Israel's Defense Industries Sector
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The Israeli defense sector includes government-owned companies as well as publicly traded ones. The main differences between these two groups of companies are highlighted in their financial reports. While the publicly traded defense companies show satisfactory results, the government-owned companies in the sector are characterized by relatively low profitability, liquidity and financial stability. However, those companies enjoy government backing and support that may have a positive effect on their financial condition. With the expansion of Israeli defense exports over the years, the correlation between Israel's defense industries sector and Israel's defense budget has weakened. Nonetheless, the latest conflict in southern Lebanon will probably have a positive effect on the sector, mainly through the need to replenish the Israeli Defense Force's supplies and equipment.

A brief overview
The Israeli defense industries sector includes the production of electronic and electro-optic systems for the enhancement of air, land, and sea military platforms, such as night-vision equipment, unmanned aerial vehicles (UAVs), laser products, air photography systems, data processing and presentation systems, communication systems, and more. In addition, the sector's activity includes the production of aerospace systems and the marketing of components of the "Amos 1" space satellite, as well as the manufacture of munitions, military hardware, and protective gear.

Activity within the sector is carried out by both publicly traded as well as government-owned companies, however most the activity is related to the government owned ones. Accordingly, the aggregate sales data shows that two thirds of the revenues of the Israeli defense goods manufacturing sector, which amounted US$5.3bn in 2005, was contributed by government owned companies. These companies include "RAFAEL Armament Development Authority Ltd.", "Israel Aircraft Industries Ltd." (IAI), "Israel Military Industries Ltd." (IMI), and "ELTA Systems Ltd." The number of employees at these companies reached 21,600 in 2004, and the companies' total assets amounted to NIS 18.3bn. To this figure can be added NIS 7.6bn worth of assets belonging to the publicly traded defense companies. It is important to note that the lion's share of assets among the publicly traded companies, approximately NIS 6.2bn in 2004, is contributed by "Elbit Systems Ltd." and" Tadiran Communications Ltd."
**Massive R&D investments**

One of the notable characteristics of all the companies in the sector, both the publicly held and government-owned companies, is that they all have high R&D expenditures. This is due to the increasing demands, by both the Israeli Ministry of Defense and also by foreign armies, for sophisticated and precise military equipment that provides a comparative advantage. The high level of R&D expenditures is apparently related as well to the general inclination by countries to acquire defense products from domestic companies. Thus, Israeli companies need to be innovative and to reach R&D targets before companies operating in target market countries do.

**Dependence of Israeli government defense spending**

Defense products are marketed in the local market to one primary customer – the Ministry of Defense. This fact creates a strong correlation between the defense budget of the state of Israel and the performance of companies in the sector. Since 2003 the proportion of the defense budget (excluding expenditures that are contingent upon revenues) out of total GDP has been on a downward trend, in accordance with the restrictive fiscal policy enacted by the government, reaching 6.8% in 2006. This figure compares to 8.5% in 2002.

This trend in Israel's defense budget has had a certain negative impact on the performance of companies in the defense sector. However, the government views the local defense industry as a strategic asset, and thus encourages and supports the companies in the sector. Through 2005 total government assistance granted to IAI, IMI, and RAFAEL amounted to US$5.32bn. Consequently, over the years these companies have made a strong contribution towards creating a technology infrastructure and comparative advantage to the entire economy via the defense sector.

The strong correlation between the performance of Israeli defense companies and Israel's defense budget stems from the proportion of business carried out for the Ministry of Defense out of total activity in the sector. In the past, the proportion of
export out of total production by the government-owned defense companies was very low, apparently in order to protect accumulated defense knowledge. Over the years this approach has changed, and these companies have increased exports with the goal of improving profitability, a development that slightly weakens the link between these companies' performances and the defense budget.

**Defense exports as a thriving business**

In contrast, it appears as though most of the output of the publicly traded defense companies is channeled towards export. For example, "Elbit Systems" and "Tadiran Communications" noted in their second quarter 2006 financial results that the proportion of orders from overseas customers amounted to 74% and 72% of total orders at the end of the quarter, respectively. In addition, the President and CEO of "Elbit Systems", Mr. Yossi Ackerman, stressed in the company's quarterly results that "Elbit Systems" is continuing to identify and to penetrate new markets, and to further establish itself in markets in which the company currently operates. This implies an on-going weakening of the link between the company performance and Israel's defense budget.

It is important to note that according to foreign sources Israel is considered one of the top five weapons exporters in the world. According to various estimates, Israeli weapons exports amount to close to US$4.5bn per year. These exports are sent to a wide range of countries, including the US, whose demand for defense equipment accounts for close to 50.0% of global demand. Other export destinations for Israel's defense companies include countries in Southeast Asia, Latin American countries, Turkey, and others. It is worth mentioning that the export's share out of the total Israeli defense sector's sales, that was some 80% in 2005, is high compared to a share of no more than 50% that characterizes other countries. These numbers reflect the foundation of the Israeli defense sector on export, a fact that may justify having such large industry for a relatively small economy.

**Better performance of non-government owned companies**

The differences between the government-owned defense companies and the publicly traded ones can be seen, among other indicators, in the profitability levels of the two groups. Whereas the publicly traded companies are characterized by relatively high operating margins, of around 11.0% on average in 2004 and 2005, the government owned companies recorded in 2004 low operating margins, of approximately 0.5%. This figure represents a decline compared to operating margins of 2.1% and 1.3%, both of which are also considered low, recorded in 2002 and 2003, respectively. The reduction in Israel's defense budget over the last two years is apparently one of the factors that have caused difficulty for these companies.

In addition, the government-owned defense companies are relatively highly leveraged, as shareholder equity represented less than 10.0% of their balance sheets in 2004. This factor reflects a relatively low degree of financial stability, which is emphasized when analyzing the composition of debt that these companies have. These companies' short-term debt, which is generally more expensive and more risky than long-term debt, represented in 2004 approximately 74.0% of the balance sheets of the government-owned defense companies. The proportion of long-term debt in the same year represented only approximately 17.0% of their balance sheets. This is in contrast to the equity levels of the publicly traded defense companies, which in 2004 and 2005
averaged 34.0% of the balance sheet, with short-term liabilities during the same years averaging 40.0% of the balance sheet, and long-term debt averaging 19.0% of the balance sheet. However, working under a government "umbrella" is a factor effectively contributing to the financial stability of the government owned-companies operating in the sector.

Also the level of liquidity of the government-owned companies, as portrayed in "the current ratio", appears lower compared to the liquidity levels that characterize the publicly traded defense companies. In 2004 "the current ratio" of the government-owned companies stood at a relatively low level of 1.0, similar to the level of the previous two years. In contrast, the average "current ratio" of the publicly traded companies stood at approximately 1.40 in 2004 and 2005.

**Government owned companies need substantial reforms**

The supposedly shaky financial condition of the government-owned defense companies, as portrayed in their financial reports, is the result of an on-going business crisis that began at the beginning of the 1990s. The main problems that apparently contributed to the deterioration in the conditions of these companies are related to their rigid business structures, together with high salary outlays, and overcapacity. Government assistance was provided to these companies through, among other things, recovery plans, which were intended to treat the fundamental problems mentioned above. However, according to reports from the Ministry of Finance in the 2006 defense budget proposal, it does not appear as though any of the problems have been solved.

The foundation of the government sponsored recovery plan for 2006 has a goal of privatizing IMI and selling it off in one package to a single investor or a group of investors from Israel or abroad. It appears that this way the company's difficult financial situation, as reflected in, among other things, negative shareholder equity and operational losses in the period from 2002-2004, can be improved.

**The impact of war**

Israel's war with Hezbollah, which ended in a ceasefire in mid-August, will apparently have a positive effect on Israel's defense companies, both in the short-term as well as in the medium-term. This is because the large amounts of munitions used up by the Israel Defense Forces (IDF) during the fighting, and the accelerated time period in which weapons reached their useful lifespan as a result of the fighting, will obligate the IDF to replenish its supplies and equipment. Moreover, as a result of lessons learned, the inclination to develop new technologies, and to equip the IDF with these new technologies, will increase in the coming years.

It is currently estimated that IDF's expenditures as a result of the war will amount to approximately NIS 8.0bn. Approximately one-half of this is supposed to be channeled towards acquisitions in Israel, and spread out across the period of more than one year. The implications for the medium-term include the expectation for a change in the downward trend of the defense budget, which started in 2003, and for an increase in defense expenditures in the coming years, amounting to approximately NIS 2.0bn per year. This development is likely to lead to a parallel increase in orders by the IDF from Israeli defense companies.
An additional consequence of the war on the defense companies is related to the marketing area. By the battlefield usage of Israeli-made fighting systems, the advantages and the high operational abilities of these systems will be highlighted. Therefore, an increase in orders from foreign countries and armies for Israeli made military equipment may be expected in the medium-term.

Together with the positive economic effects of the war on Israel's defense sector, just like other sectors that have factories in the northern part of the country, the defense sector also suffered certain damage due to the closure of factories or due to reduced operations. This development was highlighted by comments made by IMI's CEO, which were published in the media and related to the closure of the company's factory in Kiryat Shmona during the time of the fighting.

Another temporary negative impact is related to the delay in the order of weapons by foreign customers (primarily Europeans) during the fighting, as reported by "Tadiran Communications" in its second quarter 2006 results. However, it is important to point out that these negative effects on the sector appear to be negligible compared to the immediate and future positive economic impacts of the war on Israel's defense industries.

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