

**Elbit Systems Ltd.**  
**Management's Report**  
**For The Quarter Ended March 31, 2008**

**This report should be read together with the unaudited financial statements for the quarter ended March 31, 2008 of Elbit Systems Ltd. ("Elbit Systems" and together with its subsidiaries, the "Company"), the Company's audited consolidated financial statements and related notes for the year ended December 31, 2007, the Company's management report for the year ended December 31, 2007 and the Company's Form 20-F for the year ended December 31, 2006, filed by the Company with the U.S. Securities and Exchange Commission and with the Israeli Securities Authority.**

**Forward looking statements with respect to the Company's business, financial condition and results of operations in this document are subject to risks and uncertainties that could cause actual results to differ materially from those contemplated in such forward looking statements, including, but not limited to, product demand, pricing, market acceptance, changing economic conditions, governmental authorizations, risks in product and technology development, the effect of the Company's accounting policies as well as certain other risk factors which are detailed from time to time in the Company's SEC filings.**

**A. Executive Overview**

**Business Description**

The Company operates in the areas of aerospace, land and naval systems, command, control, communications, computers, intelligence, surveillance and reconnaissance ("C<sup>4</sup>ISR"), unmanned air vehicles ("UAVs"), advanced electro-optic and space technologies, electronic warfare ("EW") suites, airborne warning systems, electronic intelligence ("ELINT") systems, data links, military communications systems and equipment and radios. The Company also focuses on the upgrading of existing military platforms and developing new technologies for defense, homeland security and commercial aviation applications.

The Company provides support services for the platforms it upgrades as well as the systems and products it supplies. In addition, the Company offers a wide range of logistic support services as well as advanced engineering and manufacturing services to various customers, utilizing its significant logistic and manufacturing capabilities. The Company often cooperates with industries in Israel and in various other countries.

The Company tailors and adapts its technologies, integration skills, market knowledge and battle-proven systems to each customer's individual requirements in both existing and new platforms. By upgrading existing platforms with advanced electronic and electro-optic technologies, the Company provides customers with cost-effective solutions, and its customers are able to improve their technological and operational capabilities within limited defense budgets.

The Company operates in a competitive environment for most of its projects, systems and products. Competition is based on product and program performance, price, reputation, reliability, maintenance costs and responsiveness to customer requirements. This includes the ability to respond to rapid changes in technology. In addition, its competitive position sometimes is affected by specific requirements in particular markets.

## **Financial Highlights**

The Company's revenues increased by 52.6% and reached \$616.1 million in the first quarter of 2008, as compared to \$403.6 million in the first quarter of 2007.

Net earnings in the first quarter of 2008 were \$32.2 million (5.2% of revenues) and the diluted earnings per share were \$0.75, as compared to \$19.1 million (4.7% of revenues) and \$0.45 in the first quarter of 2007. Net earnings and EPS increased by 68% and 67%, respectively.

The Company's backlog as of March 31, 2008 reached \$4.92 billion as compared to \$4.62 billion as of December 31, 2007

The Company's cash flow generated from operations in the quarter ended March 31, 2008 was \$65.2 million, as compared to \$86.8 million in the quarter ended March 31, 2007.

The Board of Directors declared a dividend of \$0.20 per share for the first quarter of 2008.

## **B. Recent Events**

- On March 17, 2008 the District Court of Tel-Aviv approved a Settlement Agreement between Elisra Electronic Systems Ltd. and its subsidiaries Tadiran Electronic Systems Ltd. and Tadiran Spectralink Ltd. (collectively "Elisra"), in which the Company holds a 70% ownership interest, and The Phoenix Insurance Company Ltd. (the "Phoenix"). The Settlement Agreement relates to a claim by Elisra for insurance payments for damages caused in a 2001 fire at the manufacturing facilities of Elisra's subsidiaries in Holon, Israel. Under the Settlement Agreement the Phoenix will pay Elisra approximately \$38 million in addition to approximately \$10 million in insurance proceeds already paid. In accordance with the terms of the agreement signed in 2005 between the Company and Koor Industries Ltd. ("Koor") in connection with the acquisition by the Company of Elisra's shares held by Koor, as part of the consideration for the purchase price of the Elisra shares, the Company agreed to pay Koor a portion of any insurance proceedings received as a result of the claim against the Phoenix. Accordingly, as a result of the Settlement Agreement, the Company will pay Koor a sum of approximately \$13 million.
- On March 24, 2008, the Company announced that it will supply Skylark® I UAV systems to France's Special Forces, as it won a tender involving 10 of the leading UAV manufacturers worldwide. This contract marks Elbit Systems' first UAV contract with France.
- On April 2, 2008, the Company was listed as the top ranked "Best Government Contractor Ethics Program for a Foreign Supplier" for its ethics and compliance initiatives in the 2008 U.S. Government Contractor Ethics Program Ratings released by the Ethisphere Institute.
- On April 9, 2008, the Company announced that its wholly-owned subsidiary Elbit Systems Electro-Optics Elop Ltd. ("Elop") was selected by Lockheed Martin Aeronautics to supply new generation Head-Up Displays (HUDs) for the new F-16 aircraft. The multi-year project is a continuation of ongoing cooperation between the two companies in the area of HUDs for F-16 aircraft. An initial order valued at approximately \$3.8 million has been placed. The full potential value of the master purchase order is dependent on the level of future F-16 sales.

- On May 5, 2008, the Company announced that its wholly-owned subsidiary, Tadiran Communications Ltd. (“Tadiran”), received a \$127 million contract to supply tactical communications radio equipment and systems from a European customer. The systems include high frequency (HF) and very high frequency (VHF) tactical radio equipment designed for use by ground forces for data transfer and voice communications. The project will be performed over a 17-month period.

**C. Backlog of Orders**

The Company’s backlog of orders as of March 31, 2008 reached \$4,922 million, of which 68% were for orders outside of Israel. The Company’s backlog as of December 31, 2007 was \$4,624 million, of which 70% were for orders outside of Israel.

Approximately 69% of the Company’s backlog as of March 31, 2008 is scheduled to be performed in the following three quarters of 2008 and during 2009. The majority of the 31% balance is scheduled to be performed in 2010 and 2011.

**D. Critical Accounting Policies**

The Company’s significant accounting policies are described in Note 2 to the audited consolidated financial statements for the year ended December 31, 2007. See also the Company’s management report for the year ended December 31, 2007.

The Company adopted Statement of Financial Accounting Standards No. 157, The Fair Value Measurements, which defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements, as of January 1, 2008.

## E. Summary of Financial Results

The following table sets forth the consolidated statements of operations of the Company and its subsidiaries for the three-month periods ended March 31, 2008 and March 31, 2007. The financial statements of the Company in the three-month period ended March 31, 2008 include consolidation of 100% of Tadiran's financial results. In the three-month period of ended March 31, 2007, 42% of Tadiran's results is included as equity in net earnings of affiliated companies and partnership, net of amortization.

	For the three months ended			
	March 31			
	2008		2007	
	\$	%	\$	%
	(In thousands of U.S. dollars, except per share data)			
Total revenues	<b>616,063</b>	100.0	<b>403,600</b>	100.0
Cost of revenues	<b>447,710</b>	72.7	<b>300,062</b>	74.3
Gross profit	<b>168,353</b>	27.3	<b>103,538</b>	25.7
Research and development (R&D) expenses	<b>45,906</b>	7.5	<b>29,699</b>	7.4
Less – participation	<b>(7,871)</b>	(1.3)	<b>(5,606)</b>	(1.4)
R&D expenses, net	<b>38,035</b>	6.2	<b>24,093</b>	6.0
Marketing and selling expenses	<b>49,664</b>	8.1	<b>32,371</b>	8.0
General and administrative expenses	<b>32,149</b>	5.2	<b>20,318</b>	5.0
	<b>119,848</b>	19.5	<b>76,782</b>	19.0
Operating income	<b>48,505</b>	7.8	<b>26,756</b>	6.7
Finance expenses, net	<b>(4,600)</b>	(0.7)	<b>(2,928)</b>	(0.7)
Other income, net	<b>4,096</b>	0.7	<b>113</b>	-
Income before taxes on income	<b>48,001</b>	7.8	<b>23,941</b>	6.0
Taxes on income	<b>7,922</b>	(1.3)	<b>6,733</b>	(1.7)
	<b>40,079</b>	6.5	<b>17,208</b>	4.3
Minority interest in gains of subsidiaries	<b>(10,491)</b>	(1.7)	<b>(1,509)</b>	(0.4)
Equity in net earnings of affiliated companies and partnership	<b>2,565</b>	0.4	<b>3,400</b>	0.8
Net earnings	<b><u>32,153</u></b>	<u>5.2</u>	<b><u>19,099</u></b>	<u>4.7</u>
Diluted earnings per share	<b><u>0.75</u></b>		<b><u>0.45</u></b>	

## **Revenues**

The Company's sales are primarily to governmental entities and prime contractors under government defense programs. Accordingly, the level of the Company's revenues is subject to governmental budgetary constraints.

The Company's consolidated revenues increased by 52.6%, from \$403.6 million in the first quarter of 2007 to \$616.1 million in the first quarter of 2008.

The following table sets forth the Company's revenue distribution by areas of operation:

	Three-Month Period ended			
	March 31, 2008		March 31, 2007	
	\$ millions	%	\$ millions	%
Airborne systems	155.3	25.2	151.7	37.6
Land systems	156.0	25.3	81.5	20.2
C <sup>4</sup> ISR systems	164.5	26.7	86.9	21.5
Electro-optics	88.1	14.3	52.3	13.0
Other (mainly non-defense engineering and production services)	<u>52.2</u>	<u>8.5</u>	<u>31.2</u>	<u>7.7</u>
Total	<u>616.1</u>	<u>100.0</u>	<u>403.6</u>	<u>100.0</u>

The changes in revenue distribution by areas of operation were the result of ordinary quarterly fluctuations, the inclusion of Tadiran in the C<sup>4</sup>ISR area of operation and increased revenues in the electro-optics area relating to night vision equipment, mainly to European and other countries customers. The increase in the Land systems area of operations is mainly related to growth in deliveries of products to the U.S. Government.

The following table sets forth the Company's distribution of revenues by geographical regions:

	Three-Month Period ended			
	March 31, 2008		March 31, 2007	
	\$ millions	%	\$ millions	%
Israel	123.1	20.0	94.1	23.3
United States	215.1	34.9	150.9	37.4
Europe	137.1	22.2	83.7	20.8
Other countries	<u>140.8</u>	<u>22.9</u>	<u>74.9</u>	<u>18.5</u>
Total	<u>616.1</u>	<u>100.0</u>	<u>403.6</u>	<u>100.0</u>

The changes in revenues by geographic distribution were the result of standard quarterly fluctuations and revenues to customers as mentioned above.

## **Gross Profit**

The Company's gross profit represents the aggregate results of the Company's activities and projects, and is based on the mix of programs in which the Company is engaged during the reported period.

Gross profit in the quarter ended March 31, 2008 was \$168.4 million, as compared to \$103.5 million in the quarter ended March 31, 2007. The gross profit margin in the first quarter of 2008 was 27.3%, as compared to 25.7% in the first quarter of 2007.

The increase in the gross profit margin was a result of a mix of projects performed with higher gross profit.

### **Research and Development (“R&D”)**

The Company continually invests in R&D in order to maintain and further advance its technologies, in accordance with a long-term plan, based on its estimate of future market needs.

The Company’s R&D included programs which are partially funded by, third parties, including the Israeli Ministry of Defense (“IMOD”), the Office of the Chief Scientist (“OCS”) and bi-national and European Development funds. The R&D was performed in all major areas of core technological activities of the Company and mainly in the areas of advanced airborne systems, cutting edge electro-optics technology and products for surveillance, aerial reconnaissance, lasers and space based sensors, communications, electronic warfare (EW) and homeland security technologies and products.

Gross R&D expenses in the quarter ended March 31, 2008 totaled \$45.9 million (7.5% of revenues), as compared \$29.7 million (7.4% of revenues) in the quarter ended March 31, 2007.

Net R&D expenses (after reduction of third party participation) in the quarter ended March 31, 2008 totaled \$38.0 million (6.2% of revenues), as compared to \$24.1 million (6.0% of revenues) in the quarter ended March 31, 2007.

### **Marketing and Selling Expenses**

The Company maintains its activities in developing new markets and pursues at any given time various business opportunities according to the Company’s plan.

Marketing and selling expenses in the quarter ended March 31, 2008 were \$49.7 million (8.1% of revenues), as compared to \$32.4 million (8.0% of revenues) in the quarter ended March 31, 2007.

### **General and Administrative (“G&A”) Expenses**

G&A expenses were \$32.1 million (5.2% of revenues) in the quarter ended March 31, 2008, as compared to \$20.3 million (5.0% of revenues) in the quarter ended March 31, 2007.

### **Finance Expense (Net)**

Net finance expense in the quarter ended March 31, 2008 was \$4.6 million, as compared to \$2.9 million in the quarter ended March 31, 2007. The net finance expense in 2008 include the impact of a write-off relating to Auction Rate Securities in the amount of \$1.8 million.

### **Taxes on Income**

Provision for taxes in the quarter ended March 31, 2008 was \$7.9 million (effective tax rate of 16.5%), as compared to a provision for taxes of \$6.7 million (effective tax rate of 28.1%) in the quarter ended March 31, 2007.

The Company’s tax rate represents a weighted average of the tax rates to which the various Company entities are subject. The change in the effective tax rate is attributable mainly to the mix of the tax rates in the various tax jurisdictions in which the Company entities generating the taxable income operate.

## **Company's Share in Earnings of Affiliated Entities**

In the first quarter of 2008 the Company had net income of \$2.6 million from its share in earnings of affiliated companies and partnerships, as compared to \$3.4 million in the first quarter of 2007.

The companies and partnerships, in which the Company holds 50% or less in shares or voting rights and are therefore not consolidated in its financial statements, operate in complementary areas to the Company's core business activities, including electro-optics and airborne systems.

## **Net Earnings and Earnings Per Share ("EPS")**

Net earnings in the quarter ended March 31, 2008 were \$32.2 million (5.2% of revenues), as compared to net earnings of \$19.1 million (4.7% of revenues) in the quarter ended March 31, 2007. Diluted EPS in the quarter ended March 31, 2008 was \$0.75, as compared to \$0.45 in the quarter ended March 31, 2007.

Net earnings in the quarter ended March 31, 2008 include a net gain of approximately \$2 million (\$0.05 per share) related to the settlement agreement that was signed by Elisra for the Phoenix fire damage claim. This was the net result of an amount of \$4.1 million included in other income and an amount of \$2.1 million that was included in Elisra's minority rights in Elisra's gain related to the settlement.

The number of shares used for computation of diluted EPS in the quarter ended March 31, 2008 was 42,876 thousand shares, as compared to 42,175 thousand shares in the quarter ended March 31, 2007.

## **F. Liquidity and Capital Resources**

The Company's net cash flow generated from operating activities in the quarter ended March 31, 2008 was \$65.2 million, resulting mainly from net income and an increase in trade and other payables. The cash inflows were partially offset, mainly by an increase in inventories.

Net cash flow used for investment activities in the quarter ended March 31, 2008 was \$56.8 million, which was used mainly for procurement of various assets and equipment.

Net cash flow used for financing activities in the quarter ended March 31, 2008 was \$47.2 million, which was used mainly for repayment of long-term bank loans.

On March 31, 2008, the Company had total borrowings in the amount of \$413.0 million, including \$397.7 million in long-term loans, and \$1,007 million in guarantees issued on its behalf by banks, mainly in respect of advance payment and performance guarantees provided in the regular course of business. On March 31, 2008, the Company had a cash balance amounting to \$325.1 million.

As of March 31, 2008, the Company had working capital of \$154.2 million, and its current ratio was 1.12.

## **G. Derivatives and Hedges**

Market risks relating to the Company's operations result primarily from changes in interest rates and exchange rates. The Company typically uses financial instruments to limit its exposure to those changes. The Company also typically enters into forward contracts in connection with transactions that are denominated in currencies other than U.S. dollars and New Israeli Shekel ("NIS"). The Company may enter from time to time into forward contracts related to NIS, based on market conditions.

On March 31, 2008, the Company's liquid assets were comprised of bank deposits, and it had no investments in liquid equity securities that were subject to market fluctuations, except for Auction Rate Securities (see Finance Expense, net above). The Company's deposits and loans are based on variable interest rates, and their value as of March 31, 2008 was therefore not exposed to changes in interest rates. Should interest rates either increase or decrease, such change may affect the Company's results of operations due to changes in the cost of the liabilities and the return on the assets that are based on variable rates.

The Company's functional currency is the U.S. dollar. On March 31, 2008, the Company had exposure due to liabilities denominated in NIS of \$192.9 million in excess of its NIS denominated assets. These liabilities represent mostly wages and trade payables. The amount of the Company's exposure to the changes in the NIS-U.S. dollar exchange rate varies from time to time, and impacted the Company's expenses for the first quarter of 2008.

Most of the Company's assets and liabilities which are denominated in currencies other than the NIS and the U.S. dollar were covered as of March 31, 2008 by forward contracts. On March 31, 2008, the Company had \$197.4 million in Euro, \$152.5 million in GBP and \$8 million in other currencies).

## **H. Dividends**

The Board of Directors declared on May 19, 2008 a dividend of \$0.20 per share.

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