Elbit Systems Ltd.
Conference Call
March 29, 2022
Edited Transcript

Operator: Ladies and gentlemen, thank you for standing by. Welcome to Elbit Systems Fourth Quarter 2021 Results Conference Call. All participants are at present in listen-only mode. Following Management's formal presentation, instructions will be given for the question-and-answer session. As a reminder, this conference is being recorded. You should have received by now the company's press release that is available in the news section of the company's website, www.elbitsystems.com. I would now like to hand over the call to Rami Myerson, Elbit Systems Investor Relations Director. Rami, please go ahead.

Rami Myerson: Thank you, Operator. Good day, everyone, and welcome to our fourth quarter and year-end 2021 earnings call. On the call with me today are Butzi Machlis, our President and CEO; Yossi Gaspar, our Chief Financial Officer; and Kobi Kagan, who will take over from Yossi on April 1st.

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 information 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.

Yossi 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.

Earlier today we hosted an investor conference at the Tel Aviv Stock Exchange. The recording of the event will be available in the Investor Relations section of our website, www.elbitsystems.com. Investors and analysts who wish to ask questions related to topics discussed in the investor conference are welcome to present their questions during the Q&A session of this call. With that, I would like now to turn the call over to Yossi. Yossi, please.

Yossi Gaspar: Thank you Rami. Hello everyone, and thank you for joining us today. As Rami mentioned on April 1st, Kobi Kagan will take over as Chief Financial Officer. I will continue as Senior Executive Vice President Business Management and will retain among other corporate wide duties the responsibility for capital markets and investor relations, working together with Rami. I look forward to introducing Kobi to investors and analysts over the coming weeks and months. I would like to take this opportunity to wish Kobi good luck and success in his new role.

The 2021 annual results reflect the very positive transformation of Elbit over the last few years, during which we successfully moved up the value chain from a provider of products and systems to a provider of comprehensive solutions. The Hellenic Flight School contract is a good example of a comprehensive contract as a result of this transformation, as well as the growth in order backlog and revenues that indicate the strong demand for our systems and solutions.

We continue to implement mitigation plans to limit the impact of the strengthening Israeli shekel and the competition for talent. In the short term, these include the adoption of rolling currency hedge policy and efficiency measures. Over the longer term, we plan to expand our engineering and manufacturing footprint in high quality low cost countries to better balance our currency exposure and reduce risk. The introduction of a company-wide ERP system will support these.

I will now highlight and discuss some of the key figures and trends in our financial results. Fourth quarter revenues were 1 billion 494 million dollars and increased by 8 and a half percent year over year. For 2021 as a whole, our revenues were 5.3 billion dollars versus 4.7 billion dollars last year, representing growth of 13%. A major part of the growth was organic in addition to the contribution from Sparton, which we acquired in the second quarter of 2021.

In terms of annual revenue breakdown across our areas of operation, airborne systems accounted for 38% of total annual revenues and increased year-over-year mainly due to airborne precision-guided munition sales. Land system sales accounted for 24% of total revenues, a similar level of revenues to 2020. C4ISR at 26% of revenues increased year-over-year, primarily due to the acquisition of Sparton and unmanned systems sales. Electro-optics accounted for 9% of total sales, and other sales were 4% of revenues and increased year-over-year mainly due to the growth of our US medical instrumentation subsidiary.

Our diverse geographic revenue base is important to the long-term sustainability of our business. In 2021 North America contributed to 31% of our revenues, Asia Pacific 27%, Israel was 21%, and Europe 17%. The growth in US was mainly due to the Sparton acquisition and sales of commercial medical instrumentation. Asia-Pacific revenues increased mainly due to sales of precision-guided munitions and unmanned airborne systems. The growth in European revenues was primarily to training and simulation sales.

Elbit has always viewed Europe as a strategically important market with significant potential. We have made significant investments to expand our positions across the continent. Since 2014, our European revenues increased by more than 90%, significantly faster than the growth of the European NATO members' defense budgets in the same period. Almost all of this growth was organic. Following many years of investment, we believe Elbit is well positioned to benefit from the planned increase in European defense spending.

Compared with the fourth quarter last year, we saw strong growth in Asia Pacific that more than offset losses in certain other markets. This reflects the phasing of programs and trends to fluctuate from quarter to quarter. We believe the longer term trends are more representative of our business.

The non-GAAP gross margin for the fourth quarter was 25.5%, compared with the fourth quarter of 2020 at 26.3%. For the full year of 2021, non-GAAP gross margin was 26.2% compared with 26.7% last year. Non-GAAP gross margin in 2021 reflect an unfavorable program mix as well as the impact of a strong shekel versus the US dollar compared to 2020.

GAAP gross margin in the fourth quarter of 2021 was 25.1% of revenues compared with 26% in the fourth quarter of 2020. GAAP gross margin in 2021 was 25.7% compared with 25% in 2020. GAAP gross profit in 2020 included expenses of approximately 60 million dollars as a result of a non-cash expense related to inventory write-offs, and asset impairment, mainly in our commercial aviation activities, due to the impact of the COVID-19.

The fourth quarter non-GAAP operating income was 120 million dollars or 8% of revenues, compared with 113.8 million dollars or 8.3% of revenues last year. Margins declined slightly year over year due to lower gross margins and higher G&A expenses in the quarter. GAAP operating income in the fourth quarter was 107.3 million dollars versus 104.6 million dollars in the fourth quarter of 2020. Non-GAAP operating income in 2021 was 451 million dollars or 8 and a half percent of revenues compared with 390 million dollars or 8.4% of revenues last year. GAAP operating income was 490 million dollars versus 326 million dollars last year.

The operating expense breakdown in 2021 was as follows: Net R&D expenses were 7.5% of revenues versus 7.7% in 2020. Marketing and Selling expenses declined to 5.5% of revenues versus 6.2% last year. G&A expenses were 5.1% of revenues compared with 4.8% last year. The increase in the G&A expenses was mainly related to the Sparton acquisition.

While we do not provide forward guidance, I would note that the recent rise in the share price could lead to an increase in expenses in 2021 and on, related to employee share price linked compensation plans.

Financial expenses were 20 million dollars in the fourth quarter compared with 33 million dollars in 2020. The lower level of financial expenses were mainly due to exchange rate differences related to the reevaluation of lease liabilities in the quarter. Financial expenses in 2021 were 40 million dollars compared to 71 million dollars last year. We recorded a tax expense of 92.2 million dollars in the fourth quarter compared with 1.9 million dollars in 2020.

Taxes on income in the fourth quarter included a one-time expense of approximately 80 million dollars related to the release of exempt earnings. Please see our press release published on the 22nd of February this year.

We have excluded this expense from our non-GAAP net income due to the non-recurring nature of this expense. Including this extraordinary expense, the effective tax rate in 2021 was 34.3% compared with 13.9% in 2020.

Our non-GAAP diluted earnings per share was 2 dollars and 14 cents in the fourth quarter, and 8 dollars and 30 cents for the full year of 2021. GAAP diluted EPS was 18 cents for the fourth quarter and 6 dollars and 20 cents for the full year of 2021.

Our backlog of orders as of December 31st, 2021 was 13.7 billion dollars, 2.6 billion dollars higher than the backlog at the end of 2020. Approximately 60% of the current backlog is scheduled to be performed during 2022 and 2023, and the rest is scheduled for 2024 and beyond. The percentage of the short term backlog declined in recent years following the receipt of long term contracts, improving our visibility for the future revenues.

Operating cash flow for the fourth quarter was 260 million dollars compared with 172 million dollars in the same quarter last year. For 2021 as a whole, we reported 417 million dollars of operating cash flow versus 279 million dollars in 2020. Operating cash flow benefited from receipts of delayed payments from the Israeli Ministry of Defense in the fourth quarter as well as growth in advance payments on contract by customers.

The Board of Directors declared a dividend of 50 cents per share for the fourth quarter of 2021. I will now turn the call over to Mr. Machlis. Butzi, please.

Butzi Machlis: Thank you, Yossi. I would also like to wish Kobi and Yossi good luck in their new roles. I look forward to continue working with both of you.

2021 was a solid year for Elbit and the growth in revenues and backlog reflect our strategy that combines strong market positions around the world and a broad portfolio of technological capabilities that we leverage to tailor market leading, relevant and cost effective solutions for our customers.

At our investors' conference today, we discussed this strategy and the investments we made in the past, and continue to make to grow both these market positions and disruptive technologies.

We continue to see good momentum across almost all our end markets, and in recent weeks, we have all heard European and NATO leaders announce plans to dramatically increase defense spending.

Elbit Systems has established subsidiaries in countries across Europe, as part of our strategy to build a global multi domestic company. Our European subsidiaries employ hundreds of employees creating local jobs and supporting domestic supply chains. They provide engineering, manufacturing and support services for domestic and export customers.

Elbit Systems has invested a lot more than just capital to develop these subsidiaries. We have transferred technological IP, business best practices, and provided these subsidiaries with benefit of Elbit's global sales force and footprint.

Our investment in Europe has already generated good returns. Our European revenues have grown significantly faster than European defense budgets in recent years, providing an encouraging indication of both our market position and the demand for our solutions. Sweden provides another example of our strategy. In 2021, we opened Elbit Systems Sweden, following a number of commercial successes. This includes avionics for the Gripen fighter, radios and ammunition for the army, and combat management systems for the Royal Swedish Navy.

The Swedish Prime Minister recently announced plans to increase defense spending to 2% of GDP. I believe Elbit Systems Sweden can provide the Swedish military with a broad range of additional advanced and relevant technological capabilities to help address the increasing threat environment. This is also true for additional European countries with Elbit Systems subsidiaries that have also announced plans to increase defense spending, including Germany, Belgium and Romania.

In 2021, we opened our subsidiary in the United Arab Emirates, and in January this year, Elbit System Emirates received its first contract to supply DIRCM and Electronic Warfare Self-Protection System for the UAE Air Force Airbus A330 Multi-Role Tanker Transport Aircraft.

I am optimistic about the potential for Elbit Systems in the UAE and additional countries that were part of the historic Abraham Accords.

At our investor day in 2021 we presented the maritime market as one of Elbit growth drivers and the investments we have made to develop a range of solutions for this growing market.

Following the progress made over the last 12 months, we decided to highlight our activities in the maritime market at today's 2022 Investor Day. This progress includes the acquisition of Sparton is the US, a contract for our Naval Spectro XR system, as well as contracts for our Seagull unmanned naval vessel.

The 100 million dollar Royal Navy Electronic Warfare contract, our UK subsidiary Elbit System UK received in November, was a significant achievement for both our UK subsidiary and our maritime activities. As part of this contract, Elbit System UK will design and manufacture Maritime EW suites comprised of digital full-spectrum radar electronic support measures and EW command and control systems. These latest generation technologies will enhance the situation awareness and anti-ship missile defense of the Royal Navy ships, improving their capability to exploit the electromagnetic environment.

I believe there is a significant potential for cooperation across Elbit's subsidiaries that operate in the maritime market. Following the acquisition of GTI in Canada in 2018 and Sparton in the US in 2021, Elbit System today is a supplier to the US Navy, the Canadian Navy and the British Royal Navy. These three countries are members of the Five Eyes alliances with Australia and New Zealand.

I am optimistic about Elbit's potential in the maritime market, following the progress we delivered in 2021.

In summary, I believe Elbit Systems investments to build significant market position around the world, and a leading portfolio of technological capabilities will enable us to benefit from future growth in defense budgets.

And with that, I 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. *[pause]* The first question is from Pete Skibitski of Alembic Global. Please go ahead.

Pete Skibitski: Yes, hello, Butzi, Yossi, Kobi and Rami, and good afternoon. Hope everyone is doing well.

Rami Myerson: Good afternoon, Pete.

Pete Skibitski: Maybe we could start off talking about backlog. Backlog in the quarter was fairly flat versus the third quarter. But I'm wondering how the continuing resolution in the United States impacted that. Because the CR was ongoing through the entire December quarter, and really ongoing until only a few weeks ago. So I was just wondering if you saw some order headwinds from the CR in the fourth quarter? And maybe you expect that to continue through the first quarter, given the length of that.

Yossi Gaspar: Hi, Pete, this is Yossi. No, I cannot confirm that we have seen any headwinds. As you know, we have increased significantly, by about two and a half billion dollars, the backlog in this year. A significant part of that came also from the US. There are fluctuations in these incoming orders. However, we are very optimistic when we heard today that the Biden administration has proposed an increase of 4%, of over 30 billion dollars, in the recommended budget for next year. That will definitely be something very positive for us as well.

Pete Skibitski: That is a segue into my next question, because – and you guys alluded to that in your opening commentary. You know, we're seeing certainly higher defense spending in the US now. Certainly in Europe, pretty sizable increases, it sounds like. So, if we put that all together, maybe it's too early, but how are you guys now thinking of your organic revenue growth outlook, maybe through the midterm, given this, you know, pretty strong kind of macro environment we're seeing out there.

Butzi Machlis: Hi, Pete, it’s Butzi. We see a lot of interest in our portfolio and we see the funnel, the potential new business opportunity that we are managing right now, has increased a lot. So I'm – we also got some immediate orders already. We just published last week, a nice contract we got from Sweden, to provide the tank ammunition for the army. So I'm quite optimistic that this funnel will be transformed to growing backlog in the near future as well as in the long future.

Pete Skibitski: Sure, makes sense. And one last one for me, if I could. On the gross margin in the fourth quarter, could you say was, which was more of a headwind in the fourth quarter gross margin, was it, was it the program mix, or was it FX headwind? And maybe you could give us a sense of, you know, if you can reverse those headwinds in 2022.

Yossi Gaspar: Yeah, well, it's a combination of both. And, as you know, Pete, we are working very hard to mitigate these headwinds. On our future planning, we have a very extensive, long term plan to improve profitability in our business, and we are working hard to implement that. The one company I feel, that I mentioned earlier, one of them the reorganization that we did, the synergy that we are building between the various parts of the organization to reduce cost and overheads. All of that is underway with the long term planning. We hope to see some improvements in the midterm future.

Pete Skibitski: Sounds great. So, I won't ask any more questions, but let me just say, congrats on the free cash flow performance this year. It turned out to be, you know, over 90%, one of the, you know, best years I think, over five years or so for Elbit. So, great job there. And thanks for the time, guys.

Butzi Machlis: Thank you.

Yossi Gaspar: Thank you.

Rami Myerson: Thanks, Pete.

Operator: The next question is from Dina Korshunov of Leader Capital Markets. Please go ahead.

Dina Korshunov: Hi, guys. Great talking to you again today. I have a couple of questions. My first question is, regarding the war in Ukraine. Can you please detail what are the immediate and long term effects regarding the supply chains and ongoing operation, and can it escalate to a significant rise in costs or disruption in activity? This is my first question. You can answer, then I will ask the other question.

Butzi Machlis: Hi Dina,

Dina Korshunov: Hi.

Butzi Machlis: I don't see any any effect on supply chain. There is an effect on supply because of COVID, which we found some ways to handle. But I don't see any immediate effect on supply chain, and other cost drivers, which might affect our performance in the future. So I don't see, actually, I see many opportunities related to the Ukrainian war, and for new business for the company.

Dina Korshunov: I understand, thank you. The second question, what are your estimations regarding the future trend in defense budgets, the medium and the long term?

Dina Korshunov: Maybe not in the next year, but, you know, in couple of years?

Butzi Machlis: No, I think that we will see increase in defense spending in this year as well as in the future. Actually, it looks like this war was a wakeup call to NATO and there is a decision to increase defense spending in NATO countries to 2% of GDP. And just yesterday, it was announced that an increase in the defense budget of 4% might take place, which is about an additional 30 billion US dollars. We also see additional growing defense spending also in Asia Pacific, not just in NATO countries. So I believe that this year, as well as in the coming years, we will see growing defense spending all over the globe.

Dina Korshunov: Understand. And in the long term, maybe, I don't know, in 5, 10 years, won't it stop in some point of time?

Butzi Machlis: It's quite, quite difficult to predict what will be in five to six years. But it looks like many countries in Europe took a strategic decision to build strong local defense industries and to support their industries. We heard that Germany, for example, will invest 100 billion euros this year in defense, and we also see a trend to invest most of the budgets locally. And Elbit is very well positioned via our subsidiaries in Europe, as well as all around the globe, to take benefits of this growing investment.

Dina Korshunov: Great, thank you. And my last question, what are the main programs or segment that is expected to rise in the US budgets in 2023 proposal that can influence you the most, or vice versa?

Butzi Machlis: We see additional investment in the naval domain. Growing investments in the naval domain, this was one of the reasons for our strategic decision to invest in this domain. And that's one of the reasons to acquire Sparton, which supplies sonobuoys to the US Navy. And we also see increasing spending for airborne platforms. I assume that based on the last conflict in Ukraine, we will see also increase in the army budget. This year as well as in the near future.

Dina Korshunov: I understand. Thank you, great. Great answers, guys. Good luck.

Butzi Machlis: Thank you.

Rami Myerson: Thanks Dina.

Operator: The next question is from Ellen Page of Jefferies. Please go ahead.

Sheila Kahyaoglu: Hi, good morning, guys. It's actually Sheila on the line. I just wanted to follow up on some of Pete's questions actually. With regards to Europe, can you remind us of your largest exposures there, in terms of on a country basis? I know you mentioned some specific opportunities. But if you could give us a breakdown.

Yossi Gaspar: Could you repeat please?

Sheila Kahyaoglu: Sorry about the background noise. In Europe, can you remind us of your exposure on a country basis? And, you know, how we think about the opportunities actually being accretive in terms of countries?

Sheila Kahyaoglu: It's revenue exposure, in terms of countries, sorry.

Yossi Gaspar: Well, our subsidiaries, our major subsidiaries in European countries, starting with the UK, we have actually, under Elbit UK we have about five various plants that are operating the various business areas that we work on and do business in. We have hundreds of people in these operations.

The other one that worth mentioning is, of course, Germany. We have two operations there. Again, several hundreds of people operating in Germany. When I say operating, then I would say it's manufacturing, it's engineering work, customer relations, customer support, and everything related with the business that we are performing in that country.

We have in Belgium several hundred people, operating in the electro-optics and land systems. Again, developing and manufacturing equipment. We have a relatively significant base in Romania, which is a high quality, low cost territory. We are manufacturing over there are quite a lot of mechanical and electronic assemblies, parts and assemblies. And of course, we have as well, some software capability, to develop software and related with all the engineering work that we are doing. That's in Romania. We have several hundred people over there.

We have in Hungary a subsidiary that is operating in the advanced RF business, including radar systems. We have quite a lot of, quite a lot of people over there.

We have a subsidiary in Sweden, which we established about a year and a half ago, but already received significant contracts for the Swedish Ministry of Defense. And we have the people on site doing, performing these contracts.

Austria is another base of ours. It did start in the past with command control systems but it developed in many other areas as well, like fire control systems, unmanned turrets and unmanned fire control systems and communication. Everything that I mentioned is just – just a part of it. We of course have subsidiaries, maybe at a little bit lower scale, in France. We are doing over there commercial avionics, supporting the local, commercial industry. And we also have subsidiaries in Italy, and other places as well. So quite a lot of spread. In total, I would say, in Europe, we are close or probably over a thousand people that are working for our subsidiaries in this continent.

Sheila Kahyaoglu: Okay, great. Thank you for all that color. And then, maybe, I wanted to ask about free cash flow once again. We get conversion on 62% on adjusted net income and 83 or so on GAAP. I think that there are still customer payments outstanding. Can you maybe remind us of those?

Yossi Gaspar: Oh. Yeah, well, we had a short period of time during which there was no stability in the budget, the whole budget of the country of Israel. With the establishment of the new government, the budget stabilized, was approved. And as part of that budget, the budget for the Ministry of Defense here in Israel was approved, and they have actually paid up all their debt to us and actually continuing on a normal regular basis to pay whatever they have to pay to us. So I would not – I would not look at them as any debt holder for Elbit. From the point of view of inventory, you asked question?

Sheila Kahyaoglu: No, no it was customer payments. It was customer payments, but you could talk about inventory, and that's my last question.

Rami Myerson: Okay. Thank you very much.

Sheila Kahyaoglu: Thank you.

Operator: *[pause]* If there are any additional questions, please press star-one. If you wish to cancel your request, please press star-two. Please stand by while we poll for more questions. *[pause]* There are no further questions at this time. Before I ask Mr. Machlis to go ahead with his conclu– with his closing statement, I'd 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 this call will also be available on the company's website, www.elbitsystems.com. Mr. Machlis, would you like to make your concluding statement?

Butzi Machlis: Thank you. I would like to thank all our employees again 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 Ltd. fourth quarter 2021 results conference call. Thank you for your participation. You may go ahead and disconnect.