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EQUITY RESEARCH

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ISRAEL
Defence Electronics

Elbit Systems (USD 17.14) 1 - Overweight

Operating Results

The JV Quarter

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Investment Conclusion

- Elbit met our EPS estimate through a seemingly abnormal $1.9m income from its share in joint ventures, but after further inquiry into these, it seems plausible to expect recurring positive, after tax impacts on the company's net earnings. Moreover, the cash flow performance was solid and the balance sheet remains healthy. Therefore, and based on a low relative valuation, we feel confident to recommend purchase of ESLT shares to investors with a medium to long-term perspective.

Summary

- Revs were $202.2m, up 8.8% y/y; EPS at $0.31 were in-line with ours and Street estimates.
- Cash flows from operations were $22.7m vs. ($11.9m) in Q102.
- VSI got a $60m contract from Boeing for more than 300 JHMCS systems; we assess the potential Boeing-related business for VSI at $300m (over several years).

Company Rating	Target (USD)
New: 1 - Overweight	New: 21.00
Old 1 - Overweight	Old: 21.00

Sector View: 2 - Neutral

FY Dec	2002A	2003E		2004E		Change %	
Currency USD	Actual	Old	New	Old	New	2003	2004
Revenue (m)	827.5	876.8	884.7	946.9	955.5	6.9%	8.0%
Net Income (m)	50.2	56.0	55.9	65.7	65.7	11.5%	17.5%
EPS	1.26	1.40	1.40	1.60	1.60	11.0%	14.6%
Consensus		1.36		1.47			
EV/Revenues	0.82		0.77		0.71		
P/E	13.6		12.2		10.7		

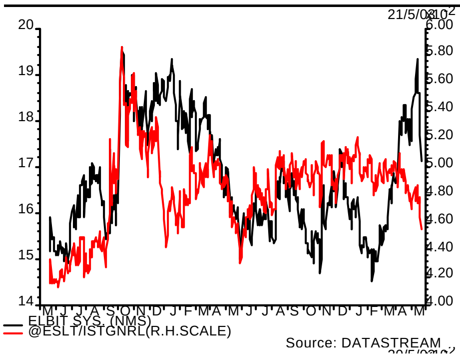
Market Data

Market Cap (m)	665.0
Shares Outstanding (m)	38.8
Float (%)	48.9
Net Div Yield (%)	2.2
Convertible	No
Share per ADR	-

Financial Summary

Five – Year EPS CAGR (%)	6.5
Return on Equity FY02 (%)	12.7
Current BVPS ($)	10.9
Net Debt ($m)	14.0

Stock Overview



Reuters	ESLT.O		
Bloomberg	ESLT		
ADR	-		
Performance	**1M**	**3M**	**12M**
Absolute %	-6	13	8
Rel. Market %	-9	3	28
Rel. Sector %	-7	-6	-9
52 Week Range	19.33 - 14.51		

Investment Conclusion

At first sight, we were a bit disappointed with Elbit's Q103 results. Although revenues were higher than expected and US sales posted a major expansion, the expense structure and margins were worse than forecasted. Furthermore, the Electro-optics segment – one of the supposed growth drivers – continues to underperform. However, given the positive impact on the net income from Elbit's various joint ventures – which operate in core business areas –, and assuming this impact is not a one-off, the first quarter results are actually better than we initially thought.

Elbit achieved the consensus EPS estimate of $0.31 through a seemingly abnormal $1.9m income from its share in affiliates and partnerships, but after further inquiry into these operations, it seems plausible to expect recurring, after tax positive impacts on the company's net earnings. Moreover, the cash flow performance was solid and the balance sheet remains healthy. Therefore, and based on a low relative valuation, we feel confident to recommend purchase of ESLT shares to investors with a medium to long-term perspective.

The JV Quarter

Investors that tend to focus on Elbit's reported "operating" items while overlooking items below "Taxes on income" are likely to miss an increasing contributor to the company's ongoing earnings – those generated out of joint ventures, affiliates and other partnerships, reported under "Equity in net earnings (losses) of affiliated companies and partnerships" ("ENELAP").

The Q103 in-line net income of $12.3m and EPS of $0.31 were achieved through an abnormal $1.9m impact from Elbit's share in affiliates' and partnerships' income. This is a record level for an item which showed losses in every year but 2002. Since these non-consolidated companies operate in Elbit's core business areas, primarily airborne and electro-optic systems, we encourage investors to follow closely the ENELAP item as it reflects the bottom line of some important joint ventures and affiliates.

We consider the following three to be the most important Elbit joint ventures:

- **Vision Systems International** (VSI; 50%, jointly-owned with Rockwell Collins; www.vsi-hmcs.com) – maker of helmet mounted display systems for fighter aircraft. We estimate that recent major orders received from Boeing (see our note dated March 12th, 2003) and expected full rate production (FRP) orders will enable VSI to contribute increasing earnings to Elbit's bottom line. However, Elbit' sales will not reflect most of the substantial growth expected at VSI.

  VSI was recently awarded a $60m contract from Boeing for the supply of more than 300 Joint Helmet-Mounted Cueing Systems (JHMCS) for the US Air Force's F-15 and F-16, and for the US Navy's F/A-18 Super Hornet fighters. In fact, VSI got more than 70% of an $81.2m related contract received by Boeing, possibly indicating a unit price close to $200k, higher than any of our previous estimates.

  VSI expects an FRP award later this year, probably following Boeing's FRP award anticipated by June 2003. Since Boeing expects US military orders for JHMCS systems to surpass 1,500 units, and assuming a similar unit price for VSI, we assess the potential Boeing-related business for VSI at $300m (over several years). VSI is also likely to be the supplier of choice of these helmets for the Lockheed Martin-built Joint Strike Fighter. Furthermore, Elbit believes that 50% of all western fighters will have helmet-mounted display systems, thus making the market opportunity even greater.

- **Semi-conductor Devices** (SCD; 50%, jointly-owned with Rafael; www.scd.co.il) – develops infrared detectors, laser diodes and other electro-optics components for various applications. Elbit and wholly-owned subsidiary El-Op integrate SCD-made components into many of their airborne and electro-optics-related projects.

- **Opgal** (50.1%, jointly-owned with Galram, a Rafael subsidiary; www.opgal.com) – uses infrared technologies originally developed at Rafael to make thermal imaging systems for commercial and paramilitary applications, as well as for upgrading existing systems. Opgal's products range from customized FLIR (forward-looking infra-red) systems to "off-the-shelf" thermal imaging engines for OEM partners and system integrators. Interestingly, recently Opgal released a Fever Detecting System to be used at major international airports for the detection of individuals who may be infected with SARS.

On one hand, Elbit's top line does not reflect any of these affiliates' sales, nor does it reflect their expenses; on the other hand, as the after-tax contribution to Elbit's net income increases, the importance of these joint ventures intensifies. Hence, income or losses from joint ventures and affiliates in avionics and electro-optics areas, albeit reported separately as after tax items, should be seen as organic results.

Q103 Results

- **Revenues** were $202.2m, up 8.8% y/y and 6% higher than our estimate.
- **EPS** at $0.31 were in-line with our estimate and the Street consensus.
- **Cash flows** from operations were $22.7m vs. ($11.9m) in Q102; net cash flows were ($6m) vs $11.4m a year ago.

- The **operating income** declined 2% y/y, as a result of a 13% increase in operating expenses as compared to the 9% sales growth. This appears to be the only disappointment in Elbit's Q103 results. However, had it not been for a $1.4m non-cash expense related to the "phantom" employee stock-options plan, the operating income would have increased 7%, and the operating margin would have been 8.1% – similar to that in Q102.

- **Balance Sheet –** DSO (TTM) declined to 113 from 119 days at the end of 2002; net debt improved to $14m from $22.5m on Dec 2002; the cash balance totaled $71.6m.

- **Profit Margins –** The gross margin was stable at 28.1%; however, the operating margin decreased to 7.4% from 8.2% in Q102, and was also well below our 8.4% estimate, as a result of higher operating expenses; the net margin was 6.1% vs. 6.3% last year and compared to our 6.5% estimate.

- **Business Segments –** Sales grew in all business areas but Electro-optics, which continued a negative trend instated in the second half of 2002.

- **Regions –** US sales jumped 56.4% y/y to $77.1m (38% of total sales), offset by sales in Europe which declined 47% to $21.4m (10.6% of tot sales, the lowest since 1996), as certain major programs entered final phases.

- **Backlog –** Elbit's backlog on March 31st 2003 remained stable at $1.69bn. However, on a relative basis, it declined to 2.00 years of sales. Although this is only slightly lower than the 2.04 level on Dec 2002, it marks the lowest point since June 2000. 63% of the backlog is related to export orders, up from 62% on Dec 2002. In 2003 we expect the backlog to increase 7.2% to $1.8bn, or 2.05 years of sales.

- Elbit declared a dividend of $0.09 per share for Q103, to be paid on June 16th, record date is June 3rd.

Outlook and Model Adjustments

According to management's traditionally scant guidance, sales are expected to grow every quarter this year (as compared to the parallel quarter last year), and to post improvement in all parameters in 2003.

We have made the following adjustments to our model, shifting primarily towards slightly lower operating margins, but with higher income from affiliates and partnerships:

- We have increased our 2003 sales estimate to $885m, up 6.9% y/y (old $877m, up 6% y/y); our 2004 sales growth estimate remains at 8%, therefore our absolute sales target shifts to $955m (old $947m).

- We now expect operating and net margins to be 7.9% (old 8.2%) and 6.3% (old 6.4%), respectively, in 2003.

- Our EPS estimates remain unchanged at $1.40 and $1.60 in 2003, 2004, respectively.

Valuation

At 12.2x and 10.7x our 2003 and 2004 EPS estimates, respectively, we think Elbit offers an attractive investment opportunity for "value" investors seeking strong profitability, consistent cash flow generation and high visibility as reflected by Elbit's solid backlog. Elbit's defence sector peers trade at a high-teens average P/E multiple based on FY03 EPS estimates. We reiterate our 1-Overweight and $21 price target, or 15x our FY03 EPS estimate.

Company description: Elbit Systems serves as a prime contractor and integrator in upgrades of airborne and ground platforms, as well as key partner and supplier of manufacturers of new platforms. It is an acknowledged world leader in the area of helmet-mounted display systems for fixed and rotary wing aircraft.

Company Name	Disclosure(s)*	Reuters Ticker	Price(21-05-2003)	Rating
Elbit Systems	-	ESLT.O	(USD 17.14)	1 - Overweight

*** PLEASE SEE DISCLOSURE LEGEND ON THE LAST PAGE**

Important Disclosures

Rating and Price Target Chart: Elbit Systems

Date	Recommendation	Target price	Closing Price
12-Nov-01	2 - Buy	24.40	17.71
11-Mar-02	2 - Buy	24.40	17.82
26-Mar-02	2 - Buy	24.40	18.01
9-Apr-02	2 - Buy	24.40	17.11
9-May-02	2 - Buy	24.40	16.26
11-Jun-02	2 - Buy	24.40	15.70
8-Aug-02	1 - Overweight	24.40	16.46
7-Nov-02	1 - Overweight	24.40	14.99
23-Jan-03	1 - Overweight	21.00	15.32
10-Feb-03	1 - Overweight	21.00	15.25
12-Mar-03	1 - Overweight	21.00	15.69

Analyst Certification:
I, Tobias Fischbein, hereby certify (1) that the views expressed in this research report accurately reflect my personal views about any or all of the subject securities or issuers referred to in this report and (2) no part of my compensation was, is or will be directly or indirectly related to the specific recommendations or views contained in this report.

Important Disclosures:
The analysts responsible for preparing this report have received compensation based upon various factors including the Firm's total revenues, a portion of which is generated by investment banking activities.

Risk Disclosure: We consider the key investment risks to be the following: upgrade contracts tend to be unpredictable and lumpy in nature, creating uncertainties around the progress of different programs; quarterly results fluctuation as a result of inconsistent development of specific programs; relatively low cash position for a defense company of its size; the failure of the Israeli defense industry to consolidate in the next 5-7 years.

Other Material Conflicts: None.

Key to Investment Opinions:

Stock Rating
1 - Overweight - The stock is expected to outperform the unweighted expected total return of the industry sector over a 12-month investment horizon.

2 - Equal weight - The stock is expected to perform in line with the unweighted expected total return of the industry sector over a 12-month investment horizon.

3 - Underweight - The stock is expected to underperform the unweighted expected total return of the industry sector over a 12-month investment horizon.

RS - Rating Suspended - The rating and target price have been suspended temporarily to comply with applicable regulations and/or firm policies in certain circumstances including when Lehman Brothers is acting in an advisory capacity in a merger or strategic transaction involving the company.

Sector View
1 - Positive - sector fundamentals/valuations are improving

2 - Neutral - sector fundamentals/valuations are steady, neither improving nor deteriorating

3 - Negative - sector fundamentals/valuations are deteriorating

Stock Ratings From February 2001 to August 5, 2002 (sector view did not exist):
This is a guide to expected total return (price performance plus dividend) relative to the total return of the stock's local market over the next 12 months.
1=Strong Buy - expected to outperform the market by 15 or more percentage point.
2=Buy - expected to outperform the market by 5-15 percentage points
3=Market Perform - expected to perform in line with the market, plus or minus 5 percentage points
4=Market Underperform - expected to underperform the market by 5-15 percentage points
5=Sell - expected to underperform the market by 15 or more percentage points.

Stock Ratings Prior to February 2001 (sector view did not exist):
1=Buy - expected to outperform the market by 15 or more percentage point
2=Outperform - expected to outperform the market by 5-15 percentage points
3=Neutral - expected to perform in line with the market, plus or minus 5 percentage points
4=Underperform - expected to underperform the market by 5-15 percentage points
5=Sell - expected to underperform the market by 15 or more percentage points
V=Venture - return over multiyear timeframe consistent with venture capital; should only be held in a well diversified portfolio

Distribution of Ratings:

Lehman Brothers Equity Research has 1501 companies under coverage.
34% have been assigned a 1-Overweight rating which, for purposes of mandatory regulatory disclosures, is classified as a Buy rating. 39% of companies with this rating are investment banking clients of the Firm.

43% have been assigned a 2-Equal weight rating which, for purposes of mandatory regulatory disclosures, is classified as a Hold rating, 14% of companies with this rating are investment banking clients of the Firm.
23% have been assigned a 3-Underweight rating which, for purposes of mandatory regulatory disclosures, is classified as a Sell rating, 53% of companies with this rating are investment banking clients of the Firm.

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