



# DUTTON ASSOCIATES

INDEPENDENT RESEARCH

## RESEARCH REPORT

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### Elron Electronic Industries LTD

November 14, 2005

Symbol (Nasdaq)		ELRN	Fiscal Year Ending: December				
Industry:	Electronics & Engineering		Year	EPS	P/E	REVS	PSR
Recent Price:	\$10.50		2003	A (\$0.25)	--- x	\$48.3	6.6 x
52-Week Price Range:	\$9.80-\$19.51		2004	A \$2.86	3.8 x	\$143.0	2.2 x
Target Price (12 months):	\$15.00		2005	N/A \$0.00	--- x	\$0.0	--- x
Avg. Daily Vol. (3 mo.):	17,567		2006	N/A \$0.00	--- x	\$0.0	--- x
			2007	N/A \$0.00	--- x	\$0.0	--- x
Balance Sheet Data (mil)		09/30/05	Ownership and Valuation (mil)		Current Rating History		
Cash Equivalent:	\$145.5		Shares Outstanding:	29.5	Date Assigned:	9/8/05	
Working Capital:	\$140.8		Inside Ownership:	1%	Price at Rating:	\$14.16	
Long-Term Liabilities:	\$4.2		Institutional Ownership:	49%	Original Price Target:	\$15.00	
Shareholders' Equity:	\$301.6		Equity Market Value:	\$319.5	Time Frame:	12 Months	

*Update Report*

**Rating: Strong Buy**

### Basis For Rating

*Elron Electronic Industries Ltd. reports third-quarter 2005 earnings of \$0.16 per share, appoints new CFO, Net Asset Value discount remains at 25%, reiterate **Strong Buy** Rating*

Elron reported third-quarter 2005 net income of \$4.8 million, or \$0.16 per share, and \$46.8 million, or \$1.59 per share, for the nine months ended September 30, 2005. Net income for the year is driven by the sale of holdings in Partner Communications and Oren Semiconductor, as well as the successful initial public offerings (IPOs) of NetVision on the Tel-Aviv Stock Exchange. Net Income for the year is reduced by Elron's consolidated losses in its group companies. Elron's share of losses in portfolio companies was reported as \$18.2 million for the nine months ended September 2005.

Highlights for the quarter include a \$3.00 per share cash dividend distribution and continued profitable growth at key holding Given Imaging (NASDAQ:GIVN). The dividend payment was a direct result of successful investment activity over the last 12 months. The recent announcement of the new investment in Gaia Broadband Services Management Ltd. shows that portfolio activity remains at a high level. The company has invested approximately \$32.3 million in new and existing group companies during 2005.

Elron announced that current Director of Finance Rinat Remler has been appointed as Elron's new Chief Financial Officer upon the departure of current CFO Tal Raz. Recall that Mr. Raz recently announced that he will leave the company in the fourth quarter to become CFO of Cellcom Israel Ltd., an Israeli cellular phone operator. Ms. Remler has been Elron's Director of Finance since 2000.

Since 2001 Elron has performed six exit transactions for cash and had two portfolio companies enter the public markets through IPOs. These cash sales garnered proceeds of more than \$340 million for a total recognizable gain of approximately \$150 million. We view these transactions as evidence that Elron's strategic focus can generate growth and solid returns. Furthermore, this offers additional support of management's strong style of execution. These frequent, and at

times sizable, returns have created a permanent capital base for continued growth in shareholder value. The Company recently declared a cash dividend of \$3.00 per share, totaling approximately \$89 million.

As of September 30, 2005, the Company remains in a strong position with \$145 million in cash on the balance sheet. This amounts to approximately \$4.90 in cash per share. At current price levels, Elron's market valuation is trading at approximately 2x cash even after the dividend and the new investments in the third quarter. We believe that it is possible for the Company to pay additional special dividends in the future as its portfolio companies mature and Elron performs profitable exits. These relatively frequent and, at times sizable, exits generate returns that have created a permanent capital base for Elron to continue to invest in new companies and grow in shareholder value

At an almost 25.6% discount to Net Asset Value (NAV), we believe that the investment community is overly discounting Elron's operations and devaluing the private-company portfolio to a great extent. Elron has taken advantage of the recent cycle of innovation in technology and developed a first-rate portfolio of high-growth companies highly diversified across sectors, industries, and development stages. We believe Elron is on the verge of developing more companies with the stature of its key holding, Given Imaging. As investors recognize the disparity between Elron's underlying NAV and the publicly traded market value of the Company, we believe the current NAV discount will narrow and possibly turn into a premium over time. Please see our recent initiation report for more detailed discussion of NAV composition and calculations.

At current price levels, Elron represents a compelling opportunity, in our view. We believe Elron shares present an attractive opportunity trading at nearly 2x balance sheet cash. The discount to NAV is significant and has widened to 25.6% from 16.5% in early September before the dividend distribution. We maintain our **Strong Buy** rating and 12-month price target of \$15. Our price target is supported by our NAV analysis, which reflects the current market values of publicly held companies, the net cash on the balance sheet, and our estimate of book value for privately held companies. (See Table 1.)

**Table 1. Summary Net Asset Value Analysis**

<b>Equity Holdings</b>					
<b>Sector</b>	<b>Public *</b>	<b>Private</b>	<b>Total</b>	<b>% Equity</b>	<b>% Total</b>
Telecom	\$49,790	\$33,931	\$83,721	29.9%	18.8%
Medical devices	\$128,392	\$38,756	\$167,148	59.7%	37.5%
Semiconductors	\$1,589	\$15,732	\$17,320	6.2%	3.9%
Advanced materials	\$0	\$12,000	\$12,000	4.3%	2.7%
<b>Totals</b>	<b>\$179,770</b>	<b>\$100,418</b>	<b>\$280,188</b>	<b>100.0%</b>	<b>62.8%</b>
<b>Balance Sheet Assets (9/30/2005)</b>					
Cash			\$145,500		32.6%
Other Assets			\$20,547		4.6%
<b>Net Asset Value Calculation</b>					
Total Asset Value			\$446,235		100.0%
Debt			-\$4,200		
Tax Liability on 2005 Dispositions **			-\$15,000		
Minority Discount for Privates (25%)			-\$25,104		
Net Asset Value			\$401,931		
Shares Outstanding			\$29,410		
Dividend per share					
<b>Bottom up NAV per share</b>			<b>\$14</b>		
<b>Market Premium / Discount</b>					
ELRN Market Price	as of 11/07/2005		\$10		
<b>Discount/Premium to Fair Value</b>			<b>-25.6%</b>		
* Public company closing prices 11/7/2005					
** Tax liability mainly on sales of partner shares					

Source: Company data, J.M. Dutton estimates

**Table 2. Income Statement**

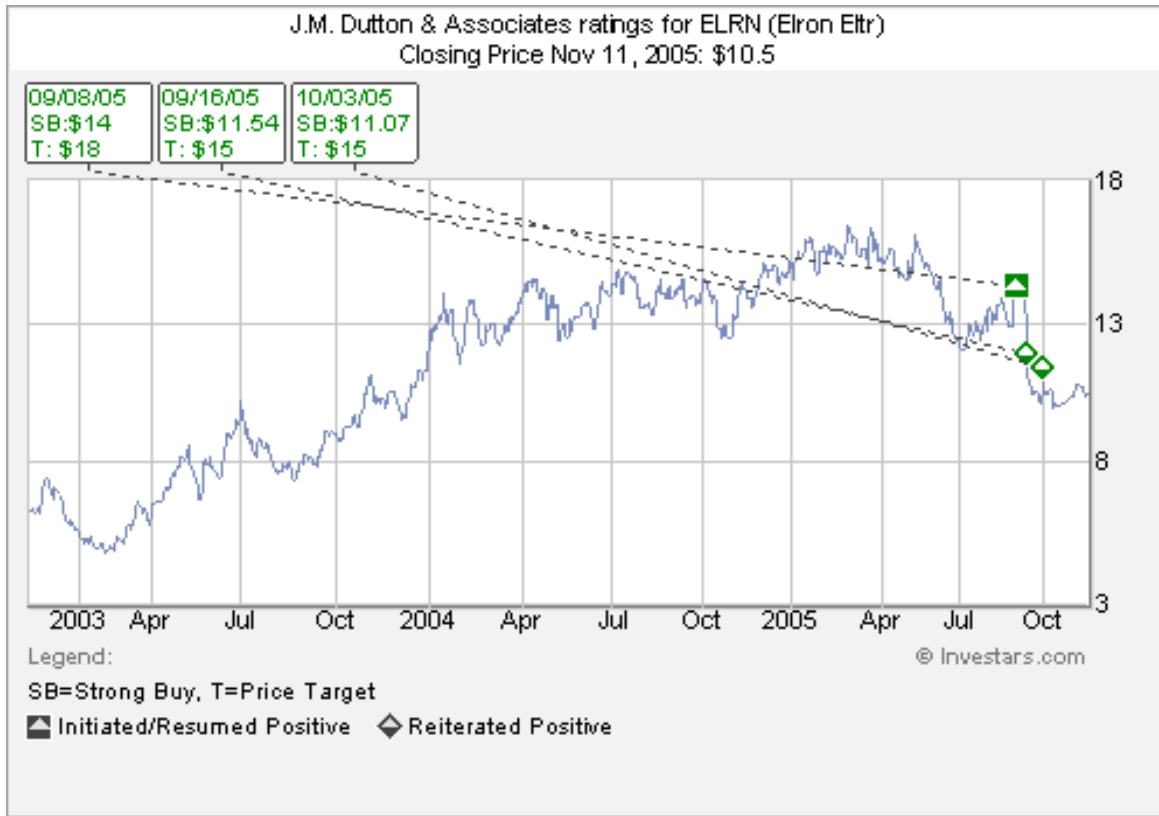
	Year Ended			Quarter Ended		
	12/31/02	12/31/03	12/31/04	3/31/05	6/30/05	9/30/05
Net Sales	\$15,179	\$16,547	\$16,330	\$4,258	\$4,260	\$3,891
Income -- Affiliates	-24,189	-8,698	-10,492	-3,588	-4,244	-5,254
Gain Holdings -- Affiliates	6,888	25,754	132,396	-10	22,399	1,124
Other Income, Net	-743	14,665	4,784	286	56,262	1,491
<b>Total Consolidated Revenue</b>	<b>-2,865</b>	<b>48,268</b>	<b>143,018</b>	<b>946</b>	<b>78,677</b>	<b>1,252</b>
Cost of Sales	10,716	10,198	9,650	2,490	2,427	
Research/Development	3,418	3,787	3,637	1,554	1,675	—
Marketing Expenses	6,412	7,763	3,202	1,099	1,233	—
General/Admin	9,658	13,923	13,285	2,147	2,492	—
Amort Intangibles	1,044	1,073	731	44	119	—
Finance	81	753	-643	-926	-3,389	—
Restructuring	1,747	0	225	—	—	—
Impairment Goodwill	—	—	1,980	—	1,329	—
Impairment Intangibles	—	—	7,097	—	—	—
<b>Total Operating Expense</b>	<b>33,076</b>	<b>37,497</b>	<b>39,164</b>	<b>6,408</b>	<b>5,886</b>	<b>7,625</b>
<b>Operating Income</b>	<b>-35,941</b>	<b>10,771</b>	<b>103,854</b>	<b>-5,462</b>	<b>72,791</b>	<b>-6,373</b>
<b>Net Income Before Taxes</b>	<b>-35,941</b>	<b>10,771</b>	<b>103,854</b>	<b>-5,462</b>	<b>72,791</b>	<b>-6,373</b>
Provision for Income Taxes	-2,862	6,834	15,132	-155	26,042	9,676
<b>Net Income After Taxes</b>	<b>-33,079</b>	<b>3,937</b>	<b>88,722</b>	<b>-5,307</b>	<b>46,749</b>	<b>3,303</b>
Minority Interest	2,823	-10,907	-4,135	194	451	1,459
Net Income Before Extra. Items	-30,256	-6,970	84,587	-5,113	47,200	4,762
Discontinued Operations	-11,323	-235	-454	—	0	—
<b>Net Income</b>	<b>-41,579</b>	<b>-7,205</b>	<b>84,133</b>	<b>-5,113</b>	<b>47,200</b>	<b>4,762</b>
Basic Weighted Average Shares	26,272	29,194	29,266	29,414	29,416	29,433
<b>Basic EPS Excluding Extraordinary Items</b>	<b>-1.15</b>	<b>-0.24</b>	<b>2.89</b>	<b>-0.17</b>	<b>1.6</b>	<b>0.16</b>
<b>Basic EPS Including Extraordinary Item</b>	<b>-1.58</b>	<b>-0.25</b>	<b>2.87</b>	<b>-0.17</b>	<b>1.6</b>	<b>0.16</b>
Dilution Adjustment	0	0	0	0	0	0
Diluted Net Income	-41,579	-7,205	84,133	-5,113	47,200	4,762
Diluted Weighted Average Shares	26,272	29,194	29,385	29,414	29,538	29,523
<b>Diluted EPS Excluding Extraordinary Items</b>	<b>-\$1.15</b>	<b>-\$0.24</b>	<b>\$2.88</b>	<b>-\$0.17</b>	<b>\$1.60</b>	<b>\$0.16</b>
<b>Diluted EPS Including Extraordinary Items</b>	<b>-1.58</b>	<b>-0.25</b>	<b>2.86</b>	<b>-0.17</b>	<b>1.60</b>	<b>0.16</b>

Source: Company data

**Table 3. Balance Sheet**

	Year Ended				Quarter Ended		
	12/31/01	12/31/02	12/31/03	12/31/04	3/31/05	6/30/05	9/30/05
<b>Assets</b>							
Cash & Equivalents	\$90,404	\$67,901	\$83,906	\$42,611	\$28,160	\$119,091	
Marketable Securities	264	3,180	37,158	146,009	141,037	142,056	
<b>Total Cash on Hand</b>	<b>\$90,668</b>	<b>\$71,081</b>	<b>\$121,064</b>	<b>\$188,620</b>	<b>\$169,197</b>	<b>\$261,147</b>	<b>\$140,800</b>
Accounts Receivable	9,627	9,238	5,016	6,112	5,550	6,390	
Accounts Receivable	9,879	10,083	—	—	—	—	
Doubtful Accounts	-252	-845	—	—	—	—	
Other Receivables	4,395	4,528	2,516	1,946	2,327	3,478	
Inventories	1,671	2,197	1,471	1,984	2,218	2,384	
<b>Total Current Assets</b>	<b>106,361</b>	<b>87,044</b>	<b>130,067</b>	<b>198,662</b>	<b>179,292</b>	<b>273,399</b>	<b>166,047</b>
Investment-Related Cos	162,260	132,204	156,819	117,124	114,110	112,541	108,638
Other Investments	7,504	89,134	128,799	155,929	164,206	58,327	70,622
Long Term Deposit/Debenture	22,127	28,928	700	0	—	—	
Deferred Tax	973	2,990	1,871	5,493	5,687	3,957	1,296
Severance Pay	2,313	2,262	2,144	2,637	2,644	2,401	2,466
Fixed Assets	4,971	11,576	8,317	8,064	8,058	7,925	7,833
Goodwill	8,833	21,538	12,019	10,268	10,268	8,939	7,963
Intangibles	10,968	18,577	9,968	2,979	2,966	2,953	
<b>Total Assets</b>	<b>326,310</b>	<b>394,253</b>	<b>450,704</b>	<b>501,156</b>	<b>487,231</b>	<b>470,442</b>	<b>364,865</b>
<b>Liabilities</b>							
Short Term Loans from Banks	16,009	15,362	11,986	2,079	1,373	2,003	
Current Portion Long Term Debt	608	17,637	44,021	2,974	2,930	2,809	
Accounts Payable	4,514	5,738	3,408	3,459	3,044	2,431	
Payable/Accrued	9,321	16,516	13,620	31,333	15,669	43,445	
<b>Total Current Liabilities</b>	<b>30,452</b>	<b>55,253</b>	<b>73,035</b>	<b>39,845</b>	<b>23,016</b>	<b>50,688</b>	<b>25,292</b>
Long-Term Debt	51,808	49,389	17,221	4,072	4,145	4,200	4,246
<b>Total Long Term Debt</b>	<b>51,808</b>	<b>49,389</b>	<b>17,221</b>	<b>4,072</b>	<b>4,145</b>	<b>4,200</b>	<b>4,246</b>
Deferred Taxes	0	23,650	40,684	41,233	43,891	7,585	8,748
Retirement Benefits	3,914	2,921	2,850	3,809	3,853	3,567	3,609
Minority Interest	1,040	3,185	20,681	23,095	22,865	22,833	21,420
Other	383	414	103	22	22	0	
<b>Total Liabilities</b>	<b>87,597</b>	<b>134,812</b>	<b>154,574</b>	<b>112,076</b>	<b>97,792</b>	<b>88,873</b>	<b>63,315</b>
<b>Shareholders' Equity</b>							
Ordinary Shares	9,567	9,572	9,572	9,572	9,572	9,572	9,572
Capital Surplus	165,680	267,482	267,113	270,005	270,114	270,187	270,187
Other Comprehensive Income	42,231	7,529	51,792	57,717	63,080	7,937	7,937
Retained Earnings	21,235	-25,142	-32,347	51,786	46,673	93,873	13,854
<b>Total Equity</b>	<b>238,713</b>	<b>259,441</b>	<b>296,130</b>	<b>389,080</b>	<b>389,439</b>	<b>381,569</b>	<b>301,550</b>
<b>Total Liabilities &amp; Shareholders' Equity</b>	<b>326,310</b>	<b>394,253</b>	<b>450,704</b>	<b>501,156</b>	<b>487,231</b>	<b>470,442</b>	<b>364,865</b>
Total Common Shares Outstanding	21,214	29,181	29,207	29,415	29,415	29,417	29,537

Source: Company data



<b>J.M. Dutton &amp; Associates Current Ratings Distribution</b>	
<b>Rating</b>	<b>% Total</b>
Sell	3.03
Strong Buy	19.19
Buy	15.15
Strong Speculative Buy	21.21
Speculative Buy	22.22
Neutral	17.17
Avoid	2.02

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**Analyst: Barry Raeburn**

Barry Raeburn has extensive equity research experience. Prior to joining Dutton Associates, Mr. Raeburn worked as a specialty technology & hardware analyst at Emerging Growth Equities, an investment bank, covering primary small and micro-cap companies within the technology industry. These included Enterprise Hardware, Storage, Networking Products, Semiconductors, Capital Equipment, and EMS. Before joining Emerging Growth Equities, Mr. Raeburn worked at Pilgrim Baxter & Associates, an investment advisor, first as a quantitative analyst responsible for developing and maintaining various stock selection and ranking models and later as technology research analyst identifying, analyzing, and making recommendations on equities within a variety of technology sectors as well as Defense/Aero, Consumer Staples, and Multi-Industry Conglomerates. Mr. Raeburn received his bachelors degree in Finance and Risk Management from Temple University. He also has begun an MBA from Temple with concentration in Finance. Mr. Raeburn is currently a candidate in the CFA program.

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**Analyst Certification:**

I, Barry Raeburn, hereby certify that the view expressed in this research report accurately reflect my personal views about the subject securities and issuers. I also certify that no part of my compensation was, is, or will be, directly or indirectly, related to the recommendations or views expressed in this research report.

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