Elbit Systems Ltd.
Edited Conference Call Transcript
August 15, 2023

Operator: Ladies and gentlemen, thank you for standing by. Welcome to Elbit Systems' Second Quarter 2023 Results Conference Call. As a reminder, this conference is being recorded. You should have all received by now the company's press release that is available in the news section of the company's website at www.elbitsystems.com.

I would now like to hand over the call to Mr. Rami Myerson, Elbit Systems' Investor Relations Director. Rami, please go ahead.

Rami Myerson: Thank you, Nathan. Good day everyone, and welcome to our second quarter 2023 Earnings Call. On the call with me today are Butzi Machlis, our President and CEO, Kobi Kagan our CFO and Yossi Gaspar, Senior EVP - Business Management.

Before we begin, I would like to point out that the Safe Harbor Statement in the Company's press release issued earlier today also refers to the contents of this conference call. As we do every quarter, we will provide you with both our regular GAAP financial data as well as certain supplemental non-GAAP information. We believe that this non-GAAP in

formation provides additional detail to help understand the performance of the ongoing business. You can find all the detailed GAAP financial data, as well as the non-GAAP information and the reconciliation, in today’s press release.

Kobi will begin by providing a discussion of the financial results, followed by Butzi who will talk about some of the significant events during the quarter and beyond. We will then turn the call over to a question and answer session.

With that, I would like now to turn the call over to Kobi.

Kobi - please?

Yaacov Kagan: Thank you Rami. Hello everyone, and thank you for joining us today.

The financial results of the Second Quarter of 2023 reflect sustained demand for our solutions, increased production capacity and the gradual easing of supply chain pressures that supported the revenue growth.

The sequential increase in operating profitability provides an encouraging initial indication of the successful implementation of the operational improvement plan. We continue our efforts across the company to improve profitability and cash generation and realize our potential.

Before I discuss some of the key figures and trends in our financial results, I would note that the sale of Ashot Ashkelon to FIMI Opportunity Funds was completed at the end of the second quarter of 2022, and our results in the second quarter of 2023 do not include a contribution from Ashot Ashkelon.

Second quarter revenues increased by 12% to one billion, four hundred and fifty four million dollars compared to one billion, three hundred and three million dollars in the second quarter of 2022, with growth across all business segments.

In terms of quarterly revenue by segment, Aerospace revenues increased by 19% in the second quarter of 2023 compared to the second quarter of 2022, mainly due to Training & Simulation sales in Europe.

C4I and Cyber revenues increased by 1% year over year.

ISTAR and EW revenues increased by 21% mainly due to European

Electronic Warfare sales.

Land revenues increased by 3% mainly due to armored vehicle upgrades and ammunition sales.

Elbit Systems of America revenues increased by 7% in the second quarter due to growth in night vision sales.

Elbit Systems benefits from a diverse geographic revenue base that reduces revenue volatility and supports the long-term sustainability of our business.

In the second quarter, Europe was our largest market contributing 32% of group revenues, North America was 23%, Asia-Pacific 22% and Israel contributed 17% of revenues.

European revenues increased mainly due to growth in training and simulation sales.

Asia-Pacific revenues declined mainly due to lower precision guided munitions sales.

The non-GAAP gross margin for the second quarter was 26.1%, compared to the second quarter of 2022 at 26.5%. GAAP gross margin in the second quarter was 25.6% of revenues compared to 26.1% in the second quarter of 2022.

Second quarter non-GAAP operating income was $112 million or 7.7% of revenues, compared with $103 million or 7.9% of revenues last year.

The sequential improvement in NON-GAAP operating profitability is an encouraging indication of the tangible benefits of the operational transformation plan.

GAAP operating income for the second quarter was $102 million or 7.0% of revenues, versus $115 million or 8.8% of revenues in the second quarter of 2022.

GAAP operating income in the second quarter of 2022 included a capital gain related to the sale of our subsidiary, Ashot Ashkelon Industries as well as the sale of a building in Israel.

The operating expense breakdown in the second quarter was as follows, Net R&D expenses were 6.4% of revenues, versus 7.4% in 2022. Marketing and selling expenses were 7% of revenues, versus 6.4% last year. The positive inflection in global defense budget growth has created multiple opportunities and the increase in Marketing and Sales spend will help to realize the potential these create.

G&A expenses were 5.2% of revenues, compared to 5.6% last year.

Financial expenses were $32 million in the second quarter, compared to $9 million in 2022.Financial expenses in the second quarter were higher as a result of the significant increase in interest rates and higher debt.

Operating cash flow in the second quarter was a $138 million outflow compared to a $169 million outflow in the same quarter last year.

Operating cashflows in the first half of 2023 reflect an increase in inventories to support revenue growth and delays of payments from the Israeli Ministry of Defense. We do not believe there is risk to receiving these outstanding payments and we continue to work with our customers to expedite these payments. Our operational improvement plans should also support our efforts to improve cash generation in the medium term.

We recorded a tax expense of $9 million in the second quarter, compared to $13 million in 2022.The effective tax rate in the second quarter was 13.6%, a similar level to the tax rate in 2022.

Our Non-GAAP diluted EPS was $1 and 57 cents in the second quarter compared with $1 and 73 cents in 2022. GAAP diluted EPS was $1 and 40 cents for the second quarter compared with $1 and 82 cents in 2022.

Our backlog of orders as of June 30, 2023 was $16.1 billion, $2 billion higher than the backlog at the end of the second quarter of 2022. Approximately 49% of the current backlog is scheduled to be performed during the remainder of 2023 and 2024, and the rest is scheduled for 2025 and beyond.

The Board of Directors has declared a dividend of 50 cents per share.

I will now turn the call over to Mr. Machlis, Elbit's CEO.

Butzi, please go ahead.

Bezhalel Machlis: Thank you Kobi. The second quarter results demonstrate the successful implementation of Elbit Systems long-term strategy. Revenue growth accelerated in the quarter as we started to benefit from the increased capacity, the easing of supply chain bottlenecks and continued demand for our portfolio of solutions from customers around the world. The operational improvement plan that we discussed with you in the past is starting to deliver tangible results with a sequential increase in operating profitability.

Financial expenses in the first half reflect the increase in interest rates and higher debt due to delayed payments from customers.

In recent years, we have leveraged a strong balance sheet to overcome the challenges presented by COVID-19 and supply chain disruptions to sustain deliveries to our customers. The increased interest rate environment has raised our cost of financing. As part of our operational improvement plans, we are working to improve cash generation and reduce financial leverage. This should contribute to a reduction in finance expenses over time.

I would like to review how the financial results in the second quarter reflect the successful implementation of Elbit Systems' long-term strategy.

The growth in European revenues in recent quarters is a direct result of our multi-year investments in building a multi domestic footprint across Europe.

Elbit Systems identified the long-term potential across European markets as part of our strategic planning. Many European Governments had significantly reduced the scale of their military forces following the end of the Cold War. This also resulted in reduced procurement from the domestic defense industrial base and the investment in defense related research and development.

At Elbit Systems, we identified the opportunity this provided to supply our advanced solutions to customers across Europe, by building domestic subsidiaries with engineering, manufacturing and support capabilities, transferring our cutting edge IP and solutions and adapting them to the requirements of the different European customers.

We established domestic subsidiaries and partnerships with local companies across Europe, from Sweden to Greece and from the UK to Romania. When we were ramping up our investment across Europe, other defense companies were shrinking their exposure and reducing investment.

The Russian invasion of Ukraine was a wakeup call for many European countries, that have subsequently decided to ramp up their defense spending, recapitalizing their military forces and the domestic industrial base.

Following years of investment in our multi-domestic presence across Europe and a portfolio of leading and relevant solutions, Elbit Systems has started to benefit from the growth in European defense spending, as demonstrated by the growth in recent quarters as well as the orders we announced for Watchkeeper-X UAVs from Romania and Airborne EW systems from Germany in recent months.

In 2018 we acquired IMI from the Israeli government and integrated it into our Land segment. IMI has two major product areas, active protection systems for armored vehicles and a broad portfolio of munitions. The strategic rationale for the acquisition was the potential we identified for the significant value creation we could generate by combining our legacy seeker technologies with IMI's munitions portfolio to develop a range of air and ground launched precision guided munitions.

As part of the acquisition, we committed to building a brand new munition production, development and testing facility in the south of Israel.

The Russian and Ukrainian militaries are consuming thousands of rounds of munitions every day of the current conflict and militaries around the world have realized the critical importance of munition production capacity and stockpiles.

We are benefitting from the strong demand for our portfolio of munitions and launchers from customers around the world. In July we announced a $60 million contract to supply Artillery Shells to the Israeli MOD. This order follows multiple orders for our PULS rocket launchers and precision rockets, artillery solutions and tank munitions.

Demand for platform protection solutions has also increased and we have received expressions of interest from customers around the world in our Iron Fist active protection system.

The strong demand for the Land segment's solutions validates the strategic rationale around the acquisition of IMI and our M&A processes. As part of our strategic processes, we regularly review our portfolio to identify capability or technology gaps that we can fill through M&A. We have spent more than a billion dollars in recent years on a series of acquisitions that are delivering tangible returns, including IMI, Night Vision and Sparton.

We also review our existing portfolio to identify the business units that are no longer relevant to our strategy and could be more successful under different ownership. When we identify these businesses, we explore opportunities to sell them. In 2022 we sold Ashot Ashkelon to FIMI opportunity funds and Ferranti Technologies Power and Control business in the UK to TT Electronics.

This is the preferred option but if we are not able to find a buyer we close the business as part of our strategy to optimize our business portfolio.

Last week, following our AGM, David Federmann was appointed Chair of Elbit Systems' board of directors replacing Michael Micky Federmann, who will remain on the board as a director. Micky was appointed as Chair of the board in July 2000 following the merger between El-Op and Elbit Systems.

In 2000 Elbit Systems reported annual revenues of $591 million and a backlog of $1.4 billion. In 2022 Elbit reported annual revenues of $5.5 billion, a 900% increase and a backlog of $15.1 Billion that increased to $16.1 Billion at the end of the second quarter.

Revenues and order backlog growth during Micky's tenure as chair outstripped global defense budget growth and Elbit Systems has become one of the leading defense companies in the world. In 2023 Elbit Systems was ranked 21st in Defense News Top 100 global defense companies.

On behalf of Elbit's employees, I would like to thank Micky for his leadership and I would like to wish David Federmann success in his role as Chair of the board of directors.

And with that, we will be happy to take your questions. Operator?

Operator: Thank you, ladies and gentlemen. At this time we will begin the question-and-answer session. If you have a question, please press star-one. If you wish to cancel your request, please press star-two. If you are using speaker equipment, kindly lift the handset before pressing the numbers. Your questions will be polled in the order they are received. Please stand by we poll for your questions.

The first question is from Sheila Kahyaoglu from Jefferies. Please, go ahead.

Sheila Kahyaoglu: Good morning, guys, and thank you. Good quarter. I just wanted to ask a few questions, if that's okay. You talked about it in the prepared remarks a little bit, but obviously, Europe was really strong in the quarter. And Israel and North America weaker. How should we think about the cadence of growth across geographies from here? And any color on the regional mix in the backlog?

Bezhalel Machlis: Hello Sheila. We see a big potential ahead of us, the funnel of opportunities we deal with this is quite big. And we see many opportunities in all domains, actually. And we expect to see growth in Europe, and we also expect to see growth in Asia Pacific, as well as in the US. Here in Israel, we are waiting for a five-year plan of the Israeli MoD, which should take place around the end of this year. After it will take place, I believe that we'll be able to get more orders from the MoD. And Latin America is shrinking. And I don't expect big orders from this region in the near quarter or in the near future. And this is it, more or less.

After the Abraham Accords, I would like to say that there are more opportunities for us in the Middle East. We have a subsidiary in the UAE, and we believe that is quite a big potential for us in this market as well. Our diverse presence is a stabilizing factor for future growth.

And I believe that the strategy of Elbit, which includes two main pillars. One is our very wide portfolio, and the other one is being a global company with many subsidiaries all around the globe, is proving itself. And I expect to see additional growth in revenues as well as in backlog.

Sheila Kahyaoglu: Great. And might I ask one or two more if that's okay. When we think about the European market, obviously, it's been fairly good again. Is there a different strategy there? You mentioned, how far your coverage is, in your prepared remarks, in Europe, like how you sell in Europe versus how you sell in North America and Asia.

Bezhalel Machlis: We continue to enhance our local presence in Europe. We have many subsidiaries. We have subsidiaries in the UK. We just inaugurated a month ago, another facility for Elbit in the UK. We are enhancing our position in Germany, we inaugurated another facility in Germany, in Ulm. We have subsidiaries in Sweden, we have subsidiaries in Belgium, we have subsidiaries in Switzerland, we have subsidiaries in Austria, as well as in Romania. And we are working hard with our customers to improve our local position in the continent because that's our strategy.

With regards to the US, as you know, we acquired two companies in the US recently. We acquired Sparton and we acquired Night Vision. And we are very happy with these acquisitions. Actually, we see a lot of interest for our portfolio in the US market, and we expect additional growth in the US.

Sheila Kahyaoglu: Great. And then one more, if you don't mind, on the free cash flow, you know, continued usage. How much of that 300 million or so of usage in the first half will reverse in the second? And how much is tied to Israel specifically on the working capital?

Kobi Kagan: Hi, Sheila, this is Kobi. We expect that the second half will be a positive one. We see some delays in payments from the Ministry of Defense here in Israel. But we don't expect that those delays will cross the year end. So we expect that in the second half, the Ministry of Defense will pay all the outstanding receivables that we are currently missing in our cash flow position.

Sheila Kahyaoglu: Great. Thank you.

Operator: The next question is from Pete Skibitski of Alembic Global. Please, go ahead.

Pete Skibitski: Hello, good afternoon, everyone.

Pete Skibitski: Butzi, I did want to follow up on Sheila's question with regard to Europe, because, you know, the revenue there has been incredible, right? Up 40% last year and roughly 60% here through the first half.

So very impressive. And just from the perspective of playing the role of a devil's advocate, as they say, how much concern do you have, about the willingness of European governments to continue to fund defense budget increases? Just in light of the inflationary pressures there. There are some macroeconomic concerns there. Do you think the governments will – will follow through with budget increases the next few years, you know, in the current kind of macroeconomic backdrop that they find themselves in?

Bezhalel Machlis: Thank you, Pete. From what I understand, all European countries, understand right now, they need to spend 2% of GDP for defense. Some countries are even investing more than that. And this is not for the short term, it's for the long term. And many countries also understand, as I discussed earlier, that they need to build local capabilities, and they want to reduce their dependency on external sources.

And this is exactly the Elbit strategy. So, I do not see a decline in defense spending in the near term or even in the medium term, in Europe. I also want to add to this that there is actually huge demand to increase inventories for munitions as well as for additional staff and products in Europe.

Actually, many countries are left without a critical mass of ammunition, of tanks, of artillery pieces, of UAVs, of communication equipment. So it will take years, to fill all this storage again, with the required quantities. So I don't see a shift or a change in the demand in the market.

I also want to add that the backlog we have, in Europe as well as in other places, is not just for the coming quarters. It's a long-term backlog, and I'm sure it will yield additional revenues in Europe.

We see a growing demand for guided munitions, for UAVs, for EW systems, for command and control and communication solutions, for anti-drone solutions, all over the continent, as results of the conflict in Ukraine, and I don't expect it to change in the near future.

Pete Skibitski: Okay. That's very helpful. I appreciate all the color on that. Let me ask one about Israel now, and not to go down a political path from thousands of miles away here. But can you briefly give us a sense of, let's call it, the recent social unrest that we've heard about. Do you expect that to have any impact upon the MOD's budget processes or contracting activities?

Bezhalel Machlis: No. Without entering into politics, as you said, I don't expect an impact, in Israel, there is an approved budget. And as a result of that, there is a process which is taking place right now in Israel to build a five-year plan for the IDF. This plan should be concluded around the end of this year, and then we expect to get orders. I don't see any change in that.

Pete Skibitski: Okay. Okay. I appreciate it. Last one for me. You know, so earlier this year, we sort of stopped talking about Phantom stock options expense because the shares had retreated a bit. But of course, now the shares are up about 25% year-to-date. So, do we have to start thinking again about stock option expense as a headwind to margin, at some point? Could you give us some color there?

Kobi Kagan: Thank you Pete, for the question. As you know, the Phantom stock option plan is a specific plan, and the terms of the option plan are scheduled so that all of the payments of this stock option plan will be concluded this year. And we don't expect any other cost on the P&L from the stock options, not this year and not in coming years.

Pete Skibitski: Okay, that's great. Thank you, guys.

Bezhalel Machlis: Thank you.

Operator: If there are any other additional questions, please press star-one. If you wish to cancel your request, please press star-two. Please stand by we poll for more questions.

The next question is from Ella Fried of Bank Leumi. Please, go ahead.

Ella Fried: Hey, good afternoon. Well, it seems that you managed to tackle the supply chain challenges, but also the cost of increasing inventories, correct me if I'm wrong. And this increase in inventories is actually a follow-up question on the cash flow. How do you plan when the supply isn't so smooth as it used to be, to face this challenge of inventories with your huge growth?

Bezhalel Machlis: Hi Ella. Good afternoon. The supply chain, as we predicted, most of the obstacles we faced during COVID are over, going down, not all of them yet, but it's much better than it was a year ago, or even a quarter ago. And, so this should have a positive effect on inventories. In the past, because of the uncertainty we faced during COVID, we had to buy more inventories in order to ensure deliveries, to our customers. Today, we are able to return back to the previous procedures, and we don't have to maintain large stocks because of supply chain issues, and this is more or less coming back to normal.

The company is growing quite a lot, as you all see, and in order to meet the demand, and in order to meet the commitments we have, we need to acquire more stocks, in order to be able to deliver the goods to the customer.

And that's actually what you see in the results. We continue to work hard to reduce inventories. As I said, the fact that supply chain is more normal right now will help us to do so. And this is an important effort in the company which take place these days.

Ella Fried: Well, it seems that the headwinds of supply chain actually was replaced in the kind of decreasing impact of the cost of labor and delays. And the question is, do you think it will follow us into 2024? And how are you handling it?

Bezhalel Machlis: No, with regards to workforce, it's the contrary, Ella. As you know, the company has grown a lot, and we still have to recruit additional people. It was quite challenging during the COVID time.

Right now, it's easier for us to find good talent in the country. So, it's easier to find good people, and also the salaries are more reasonable. So, this factor is also easing. And I don't see major challenges for us now to recruit good talent in the country with reasonable costs. So it wasn't the case a year ago. And right now, it's much better.

Ella Fried: So, I think the next question is for Kobi. So how should we look at the profitability in 2024 in comparison to this quarter? I mean, do we expect a very substantial improvement, I remember that you told us that we should expect a quarter-after-quarter increase and improvement. But when I'm looking at this quarter, with the impact of higher financial expenses, how should we be looking at 2024, in comparison to this quarter?

Yaacov Kagan: Hi Ella, and thank you for the question. As you know very well, we don't provide guidance. So as Butzi mentioned before, we are looking for a sequential improvement in non-GAAP operational profitability. We promised that, and we think we kept our word. And there is improvement, a gradual improvement in non-GAAP operational profitability, and the company is making doing a lot of efforts to achieve this improvement.

For the second half of your question, as to financial cost, we see a dramatically increased neighborhood of interest rates, and we face higher interest rates. Our rating is excellent. But as you know, the base interest rates, the SOFR, is now 5.5%, compared to almost zero a year ago. So, with almost the same debt, we face higher financial costs, and this is the new reality. And as we mentioned, we are looking at improving cash generation to reduce our financial debt.

Bezhalel Machlis: And we are committed also, as mentioned earlier, to continue to improve our operational profit, our non-GAAP operational profit. As you saw in the last few quarters. It will continue in the future as well.

Ella Fried: Okay, thank you. And good luck. And, maybe a not very politically correct question. But can you tell us what actually happened with Denmark? Because there are so many publications about it and does it impact, first and most important for Elbit, does it impact the order? And the second question, is it relevant in any way to Elbit's position?

Bezhalel Machlis: So the answer is very, very clear and easy. It has nothing to do with Elbit. There was an urgent requirement, the Danish MoD came here and took a decision to acquire our solutions. We received an order, this order is valid. The criticism, which is taking place in Denmark right now, is not on Elbit, it is an internal process in Denmark. We delivered already some equipment to them. And this program is valid, is active. And we believe that we'll get additional orders from them, I hope, in the future. And, as you know, we won rocket launcher orders, not just in Denmark, also in the Netherlands, just recently, a 300 million dollar contract. And I foresee big opportunities for us for guided munitions in Europe.

Ella Fried: Thank you very much, and congrats on the improvement in the quarter.

Operator: The next question is from Elad Kraus of Meitav. Please, go ahead.

Elad Kraus: Thank you very much. First of all, good afternoon. Well, you've answered most of my questions, but I do have still one. Do you see any change in the competition right now can affect the company's 2024, 2025 margins? Maybe to be higher or lower than today?

Bezhalel Machlis: Of course, there is competition in the market, but I believe that the depth of the portfolio we have, and the global positions we have are very unique. And customers are looking to get mature equipment, and to get it as soon as possible, and to get it from local providers. And we are unique with our offering. Of course, it gives us an advantage in the market. But, of course, there is still competition. It depends on each segment. In each segment, it's a different type of competition, but there aren't many companies, who have a portfolio, and a market position like us.

Elad Kraus: So, if this is the case, should we expect to the same margins we saw in the last couple of years?

Bezhalel Machlis: I can tell you that the gross profitability of our backlog is higher than the gross profit of the revenues that you see in our quarterly results. And because of that, I am able to commit that our profit in the future will be higher.

Elad Kraus: Thank you very much.

Bezhalel Machlis: You're welcome.

Operator: The next question is from Boaz Ben-Shitrit of Altshuler. Please, go ahead.

Boaz Ben-Shitrit: I have three little references that I wanted to ask. First of all, the delayment of payments from the Israeli Defense Force. Are you getting any compensation for that, because of bearing the cost? And the other side of it is if I'm looking forward, I see higher interest rates. What can we expect coming next year? Is it similar to this past six months, or more, even? And on your future contracts, mainly the backlog, is it linked to interest rates, or inflation? Because the world changed in the past year, and your backlog is about two, or maybe three years long. So how will we see this in the coming quarters? Thanks.

Yaacov Kagan: Hi, Boaz. For your first question, we are negotiating with the Ministry of Defense, and I would not like to disclose the details of the negotiation. And as I mentioned before, we expect all the payments to be made until the end of the year. As to the second questions, the second question, we see, probably, at the same level of this quarter, financial expenses for the next quarters, as the interest rate levels, have reached a peak, and we don't foresee an additional increase in interest levels. And, we are expecting, with cash generation, to decrease the debt level. So we hope to see some decrease in financial expenses.

And as for price-adjusted contracts, we have some of our contracts which are price adjusted, and some of the contracts which are fixed contracts. We are subject to competition. And of course, part of the competition is determining the competition rules, and part of our contracts are price adjusted and part are not.

Operator: The next question is from Pete Skibitski of Alembic Global. Please, go ahead.

Pete Skibitski: Yeah, I did have one follow-up, but I think it's largely been asked, for Kobi. So Kobi, if cash collections do improve in the second half, it sounds like you intend to pay down some of the short-term debt that you raised this quarter. But what would you guys prioritize, debt pay down over M&A, if an attractive deal comes your way? Or are you more flexible in that sense, for capital deployment?

Yaacov Kagan: So, we are known for very strict capital deployment, and we know how to deploy our capital. We do that very diligently. And as to specifics, we don't have any specifics on big M&A transactions. We are always looking for opportunities. As we mentioned before, we look for M&A to increase our portfolio, or to increase market share. So there is always a search in the company. And as we have proven in the past, we know our way around M&A transactions. And of course, if we have positive cash generation, we will decrease our short-term debt. That's for sure, Pete.

Pete Skibitski: Okay. Thank you very much.

Operator: There are no further questions at this time. Before I ask Mr. Machlis to go ahead with his closing statement, I would like to remind participants that a replay of this call will be available two hours after the conference ends. In the US, please call 1-888-782-4291. In Israel, please call 03-925-5900. And internationally, please call 972-3-925-5900. A replay of the call will be also available on the company's website, at www.elbitsystems.com. Mr. Machlis, would – would you like to make your concluding statement?

Bezhalel Machlis: I would like to thank all our employees for their continued hard work and contribution to Elbit Systems' success. To everyone on the call, thank you for joining us today and for your continued support and interest in our company. Have a good day, and goodbye.

Operator: Thank you. This concludes the Elbit Systems second quarter 2023 results conference call. Thank you for your participation. You may now go ahead and disconnect.

[End of conference call.]