## MANAGEMENT REPORT FOR 2003

The following management report should be read in conjunction with our consolidated financial statements as of and for the year ended December 31, 2003 and the notes thereto. This report contains forward-looking statements that involve risks and uncertainties. Such forward-looking statements may be identified by the words “anticipate”, “believe”, “estimate”, “expect”, “plan” and similar expressions. Our actual results could differ materially from those anticipated in these forward-looking statements as a result of certain factors, including, but not limited to, those discussed in our filings with the U.S. Securities and Exchange Commission from time to time.

## OVERVIEW

We are a multi-national high technology operational holding company that operates through subsidiaries and affiliated companies, referred to as our group companies. Founded in 1962, we have been a major force in the development of the Israeli high technology industry by building Israeli and Israel-related companies with technologies in the fields of advanced defense electronics, communications and semiconductors. In recent years we have pursued a strategy of focusing our holdings also on medical devices, software products and services and advanced materials and increasing our direct involvement in these areas. Most of our group companies were established together with entrepreneurs or started as activities within Elron and were subsequently spun-off. . In addition, some of our group companies grew out of our subsidiary, RDC Rafael Development Corporation Ltd. (“RDC”), a joint venture with Rafael Armament Development Ltd. ("Rafael"), the largest research and development organization of Israel's Ministry of Defense. RDC was established for the purposes of exploiting Rafael's technology in non-military markets. Our group companies include both publicly traded and privately held companies.

Technology industries are characterized by the high degree of risk inherent in their products, their continuous technological innovation and their penetration into world markets, which requires investment of considerable resources and continuous development efforts. The future success of our group companies is dependent upon their technological quality, prices and nature of their products in comparison to their competitors and their ability to introduce new products to the markets at the right time, while offering cost effective solutions suitable to their customers' needs as well as their ability to raise financing and the condition of the capital markets.

Our activities range from complete operational control over the business to involvement in the management of our group companies in which we maintain controlling or significant holdings, and, in a limited number of cases, minority holdings. We participate in the management of most of our group companies by means of active membership on their boards of directors and board committees. As a result, we are involved in matters of policy, strategic planning, marketing, selecting and manning senior management positions, approving investments and budgets, financing and the overall ongoing monitoring of our group companies’ performance. In addition to our representation on the boards of directors of our group companies, we provide hands-on assistance to the group companies' management in support of their growth. We view our hands-on involvement in the operations of our group companies as a key element of our business. Our group companies therefore benefit from the experience of our management team in various areas in which they need support and leadership, including, but not limited to, budgetary control, legal support, market analysis, risk management, identifying joint venture opportunities, introductions to potential customers and investors, business plan preparation, strategic planning and research and development guidance.

We expect to continue to build and realize value for our shareholders from our group companies through the sale of a portion or all of our holdings in, or the issuance of shares by any of our group companies to third parties, while simultaneously pursuing the acquisition of, or investment in, new and existing companies. We believe that this strategy provides the ability to increase shareholder value as well as capital to support the growth of our group companies.

Our net income (or loss) in any given period is due, in the most part, to the results of operations of our group companies (which are accounted by us under the consolidation or equity method of accounting) and dispositions and changes in our holdings of group companies. As most of our group companies are technology companies which have not yet generated significant revenues and which invest considerable resources in research and development and in marketing activities, we have experienced, and expect to continue to experience, losses in respect of these companies. Our capital resources in any given period are primarily affected by the extent of our investment in existing and new companies and the realization of certain holdings. The results of operations of our group companies, and consequently, our results of operations and capital resources, are affected by general economic market conditions as well as by factors specifically related to the technology markets, which also affect the ability of our group companies to raise financing and our ability to dispose of holdings and realize gains from our investments.

## TREND INFORMATION

The downturn in the world economy and, in particular, in the technology sector during the last three years affected our and our group companies' results of operations and their ability to raise additional financing from other sources and led us to re-examine our group company structure at all levels. As a result, our main focus was on the following: (i) supporting the financing needs of our existing companies while investing to a lesser extent in new companies; (ii) adjusting group companies operations and minimizing their cash burn-rate without adversely affecting their core activities and potential growth; (iii) divesting from other companies in our group not operating in our main areas of involvement; and (iv) merging Elbit Ltd. (“Elbit”) and DEP Technology Holdings Ltd. (“DEP”) into Elron in order to create a more simplified and efficient organizational structure as well as to reduce operational and management costs. Market conditions also affected our ability to successfully "exit" some of our group companies and record capital gains at the same level that we experienced in the years prior to the downturn.

In the second half of 2003, there were initial indications of recovery in the technology sector and capital markets. This trend was reflected in the improvement in the results of operations of most of our group companies as well as the raising of funds from new strategic investors in private placements completed by some of our group companies, namely Wavion and Oren Semiconductor in the second half of 2003 and Chip Express in the beginning of 2004. In addition, we recorded gains as a result of the merger of the urology therapy units of our subsidiary Galil Medical Ltd. (“Galil Medical”) with the brachytherapy business of Amersham plc (“Amersham”), the sale of assets and business of our subsidiary Elron Software Inc. (“ESI”) to Zix Corporation (”Zix”) and from the sale of a portion of our shares in Partner Communications Company Ltd. (“Partner”).

We believe, based on published analyst and research group reports, that the recovery trend of the technology sector will continue in 2004 and we anticipate this to have a positive effect on our group companies. We also anticipate increasing our investments in new companies in our main areas of operation.

## MAJOR DEVELOPMENTS IN OUR SUBSIDIARIES

***Galil Medical and Amersham merge urology therapy units.*** On July 1, 2003, the merger between the urology business of our subsidiary, Galil Medical, and the brachytherapy business of Amersham (LSE, NYSE, OSE: AHM) was completed. According to the merger agreement, a new company, Oncura, Inc., was incorporated. Oncura has a global presence in minimally invasive treatments of prostate cancer. Oncura provides minimally invasive treatment options for prostate cancer using brachytherapy (radio-active seeds) and cryotherapy (hyper-cooling) technologies. Galil Medical has developed innovative cryotherapy, a minimally invasive advanced hyper-cooling technology that allows extremely fast, high-resolution and controlled destruction of cancerous tissue. Cryotherapy is a new technology, used to treat advanced stages of prostate cancer or recurrent disease. It complements the brachytherapy in which Amersham is a market leader. Both minimally invasive techniques offer physicians and patients alternatives to prostatectomy surgery. At the closing, Amersham and Galil Medical each contributed the related operations and assets necessary for Oncura to conduct the brachytherapy business and the cryotherapy business, respectively, in the urology field, and in exchange for such assets, Amersham received 78% and Galil Medical received 22%, of the outstanding shares of Oncura. In addition, at the closing, Galil Medical purchased 3% of Oncura from Amersham in consideration for $4.5 million in cash, of which $3.0 million was paid as of December 31, 2003, and the balance is due in June 2004, resulting in Galil Medical's aggregate ownership interest of 25% of Oncura. Until the payment of the balance, 4% of Oncura shares held by Galil Medical, are pledged in favor of Amersham. As a result of the transaction, a gain in the amount of $21.2 million was recorded in 2003. Our share in this gain (net of minority interest and income taxes) amounted to $4.4 million. The investment in Oncura is accounted for under the equity method of accounting. (See also "Critical Accounting Policies").

Galil Medical and Amersham each entered, separately, into supply and research and development ("R&D") service agreements pursuant to which Galil Medical and Amersham provide Oncura with certain exclusive supply, manufacturing and R&D services, upon a cost plus basis, according to the terms and conditions stipulated in the relevant agreements. Galil Medical plans to continue developing its cryotherapy technology for applications in other health care fields.

***Sale of substantially all of Elron SW (formerly: Elron Software) assets and business***. On September 2, 2003, our subsidiary, ESI, sold substantially all of its assets and business to Zix Corporation (Nasdaq: ZIXI) ("Zix"), a global provider of e-messaging protection and transaction services, in consideration for 1,709,402 shares of Zix's common stock, with a market value of approximately $6.0 million and a 5.75% convertible note of $1.0 million. In addition, Zix assumed certain liabilities of ESI in the net amount of approximately $1.0 million. As part of the transaction, ESI changed its name to Elron SW Inc. ("ESW").

The transaction resulted in a gain of approximately $4.1 million, of which approximately $2.5 million represents the elimination of the liability to minority shareholders previously recorded by us in respect of ESW's employee stock options, due to the expiration of those options.

According to SFAS 144, "Accounting for the Impairment or Disposal of Long-Lived Assets", since the operations and cash flows of the business sold have been eliminated from the operations of ESW and ESW will no longer have continuing involvement in the operations of the business after its sale, the 2003 results of operations of the business and the gain on the sale have been classified as discontinued operations in the statement of operations and prior periods results have been reclassified accordingly.
During the fourth quarter of 2003 we sold 1,117,155 Zix shares, including 262,454 shares resulting from the conversion of the convertible note, for approximately $9.0 million and recorded a gain, after tax, of approximately $3.2 million. As of December 31, 2003, the remaining common shares held by us constitute approximately 3% of the outstanding share capital of Zix and are accounted for as available for sale securities in accordance with SFAS 115 "Accounting for Certain Investments in Debt and Equity Securities". These remaining shares are subject to a lock-up agreement with Zix and may be sold ratably on a monthly basis until September 2004.

Subsequent to December 31, 2003 and through March 9, 2004 we sold additional 271,812 shares for approximately $3.2 million, resulting in a gain, after tax, of approximately $1.5 million, which will be recorded in the first quarter of 2004.

***Sale of MediaGate assets and business.*** On December 16, 2003, MediaGate signed an agreement with Telrad Networks Ltd. ("Telrad"), for the sale of its technology and related intellectual property assets. Telrad is an Israeli corporation providing telecommunications solutions in a wide range of areas to many countries in Latin America, Africa, Eastern Europe and Asia Pacific. The closing of the transaction occurred on January 28, 2004. According to the agreement, the consideration for the technology is in the form of future royalties, up to a maximum of $5 million, to be paid on future sales through December 31, 2009, of products that are based on MediaGate's technology. The royalties range from 5% of sales in 2004 and increase gradually up to 15% of sales in 2009.

## CRITICAL ACCOUNTING POLICIES

We prepare our consolidated financial statements in conformity with accounting principles generally accepted in the United States ("US GAAP"). Our significant accounting policies are more fully described in Note 2 to the notes to our consolidated financial statements. Certain accounting principles require us to make certain estimates, judgments and assumptions. We believe that the estimates, judgments and assumptions upon which we rely are reasonable based upon information available to us at the time that these estimates, judgments and assumptions are made. These estimates, judgments and assumptions can affect the reported amounts of assets and liabilities as of the date of the financial statements, as well as the reported amounts of revenues and expenses during the periods presented. To the extent there are material differences between these estimates, judgments or assumptions and actual results, our financial statements will be affected. The significant accounting policies that we believe are the most critical to aid in fully understanding and evaluating our reported financial results include the following:

- Principles of accounting for holdings in group companies
- Business combinations
- Impairment of goodwill and other intangible assets
- Other-than-temporary decline in value of investments in group companies
- Revenue recognition
- Accounting for income taxes
- Non-Monetary transactions

### *Principles of Accounting for Holdings in Group Companies*

The various holdings that we have in our group companies are accounted for under several methods, based on our level of ownership in our group companies, as described below.

***Consolidation***. Companies over which we have control are accounted for under the consolidation method of accounting. Control is usually assumed when we own and/or our subsidiary owns more than 50% of the outstanding voting securities of a company, however, whether or not we control a group company also depends on an evaluation of several factors, including, among others, our representation on the board of directors, the level of financing provided by us to the group company and any minority rights. Under the consolidation method, a company's assets and liabilities are included within our consolidated balance sheet and its income and expense items are included within our consolidated statements of operations. The share of other shareholders in the net assets and in the net income or losses of a consolidated company is reflected in minority interest in our consolidated balance sheet and in our consolidated statements of operations, respectively. The minority interest amount adjusts our consolidated net income (loss) to reflect only our share in the earnings or losses of any consolidated company. Financial Accounting Standards Board ("FASB") Interpretation No. 46 ("FIN 46" or the "Interpretation") (as revised in December 2003), *"Consolidation of Variable*

*Interest Entities, an interpretation of Accounting Research Bulletin No. 51"*, which is further discussed below, provides additional conditions under which a company is required to consolidate another entity.

***Equity Method***. Group companies which we do not control, but over whom we exercise significant influence, are accounted for under the equity method of accounting. Significant influence is usually assumed when we hold 20% or more of a group company's voting securities, however, whether or not we exercise significant influence with respect to a group company also depends on an evaluation of several factors, including, among others, our representation on the board of directors, agreements with other shareholders, our participation in policy making processes, the existence of material intercompany transactions and technological dependency, the extent of ownership by an investor in relation to the concentration of other shareholdings, and other factors which may require management to make certain judgmental decisions regarding significant influence. We also account for our interests in private equity funds under the equity method of accounting, based on our holding percentage. Under the equity method of accounting, a group company's assets and liabilities are not included within our consolidated balance sheet and their results of operations are not reflected within our consolidated statements of operations; however, our share in the net income or losses of the group company is reflected as an equity income (loss) in our consolidated statements of operations. The share of income or losses is generally based upon our ownership level of the outstanding share capital of the group company. Notwithstanding the above, in circumstances where our ownership in an investee is in the form of a preferred security or other senior security, we recognize equity method losses based on our ownership level in the particular investee security or loan held by us to which the equity method losses are being applied.

***Other Methods***. Other companies that we do not account for under either the consolidation or the equity method of accounting are generally accounted for under three different methods:

- Non-marketable securities are presented at cost. Under this method, our share in the income or losses of these entities is not included in our consolidated statements of operations.
- Marketable securities, which are classified as trading securities, are presented at fair market value and the changes in the market value are reflected in our results of operations during each reporting period.
- Marketable securities which are classified as available-for-sale are presented at fair market value and the effect of any unrealized change in market value is reflected in other comprehensive income (loss). When realized, realized gain or loss is included in our results of operations.

Notwithstanding the above, FIN 46 provides additional criteria for consolidation of entities and a new framework for identifying variable interest entities (VIEs) and determining when a company should include the assets, liabilities, noncontrolling interests and results of activities of a VIE in its consolidated financial statements.

In general, a VIE is a corporation, partnership, limited-liability corporation, trust or any other legal structure used to conduct activities or hold assets that either (1) has an insufficient amount of equity to carry out its principal activities without additional subordinated financial support, (2) has a group of equity owners that are unable to make significant decisions about its activities, or (3) has a group of equity owners that do not have the obligation to absorb the losses or the right to receive returns generated by its operations. However, the Interpretation provides several exceptions to its scope, such as that an entity that is deemed to be a business (as defined in the Interpretation) need not to be evaluated to determine if it is a VIE unless one of the conditions specified in the Interpretation exists.

The Interpretation requires a VIE to be consolidated if a party with an ownership, contractual or other financial interest in the VIE (a variable interest holder) is obligated to absorb a majority of the risk of loss from the VIE's activities, is entitled to receive a majority of the VIE's residual returns (if no party absorbs a majority of the VIE's losses) or both. A variable interest holder that consolidates the VIE is called the primary beneficiary. Upon consolidation, the primary beneficiary generally must initially record all of the VIE's assets, liabilities and noncontrolling interests at fair value and subsequently account for the VIE as if it were consolidated based on a majority voting interest. FIN 46 also requires disclosures about VIEs that the variable interest holder is not required to consolidate but in which it has a significant variable interest. Presently, entities are generally consolidated by an enterprise that has a controlling financial interest through ownership of a majority voting interest in the entity.

The provisions of this interpretation are to be applied as of March 31, 2004. As an operational holding company, we have investments in and loans to various companies that are engaged primarily in the fields of high technology. Some of these companies are in their early stages of development and will require substantial external investments until they can finance their activities without additional support from other parties. These companies are currently primarily funded with financing from venture capital funds, other holding companies and private investors. As described above, we are currently accounting for the investments in these companies either by the consolidation or equity method. We are currently evaluating the effects of this interpretation in respect of our holdings in our group companies. It is possible that some of our investees may be considered VIEs in accordance with the interpretation. Accordingly, if it is determined that we are the primary beneficiary of a VIE, we will be required to consolidate the financial statements of such a VIE with our own financial statements as of March 31, 2004. Our maximum exposure to loss to date with respect of these companies does not exceed the carrying value of our investment in any of these companies.

***Business combinations***

According to SFAS 141, *"Business Combination"*, commencing on July 1, 2001, all business combinations are accounted for using the purchase method of accounting. Under the purchase method, the total purchase price is allocated to the acquired company's assets and liabilities, based on their estimated fair values, and the remainder, if any, is attributed to goodwill.

The aggregate purchase price of approximately $74.0 million resulting from the merger with Elbit, that took place in 2002, has been allocated to Elbit’s assets based on their estimated fair value according to an analysis made by an independent appraiser. Of the total purchase price, $55.0 million has been allocated to Elbit’s identifiable net assets and the remaining $19.0 million has been allocated to goodwill. The goodwill recorded reflects the anticipated synergies resulted from the combined entity, including anticipated reductions in operational and management costs, the creation of an enhanced platform, a more simplified and efficient organizational structure and greater resources and scope of operations, which will benefit the group companies. Subsequently to the acquisition date and through December 31, 2003, Goodwill was reduced by $14.3 million, as a result of the reversal of a valuation allowance recorded at the acquisition date in respect of Elbit’s carryforward losses that had accumulated through that date.

The aggregate purchase price of approximately $29.5 million resulting from the share purchase of DEP’s shares, that took place in 2002, has been allocated to the assets and liabilities of DEP and its subsidiary, RDC, the majority of which has been allocated to investments accounted for under the equity method. The allocation to DEP’s assets was based on an analysis made by an independent appraiser. Aggregate amounts of $16.5 million and $6.5 million were allocated to identifiable net intangible assets and goodwill of the equity investments, respectively. The amortization of the identifiable intangible assets is included as part of our share in the net losses of equity investments.

Estimating the fair value of certain assets acquired and liabilities assumed is judgmental in nature and often involves the use of significant estimates and assumptions, mainly with respect to intangible assets. As mentioned above, we obtained appraisals from an independent appraiser in order to assist us in this process. While there were a number of different methods used in estimating the value of intangibles acquired, the primary method used was the discounted cash flow approach. Some of the more significant estimates and assumptions inherent in the discounted cash flow approach include projected future cash flows, including timing, a discount rate reflecting the risk inherent in the future cash flows and terminal growth rate. Another area which required judgment which can impact our result of operations was estimating the expected useful lives of the intangible assets. To the extent intangible assets are ascribed with longer useful lives, there may be less amortization recorded in any given period. As we and our group companies operate in industries which are rapidly evolving and extremely competitive, the value of the intangible assets, including goodwill, their respective useful lives and the investments in companies is exposed to future adverse changes which can result in a charge to our results of operation. In 2002 and 2003, we recorded impairment losses in respect of certain investments, to which we allocated a portion of the purchase price at the time of the aforementioned acquisitions, in the amount of $4.5 million and $2.5 million (See also "Critical Accounting Policies", "Other-Than-Temporary Decline in Investments in Group Companies").

***Impairment of Goodwill and Other Intangible Assets***

In accordance with SFAS 142, *“Goodwill and Other Intangible Assets”*, commencing on January 1, 2002, goodwill is no longer being amortized. In lieu of amortization, an annual impairment review of the goodwill is required at the level of each reporting unit. SFAS 142 prescribes a two-phase process for impairment testing of goodwill. The first phase screens for impairment while the second phase (if necessary) measures the impairment. We performed the first phase impairment analysis and found no instances of impairment of our recorded goodwill. Accordingly the second phase was not necessary during 2003. The first phase impairment analysis is performed by estimating the fair value of each reporting unit and comparing it to its reported carrying amount. Determining fair value under the first phase involves the use of significant estimates and assumptions. These estimates and assumptions could have an impact on whether or not an impairment charge is recognized. To determine fair value, we have used a number of valuation methods including quoted market prices, discounted cash flows and revenue multiples. In certain cases we obtained an opinion from an independent appraiser. As mentioned above, these approaches use estimates and assumptions including projected future cash flows, discount rate and perpetual growth rate. As we operate in industries which are rapidly evolving and extremely competitive, it is possible that our estimates could change in the near term and there can be no assurance that future goodwill impairment tests will not result in a charge to our results of operation. At December 31, 2003, goodwill amounted to approximately $12.0 million.

Other intangible assets with definite useful lives are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable in accordance with the guaidance of SFAS 144 *"Accounting For The Impairment Or Disposal Of Long-Lived Assets"*. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to the future undiscounted cash flows expected to be generated by the asset. If an asset is considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the asset exceeds its fair value. In the evaluation of impairment, we use significant estimates and assumptions such as projected future cash flows which are subject to high degree of judgment. As of December 31, 2003 we found no instances of impairment of other intangible assets. As we operate in industries which are rapidly evolving and extremely competitive, changes in the assumptions and estimates may affect the carrying value of the intangible assets, and could result in impairment charge to our results of operation. At December 31, 2003, consolidated intangible assets, other than goodwill, amounted to approximately $10.0 million.

***Other-Than-Temporary Decline in value of Investments in Group Companies***

At the end of each reported period, we must evaluate whether an other-than-temporary decline in value of an investment in a group company has been sustained. This evaluation is judgmental in nature. If it has been determined that an investment has sustained an other-than-temporary decline in its value, the investment is written down to its fair value by a charge to our results of operations.

A valuation of fair value is dependent upon specific facts and circumstances. Factors that are considered by us in this determination include financial information (including, among others, budgets, business plans and financial statements) and the value at which independent third parties have invested or have committed to invest and independent appraisals, if available. Factors indicative of an other-than-temporary decline include recurring operating losses, credit defaults, and subsequent rounds of financing at an amount below the cost basis of the investment. This list is not all inclusive and we weigh all quantitative and qualitative factors in determining if an other-than-temporary decline in value of an investment has occurred. As we operate in industries which are rapidly evolving and extremely competitive, it is possible that our estimates could change in the near term and there can be no assurance that an additional write-down or write-off of the carrying value will not be required in the future. In 2002 and 2003 we recorded write-downs in the amounts of $4.5 million and $4.2 million, respectively, with respect to certain group companies, mainly Cellenium and Textology.

***Revenue Recognition***

Our revenues are derived from our consolidated subsidiaries. Revenues from sales of products and services are recognized after all of the following occurs: the product is delivered, collection is probable, fees are fixed or determinable, vendor-specific objective evidence exists to allocate the total fee to elements of an arrangement and persuasive evidence of an arrangement exists. The determination whether collection is probable is judgmental in nature and based on a variety of factors, including the payment and other terms of the individual customer contract, credit history of the customer, prior dealings with specific customers, and certain other factors. Maintenance revenue is recognized on a straight-line over the term of the contract period. Reserves for estimated returns and allowances are provided at the time revenue is recognized when a right of return exists. Such reserves are recorded based upon historical rates of returns and other factors.

Income and profit derived from projects related to software development are recognized upon the percentage of completion method, based on the ratio of hours performed to date to estimated total hours at completion. Estimated gross profit or loss may change due to changes in estimates resulting from differences between actual performance and original forecasts. Estimates are reviewed periodically, and the effect of any change in the estimated gross profit for a project is recorded in results of operations in the period in which the change becomes known on a cumulative catch-up basis. Anticipated losses on projects are charged to earnings when identified. A number of internal and external factors affect our subsidiaries cost estimates, including labor rates, revised estimates of uncompleted work, efficiency variances, customer's specifications and testing requirements changes. If any of these factors were to change, or if different assumptions are used, our results of operations may be affected. In addition estimates are made as to the total hours at completion. The number of hours may change due to the actual progress on the project. Change in estimates regarding the percentage of completion may affect the results of operations.

***Accounting for Income Taxes***

At the end of each reported period, we are required to estimate our income taxes. This process requires us to estimate our actual current tax liabilities and make an assessment of temporary differences resulting from differing treatment of items, for tax and accounting purposes. These differences result in deferred tax assets and liabilities, which are included within our consolidated balance sheet. We must then assess the likelihood that our deferred tax assets will be realized through future taxable income and, to the extent we believe that realization is not likely, we must establish a valuation allowance. Management judgment is required in determining our provision for income taxes, our deferred tax assets and liabilities and any valuation allowance recorded against our net deferred tax assets. Our judgment as to the probability to realize our net deferred tax assets is largely based upon interpretations of certain tax laws and estimates and assumptions with respect to our ability to realize investments in our group companies. Our ability to realize investments is mainly dependent upon factors such as the condition of the securities markets and other general economic conditions. As the securities markets for our group companies are highly volatile, changes in our assumptions and estimates may require us to increase the valuation allowance and therefore we may be required to include an expense within the tax provision in our statement of operations.

In 2002 and 2003, we recorded a deferred tax asset in the amount $10.0 million and $12.7 million, respectively, mainly by reducing our previous valuation allowance in respect of losses incurred in prior periods. As mentioned above (see "Business combinations"), the majority of the reduction in the valuation allowance was recorded as a reduction of goodwill since the deferred tax assets related to carryforward losses in Elbit and RDC incurred in periods prior to the acquisition of these companies. During 2003, we recorded tax expenses by realizing our deferred taxes mainly due to the sale of shares of Partner, Given Imaging, Zix and 24/7 Real Media. As of December 31, 2003, deferred tax assets with respect to carryforward losses that are more likely than not to be realized in future years amounted to approximately $8.9 million. Deferred tax liabilities amounted, as of December 31, 2003, to $47.7 million, mainly with respect to investment in available-for-sale securities, primarily Partner.

***Non-Monetary Transactions***

The basic principle in APB 29 "Accounting for Non-monetary Transactions" is that the accounting for non-monetary transactions should be based on the fair values of the assets exchanged. The cost of a non-monetary asset acquired in exchange for another non-monetary asset is the fair value of the asset received or the fair value of the asset surrendered to obtain it (if more clearly evident than the asset received).However, in an exchange of similar productive assets, since the culmination of an earning process has not occurred, the exchange should not be recorded at fair value and the asset received should be recorded at the recorded amount of the assets given up. According to EITF 01-2, "Interpretations of APB Opinion No. 29", transactions by SEC registrants that involve the exchange of a business for any non-monetary asset, including an equity method investment that is not an interest in a joint venture, are not exchanges of productive assets and must be accounted for at fair value unless fair value is not determinable within reasonable limits. In determining whether the asset given up constitutes a business, the guidance in EITF 98-3, "Determining whether a non-monetary transaction involved receipt of productive assets or of a business" should be followed.

Determining whether the assets transferred constitute a business requires significant judgment and is dependent on the particular facts and circumstances, mainly regarding the determination of the degree of difficulty or level of investment necessary to obtain access or to acquire missing elements in the set of assets transferred. In addition, determining the fair value of the transaction is judgmental in nature and often involves the use of significant estimates and assumptions. In determining the fair value of the business transferred by Galil Medical to Oncura, Oncura obtained appraisals from an independent appraiser in order to assist in the valuation of its assets. The method applied in the valuation study was discounted cash flow, which includes significant estimates and assumptions. As Oncura operates in an industry which is rapidly evolving and extremely competitive, its value, as well as the value of its intangible assets, including goodwill, can be exposed to future adverse changes which can result in a charge to its, and in turn, to our results of operations. In determining the fair value of the business sold by ESW, we valued the consideration received in the form of Zix common stock at $5.4 million, a discount from market value of approximately 10% due to the restrictions on their sale. Such valuation is judgmental in nature and involved the use of estimates and assumptions.

**BASIS OF PRESENTATION**

As a result of the merger with Elbit and the share purchase of DEP which were completed in May 2002, Elbit and DEP became wholly owned subsidiaries, and accordingly, their results of operations are consolidated within our results of operations subsequent to the acquisition date. In addition, in the second half of 2002, we acquired a controlling interest in both Galil Medical and MediaGate, following which their results of operations are consolidated within our results of operations subsequent to the acquisition date.

As a result of the purchase of DEP in 2002, our interest in Given Imaging, Galil Medical, Witcom and 3DV Systems, in which we had direct and indirect interests through RDC, increased. In 2003, our interest in Oren Semiconductor increased as a result of a financing round in which we also invested as well as the conversion of our loans granted to Oren in previous periods. In accordance with APB 18, an investee that was previously accounted for other than under the equity method of accounting may become qualified for use of the equity method of accounting by an increase in the level of ownership. In such cases, the results of operations and retained earnings should be adjusted retroactively under the equity method of accounting ("step-by-step acquisition"). Accordingly, in 2003, we have restated our financial statements for all prior periods in which our investment in Oren Semiconductor was recorded at cost. The aforementioned restatements resulted in an aggregate increase in our net loss of approximately $2.3 million, or $0.08 per share, and approximately $1.5 million, or $0.07 per share, for the years ended December 31, 2002 and 2001, respectively.

For comparison purposes, we have provided pro forma information in accordance with SFAS 141, which gives effect to the merger with Elbit, the share purchase of DEP and the acquisition of a controlling interest in Galil Medical and in MediaGate as if these transactions had been in effect at January 1, 2002 (see Note 9 to the Consolidated Financial Statements for the year ended December 31, 2003).

***Consolidation.*** Our consolidated financial statements include the accounts of the Company and all of its direct or indirect controlled subsidiaries. The following are our main subsidiaries:

| Year ended December 31, | |
|---|---|
| 2003 | 2002 |
| ESW | ESW |
| Elron Telesoft | Elron TeleSoft |
| Elbit | Elbit[1] |
| DEP | DEP[1] |
| RDC | RDC[1] |
| Galil Medical | Galil Medical[2] |
| Mediagate | MediaGate[2] |

1 Since May 2002, following the completion of the Elbit merger and DEP share purchase
2 Since July 2002

***Equity Method***. Our main group companies accounted for under the equity method of accounting include:

| Year ended December 31, | |
|---|---|
| 2003 | 2002 |
| Elbit Systems | Elbit Systems |
| NetVision | Elbit[1] |
| Chip Express | NetVision |
| Wavion | MediaGate[2] |
| KIT | Chip Express |
| Pulsicom | DEP[1] |
| Given Imaging | Wavion |
| Witcom | KIT |
| 3DV | Pulsicom |
| CellAct | AMT[4] |
| AMT | Given Imaging |
| Notal Vision[6] | Galil Medical[2] |
| Oren Semiconductor | Witcom |
| Oncura[7] | 3DV |
| | Cellenium[5] |
| | CellAct |
| | Oren Semiconductor[3] |

1 Through May 2002, prior to the completion of the Elbit merger and DEP share purchase
2 Through July 2002
3 Restated (see "Basis of presentation")
4 Since August 2002
5 Through November 2002
6 Since January 2003
7 Since July 2003

## RESULTS OF OPERATIONS

***Year Ended December 31, 2003 compared to Year Ended December 31, 2002.***

The following tables set forth our results of operations in the reported period:

| | Year ended December 31, | |
|---|---|---|
| | 2003 | 2002 |
| | (millions of $, except per share data) | |
| Net loss | (7.2) | *(41.6) |
| Net loss per share | (0.25) | *(1.58) |

* Restated (see "Basis of presentation")

Our net loss in 2003 decreased significantly as compared to the net loss in 2002 mainly as a result of the following factors:

(i) a gain, net after tax, of approximately $7.1 million, resulting from the sale of 6,278,226 Partner shares in 2003;
(ii) our share in the gain resulting from the merger in 2003 of the urology therapy units of Galil Medical and Amersham in the amount of approximately $4.4 million;
(iii) a gain of approximately $4.1 million resulting from the sale of substantially all of ESW assets and business to Zix in 2003 in consideration for 1,709,402 Zix shares and $1.0 million convertible note and a gain, net after tax, of approximately $3.2 million resulting from the subsequent sale of 1,117,155 Zix shares, including 262,454 shares resulting from the conversion of the note; and
(iv) a decrease, net, of approximately $19.7 million in losses recorded with respect to our group companies, of which $12.7 million was due to a decrease in losses with respect to certain group companies which were sold or discontinued their operations in the second half of 2002 as part of the reorganization of Elron, Elbit, and DEP group companies following the completion of our merger. The reminder of the decrease reflects the improvements in the results of operation of most of our group companies, mainly Given Imaging as a result of its revenue growth, and the decrease in the net losses of ESW (which business was sold on September 2, 2003) and Elron TeleSoft, as a result of restructuring and cost reduction programs undertaken by them.

***Pro forma results.*** Pro forma net loss for 2002, as restated, which gives effect to the merger with Elbit, the share purchase of DEP and the acquisition of a controlling interest in Galil Medical and in MediaGate as if these transactions had been in effect at January 1, 2002, amounted to approximately $54.6 million, or $1.88 per share, compared to the net loss in 2003 of approximately $7.2 million, or $0.25 per share. The following factors contributed to the significant decrease in net loss:

(i) An increase in gains we recorded with respect to realization of investments by way of selling shares in the open market and by way of merger and acquisition transactions as mentioned above;
(ii) the decrease, net, in losses with respect to our group companies in the amount of $30.6 million, of which $20.9 million was due to a decrease in losses with respect to certain group companies which were sold or discontinued their operations in the second half of 2002 as part of the reorganization of Elron, Elbit, and DEP group companies following the completion of our merger;
(iii) non-recurring merger expenses in the amount of $3.6 million which are reflected in the pro forma net loss in 2002; and
(iv) The corporate operating expenses in 2003 were lower by $0.9 million than the pro-forma corporate operating expenses in 2002.

***Reportable Segments***

Subsequent to the sale of ESW on September 2, 2003 our reportable segments are i) The Systems and Projects Segment - Elron TeleSoft; and ii) Other holdings and the corporate operations, which includes our holdings in subsidiaries, affiliates and other companies, engaged in various fields of advanced technology, and corporate operations, which provide the strategic and operational support to the group companies. Prior to September 2, 2003, we operated indirectly through ESW in a third business segment – Internet Products – which has been reclassified as discontinued operations.
At December 31, 2003, the main group companies were classified into the following segments:

| | Internet products | Systems and projects | Other holdings and corporate operations |
|---|---|---|---|
| Consolidated | ESW | Elron TeleSoft | Elbit; DEP; RDC; Galil Medical; MediaGate |
| Equity basis | | | Elbit Systems; NetVision; Chip Express; Wavion; KIT; Pulsicom; Given Imaging; Witcom; 3DV; CellAct; AMT, Notal Vision; Oren Semiconductor; Oncura |
| Marketable securities presented as available-for-sale | | | Partner; Elbit Vision System; Zix |

The following tables reflect our consolidated data by reported segments:

| | Internet products - Elron SW (Discontinued operations) | Systems and projects - Elron TeleSoft | Other holdings and corporate operations | Consolidated |
|---|---|---|---|---|
| | (millions of $) | | | |
| | Year ended December 31, 2003 | | | |
| Income** | - | 7.4 | 40.9 | 48.3 |
| Costs and Expenses | - | 9.5 | 28.0 | 37.5 |
| Loss from continuing operations | - | (2.1) | (4.8) | (6.9) |
| Net loss | *(0.7) | (2.1) | (4.4) | (7.2) |
| | Year ended December 31, 2002 | | | |
| Income** | - | 10.1 | (13.0) | (2.9) |
| Costs and Expenses | - | 15.9 | 17.1 | 33.0 |
| Loss from continuing operations | - | (5.9) | (24.3) | (30.2) |
| Net loss | *(8.6) | (5.9) | (27.1) | (41.6) |

* loss from discontinued operations
** Income in the Other holdings and corporate operations includes net losses from equity investments

**Internet Products - Elron SW ("ESW") – Discontinued operations**

As described under "Major Developments", ESW which was focused on web access control and e-mail content filtering for organizations, sold substantially all of its assets and business to Zix, and accordingly, its current period results of operations and the gain on the sale have been classified as discontinued operations and prior periods have been reclassified respectively.

The following table sets forth the composition of the discontinued operating of ESW:

| | Year ended December 31, | |
|---|---|---|
| | 2003 | 2002 |
| | (millions of $) | |
| Gain (loss) from discontinued operations: | | |
| Loss from operations | (4.8) | (8.6) |
| Gain on disposal | 4.1 | - |
| Loss from Discontinued operations | (0.7) | (8.6) |

The decrease in loss from operations in the reported period was primarily due to a decrease in operating expenses as a result of restructuring and cost reduction programs implemented by ESW at the end of 2002 and at the beginning of 2003.

**Systems and Projects - Elron TeleSoft**

Elron TeleSoft is focused on telecom network management and revenue assurance products. The following table sets forth the operating results of Elron TeleSoft:

| | Year ended December 31, | |
|---|---|---|
| | 2003 | 2002 |
| | (millions of $) | |
| Net revenues | 7.4 | 10.1 |
| Cost of revenues | 4.6 | 8.0 |
| Gross profit | 2.8 | 2.1 |
| Operating expenses* | 2.6 | 4.3 |
| Amortization of other assets | 0.8 | 0.8 |
| Restructuring charges, net | - | 1.3 |
| Operating loss | (0.6) | (4.3) |
| Finance expenses, net | 1.5 | 1.5 |
| Tax on income | - | 0.1 |
| Net loss | (2.1) | (5.9) |

*Excluding amortization of other assets and restructuring charges, net, which are presented separately.

***Net Revenues.*** Elron TeleSoft's net revenues in 2003 decreased by $2.7 million, or 27%, to $7.4 million, compared to $10.1 million in 2002, mainly as a result of the decrease in revenues derived from sale of third parties' products.

***Cost of revenues***. Cost of revenues of Elron TeleSoft in 2003 were $4.6 million, representing a gross margin of 38%, compared to $8.0 million in 2002, representing a gross margin of 21%. The increase in gross margins in 2003 is mainly due to change in revenue mix as revenues derived from Elron TeleSoft's products with higher gross margins increased relative to revenues derived from sale of third parties' products, as well as due to increased efficiency as a result of the restructuring programs implemented by Elron TeleSoft.

***Operating loss.*** Elron TeleSoft's operating loss decreased by $3.7 million, or 86%, to $0.6 million in 2003, compared to $4.3 million in 2002. The decrease in operating loss, notwithstanding the decrease in revenues, was primarily due to the higher gross margin as well as the decrease in operating expenses as a result of restructuring and cost reduction programs implemented by Elron TeleSoft which enabled Elron TeleSoft to adjust its operating expenses to the decreased revenue levels.

**Other Holdings and Corporate Operations Segment**

The other holdings and corporate operations segment includes our holdings in subsidiaries, affiliates and other companies engaged in various fields of advanced technology, and corporate operations which provide strategic and operational support to the group companies. The following table sets forth this segment's operating results:

| | Year ended December 31, | |
|---|---|---|
| | 2003 | 2002 |
| | (millions of $) | |
| Net revenues | 9.2 | 5.1 |
| Net loss from equity investments | (8.7) | (24.2) |
| Gain from disposals of businesses and affiliated companies and changes in holdings in affiliated companies, net | 25.8 | 6.9 |
| Other income (expenses), net | 14.6 | (0.8) |
| Total income | 40.9 | (13.0) |
| Cost of revenues | 5.6 | 2.7 |
| Operating expenses* | 22.9 | 15.3 |
| Amortization of other assets | 0.3 | 0.2 |
| Restructuring charges, net | - | 0.4 |
| Finance expenses (income), net | (0.8) | (1.5) |
| Total costs and expenses | 28.0 | 17.1 |
| Income (loss) from continuing operations before tax benefit (taxes on income) | 12.9 | (30.1) |
| Tax benefit (taxes on income) | (6.8) | 3.0 |
| Minority interest | (10.9) | 2.8 |
| Loss from continuing operations | (4.8) | (24.3) |
| Gain (loss) from discontinued operations | 0.4 | (2.8) |
| Net Loss | (4.4) | (27.1) |

* Excluding amortization of other assets and restructuring charges, net, which are presented separately.

**Income**

***Net revenues.*** Net revenues of the other holdings and corporate operations segment consisted of sales of products and services by our subsidiaries, Galil Medical and MediaGate, which were consolidated for the first time in the second half of 2002. The following table sets forth the segment revenues:

| | Year ended December 31, | |
|---|---|---|
| | 2003 | 2002* |
| | (millions of $) | |
| Galil Medical | 7.6 | 3.0 |
| MediaGate | 1.5 | 2.1 |
| Other | 0.1 | - |
| | 9.2 | 5.1 |

* Through June 30, 2002 the companies' results were presented under the equity method.

***Galil Medical*** recorded revenues of $7.6 million in 2003 compared to $5.0 million in 2002. The increase in revenues is mainly due to the growing awareness and acceptance of the cryotherapy technology by physicians and patients as an effective treatment for prostate cancer. Following the merger of the urology therapy units of Galil Medical and

Amersham, Galil Medical's revenues derived mainly from supplying of cryo products and R&D services to Oncura, in which it has a 25% ownership interest.

***MediaGate's*** revenues from selling advanced messaging systems decreased to approximately $1.5 million in 2003 compared to $2.6 million in 2002 as a result of the slow adoption of advanced messaging technology by telecom operators as well as by the competition from more established companies in the market with larger resources, which led the company to sell its technology and related intellectual property assets to Telrad at the end of 2003.

***Share in net losses of affiliated companies.*** Our share in net losses of affiliated companies resulted from our holdings in certain investments that are accounted for under the equity method (see above under "Basis of Presentation"). The share in net losses of affiliated companies amounted to $8.7 million in 2003 compared to $24.2 million in 2002 (as restated).

The decrease in our share in net losses of our affiliated companies in 2003, compared to 2002, resulted mainly from the following:

(i) Following the completion of the merger between Elron, Elbit and DEP, and subsequent to the acquisition of a controlling interest in MediaGate and in Galil Medical, we consolidated these companies' results of operations into our results of operations and ceased accounting for them under the equity method of accounting. Equity losses recorded in 2002 with respect to these companies for the period in which there were not consolidated amounted to $12.8 million.

(ii) The decrease in losses we recorded with respect to affiliated companies which were sold in the amount of $4.2 million and the decrease in our share in net losses of group companies whose results improved, mainly Given Imaging and Oren Semiconductor, in the amount of $1.5 million.

The above decrease was partially offset by $2.6 million, increase in our share in the losses of new group companies which are accounted under the equity method, mainly AMT, Notal Vision and Oncura.

**Highlights of the Results of Operations of Our Major Affiliates**:

***Elbit Systems Ltd. (Nasdaq: ESLT) (a 20% holding).*** Elbit Systems develops, manufactures and integrates advanced high-performance defense electronic systems. Our share in the net income of Elbit Systems amounted to $9.1 million in 2003, compared to $9.5 million in 2002.

The following are highlights of the results of operations of Elbit Systems:

- Elbit Systems' revenues increased in 2003 by 8.5% to $898.0 million from $827.5 million in 2002. The main increase in revenues was in the Armored Vehicles systems area of Elbit Systems' operation.
- As of December 31, 2003, Elbit Systems' backlog of orders was $1,752 million, of which approximately 79% is scheduled to be performed in 2004 and 2005. Elbit Systems' backlog of orders as of December 31, 2002 was $1,689 million.
- Elbit Systems' operating income in 2003 was $53.5 million (6% of revenues) compared to $57.8 million (7% of revenues) in 2002.
- Elbit Systems' net income in 2003 was $45.9 million (5.1% of revenues) compared to $45.1 million (5.5% of revenues) in 2002.

***Given Imaging (Nasdaq: GIVN)*** (a 17% holding directly and indirectly through RDC). Given Imaging, a medical device company that developed and markets a disposable miniature video camera in a capsule for visualizing the gastrointestinal tract, recorded revenues of $40.5 million in 2003, an increase of 40.3% over the revenues recorded in 2002 of $28.9 million, and a gross profit of 66.6%, compared to 58.8% in 2002. Revenue growth was driven by continued installations of new systems, expansion in reimbursement coverage and the removal of the "adjunctive tool" qualifier from its label, enabling Given Imaging to market its product as a first line tool in diagnosing disorders of the small bowel. Given Imaging's net loss decreased significantly in 2003 to $9.6 million, compared to $18.3 million in 2002, resulting mainly from increased revenues. In the fourth quarter of 2003, Given Imaging announced record sales of $12.5 million, a net loss of $0.6 million and positive cash flow for the first time in its history of $0.9 million.

***Notal Vision (a 24% holding)***. In January 2003, we completed a new investment of $2.0 million, out of $4.5 million raised by Notal Vision, a medical device company operating in the field of early detection of Age Related Macular Deterioration (AMD). In 2003, Notal Vision commenced selling its product pursuant to its distribution agreement with its strategic partner, Carl Zeiss Meditec Inc., one of the leading manufacturers of professional optics equipment, and recorded revenues of $0.9 million, and its net loss amounted to $1.6 million, consisting mainly of research and development costs.

***Oncura (a 25% holding by Galil).*** Oncura commenced its operations on July 1, 2003 following the completion of the merger of the urology therapy units of Galil and Amersham which created Oncura. Oncura markets and sells therapeutic device systems and related consumables used primarily in the performance of minimally-invasive, urologic cancer treatment. Oncura's revenues since commencing operations and through December 31, 2003, amounted to $31.4 million. Oncura's net loss amounted to $0.9 million, which resulted primarily from integration costs arising from combining the urology units of Amersham and Galil and amortization of intangible assets.

***NetVision (a 46% holding)***. NetVision provides Internet services and solutions in Israel. In 2003 NetVision changed its operating currency to the New Israeli Shekel (NIS). Accordingly, all figures below are translations for convenience purposes of NetVision's NIS figures into US dollars at the representative rate of exchange prevailing at December 31, 2003 according to which $1.00 equaled NIS 4.379.
In 2003, NetVision experienced increased competition in gaining broadband communication market share resulting from the transition of customers to broadband communication from narrow-band dial-up connections. Nevertheless, NetVision improved its operating results in 2003 and recorded an increase of 8% in revenues to $64.6 million, from $59.8 million in 2002 and its operating income increased to $4.7 million, compared to $3.4 million in 2002. However, due to higher finance expenses in 2003, NetVision's net income decreased to $0.8 million compared to $2.9 million in 2002. As of December 31, 2003, NetVision had a customer base of approximately 361,000 compared to 340,000 at the end of 2002.
NetVision expects its revenue growth and its operating results to continue to be affected by the competitive broadband market environment, which will affect market prices and penetration costs.

***Wavion (a 38% holding).*** Wavion is a developer of broadband wireless access systems for wireless LANs. In 2002, as a result of the downturn in the broadband wireless communications market, which delayed the release of Wavion’s products, Wavion significantly reduced its research and development expenses and began to sell subcontracting services for the development of wireless sub-systems. In 2003, Wavion completed a financing round led by Sequoia Seed Capital, raising $12.5 million out of which we invested $3 million. Wavion intends to use the proceeds to finance its development efforts. Accordingly, Wavion directed resources away from its subcontracting activities and its revenues in 2003 amounted to $1.8 million, similar to revenues recorded in 2002 of $1.7 million. The increase in its research and development costs resulted in an increase in Wavion's net loss which amounted to $1.7 million in 2003, compared to a net loss of $0.6 million in 2002. We expect these research and development costs to continue to increase in 2004.

***K.I.T. eLearning (a 45% holding).*** K.I.T. eLearning provides online academic programs. In 2003 we invested $2.0 million in K.I.T. eLearning B.V ("K.I.T. eLearning", formerly Kidum Holding B.V) as part of an aggregate investment round of $4.0 million, the balance of which was invested by Discount Investment Corporation Ltd. ("DIC"), which holds approximately 38.5% of our shares. K.I.T. eLearning was previously the operating subsidiary of Kidum Elron IT Ltd. ("KIT") in which we held approximately 29%.
K.I.T. eLearning's revenues increased in 2003 by 106% to $7.0 million, compared to $3.4 million in 2002, as a result of the increase in student enrollments. KIT eLearning’s operating loss decreased to $3.3 million compared to $6.1 million in 2002, primarily due to the increase in revenues. At December, 2003, K.I.T. eLearning had approximately 1,700 students, mainly from the United Kingdom, Holland, Canada, Germany, China and Singapore, as compared to approximately 1,100 students at the end of 2002.

***Chip Express (a 36% holding).*** Chip Express is a manufacturer of late stage programmable gate array ASICs (Application Specific Integrated Circuits). Chip Express' revenues in 2003 amounted to $13.7 million, compared to $16.5 million in 2002. The decrease in revenues resulted mainly from the slowdown in the semiconductor industry through the first half of 2003. In light of the recovery in this industry in the second half of 2003, Chip Express revenues increased to $7.4 million during the second half of 2003, as compared to $6.4 million in the first half of 2003 and $6.6 million in the second half of 2002. Chip Express' net loss in 2003 amounted to $7.8 million, compared to $6.4 million in 2002. However, as a result of an increase in revenues during the second half of 2003, Chip Express' net loss decreased to $3.2 million as compared to $4.6 million in the first half of 2003 and $4.7 million in the second half of 2002.
In March 2004, Chip Express raised $12.0 million in a private placement, out of which Elron invested approximately $2.6 million. As a result, Elron's interest in Chip Express decreased to approximately 26%.

***Oren Semiconductor (a 41% holding).*** Oren is a developer of chips for the digital television market. In 2003, we completed an investment of $3.0 million in Oren, as part of an aggregate investment of $8.0 million from existing shareholders and from Zoran Corporation (Nasdaq: ZRAN). In addition to the investment, we and other shareholders converted all the loans previously granted to Oren, in the amount of approximately $8.4 million into shares, of which our portion was approximately $4.4 million. Following the investment and the loan conversion, we hold approximately 41% in Oren. Zoran and Oren have agreed to cooperate to sell Oren’s front-end solution with Zoran’s

back-end chips to major players in the digital television market. Zoran is the second strategic investor in Oren after Sony Corporation invested in April 2001. Oren will use the proceeds of this equity investment to finance its marketing and sales operations in the United States and Japan and to complete the development of its new products for those markets.
In 2003, Oren’s revenues increased to $4.4 million from $2.0 million in 2002, due to a combined increase in product sales as well as in revenues derived from development projects. As a result of the increased revenues, Oren's net loss in 2003 decreased to $4.6 million compared to $6.1 million in 2002.

***AMT (a 28% holding).*** Since our investment in the company in August 2002, AMT's two operating companies, namely AHT and ACS, commenced introducing their amorphous metals technology-based products to the market and built up their operating and manufacturing infrastructure. In 2003, AHT recorded revenues of $0.8 million compared to $0.1 million in 2002, and net losses of $1.6 million, the same level as in 2002. ACS recorded in 2003 revenues of $0.6 million compared to $0.1 million in 2002, and net losses of $1.2 million compared to $1.1 million in 2002.

Despite the improvements in our share in the net losses from our group companies in 2003, we expect that most of our group companies will continue to recognize losses in future periods, as they invest significant resources in research and development and sales and marketing activities and have not yet generated significant revenues. In addition, investment in new early stage companies will result in additional losses. Therefore, we anticipate that our share in the results of these companies will continue to negatively affect our results of operations.

***Results of operations of significant group companies which are accounted for other than under the equity method of accounting.*** In addition to companies accounted for under the equity method, we have significant investment in Partner (Nasdaq: PTNR) which is accounted for as available-for-sale security and whose results do not affect our results of operations.

***Partner (Nasdaq: PTNR) (a 8.7% holding).*** At December 31, 2003, the market value of our investment in Partner amounted to $124.3 million. Partner is a Global System for Mobile Communications, or GSM, mobile telephone network operator in Israel. In 2002, Partner reached a significant milestone, as it became a profitable company and generated cash flow. In 2003, Partner continued to improve its financial performance and demonstrate its ability to sustain revenue growth, profitability and positive cash flow. The following are highlights of the results of operations of Partner for 2003 (all figures below are convenience translations of Partner’s nominal New Israeli Shekel (NIS) figures into US dollars at the rate of the exchange prevailing at December 31, 2003 according to which $1.00 equaled NIS 4.379):

- Partner’s revenues in 2003, driven primarily by subscriber growth of 14.5%, increased to $1,020.3 million, up 10.2% from $925.9 million in 2002. Partner’s subscriber base at the end of 2003 was 2,103,000 as compared to 1,837,000 at the end of 2002.
- Partner’s operating income in 2003 increased to $195.2 million from $121.8 million in 2002, an increase of 60.3%. Operating income in 2003, as a percentage of revenues, increased to 19.1% versus 13.2% in 2002.
- Partner’s net income in 2003 was $265.5 million, which include a $144.6 million tax benefit resulting from its accumulated carryforward taxes losses. In 2002, Partner’s net income was $19.2 million.

Partner has a line of credit agreement with a consortium of banks that provides for borrowings of up to $683 million of which $282 million had been drawn as of December 31, 2003. The line of credit is guaranteed by shares held by the original shareholders of Partner, pro rata to their respective original holdings. All of the shares held by us as of December 31, 2003, amounting to approximately 15.9 million shares, are pledged by us in favor of the consortium of banks.

***Gains from Disposals of Businesses and Affiliated companies and Changes in Holdings in Affiliated Companies.*** Our gains from disposals of businesses and affiliated companies and changes in holdings in affiliated companies amounted to $25.8 million in 2003 compared to $6.9 million in 2002. The gain in 2003 was mainly due to the gain from the merger of the urology therapy business of Galil Medical and Amersham in the amount of approximately $21.2 million (which after minority interest and income taxes amounted to $4.4 million) and $4.5 million gain from the sale of 753,600 shares of Given Imaging held by RDC for approximately $7.8 million and changes in holding in Given Imaging as a result of exercise of options.
The gain in the comparable period in 2002 was mainly due to a $5.3 million gain from the sale of Given Imaging shares and a $1.6 million from the sale of 380,000 shares of Elbit Systems.

***Other Income (expenses), net.*** Other income, net, amounted to $14.6 million in 2003 compared to a loss of $0.8 million in 2002. The gain in 2003 resulted primarily from the following: (i) the sale of 6,278,226 Partner shares for approximately $29.3 million which resulted in a $11.1 million gain before tax; (ii) the sale of 1,117,155 shares of Zix

for approximately $9.0 million which resulted in a $4.8 million gain before tax; and (iii) a $2.0 million gain, before tax, from the sale of all the shares of 24/7 Real Media shares (Nasdaq: TFSM) for approximately $5.2 million. These gains were partially offset by $3.7 million of write-downs mainly with respect to Cellenium and Textology.
Other expenses in 2002 resulted mainly from a $1.6 million write-downs of certain investment as well as a decrease in the market value of certain marketable securities, which were partially offset by $0.7 million gain from the sale of other marketable securities, primarily of NetManage Inc. (Nasdaq: NETM) held by us at that time.

**Expenses**

***Operating expenses.*** Operating expenses are comprised of research and development expenses, sales and marketing and general and administrative expenses of our subsidiaries, mainly Galil Medical and MediaGate, which were consolidated for the first time in the second half of 2002 as well as our and RDC's corporate operations expenses. The following table sets forth the segment operating expenses. The operating expenses presented below exclude restructuring expenses and amortization of other assets, in the amount of $0.3 million in 2003, and $0.6 million in 2002, which also constitute part of operating expenses under US GAAP but for presentation purposes are included as a separate item:

| | Year ended December 31, | |
|---|---|---|
| | 2003 | 2002 |
| | (millions of $) | |
| Corporate | 7.1 | 6.1 |
| Galil Medical* | 10.7 | 7.4 |
| MediaGate* | 3.1 | 1.8 |
| Other | 2.0 | - |
| | 22.9 | 15.3 |

* In the first half of 2002, the company's results were presented under the equity method.

Our corporate operating costs, which following the merger with Elbit in May 2002 represent the costs of the combined management, were $7.1 million in 2003, compared to $6.1 million in 2002. The increase in the corporate costs resulted mainly from the increase in costs related to the company's employee stock option plans and insurance costs. With respect to employee stock options granted in 2003, we adopted FASB Statement No.123 *"Accounting for Stock-Based Compensation"*, according to which compensation expenses are measured under fair value method (instead of intrinsic value method) using Black & Scholes option-pricing model. Amortization of deferred stock compensation amounted in 2003 to $0.4 million compared to $0.2 million in 2002.

Operating expenses of Galil Medical in 2003 were $10.7 million compared to $13.0 million in 2002. Operating expenses in 2003 includes approximately $1.2 million of non-recurring costs related to the merger of the urology therapy units of Galil Medical and Amersham. Galil Medical's operating loss in 2003 decreased to $7.6 million compared to $9.8 million in 2002 mainly as a result of the merger of the urology therapy units of Galil Medical and Amersham which resulted in a significant decrease in marketing and selling expenses. Galil plans to continue developing its cryotherapy technology for application in other health care fields, and to supply Oncura manufacturing and research and developments services on a cost plus basis, and therefore its operating loss is expected to continue to decrease. However, Galil Medical's results of operations will be affected in the future quarters by the extent of future research and developments activities for the development of new Cryo applications.

Operating expenses of MediaGate in 2003 were $3.1 million compared to $4.2 million in 2002. MediaGate's operating loss in 2003 amounted to $2.4 million compared to $3.6 million in 2002. The decrease in the operating loss of MediaGate resulted primarily from the decrease in operating expenses due to cost reduction programs implemented by MediaGate during 2002 and 2003. Following the sale of MediaGate's assets and intellectual property to Telrad, Mediagate ceased its operations.

Other operating expenses include mainly the operating expenses of RDC. At the end of 2003, RDC launched a new company named Starling Advanced Communications ("Starling"), in which RDC and Elbit Systems hold 50% each. Starling develops an antenna and satellite communication solution that enables commercial airborne broadband connectivity. Starling's research and development costs were included through its incorporation in RDC's results of operations.

***Income Taxes.*** Income taxes, net, in 2003 were $6.8 million, which were mainly due to income taxes with respect to the sale of shares of Partner, Given Imaging, Zix and 24/7 Real Media, as well as with respect to the merger of the urology therapy units of Galil Medical and Amersham. In 2002, we recorded a tax benefit of $3.0 million mainly with respect to corporate expenses.

***Loss from Discontinued Operations*** of $2.8 million in 2002 was mainly with respect to our subsidiary VFlash which sold substantially all of its assets and business to 24/7 Real Media Inc. (Nasdaq: TFSM) in exchange for shares of 24/7 Real Media, resulting in a gain of $2.0 million which was partially offset by the results of operations of VFlash in the amount of $1.9 million. Also included in this item are the net losses of other subsidiaries such as Textology which was sold in the aggregate amount of $2.9 million.

## QUARTERLY RESULTS OF OPERATIONS

The table below sets forth unaudited consolidated statement of operations data for each of the four consecutive quarters ended December 31, 2003.

| | Q1/2003 | Q2/2003 | Q3/2003 | Q4/2003 | 2003 |
|---|---|---|---|---|---|
| | | | (millions of $) | | |
| Net revenues | 3.8 | 4.0 | 4.7 | 4.0 | 16.5 |
| Net loss from equity investments | (3.0) | (3.9) | (1.2) | (0.6) | (8.7) |
| Gain from disposals of business and affiliated companies and changes in holdings in related companies, net | 0.4 | 0.9 | 24.4 | 0.1 | 25.8 |
| Other income (expenses), net | (1.2) | 7.3 | 3.7 | 4.9 | 14.7 |
| Total income | - | 8.3 | 31.6 | 8.4 | 48.3 |
| Costs and expenses | 10.3 | 10.2 | 9.4 | 7.6 | 37.5 |
| Gain (loss) from continuing operations before tax benefit (taxes on income) | (10.3) | (1.9) | 22.2 | 0.8 | 10.8 |
| Tax benefit (taxes on income) | 0.4 | (2.2) | (3.9) | (1.1) | (6.8) |
| Minority interest | 2.0 | 1.7 | (15.6) | 1.0 | (10.9) |
| Income (loss) from continuing operations | (7.9) | (2.4) | 2.7 | 0.7 | (6.9) |
| Gain (loss) from discontinued operations | (1.4) | (1.6) | 0.3 | 2.4 | (0.3) |
| Net income (loss) | (9.3) | (4.1) | 3.0 | 3.1 | (7.2) |

Because we are a high technology operational holding company that operates through group companies, and therefore the major contributions to our net income (or loss) in any given quarter are our share in our group companies' result of operation and gain (or loss) from disposition of and changes in our holdings in group companies, we have experienced, and expect to continue to experience, significant volatility in our quarterly results.
Most of our group companies' results continue to improve, reducing the level of losses with respect to these companies during 2003. In addition, since the second quarter of 2003 we recorded significant gains from sale of shares of our group companies (mainly Partner shares in the second and the third quarter of 2003) as well as gains from the merger between the urology therapy units of Galil Medical and Amersham in the third quarter of 2003 and the sale of ESW assets and business and the shares of Zix received as a consideration in the third and fourth quarter of 2003, enabling us to offset our share in the group companies' losses and to report net income.

## LIQUIDITY AND CAPITAL RESOURCES

Consolidated cash, debentures and deposits (including short and long-term) at December 31, 2003 were approximately $114.6 million compared with $96.8 million at December 31, 2002.
At December 31, 2003, the corporate cash, debentures and deposits (including short and long term) were $107.3 million (of which 99% were held in U.S. dollar accounts) compared with $94.1 million at December 31, 2002. An amount of $27.2 million is collateralized to secure current maturities of long-term bank loans of ESW and Elron TeleSoft. An amount of $76.6 million has average maturities of less than three months. An amount of $5.5 million is invested in commercial marketable debentures and certificates of deposits, all with credit quality issuers and with limited amount of credit exposure to any one issuer.

The main sources of the corporate cash and other liquid instruments in 2003 were $29.3 million proceeds from the sale of 6,278,226 shares of Partner, $9.0 million proceeds from the sale of 1,117,155 shares of Zix, $5.2 million proceeds from the sale of 24/7 Real Media shares, a $4.3 million repayment of loan granted to RDC, and a $3.0 million dividend received from Elbit Systems.

The main uses of the corporate cash and other liquid instruments in 2003 were an aggregate of $19.8 million investments in new and existing group companies and $5.8 million repayment of bank loans. In addition, in 2003, we and Rafael, the minority shareholder of RDC, purchased two million unregistered shares of Given Imaging (one million each) from RDC for a total consideration of $12.2 million. RDC used the proceeds to repay $5.0 million shareholders' loans to each of Rafael and us, $2.5 million to repay a bank loan, and the remainder was used for its investment activity.

The following table sets forth the investments made during 2003 by Elron (in million of $):

| | |
|---|---|
| Oren Semiconductor | 3.6 |
| Galil Medical | 3.2 |
| Wavion | 3.0 |
| MediaGate | 2.7 |
| Notal | 1.7 |
| KIT | 1.5 |
| AMT | 1.3 |
| Pulsicom | 0.5 |
| Other | 2.3 |
| | 19.8 |
| Purchase of Given Imaging shares from RDC | 6.1 |
| | 25.9 |

Consolidated working capital on December 31, 2003 was $57.0 million compared to $31.8 million at December 31, 2002. The increase was primarily due to increase in cash and cash equivalents mainly as a result of the sale of Partner, Zix and 24/7 Real Media shares in the aggregate amount of $43.5 million. This increase was partially offset by $25.9 million investment in our group companies and in new companies.

At December 31, 2003, we and our subsidiaries had no material contractual obligations which are expected to affect our consolidated cash flow in future periods, except for capital lease obligations and payments of bank credits, bank loans and loans from others, including short term loans taken by our subsidiaries, in each case due in future periods as set forth in the table below.

| Type of Obligation | 2004 | 2005 | 2006 | With no specified maturity date | Total |
|---|---|---|---|---|---|
| Loans from banks | $ 52.9 million | $ 14.6 million | - | $ 2.6 million | $ 70.1 million |
| Loans from other | $ 3.1 million | - | - | - | $ 3.1 million |
| Capital leases | $ 0.5 million | $ 0.3 million | $ 0.1 million | - | $ 0.9 million |

Consolidated loans at December 31, 2003 were approximately $73.2 million, of which $67.5 million is attributed to Elron Telesoft and ESW, associated with the purchase of their main operations and net assets. Elron provided guarantees to banks of up to approximately $76.1 million to secure bank loans made available to Elron TeleSoft and ESW and of which $67.5 million have been utilized as of December 31, 2003. In addition, in connection with some of Elron TeleSoft's bank loans, we have provided to the lending banks comfort letters pursuant to which we undertook not to reduce our holdings beyond a certain percentage.

Neither Elron Telesoft nor Elron Software is currently generating or is expected, in the near future, to generate sufficient revenues to repay their loans to the banks and accordingly we may be required to repay such indebtedness when due under the current lending arrangements or to refinance such loans under new terms which will not be necessarily on terms favorable to us.

MediaGate's bank's loan in the amount of approximately $2.6 million has been secured by a first ranking pledge over the future proceeds to be received as royalties as a consideration for the sale of its technology to Telrad.

In 2001, we, together with other major shareholder of NetVision, provided letters of comfort in connection with the credit line granted to NetVision by banks pursuant to which we jointly undertook not to reduce our joint holdings beyond a certain percentage. The amount outstanding under the credit line at December 31, 2003 was approximately $21.3 million.

All of Partner's shares held by us as of December 31, 2003, amounting to approximately 15.9 million shares, are pledged by us in favor of Partner's consortium of banks.

Subsequent to December 31, 2003 and through March 9, 2004, we invested an additional aggregate amount of approximately $3.7 million in our group companies, which include mainly $2.6 million in Chip Express.

We believe that our existing capital will be sufficient to fund our and our subsidiaries' operations and our investment plan in existing and new companies as well as repaying bank loans provided to ESW and Elron Telesoft, when they become due and if not extended, for at least the next twelve months.
Shareholders' equity at December 31, 2003, was approximately $296.1 million representing approximately 66% of the total assets compared with $259.4 million representing approximately 66% of total assets at December 31, 2002.

## QUALITIVE AND QUANTITIVE DISCLOSURE ABOUT MARKET RISK

Market risks relating to our operations result primarily from changes in interest rates, exchange rates and equity prices. In order to limit our exposure, we may enter, from time to time, into various derivative transactions. Our objective is to reduce exposure and fluctuations in earnings and cash flows associated with changes in interest rates, foreign currency rates and equity prices. We do not use financial instruments for trading purposes. It is our policy and practice to use derivative financial instruments only to limit exposure.

***Interest Rate Risks.*** We are exposed to market risks resulting from changes in interest rates, relating primarily to our funds and loan obligations to banks. We do not use derivative financial instruments to limit exposure to interest rate risk. At December 31, 2003, we had fixed rate financial assets of $5.5 million held for up to 3 years, and variable rate financial assets of $101.8 million. At the same time, our subsidiaries had variable interest loans of $71.1 million. Therefore, we believe that the potential loss that would result from an increase or decrease in the interest rate is immaterial to our business and net assets.

***Exchange Rate Risk.*** Since most of our group companies are Israeli-related, our main exposure, if any, results from changes in the exchange rate between the New Israeli Shekel and the U.S. dollar. Our functional currency, as well as that of our principal subsidiaries and affiliated companies, is the U.S. dollar. Our policy is to reduce exposure to exchange rate fluctuations by having most of our and our subsidiaries' assets and liabilities, as well as most of the revenues and expenditures in U.S. dollars, or U.S. dollar linked. Therefore, we believe that the potential loss that would result from an increase or decrease in the exchange rate is immaterial to our business and net assets.

***Equity Price Risk.*** We are exposed to fluctuations in the equity price of our holdings in publicly traded companies. At December 31, 2003 we directly and indirectly held shares of the following publicly traded companies: Elbit Systems (Nasdaq: ESLT), Given Imaging (Nasdaq: GIVN), Partner Communication Company Ltd. (Nasdaq: PTNR), Elbit Vision Systems (Nasdaq: EVSNF), and Zix (Nasdaq: ZIXI).
Stock prices in the industries of these companies have experienced significant historical volatility. Changes in the market value of our publicly traded holdings, including holdings through our affiliates, which are accounted under the equity method of accounting or as available-for-sale securities will not affect our results of operations but may have a significant effect on our market value. We view the risks of reduction in market price of these companies as part of our business risks and we examine, from time to time, the possibility of having a partial hedge against equity price risks. Based on closing market prices at December 31, 2003, the fair market value of our holdings in public securities was approximately $355.2 million. As of December 31, 2003 no financial instruments are used to hedge against equity price fluctuations.
Changes in the market value of our available-for-sale securities (which mainly include our holding in Partner) are reported in other comprehensive income, which is included as a component of shareholders' equity, and not as part of our results of operations. The market value of our available-for-sale securities as of December 31, 2003 amounted to $132.3 million.

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