Report of the State Comptroller of Israel | March 2022

The Government-Owned Defense Industries

The Financial Statements of Israel Aerospace Industries Ltd. – State of the Company and its Risks

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Background

The government of Israel entirely owns Israel Aerospace Industries Ltd. (IAI). IAI deals in missilery, space, military electronics, military aircraft, and civilian areas, including business jets, conversion of passenger aircraft to cargo configuration, and accompanying aviation support services. IAI operates through four business divisions: three divisions operate mainly in the military-defense area, and the fourth is mainly in the civilian area. In 2019 about 73% of IAI's revenue came from the military-defense area[1]. That year, IAI was the government-owned company with the second-largest revenue turnover. Approximately 74% of IAI's revenue in 2019 was from customers outside Israel. As of December 31, 2019, the company employed approximately 15,000 people. In November 2020, the Ministerial Committee on Privatization approved the sale of up to 49% of IAI share capital through a public offering on the Tel Aviv Stock Exchange[2].

1 The data included in this report from the financial statements of IAI originate in the consolidated financial statements, unless otherwise noted.

2 Sale of over 35% of the company's share capital shall be subject to an additional decision by the Ministerial Committee on Privatization.

Key figures

USD 5.8 billion	**3%**	**USD 25 billion**	**USD 57 million**
balance sheet total of IAI as of December 31, 2019	operating profit margin of IAI in 2019	revenue of IAI in the years 2011–2017	dividends declared by IAI for the years 2011–2017
USD (27) million	**USD 13.4 billion**	**USD 5 million**	**75%**
IAI's Cash flow (negative) from operating activities in 2019	order backlog of IAI as of December 31, 2019	depreciated cost of land in IAI books as of December 31, 2019	the percentage of land for which the rights of IAI have not been resolved in agreements or for which the agreements are no longer valid, out of all the land on which IAI is active

Audit actions

From February to November of 2020, the State Comptroller's Office examined aspects of the financial reporting of IAI and the state of its business, as reflected in its financial statements and information systems, as well as aspects related to its fixed assets and real estate. The audit was conducted at IAI and the Israel Land Authority. Supplementary examinations were performed at the Government Companies Authority, the ministry of Defense, the Ministry of Finance, Rafael Advanced Defense Systems Ltd. (Rafael), and the Land Registry and Settlement of Rights in the Ministry of Justice (Tabu).

This report was presented to the Prime Minister and the State Control Committee of the Knesset on 15.2.21, with the duty of confidentiality imposed on it until discussion in the subcommittee of the State Control Committee.

By force of the authority vested in the State Comptroller's Office under Section 17(c) of the State Comptroller Law 1958 [Consolidated Version] and considering the government's reasoning, and after consulting with the bodies in charge of the protection of national security information and coordination with the Chairman of the Knesset, and since the stated subcommittee failed to convene, it was decided to publish this report while imposing confidentiality on sections of it. These sections shall not be submitted to the Knesset, nor shall they be published.

The findings of this audit report and its recommendations are valid as of the above date of its presentation.

Key findings

- **Income and Profitability** – average gross and operating profit margins from IAI income over the last five years (2015–2019) were approximately 14% and 1%, respectively. These margins indicate the stability of the low profitability margins of IAI. The operating profit margins from IAI income are relatively low compared to the domestic competitors – Rafael and Elbit Systems Ltd (Elbit), and its EBITDA[3] margins are low compared to foreign competitors as well. Nevertheless, it should be noted that the average operating profit margin from income in the years 2016–2019 in the military area and the EBITDA ratio for 2019 in IAI's military area were relatively high compared to Elbit and Rafael. Figures of income per worker in the years 2015–2019 in IAI were low compared to Elbit, Rafael, and the average of foreign competitors, by an average ratio of approximately 8%, 20%, and 37%, respectively, figures of gross profit per worker in these years were relatively low compared to Elbit and Rafael, by an average ratio of approximately 54% and 48% respectively. The average operating profit margins from 2017 to 30.06.20 of two of the three divisions operating in the military area (approximately 12% and 8%) were relatively high compared to the average operating profit margins of the third division operating in the military area, and the fourth divisin operating in the civilian area (approximately 6% and 0% respectively).

- **A certain gap in the fulfillment of Projects' Milestones** – a certain gap exists in execution of milestones in IAI projects.

- **Research and Development (R&D) Expenses and Investment in Subsidiaries and Associated Companiess** – the ratio of investment of IAI in self-R&D from its total income in the years 2016–2019 was lower than that of the competitors – Rafael and Elbit, in the extent of approximately 38%; its ordered R&D too was lower than that of Rafael. Furthermore, in the years 2016–2019, IAI failed to realize its plans for investment in companies, which would have facilitate it in "inorganic growth," including penetration

3 Profit before finance costs (income), taxes on income, depreciation and devaluation.

of new markets, product lines, and complementary technologies. As against an accumulated budget in the sum of hundreds of millions of USD for investment in the companies in the years 2016–2019, execution stood at approximately 11%.

Risk Management at IAI – the list of key risks approved by the board of directors in October 2019 included risks not included in the IAI periodic report as of December 31, 2019.

Resolution of IAI Rights in Lands – the rights of IAI in approximately 690 dunams of land, constituting approximately 20% of the lands on which it operates, are in lease agreements that have already expired. IAI did not request the Israel Land Authority to renew the agreements for which the lease period expired after the year 2016. The rights of IAI in about 55% of the land on which it operates are not adequately resolved in agreements with the Israel Land Authority, and it does not pay for the use of some of its land.

Appointment of an Auditing Accountant – since 2016, the procedure for receiving ministers' approval for appointing the committee members choosing auditing accountants have not been completed. As a result, most government-owned companies' auditing accountants have not been replaced. In IAI and its subsidiary ELTA Systems Ltd., the same accountants have been in office for 13 and 14 years, respectively.

Improvement of IAI business performance – in 2018, IAI determined a strategic plan for increasing profitability. The revenue of IAI increased from approximately USD 3.1 billion in 2012 to approximately USD 4.1 billion in 2019. In the first half of 2020, the IAI revenue grew by 5% compared to the same period in 2019; gross and operating profit margins from its income in the first half of 2020 were approximately 16% and 6%, respectively, as opposed to approximately 13% and 3% in the same period of the previous year.

Financial objectives set for IAI by the Government Companies Authority – in 2019, the Government Companies Authority set long-term financial objectives for IAI. IAI achieved the objectives for financial resilience and growth already in 2019.

Order backlog – IAI's large order backlog, which on December 31, 2019, stood at USD 13.4 billion, gives it a significant degree of certainty and security for both its short-term and long-term income. IAI's order backlog is larger than those of Rafael and Elbit.

Key recommendations

- It is recommended that the IAI management and board of directors continue to closely examine those business units operating at a loss and with low-profit margins while analyzing their causes, and preparing a detailed plan to improve their business condition, including business objectives and timetables for their achievement.

- It is recommended that IAI management continue to operate and conclude about a certain gap in the achievement of project milestones, emphasizing the causes thereof.

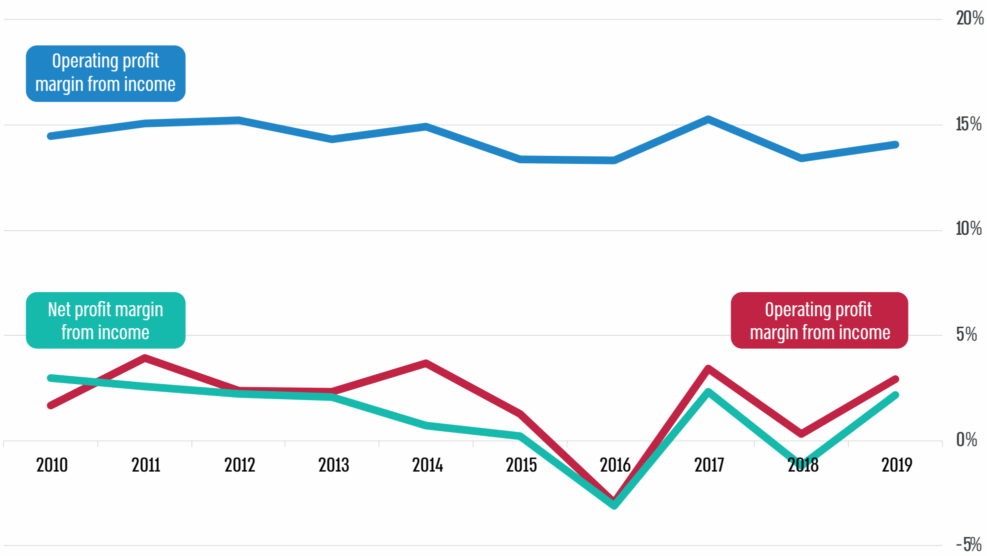
- It is recommended that IAI assess its investment in R&D, against the objectives in its strategic plan, to maximize the return on this investment. This is to preclude any compromise of its relative competitive advantages in technological areas and avoid harming its future business results.

- It is recommended that the Government Companies Authority, in cooperation with IAI, examine the obstacles that hinder IAI's ability to realize mergers and acquisitions and their causes.

- The Israel Land Authority and IAI should address the issue of settling the rights and terms of use for lands on which IAI operates renewing expired agreements and work towards signing agreements about lands for which no lease agreements have been signed. This is also according to the November 2020 decision on privatization. In addition, IAI should arrange to register its rights to the land at the Land Registry to establish its legal rights to it.

- It is recommended that the Accountant-General Department in the Ministry of Finance and the Government Companies Authority verify that IAI's rights to lands will be settled appropriately, including their usage fees, terms of use, and transfer of ownership thereof.

IAI's gross profit, operating profit, and net profit margins from its revenue, 2010–2019



Source: IAI Financial Statements for the years 2010–2019

Summary

In view of the characteristics of IAI, including its unique capabilities and the extent of its activity in Israel and abroad, together with other Israeli defense industries, it constitutes an essential component in the national security of the State of Israel. Therefore, maintaining its business and financial resilience is a state's security and economic interest. An analysis of IAI's business results indicates that the company has contended with many difficulties in recent years. It is recommended that IAI, in cooperation with the Government Companies Authority, continue to pursue the execution of its strategic plan, while closely monitoring its implementation; and that the expected proceeds from the issue of its shares be used according to the November 2020 decision on privatization, among other things, to strengthen and reinforce its economic resilience. Furthermore, by the decision on privatization, it is recommended that the Ministry of Finance, Government Companies Authority, Israel Land Authority, and IAI pursue the arrangement of land registration, which could have a substantial impact on the company's activity and its value.