**Marc E. Nabi**
First Vice President
(1) 212 449-2468
*marc_nabi@ml.com*

**Ryan D. Brown, CFA**
Assistant Vice President
(1) 212 449-4632
*ryan_d_brown@ml.com*

# Gilat Satellite Networks

## 4Q01 Review

**NEUTRAL***

**Reason for Report:** Analysis of Sales / Earnings

**Long Term BUY**

**Price: $3.91**

| Estimates (Dec) | 2000A | 2001A | 2002E |
|---|---|---|---|
| EPS: | $0.81 | d$15.03 | d$0.95 |
| P/E: | 4.8x | NM | NM |
| EPS Change (YoY): | | NM | NM |
| Q4 EPS (Dec): | d$0.44 | d$0.47 | |
| Cash Flow/Share: | $3.78 | d$9.89 | $2.23 |
| Price/Cash Flow: | 1.0x | NM | 1.8x |
| Dividend Rate: | Nil | Nil | Nil |
| Dividend Yield: | Nil | Nil | Nil |

**Opinion & Financial Data**

| | |
|---|---|
| Investment Opinion: | D-3-2-9 |
| Volatility Risk: | High |
| Mkt. Value / Shares Outstanding (mn): | $93.8 / 24 |
| Book Value/Share (Jun-2000): | $21.15 |
| Price/Book Ratio: | 0.2x |
| LT Liability % of Capital: | 36.7% |

**Stock Data**

| | |
|---|---|
| 52-Week Range: | $42.00-$2.00 |
| Symbol / Exchange: | GILTF / OTC |
| Options: | Chicago |
| Institutional Ownership-Vickers: | 38.1% |
| Brokers Covering (First Call): | 8 |

**ML Industry Weightings & Ratings****

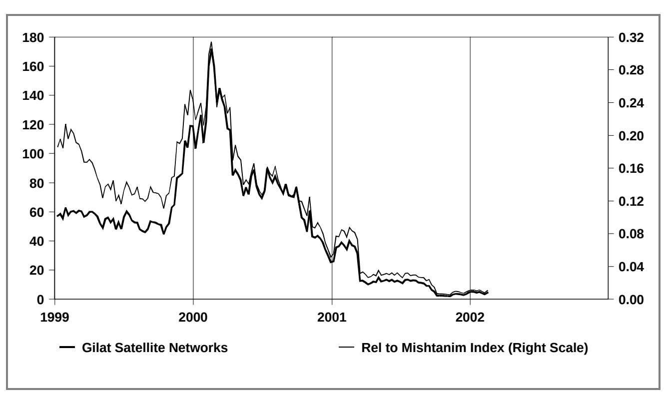
| | | |
|---|---|---|
| **Strategy; Weighting Rel. to Mkt.:** | | |
| Income: | In Line | (25-Oct-2000) |
| Growth: | In Line | (18-Jun-2001) |
| Income & Growth: | In Line | (25-Oct-2000) |
| **Market Analysis; Technical Rating:** | Below Average | (28-Nov-2000) |

*Intermediate term opinion last changed on 12-Mar-2001.
**The views expressed are those of the macro department and do not necessarily coincide with those of the Fundamental analyst.
For full investment opinion definitions, see footnotes.

## Highlights:

- **Gilat reported 4Q01 results that were inline with downward revised forecasts and sharply lower than last year.**
- **Gilat's total revenue decreased nearly 50% to $89 million in 4Q01 from $175 million in 4Q00. This was below our estimate of $92 million, yet broadly inline with management's $90 million forecast. Given negligible consumer market revenues, Gilat's 4Q01 core VSAT equipment / services sales mark a sharp decline from $125 million in 4Q00.**
- **Operating Income was negative ($5) million, below 4Q00's EBIT gain of $12 million. This was better than our ($8) million forecast on higher gross margins and 15% operating expense improvement vs. 3Q01.**
- **Management remains comfortable with its 2002 forecasts released last November.**
- **We continue to rate Gilat intermediate-term Neutral. Gilat remains a significant player in the VSAT market and is making the necessary changes to get back on track in 2002. Despite cost cutting, little has fundamentally changed from our March 2001 downgrade.**

**Stock Performance**






Merrill Lynch & Co.
Global Securities Research & Economics Group
Global Fundamental Equity Research Department

## Summary and Investment Conclusion

**We reiterate our Neutral rating on Gilat.** We credit management for succeeding on many of the initiatives put forth during its March 2001 conference call including (i) restructuring/downsizing, (ii) disposing non-core assets, (iii) reducing exposure to vertical markets and (iv) moving to a lower risk, wholesale model for StarBand. However, little has fundamentally changed from our March 2001 downgrade to Neutral. The IT spending deceleration continues to extend VSAT purchase cycles and has reduced earnings visibility and profit margins in the enterprise VSAT sector. We see fewer sizable contracts on the horizon with an increased emphasis on more rudimentary products such as telephony to markets such as Asia and Latin America. We are positively inclined by management's efforts to rationalize Gilat's cost structure to match more tempered sales growth expectations. Gilat's previously disclosed 2002 forecasts of slowing revenue without strong gross margin expansion affirm our concerns. Yet we are positively inclined by management's commitment to meeting its 2002 financial metrics and improving working capital and liquidity. We are hopeful for the potential return of clean financials as the company looks to unencumber itself for a potential rebound next year. Given negligible capital spending, Gilat expects to generate positive free cash flow in 2002 as cost savings materialize.

**CAPITAL STRUCTURE** While Gilat may appear inexpensive on an absolute value basis, we believe the warrant market risk premium outweighs potential rewards of ownership. We continue to question how much of Gilat's warrant long-term enterprise value (beyond 2003) is absorbed by the company's creditors. Liquidity concerns may exist should Gilat loss its current operational focus, a poor economic environment persists and future working capital inflows not materialize (i.e. accounts receivable collection, asset sales, further inventory write-offs, lease accelerations). Notwithstanding sustainable improvement in company fundamentals, meaningful share appreciation will likely not occur until Gilat's approximately $500 million in long-term liabilities are reorganized or pared down via asset securitization or potential equity dilution. Fortunately, Gilat enjoys long-standing relationships with Israeli banks and varied non-operating monetization options exist. In addition, we believe that liens on specific Gilat assets are inconsequential relative to its collective asset base. Management sees no need to reschedule near-term debt repayment obligations ($18mm in 2002, $36mm in 2003).

## 4Q01 Results

**Consolidation of rStar in 4Q01** Gilat has consolidated *rStar*. Although Gilat's revenues and net income are unaffected, marginal increases in Gilat's operating expenses occurred as a result. The consolidation should have an insignificant impact on Gilat's financial statements by 2Q02 with the expected completion of the rStar tender offer.

**Exhibit 1: Gilat 4Q01 Summary**

| | | | 4Q01E Forecasts | |
|---|---|---|---|---|
| | 4Q01 | 4Q00 | ML | Company |
| Total Revenue | $89 | $175 | $92 | $90 |
| Gross Profit | 28.6 | 53 | 28 | |
| Gross Margin | 32.2% | 30.4% | 30.2% | |
| Operating Income | (5) | 12 | (8) | (5) |
| EBIT Margin | NM | 6.9% | NM | NM |
| EPS | ($0.47) | $0.44 | ($0.61) | ~($0.43) |

Overall, Gilat reported 4Q01 results that were inline with downward revised forecasts and sharply lower than last year.

**REVENUE** Gilat's total revenue decreased nearly 50% to $89 million in 4Q01 from $175 million in 4Q00. This was below our estimate of $92 million, yet broadly inline with management's $90 million forecast. Given negligible consumer market revenues, Gilat's 4Q01 core VSAT equipment / services sales mark a sharp decline from $125 million in 4Q00. Ongoing difficulty in developed markets and the elimination of vertical market sales that were present in the prior year quarter have contributed. Of the core 2001 VSAT sales, approximately 70% were from equipment sales, with the remaining from services. Management expects services will represent 25-30% of core sales going forward. Telephony products for less developed regions represent about 25% of existing revenue and new business according to prior disclosures. Again, 4Q01 consumer sales were not meaningful vs. 4Q00's $50 million as few new *StarBand* terminals changed hands. Adequate supply of 360 terminals already exist in the pipeline to handle current demand. Gilat reported total revenue of approximately $389 million for the full year 2001, down 23% from 2000's $505 million.

**GROSS PROFIT** Gilat recorded gross profit of $29 million compared to our $28 million expectation and was down from $53 million (ex-rStar) in 4Q00. At 32.2%, Gilat exceeded our 4Q01 gross margin forecast of 30.2% due to higher margins on enterprise VSAT sales. Core segment sales (telephony and enterprise VSAT) can support margins of up to 40% whereas Gilat forecasts consumer products to have 0-10% margins. We continue to believe there will be choppy quarter-to-quarter sales. Likewise gross margins will also fluctuate (likely between 30-33%) resulting primarily from the mix of device sales.

**OPERATING INCOME** was negative ($5) million, below 4Q00's EBIT gain of $12 million. This was better than our ($8) million forecast on higher gross margins and 15% operating expense improvement vs. 3Q01. 4Q01 EBIT included the prepayment of Gilat's remaining royalty commitments due Israeli's Office of the Chief Scientist (OCF) for future technology use. This payment is not ongoing and should provide incremental cost savings going forward.

*(Continued)*

4Q01 SG&A of $26 million (29.7% of revenues) was inline with our estimate of $26 million (28.6% of sales) and $23 million (13.1% of sales) in 4Q00. Excluding the consolidated portion of rStar expenses, Gilat's 4Q01 SG&A would have been $23 million or 25.3% of sales.

Net R&D was $8 million or 8.7% of revenues compared to our 10.4% estimate and 4.7% in the prior year period. At nearly $10 million, *total* R&D remained relatively flat year over year with the difference from greater funded grant spending. Including $22 million of losses at rStar and extensive one-time charges incurred throughout the year, Gilat reported a 2001 operating income loss of ($294) million, down from positive $43 million in 2000. After cost cutting efforts are finished in 1Q02, management reiterated that operating expenses should decline 25-30% from $35 million recorded in 3Q01 (ex rStar).

**EPS** Gilat reported a consolidated 4Q01 loss of ($11) million, or ($0.47) per share, broadly inline with management's ($0.43) projected loss. We had projected an EPS loss of ($0.61) in 4Q01 versus negative ($0.44) in 4Q00.

**CASH BALANCE** Excluding $31 million of cash at rStar, Gilat ended 4Q01 with about $96 million ($79mm of free cash, $12mm of restricted cash and $5mm available credit), lower than $103 million in 3Q01. However, Gilat used $4 million of net cash for ongoing restructuring efforts vs. management's $10-20 million expectation. Cost cutting efforts should be completed shortly with no more than a $10 million use of cash expected in 1Q02. In terms of investing cash needs, management maintains that Gilat will spend approximately $2-4 million in capital expenditures per quarter. Gilat showed 4Q01 working capital improvement on nearly every metric. Given its inventory stockpile and more stringent focus on converting sales into cash, we are hopeful Gilat generates additional working capital inflows. Gilat's first debt maturity is for $18 million due 2Q02, after which it must pay an additional approximately $36 million per year in 2003. Total 2002 financing costs are forecast at $38-40 million. Longer term, Gilat anticipates approximately $220 million of cash generated / saved from various non-operating activities (rStar/GVT Brazil debt-to-equity conversation, acceleration of long-term leases, $65mm of Starband receivables, facility sales).

**RECEIVABLES** declined to $131 million in 4Q01 from $163 million in 3Q01. Yet when including non-current receivables of $21 million from rStar and in investments in other companies which are now consolidated, the receivable improvement is less great. We believe a long-term convertible debt from GVT Brazil due late 2002, StarBand's receivable due Gilat and capital leases are also included in this figure. With Gilat's likely conversion of rStar's and GVT Brazil's debt into equity, and the company's confidence regarding StarBand's long-term receivables, management does not foresee additional write downs from these items.

**INVENTORY** levels remained basically flat sequentially at $122 million in 4Q01. We note that many of the model 180 modems currently in the market will be exchanged for 360's (no additional revenue recognized). During the next several months, Gilat is expected to reclaim the outstanding 180 modems and resell them (recognize revenue) to enterprise customers. These refurbished modems will support many IP-based functions beyond traditional Internet access and should maintain a high margin since the cost of production has already been incurred. Gilat's 3Q01 write-down of inventory was done to reduce excess levels from the nearly $170 million at the time of inventory on hand, which was nearly double what the company projected it would need. This inventory is primarily related to the company's core markets and is *not* related to StarBand inventory.

## 2002 Forecasts Affirmed

Management remains comfortable with its 2002 forecasts released last November. Generally, sales and margins will progressively expand throughout the year as the first quarter is usually the company's weakest. As of 12/31/01, Gilat's backlog stood at $230 million (excluding the US Postal Service contract). This is relatively unchanged from $300 million at yearend 2000 when excluding $70 million of service sales from Gilat's vertical partners. These were subsequently written down. Management forecasts that 40-55% of backlog should be recognized on Gilat's financial statements in 2002. This provides good 2002 visibility, yet the importance of new bookings becomes increasingly important. Although service revenues account for 25-30% of sales, services accounts for the majority of backlog given that most equipment orders are booked, billed and shipped within a couple of months of receipt. Spacenet's current transponder utilization stands at 80-85%. Repricing its transponder lease rates or giving up unused capacity may provide incremental cost savings.

**Exhibit 2: Gilat's Operating Forecasts (presented 11/2001)**

| | 2002E | |
|---|---|---|
| | **Quarterly** | **Full Year** |
| Enterprise Sales | $70-90mm | $300-360mm |
| Consumer Sales | $5-10mm | ~$20mm |
| **Total Revenue** | **$80-95mm** | **$320-380mm** |
| Gross Profit | $24-31mm | $96-124mm |
| ***Margin*** | ***30-33%*** | ***30-33%*** |
| Operating Expense | $25-26mm | $100-104mm |
| *% of Revenue* | *26-33%* | *26-33%* |
| **EBIT** | **($2) -$7mm** | **($8) -$28mm** |
| D&A | $11-12mm | $44-48mm |
| Interest Expense | $5.5mm | ~$22mm |
| Approx. Net Income | ($19-$10)mm | ($78-$38)mm |
| Capital Expenditures | (~$3mm) | (~$12mm) |
| Working Capital Changes | ~3.5mm | ~$14mm |
| Use of Cash | | |

Source: Gilat Satellite Networks
Excludes the consolidation of rStar

## Other Items

**PROPOSED DISH/GMH MERGER** In our view, one additional risk that Gilat faces is the impact of the proposed EchoStar/Hughes merger. We believe that this potential merger could have an impact on EchoStar's long-term commitment to StarBand in turn could have an impact on the potential for wholesale consumer terminal sales by Gilat. EchoStar remains StarBand's primary retail supplier. Gilat indicated it believes EchoStar remains committed to StarBand, citing current distribution through over 1,000 EchoStar dealers. According to Gilat's management, StarBand should remain strategically important to EchoStar (at least for the next year) because the ongoing existence of StarBand may be necessary for EchoStar to prove competition on the broadband side in rural markets (to avoid market concentration issues). One test of EchoStar's commitment to the StarBand venture is its commitment to commence construction of a Ka/Ku band hybrid satellite for StarBand's use.

Gilat currently has a greater than $50 million receivable due from StarBand. Although collecting the StarBand receivable will not occur for some time, Gilat has not taken recovery charges for this amount, and expects to receive the entire receivable.

**CONNEXSTAR FORMED** Gilat recently rolled out this VSAT service targeting small and medium size enterprises (SME's). With the Connexstar platform, Gilat can now more economically compete against business DSL through the use of straight forward, standardized consumer offers. Further, both sell throughs and installation times are reduced and the program requires no network customization.

**SHIPMENTS / ORDERS** Management provided the following equipment shipment and order breakdown by region and market segment. Although enterprise shipments increased vs. 2000, management cited fewer high-priced hub sales caused Gilat's year over year revenue decline.

**Exhibit 3: Gilat 2001 Shipments and Orders**

| | Sites Shipped | Sites Ordered |
|---|---|---|
| US | 14,890 | 16,600 |
| Europe | 11,619 | 11,777 |
| Latin America | 17,252 | 14,922 |
| ROW | 12,947 | 14,342 |
| Total | 56,708 | 57,641 |
| | | |
| Enterprise | 44,192 | 50,554 |
| Telephony | 12,516 | 9,587 |
| Core Total | 56,708 | 60,141 |
| Consumer | 51,000 | 51,300 |
| Total | 107,788 | 111,441 |

Source: Company Data

**Exhibit 4: 2000 VSAT Shipment Breakdown**

| | 2000 Gilat | 2001 Gilat* | Change | 2000 HNS |
|---|---|---|---|---|
| Enterprise | 29,100 | 44,192 | 52% | 33,700 |
| Star DAMA | 4,840 | 10,906 | 125% | 620 |
| Mesh DAMA | 2,965 | 1,610 | 46% | 2,310 |
| Consumer | 38,500 | 51,000 | 32% | 1,500 |
| Total | 74,405 | 107,708 | 45% | 38,130 |

Source: Comsys VSAT Report 2001
*Company Data
Management refutes Comsys data, yet it provides fair comparability.