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RADA ELECTRONIC INDUSTRIES LTD
Form 20-F
March 31, 2005

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON D.C. 20549
FORM 20-F

REGISTRATION STATEMENT PURSUANT TO SECTION 12(b) OR
12(g) OF THE SECURITIES EXCHANGE ACT OF 1934

or

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF
THE SECURITIES EXCHANGE ACT OF 1934
For the fiscal year ended December 31, 2004

or

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE
SECURITIES EXCHANGE ACT OF 1934
For the transition period from _____ to _____

Commission file number: 0-15375

RADA ELECTRONIC INDUSTRIES LTD.
(Exact Name of Registrant as Specified in Its Charter
and Translation of Registrant's Name Into English)

Israel
(Jurisdiction of Incorporation or Organization)

7 Giborei Israel Street, Netanya 42504, Israel
(Address of Principal Executive Offices)

Securities registered or to be registered pursuant to Section 12(b) of the Act:
None

Securities registered or to be registered pursuant to Section 12(g) of the Act:
Ordinary Shares, NIS 0.005 Par Value
(Title of Class)

Securities for which there is a reporting obligation pursuant to Section 15(d)
of the Act:
None
(Title of Class)

Indicate the number of outstanding shares of each of the issuer's classes of
capital or common stock as of the close of the period covered by the annual
report:

Ordinary Shares, par value NIS 0.005 per share..... 20,448,364

Indicate by check mark whether the registrant: (1) has filed all reports
required to be filed by Section 13 or 15(d) of the Securities Exchange Act
of 1934 during the preceding 12 months (or for such shorter period that the
registrant was required to file such reports), and (2) has been subject to
such filing requirements for the past 90 days.

Yes No

Indicate by check mark which financial statement item the registrant has elected

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to follow:

Item 17 [] Item 18 [X]

This annual report on Form 20-F is incorporated by reference into the registrant's Registration Statements on Form F-3, Registration Nos. 333-12074 333-115598 and 333-117954.

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THIS ANNUAL REPORT ON FORM 20-F CONTAINS VARIOUS "FORWARD-LOOKING STATEMENTS" WITHIN THE MEANING OF SECTION 27A OF THE SECURITIES ACT OF 1933, AS AMENDED, AND SECTION 21E OF THE SECURITIES EXCHANGE ACT OF 1934, AS AMENDED, AND WITHIN THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995, AS AMENDED. SUCH FORWARD-LOOKING STATEMENTS REFLECT OUR CURRENT VIEW WITH RESPECT TO FUTURE EVENTS AND FINANCIAL RESULTS. FORWARD-LOOKING STATEMENTS USUALLY INCLUDE THE VERBS "ANTICIPATES," "BELIEVES," "ESTIMATES," "EXPECTS," "INTENDS," "PLANS," "PROJECTS," "UNDERSTANDS" AND OTHER VERBS SUGGESTING UNCERTAINTY. WE REMIND READERS THAT FORWARD-LOOKING STATEMENTS ARE MERELY PREDICTIONS AND THEREFORE INHERENTLY SUBJECT TO UNCERTAINTIES AND OTHER FACTORS AND INVOLVE KNOWN AND UNKNOWN RISKS THAT COULD CAUSE THE ACTUAL RESULTS, PERFORMANCE, LEVELS OF ACTIVITY, OR OUR ACHIEVEMENTS, OR INDUSTRY RESULTS, TO BE MATERIALLY DIFFERENT FROM ANY FUTURE RESULTS, PERFORMANCE, LEVELS OF ACTIVITY, OR OUR ACHIEVEMENTS EXPRESSED OR IMPLIED BY SUCH FORWARD-LOOKING STATEMENTS. READERS ARE CAUTIONED

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NOT TO PLACE UNDUE RELIANCE ON THESE FORWARD-LOOKING STATEMENTS, WHICH SPEAK ONLY AS OF THE DATE HEREOF. WE UNDERTAKE NO OBLIGATION TO PUBLICLY RELEASE ANY REVISIONS TO THESE FORWARD-LOOKING STATEMENTS TO REFLECT EVENTS OR CIRCUMSTANCES AFTER THE DATE HEREOF OR TO REFLECT THE OCCURRENCE OF UNANTICIPATED EVENTS.

UNLESS SPECIFICALLY INDICATED OTHERWISE, ALL NUMBERS OF ORDINARY SHARES AND PER SHARE DATA IN THIS ANNUAL REPORT REFLECT A TWO AND ONE HALF SHARE FOR ONE SHARE REVERSE STOCK SPLIT OF OUR ORDINARY SHARES EFFECTED ON APRIL 4, 2001.

PART I

ITEM 1. IDENTITY OF DIRECTORS, SENIOR MANAGEMENT AND ADVISERS

Not applicable.

ITEM 2. OFFER STATISTICS AND EXPECTED TIMETABLE

Not applicable.

ITEM 3. KEY INFORMATION

A. SELECTED FINANCIAL DATA

We derived the following consolidated statements of operations data for the years ended December 31, 2002, 2003 and 2004 and the consolidated balance sheet data as of December 31, 2003 and 2004 from our audited consolidated financial statements and notes included in this annual report. We derived the consolidated statements of operations data for the years ended December 31, 2000 and 2001, and the consolidated balance sheet data as of December 31, 2000, 2001 and 2002 from our audited consolidated financial statements that are not included in this annual report.

	YEAR ENDED DECEMBER 31		
	2000	2001	2002
	(U.S. dollars in thousands, except		
Revenues.....	\$ 3,816	\$ 8,342	\$ 10,399
Cost of revenues.....	5,307	7,416	9,223
Gross profit (loss).....	(1,491)	926	1,176
Research and development expenses.....	730	534	122
Marketing, selling, general and administrative expenses.....	3,612	3,617	3,809
Operating income (loss) from continuing operations.....	(5,833)	(3,225)	(2,035)
Financial income (expenses), net.....	(861)	(210)	(364)
Other income (expenses), net.....	563	(30)	(290)
Operating income (loss).....	(6,131)	(3,465)	(2,689)
Minority interest in losses of subsidiary.....	32	96	206

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Net income (loss)	\$ (6,099)	\$ (3,369)	\$ (2,483)
	=====	=====	=====
Basic net income (loss) per share.....	\$ (0.46)	\$ (0.24)	\$ (0.15)
	=====	=====	=====
Diluted net income (loss) per share.....	\$ (0.46)	\$ (0.24)	\$ (0.15)
	=====	=====	=====
Weighted average number of shares used to compute basic net income(loss) per share.....	13,305	13,817	16,555
	=====	=====	=====
Weighted average number of shares used to compute diluted net income (loss) per share.....	13,305	13,817	16,555
	=====	=====	=====

AS OF DECEMBER 31,

	2000	2001	2002
	-----	-----	-----

(U.S. dollars in thous

BALANCE SHEET DATA:

Working capital (deficiency).....	\$ (8,668)	\$ (9,446)	\$ (8,055)
Total assets.....	18,874	16,332	14,607
Short-term credits and current maturities of long-term debt.....	5,624	5,920	5,697
Long-term debt, net of current maturities.....	8	--	--
Convertible note.....	--	--	--
Shareholders' equity.....	4,069	700	485

B. CAPITALIZATION AND INDEBTEDNESS

Not applicable.

C. REASONS FOR THE OFFER AND USE OF PROCEEDS

Not applicable.

D. RISK FACTORS

INVESTING IN OUR ORDINARY SHARES INVOLVES A HIGH DEGREE OF RISK AND UNCERTAINTY. YOU SHOULD CAREFULLY CONSIDER THE RISKS AND UNCERTAINTIES DESCRIBED BELOW BEFORE INVESTING IN OUR ORDINARY SHARES. OUR BUSINESS, PROSPECTS, FINANCIAL CONDITION AND RESULTS OF OPERATIONS COULD BE ADVERSELY AFFECTED DUE TO ANY OF THE FOLLOWING RISKS. IN THAT CASE, THE VALUE OF OUR ORDINARY SHARES COULD DECLINE, AND YOU COULD LOSE ALL OR PART OF YOUR INVESTMENT.

RISKS RELATED TO OUR BUSINESS AND OUR INDUSTRY

WE HAVE A HISTORY OF LOSSES, AND MAY NOT BE ABLE TO MAINTAIN PROFITABLE OPERATIONS IN THE FUTURE.

Although we reported net income of \$758,000 and \$822,000 for the fiscal

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years ended December 31, 2003 and 2004, we incurred losses in the five preceding years. As of December 31, 2004 our accumulated deficit was \$56.9 million. No assurance can be given that we will be able to maintain our current level of revenues or profitability in the future.

WE MAY NEED TO RAISE ADDITIONAL CAPITAL IN THE FUTURE, WHICH MAY NOT BE AVAILABLE TO US.

Our working capital requirements and the cash flow provided by our operating activities are likely to vary greatly from quarter to quarter, depending on the timing of orders and deliveries, the build-up of inventories, and the payment terms offered to our customers. As a consequence of our significant losses, we incurred significant bank debt and sold equity and debt securities in private placements in the years 1997 through 2004. In June 2003 we reached an agreement to restructure our debt with Bank Hapoalim B.M. and Bank Leumi Le-Israel B.M. that significantly improved our financial position. We may need to raise additional funds for a number of uses, including:

- o working capital and operating activities;
- o implementing marketing and sales activities for our products;
- o maintaining and expanding research and development programs;
- o hiring additional qualified personnel; and
- o supporting an increased level of operations.

We may not be able to obtain additional funds on acceptable terms or at all. If we cannot raise needed funds on acceptable terms, we may be required to delay, scale back or eliminate some aspects of our operations and we may not be able to:

- o develop new products;
- o enhance our existing products;
- o remain current with evolving industry standards;
- o fulfill our contractual obligations;

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- o take advantage of future opportunities;
- o respond to competitive pressures or unanticipated requirements; or
- o retain our listing on the Nasdaq SmallCap Market.

If adequate funds are not available to us, our business, results of operations and financial condition will be materially and adversely affected. Any equity or debt financings, if available at all, may cause dilution to our then-existing shareholders and may increase our financing expenses. If additional funds are raised through the issuance of equity securities, the net tangible book value per share of our ordinary shares would decrease and the percentage ownership of then current shareholders would be diluted.

WE MAY NOT BE ABLE TO IMPLEMENT OUR GROWTH STRATEGY.

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In line with our growth strategy, we have entered into teaming agreements and other co-operation agreements with Smiths Aerospace Electronic Systems, or Smiths, and Lockheed Martin Aerospace to increase our penetration into the aviation market. We are currently investing and intend to continue to invest significant resources to develop these relationships. Should our relationships fail to materialize into significant agreements or should we fail to work efficiently with such parties, we may lose sales and marketing opportunities and our business, results of operations and financial condition could be adversely affected.

As part of our growth strategy, we seek to acquire or invest in complementary, including competitive, businesses, products and technologies. We acquired the assets of Vectop Ltd. in the first quarter of 2005, and are seeking additional potential acquisition candidates. We currently have no commitments or agreements with respect to any future acquisitions or investments and we cannot assure you that we will eventually be able to consummate any acquisition or investment. Even if we do acquire or invest in these businesses, products or technology, the process of integrating acquired assets into our operations may result in unforeseen operating difficulties and expenditures and may absorb significant management attention that would otherwise be available for the ongoing development of our business.

In addition, we have limited experience in managing acquisitions and growth. We cannot assure you that the anticipated benefits of any acquisition will be realized. In addition, future acquisitions by us could result in potentially dilutive issuances of our equity securities, the incurrence of debt and contingent liabilities and amortization expenses related to goodwill and other intangible assets, any of which could materially adversely affect our operating results and financial position. Acquisitions also involve other risks, including risks inherent in entering markets in which we have no or limited prior experience and the potential loss of key employees and the risk that we may experience difficulty or delays in obtaining necessary permits.

COMPETITION IN THE MARKET FOR AUTOMATED TEST EQUIPMENT AND AVIONICS EQUIPMENT IS INTENSE AND WE MAY BE UNABLE TO ACHIEVE PROFITABILITY.

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The market for our products is highly competitive, and we may not be able to compete effectively in our market. Our principal competitors in the automated test equipment market are Zaban in Israel, and Aerospatiale Avionique and Avtron abroad. Our principal competitors in the avionics market are Harris, Rockwell Collins, Honeywell, Elbit Systems Ltd., IAI, R.S.L. Ltd. TEAK and Elisra Systems Ltd. We expect to continue to face competition from these and other competitors. Most, if not all, of our competitors are far larger, have substantially greater resources including financial, technological, marketing and distribution capabilities, and enjoy greater market recognition than we have. These competitors may be able to achieve greater economies of scale and may be less vulnerable to price competition than us. We may not be able to offer our products as part of integrated systems to the same extent as our competitors or successfully develop or introduce new products that are more cost effective or offer better performance than those of our competitors. Failure to do so could adversely affect our business, financial condition and results of operations.

OUR INITIATIVE OF PROVIDING MANUFACTURING SERVICES MAY NOT SUCCEED, AND AS A RESULT, WE MAY BE UNABLE TO ACHIEVE PROFITABILITY IN OUR BEIT-SHE'AN PRODUCTION FACILITY AND MAY BE FORCED TO SHUT DOWN ITS OPERATIONS.

In June 2000, we began to provide manufacturing services to original

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equipment manufacturers in Israel and the United States, using the manufacturing capabilities of our Beit-She'an plant. The market for our manufacturing services is highly competitive and we may not be able to compete effectively in this market. The cost of labor and the efficiency of the production equipment and production processes are crucial to our success in this market. Consequently, should we fail to maintain low labor costs, enhance our production equipment and develop new and more efficient production methods, we may have to shut down the operations of our Beit-She'an plant, which may harm our competitiveness and could adversely affect our business, results of operations and financial condition.

REDUCTION IN MILITARY BUDGETS WORLDWIDE MAY CAUSE A REDUCTION IN OUR REVENUES, WHICH WOULD ADVERSELY AFFECT OUR BUSINESS, OPERATING RESULTS AND FINANCIAL CONDITION.

A significant portion of our revenues is derived from the sale of products with military applications. These revenues, on a consolidated basis, totaled approximately \$11.8 million, or 83 % of revenues in 2004, \$9.6 million, or 78% of revenues, in 2003 and \$6.9 million, or 66% of revenues, in 2002. The military budgets of a number of countries may be reduced in the future. Declines in military budgets may result in reduced demand for our products and manufacturing services. This would result in reduction in our core business' revenues and adversely affect our business, results of operations and financial condition.

SALES OF OUR PRODUCTS ARE SUBJECT TO GOVERNMENTAL PROCUREMENT PROCEDURES AND PRACTICES; TERMINATION, REDUCTION OR MODIFICATION OF CONTRACTS WITH OUR CUSTOMERS, AND ESPECIALLY WITH THE GOVERNMENT OF ISRAEL, OR A SUBSTANTIAL DECREASE IN OUR CUSTOMERS' BUDGETS MAY ADVERSELY AFFECT OUR BUSINESS, OPERATING RESULTS AND FINANCIAL CONDITION.

Our military aviation products are sold primarily to government agencies and authorities and government-owned companies, many of which have complex and time-consuming procurement procedures. A long period of time often elapses from the time we begin marketing a product until we actually sell that product to a particular customer. In addition, our sales to government agencies, authorities and companies are directly affected by these customers' budgetary constraints and the priority given in their budgets to the procurement of our products.

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Further, our business with the State of Israel and other governmental entities is, in general, subject to delays in funding and performance of contracts and the termination of contracts or subcontracts for convenience, among others. The termination, reduction or modification of our contracts or subcontracts with the Government of Israel in the event of change in requirements, policies or budgetary constraints would have an adverse effect on our business, operating results and financial condition.

IF WE DO NOT RECEIVE THE GOVERNMENTAL APPROVALS NECESSARY FOR THE EXPORT OF OUR PRODUCTS, OUR REVENUES MAY DECREASE. SIMILARLY IF OUR SUPPLIERS AND PARTNERS DO NOT RECEIVE THEIR GOVERNMENT APPROVALS NECESSARY TO EXPORT THEIR PRODUCTS OR DESIGNS TO US, OUR REVENUES MIGHT DECREASE AND WE MAY FAIL TO IMPLEMENT OUR GROWTH STRATEGY.

Under Israeli law, the export of certain of our products and know-how is subject to approval by the Israeli Ministry of Defense. To initiate sales proposals with regard to exports of our products and know-how and to export such products or know-how, we must obtain permits from the Ministry of Defense. We cannot assure you that we will receive in a timely manner all the required

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permits for which we may apply in the future.

Similarly, under foreign laws the export of certain military products, technical designs and spare parts require the prior approval of, or export license from, such foreign governments. In order to maintain our third party production, certain co-development activities and procurements required for the performance of certain contracts, we must receive detailed technical designs, products or products' parts samples from our strategic partners or suppliers. We cannot assure you that we will be able to receive all the required permits and/or licenses in a timely manner. Consequently, our revenues may decrease and we may fail to implement our growth strategy.

WE DEPEND ON SALES TO KEY CUSTOMERS AND THE LOSS OF ONE OR MORE OF OUR KEY CUSTOMERS WOULD RESULT IN A LOSS OF A SIGNIFICANT AMOUNT OF OUR REVENUES.

A significant portion of our revenues is derived from a small number of customers. Our major customers during the three years ended December 31, 2004 were as follows:

	PERCENTAGE OF REVENUES		
	2002	2003	2004
Smiths Electronic Systems.....	34%	22%	5%
The Boeing Company.....	19%	14%	10%
Israeli Ministry of Defense.....	3%	11%	19%
Israel Aviation Industries.....	5%	12%	6%
Portuguese Air Force.....	4%	19%	17%
U.S. Navy.....	-	-	11%

We anticipate that a significant portion of our future revenues will continue to be derived from sales to a small number of customers. Further, in accordance with our growth strategy, we are attempting to expand the number of our customers while building long-term relationships with them. If our principal customers do not continue to purchase products from us at current levels or if such customers are not retained and we are not able to derive sufficient revenues from sales to new customers to compensate for their loss, our revenues would be reduced and adversely affect our business, financial condition and results of operations.

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WE DEPEND ON A LIMITED NUMBER OF SUPPLIERS OF COMPONENTS FOR OUR PRODUCTS AND IF WE ARE UNABLE TO OBTAIN THESE COMPONENTS WHEN NEEDED, WE WOULD EXPERIENCE DELAYS IN MANUFACTURING OUR PRODUCTS AND OUR FINANCIAL RESULTS COULD BE ADVERSELY AFFECTED.

We acquire most of the components for the manufacturing of our products from a limited number of suppliers and subcontractors, most of whom are located in Israel and the United States. Certain of these suppliers are currently the sole source of one or more components upon which we are dependent. Suppliers of some of the components for manufacturing require us to place orders with significant lead-time to assure supply in accordance with our manufacturing requirements. Inadequacy of operating funds may cause us to delays placement of such orders and may result in delays in supply. Delays in supply may

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significantly hurt our ability to fulfill our contractual obligations and may significantly hurt our business and result of operations. We cannot assure you that we will be able to continue to obtain such components from these suppliers on satisfactory commercial terms. Temporary disruptions of our manufacturing operations would ensue if we were required to obtain components from alternative sources, which may have an adverse effect on our financial results.

WE RELY ON THE AIRLINE INDUSTRY AND THE CONTINUED FINANCIAL CRISES IN THIS INDUSTRY ADVERSELY AFFECTS OUR SALES.

The airline industry is an important market for our automated test equipment products and product support services. Our ability to achieve growth and profitability in this market depends in great measure on the economic condition of the commercial aviation industry. Since 2001, and especially following the tragic events of September 11, 2001, the airline industry has suffered from economic decline that caused the bankruptcy of several airlines and imposed financial constraints on the entire industry. As a result of these conditions, the sales of our automated test equipment products have materially decreased. The continuance of the crisis in the commercial aviation industry will adversely affect our business, financial condition and results of operations.

RAPID TECHNOLOGICAL CHANGES MAY ADVERSELY AFFECT THE MARKET ACCEPTANCE OF OUR PRODUCTS.

The avionics market in which we compete is subject to technological changes, introduction of new products, change in customer demands and evolving industry standards. Our future success will depend upon our ability to keep pace with technological developments and to timely address the increasingly sophisticated needs of our customers by supporting existing and new technologies and by developing and introducing enhancements to our current products and new products. We cannot assure you that we will be successful in developing and marketing enhancements to our products that will respond to technological change, evolving industry standards or customer requirements; that we will not experience difficulties that could delay or prevent the successful development, introduction and sale of such enhancements; or that such enhancements will adequately meet the requirements of the market and achieve any significant degrees of market acceptance. If release dates of our new products or enhancements are delayed or, if when released, they fail to achieve market acceptance, our business, operating results and financial condition would be materially adversely affected.

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WE MAY ENCOUNTER DIFFICULTIES WITH OUR INTERNATIONAL OPERATIONS AND SALES.

While our principal executive offices are located in Israel, 65% of our sales in 2004, 74% of our sales in 2003 and 86% of our sales in 2002 were exports. This subjects us to many risks inherent in international business, including:

- o limitations and disruptions resulting from the imposition of government controls;
- o changes in regulatory requirements;
- o export license requirements;
- o economic or political instability;

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- o trade restrictions;
- o changes in tariffs;
- o currency fluctuations;
- o longer receivable collection periods and greater difficulty in accounts receivable collection;
- o greater difficulty in safeguarding intellectual property;
- o difficulties in managing overseas subsidiaries and international operations; and
- o potential adverse tax consequences.

We cannot assure you that we will be able to sustain or increase revenues from international operations or that we will not encounter significant difficulties in connection with the sale of our products in international markets or that one or more of these factors will not have a material adverse effect on our future revenues and, as a result, our business, operating results and financial condition.

CURRENCY EXCHANGE RATE FLUCTUATIONS IN THE WORLD MARKETS IN WHICH WE CONDUCT BUSINESS COULD HAVE A MATERIAL ADVERSE EFFECT ON OUR BUSINESS, RESULTS OF OPERATIONS AND FINANCIAL CONDITION.

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We may be adversely affected by fluctuations in currency exchange rates. While our revenues are generally denominated in U.S. dollars, a significant portion of our expenses is incurred in NIS. We do not currently engage in any currency hedging transactions intended to reduce the effect of fluctuations in foreign currency exchange rates on our results of operations. If we were to determine that it was in our best interests to enter into any hedging transactions in the future, there can be no assurance that we will be able to do so or that such transactions, if entered into, will materially reduce the effect of fluctuations in foreign currency exchange rates on our results of operations. In addition, if for any reason exchange or price controls or other restrictions on the conversion of foreign currencies into NIS were imposed, our business could be adversely affected. There can be no assurance such fluctuations in the future will not have a material adverse effect on revenues from international sales, and consequently, on our business, operating results and financial condition.

WE ARE DEPENDENT ON OUR SENIOR MANAGEMENT AND KEY PERSONNEL, IN PARTICULAR HERZLE BODINGER, OUR PRESIDENT AND CHAIRMAN OF THE BOARD, WHOSE LOSS COULD ADVERSELY AFFECT OUR BUSINESS.

Our future success depends in large part on the continued services of our senior management and key personnel. In particular, we are dependent on the services of Herzle Bodinger, our chairman and president. We do not carry key person life insurance on our senior management or key personnel. Any loss of the services of Herzle Bodinger, other members of senior management or other key personnel could negatively and materially affect our business.

OUR PROPRIETARY TECHNOLOGY IS DIFFICULT TO PROTECT AND UNAUTHORIZED USE OF OUR PROPRIETARY TECHNOLOGY BY THIRD PARTIES MAY IMPAIR OUR ABILITY TO COMPETE

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EFFECTIVELY.

Our success and ability to compete largely depends upon protecting our proprietary technology. We rely on a combination of trade secrets, copyright law and confidentiality, non-disclosure and assignment-of-inventions agreements to protect our proprietary technology. Except for a patent that relates to our ACE(TM) system, we do not have any patents.

OUR PRODUCTS MAY INFRINGE ON THE INTELLECTUAL PROPERTY RIGHTS OF OTHERS.

Third parties may assert infringement claims against us or claims that we have violated a patent or infringed on a copyright, trademark or other proprietary right belonging to them. In addition, any infringement claim, even one without merit, could result in the expenditure of significant financial and managerial resources to defend.

WE MAY NOT BE ABLE TO OBTAIN TITLE TO THE LAND AND BUILDINGS OF OUR CHINESE SUBSIDIARY AND MAY BE REQUIRED TO INITIATE LITIGATION IN ORDER TO ENFORCE OUR RIGHTS TO RECEIVE TITLE TO SUCH PROPERTIES.

Beijing Huarui Aircraft Components Maintenance and Services Co., Ltd. or CACS, our Chinese subsidiary, conducts its business in an approximately 16,000 square foot facility in Beijing that includes offices and test and repair facilities. The land for this facility was leased by Beijing Tianzu Forestry Company or Tianzu, the minority shareholder in CACS, from the Chinese government for 30 years. Under a joint venture agreement, and in consideration for its equity investment in CACS, Tianzu granted CACS usage rights in the land, constructed the buildings and granted CACS the ownership of these buildings. However, the transfer of the title to the land and the buildings has not been completed, which may prevent the disposition of these assets should CACS desire to do so. Although Tianzu is legally obligated to complete such transfer of title to the land and the buildings, we can not guarantee that such transfer will be completed, or that we will not be required to initiate litigation in order to enforce our rights to receive title to the land and buildings.

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COMPLIANCE WITH CHANGING REGULATION OF CORPORATE GOVERNANCE AND PUBLIC DISCLOSURE MAY RESULT IN ADDITIONAL EXPENSES.

Changing laws, regulations and standards relating to corporate governance and public disclosure, including the Sarbanes-Oxley Act of 2002, new Securities and Exchange Commission regulations and NASDAQ Stock Market rules, are creating uncertainty for companies such as ours. We are committed to maintaining high standards of corporate governance and public disclosure. As a result, we intend to invest reasonably necessary resources to comply with evolving standards, and this investment may result in increased general and administrative expenses and a diversion of management time and attention from revenue-generating activities to compliance activities, which could harm our operating results and business prospects.

THE IMPLEMENTATION OF SFAS NO. 123(R), WHICH WILL REQUIRE US TO RECORD COMPENSATION EXPENSE IN CONNECTION WITH EQUITY SHARE BASED COMPENSATION AS OF THE THIRD QUARTER OF 2005, WILL REDUCE OUR PROFITABILITY.

On December 16, 2004, the Financial Accounting Standards Board, or FASB, issued Statement No. 123 (revised 2004), Share-Based Payment, or SFAS No. 123(R), which is a revision of SFAS No. 123. Generally, the approach in SFAS 123(R) is similar to the approach described in Statement 123. However, SFAS No.

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123 permitted, but not required, share-based payments to employees to be recognized based on their fair values while SFAS No. 123(R) requires, as of the third quarter of 2005, all share-based payments to employees to be recognized based on their fair values. SFAS No. 123(R) also revises, clarifies and expands guidance in several areas, including measuring fair value, classifying an award as equity or as a liability and attributing compensation cost to reporting periods. We do not expect the adoption of SFAS No. 123(R) to have a significant effect on our results of operations in the future. Such adoption could limit our ability to use stock options as an incentive and retention tool, which could, in turn, hurt our ability to recruit employees and retain existing employees.

RISK FACTORS RELATED TO OUR ORDINARY SHARES

OUR SHARE PRICE HAS BEEN VOLATILE IN THE PAST AND MAY DECLINE IN THE FUTURE.

Our ordinary shares have experienced significant market price and volume fluctuations in the past and may experience significant market price and volume fluctuations in the future in response to factors such as the following, some of which are beyond our control:

- o quarterly variations in our operating results;
- o operating results that vary from the expectations of securities analysts and investors;
- o changes in expectations as to our future financial performance, including financial estimates by securities analysts and investors;

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- o announcements of technological innovations or new products by us or our competitors;
- o announcements by us or our competitors of significant contracts, acquisitions, strategic partnerships, joint ventures or capital commitments;
- o changes in the status of our intellectual property rights;
- o announcements by third parties of significant claims or proceedings against us;
- o additions or departures of key personnel;
- o future sales of our ordinary shares;
- o de-listing of our shares from the Nasdaq SmallCap Market; and
- o stock market price and volume fluctuations.

Domestic and international stock markets often experience extreme price and volume fluctuations. Market fluctuations, as well as general political and economic conditions, such as a recession or interest rate or currency rate fluctuations or political events or hostilities in or surrounding Israel, could adversely affect the market price of our ordinary shares.

In the past, securities class action litigation has often been brought against companies following periods of volatility in the market price of its

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securities. We may in the future be the target of similar litigation. Securities litigation could result in substantial costs and divert management's attention and resources both of which could have a material adverse effect on our business and results of operations.

SUBSTANTIAL FUTURE SALES OF OUR ORDINARY SHARES MAY DEPRESS OUR SHARE PRICE.

If our shareholders sell substantial amounts of our ordinary shares, including shares issued upon the exercise of outstanding warrants, or convertible notes, or if the perception exists that our shareholders may sell a substantial number of our ordinary shares, the market price of our ordinary shares may fall. Any substantial sales of our shares in the public market also might make it more difficult for us to sell equity or equity related securities in the future at a time, in a place and on terms we deem appropriate.

WE DO NOT INTEND TO PAY DIVIDENDS.

We have never declared or paid any cash dividends on our ordinary shares. We currently intend to retain future earnings, if any, to finance operations and expand our business and, therefore, do not expect to pay any dividends in the foreseeable future.

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RISKS RELATING TO OUR LOCATION IN ISRAEL

CONDUCTING BUSINESS IN ISRAEL ENTAILS SPECIAL RISKS.

We are incorporated under the laws of, and our executive offices, manufacturing plant and research and development facilities are located in, the State of Israel. Although most of our sales are made to customers outside Israel, we are nonetheless directly affected by the political, economic and military conditions affecting Israel. Specifically, we could be adversely affected by any major hostilities involving Israel, a full or partial mobilization of the reserve forces of the Israeli army, the interruption or curtailment of trade between Israel and its present trading partners, or a significant downturn in the economic or financial condition of Israel.

Since the establishment of the State of Israel in 1948, a number of armed conflicts have taken place between Israel and its Arab neighbors, and a state of hostility, varying from time to time in intensity and degree, has led to security and economic problems for Israel. Since September 2000, there has been a marked increase in violence, civil unrest and hostility, including armed clashes, between the State of Israel and the Palestinians, and acts of terror have been committed inside Israel and against Israeli targets in the West Bank and Gaza. There is no indication as to how long the current hostilities will last or whether there will be any further escalation. Any continuation of, or further escalation in, these hostilities or any future armed conflict, political instability or violence in the region may have a negative effect on our business condition, harm our results of operations and adversely affect our share price.

Furthermore, there are a number of countries that restrict business with Israel or Israeli companies. Restrictive laws or policies of those countries directed towards Israel or Israeli businesses had, and may in the future continue to have, an adverse impact on our operations, our financial results or the expansion of our business. No predictions can be made as to whether or when a final resolution of the area's problems will be achieved or the nature thereof and to what extent the situation will impact Israel's economic development or

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our operations.

OUR RESULTS OF OPERATIONS MAY BE NEGATIVELY AFFECTED BY THE OBLIGATION OF OUR PERSONNEL TO PERFORM MILITARY SERVICE.

Many of our executive officers and employees in Israel are obligated to perform annual military reserve duty and are subject to being called for active duty under emergency circumstances. If a military conflict or war arises, these individuals could be required to serve in the military for extended periods of time. Our operations could be disrupted by the absence for a significant period of one or more of our executive officers or key employees or a significant number of other employees due to military service. Any disruption in our operations could adversely affect our business.

THE ECONOMIC CONDITIONS IN ISRAEL HAVE NOT BEEN STABLE IN RECENT YEARS.

In recent years Israel has been going through a period of recession in economic activity, resulting in low growth rates and growing unemployment. Our operations could be adversely affected if the economic conditions in Israel continue to deteriorate. In addition, due to significant economic measures proposed by the Israeli Government, there have been several general strikes and work stoppages in 2003 and 2004, affecting banks, airports and ports. These strikes have had an adverse effect on the Israeli economy and on business, including our ability to deliver products to our customers.

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WE MAY BE ADVERSELY AFFECTED IF THE RATE OF INFLATION IN ISRAEL EXCEEDS THE RATE OF DEVALUATION OF THE NIS AGAINST THE U.S. DOLLAR.

In 2004 approximately 34% of our expenses were in U.S. dollars or U.S. dollar-linked NIS, in 2003 approximately 25% of our expenses were in U.S. dollars or U.S. dollar-linked NIS and in 2002 approximately 39% of our expenses were in U.S. dollars or U.S. dollar-linked NIS. In each of these years, virtually all our remaining expenses were in unlinked NIS. Our expenses that are denominated in U.S. dollars or paid in Israeli currency linked to the U.S. dollar-NIS exchange rate are influenced by the extent to which any inflation in Israel is not offset (or is offset on a lagging basis) by the devaluation of the NIS in relation to the U.S. dollar. In 1998, 2001 and 2002, the rate of devaluation of the NIS against the dollar exceeded the rate of inflation in Israel, which benefited us. In 1999 and 2000, the rate of inflation exceeded the rate of devaluation of the NIS against the U.S. dollar. In 2003, the rate of inflation was negative and the NIS was revaluated vis-a-vis the dollar. In 2004, the rate of inflation was 1.2% and the NIS was reevaluated vis-a-vis the dollar. These changes, as well as the recent world-wide devaluation of the U.S. dollar, have affected our operations, financial condition and results of operations by decreasing the NIS equivalents of our U.S. denominated revenues and increasing the U.S. dollar equivalents of our NIS denominated expenses. We cannot assure you that we will not be materially adversely affected in the future if the rate of inflation in Israel exceeds the devaluation of the NIS against the U.S. dollar or if the timing of this devaluation lags behind increases in inflation in Israel.

SERVICE AND ENFORCEMENT OF LEGAL PROCESS ON US AND OUR DIRECTORS AND OFFICERS MAY BE DIFFICULT TO OBTAIN.

Service of process upon our directors and officers and the Israeli experts named herein, all of whom reside outside the United States, may be difficult to obtain within the United States. Furthermore, since substantially all of our

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assets, all of our directors and officers and the Israeli experts named in this annual report are located outside the United States, any judgment obtained in the United States against us or these individuals or entities may not be collectible within the United States.

There is doubt as to the enforceability of civil liabilities under the Securities Act and the Securities Exchange Act in original actions instituted in Israel. However, subject to certain time limitations and other conditions, Israeli courts may enforce final judgments of United States courts for liquidated amounts in civil matters, including judgments based upon the civil liability provisions of those Acts.

PROVISIONS OF ISRAELI LAW MAY DELAY, PREVENT OR MAKE THE ACQUISITION OF OUR COMPANY DIFFICULT, WHICH COULD PREVENT A CHANGE OF CONTROL AND THEREFORE DEPRESS THE PRICE OF OUR SHARES.

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Provisions of Israeli corporate and tax law may have the effect of delaying, preventing or making more difficult a merger with, or other acquisition of, us. This could cause our ordinary shares to trade at prices below the price for which third parties might be willing to pay to gain control of us. Third parties who are otherwise willing to pay a premium over prevailing market prices to gain control of us may be unable or unwilling to do so because of these provisions of Israeli law.

YOUR RIGHTS AND RESPONSIBILITIES AS A SHAREHOLDER WILL BE GOVERNED BY ISRAELI LAW AND DIFFER IN SOME RESPECTS FROM THE RIGHTS AND RESPONSIBILITIES OF SHAREHOLDERS UNDER U.S. LAW.

We are incorporated under Israeli law. The rights and responsibilities of holders of our ordinary shares are governed by our memorandum of association, our articles of association and by Israeli law. These rights and responsibilities differ in some respects from the rights and responsibilities of shareholders in typical U.S. corporations. In particular, a shareholder of an Israeli company has a duty to act in good faith toward the company and other shareholders and to refrain from abusing his power in the company, including, among other things, in voting at the general meeting of shareholders on certain matters. Israeli law provides that these duties are applicable in shareholder votes on, among other things, amendments to a company's articles of association, increases in a company's authorized share capital, mergers and interested party transactions requiring shareholder approval. In addition, a shareholder who knows that it possesses the power to determine the outcome of a shareholder vote or to appoint or prevent the appointment of a director or executive officer in the company has a duty of fairness toward the company. However, Israeli law does not define the substance of this duty of fairness. Because Israeli corporate law has undergone extensive revision in recent years, there is little case law available to assist in understanding the implications of these provisions that govern shareholder behavior.

ITEM 4. INFORMATION ON THE COMPANY

A. HISTORY AND DEVELOPMENT OF THE COMPANY

RADA Electronic Industries Ltd. was incorporated under the laws of the State of Israel on December 8, 1970 for an indefinite term. We are a public limited liability company under the Israeli Companies Law 1999-5759, or the Israeli Companies Law, and operate under this law and associated legislation. Our registered offices and principal place of business are located at 7 Giborei

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Israel Street, Netanya 42504, Israel, and our telephone number is 972-9-892-1111. Our address on the internet is www.rada.com. The information on our website is not incorporated by reference into this annual report.

We develop, manufacture and sell automated test equipment, avionics products and ground debriefing systems and provide manufacturing services for military and commercial use, mainly in Israel, the U.S. and Europe. We refer to these activities as our core business. We also provide test and repair services using our CATS(R) testers and test program sets through our Chinese subsidiary.

In April 1985, we completed an initial public offering. We traded on the Nasdaq National Market under the symbol "RADIF" since our initial public offering in 1985 until June 10, 2002 when the listing of our ordinary shares was transferred to the Nasdaq SmallCap Market. On December 13, 2004, we changed our symbol to "RADI."

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In February 2005, we purchased all the assets of Vectop Ltd., an Israeli company specializing in the design, development, marketing and sale of electro-optic equipment and debriefing systems. Such assets included the know-how, intellectual property and patents that were used by, or connected to Vectop's business.

B. BUSINESS OVERVIEW

OUR CORE BUSINESS

We provide integrated avionic solutions. Our aim is to provide not only a state of the art product but also a comprehensive end to end solution for one or more avionic systems. The first integrated system that we provided was for the A-4 avionics upgrade program of the Israeli Air Force, or IAF. This program is the first comprehensive and complete avionics system to be provided entirely by us. During 2004 we increased our involvement and development efforts in the area of unmanned aircraft vehicles.

Our solutions include the following:

- o Advanced training solutions, based on our recently completed Net Centric Digital Recorder;
- o Integrated trainer aircraft avionics packages;
- o Flight data recorders and supporting ground analysis;
- o Integrated weapons management systems;
- o Video cameras for ground and airborne applications, based on the Vectop's Ltd. products;
- o Inertial and global positioning system based on navigation solutions;
- o Unmanned aerial vehicle avionics; and
- o Automatic testing solutions;

We also provide manufacturing services to original equipment manufacturers in Israel and in the United States, using the manufacturing capabilities of our Beit-She'an plant. We offer production of turnkey solutions, in "build to print"

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or "build to specification" modes. To date, we have provided our manufacturing services to, among others, Smiths, Israeli Aircraft Industries, or IAI, and RAFAEL Armament Development Authority Ltd., or RAFAEL. Our China based subsidiary provides test and repair services using our CATS(R) testers and test program sets.

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Our core business activity is based in Israel. Our U.S.-based subsidiaries have been inactive since January 1, 2002.

ADVANCED TRAINING SOLUTIONS

GENERAL

Our training solutions are based on a complete and integrated system that incorporates an airborne component installed in the aircraft and a ground-based component, installed in the squadron facilities. Recent technological developments, undertaken primarily for the IAF, enable system adaptation to any kind of aircraft, regardless of its onboard avionics systems. Our recent solutions are based on our newly developed Net Centric Digital Recorder, that allows the integration of our airborne digital video recordings with numerous other digital data items and provides the essential building blocks for a squadron information management network, or SIMNET, as a ground component.

AUTONOMOUS AIR COMBAT EVALUATION SYSTEM - ACE(TM)

ACE(TM) is an avionics system used for debriefing air combat missions and is based on data recordings from digital and analog communication channels in the aircraft. The system converts the data into digital form and inserts it on unused portions of the recording tape in the existing aircraft analog videocassette recorder, or VCR. The data is extracted from the videocassette and utilized by our ground debriefing station to generate 3-D graphic displays that portray all the aircraft maneuvers during operational and training missions, and fully synchronize between all the participating aircrafts. For each individual aircraft, the graphic display is fully synchronized with the heads-up display image captured on the VCR media. The IAF (F-16 A/B, A-4) and three other air forces (F-5, F-16 A/B) currently utilize the ACE(TM) system.

Debriefing of air combat maneuvers can also be implemented as an expansion application to our FACE(TM) system. The Royal Netherlands Air Force has upgraded its FACE(TM) system s with this capability to debrief its aircrews.

The latest enhancement of the ACE(TM) concept resulted in a contract with the Israeli Ministry of Defense and the IAF in the first quarter of 2003. Under the contract we will upgrade all of the existing IAF A-4 aircraft with our advanced ACE(TM) debriefing capabilities. The absence of advanced avionics systems and associated data onboard the A-4 aircraft required us to integrate a stand-alone Internal Navigation System, or INS, and a Global Positioning System, or GPS, on board the aircraft. We believe this enhanced solution will open the market segment of aircraft fleets not equipped with modern avionics platforms for the ACE(TM). We believe that this program uniquely positions us as the ultimate provider for debriefing solutions for all the advanced IAF trainers.

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SQUADRON INFORMATION MANAGEMENT NETWORK (SIMNET)

Since 1999 we have offered operational ground debriefing stations complementing our airborne systems. The operational ground debriefing station is a PC-based application operating in a Windows NT/2000(R) environment, supported by a proprietary plug-in board. The solution, designed by our employees (IAF F-16 and F-15 pilots in reserve service), provides a state-of-the-art debriefing environment, fully capitalizing on all available digital and video information in a highly synchronized presentation. Further capitalizing on current day technology, individual stations have a networking capability, providing data sharing, as well as cross-unit and inter-air force debriefing.

The IAF and two other air forces have purchased ground debriefing systems for their F-16 A/B, F-5 and A-4 fleets.

NET CENTRIC DIGITAL RECORDER (NCDR) BASED TRAINING SYSTEMS

Recent developments in digital video recording systems and the significant reduction in size and cost of solid state memory hardware have turned solid state digital video recording systems into the de-facto standard solution for airborne applications. These systems have begun penetrating the aviation industry, in new aircraft such as the F-16I as well as in the retrofit market. Identifying this trend, we have ported our debriefing solutions to the digital domain, with the initial system developed for the new IAF F-16Is, delivered under the Peace Marble, or PM-V, Program and the new Net Centric Digital Recorder. We developed our Net Centric Digital Recorder with the view of capturing sales from the potential retrofit market for airborne video tape recorders. This new solution focuses on the throughput, data management and archiving requirements of the massive amounts of information generated by each aircraft, as well as on seamless data sharing within the squadron and the air force as a whole.

Based on the PM-V Program, we delivered two additional debriefing systems to Lockheed Martin Aerospace during the fourth quarter of 2002 for use in integration and flight-testing. We are in the midst of the development, integration and delivery of a complete digital debriefing system for the new F-16s purchased by the Chilean Air Force. As an extension of the development work completed as part of the PM-V Program, we are supplying the Chilean Air Force with a digital video recorder for each F-16 aircraft as well as an advanced digital video ground debriefing station. This station will be linked to the F-5 ground debriefing station we previously delivered to the Chilean Air Force, creating a common network debriefing solution for both front-line aircraft.

We have identified a growing need for digital video replacement of aging analogue airborne tape recorders (approximately 15,000 VTRs are installed onboard fighter aircraft today) and have initiated a world wide marketing effort to promote the replacement of these aging VTRs with our new NCDR. The NCDR, together with our ground debriefing system, enables advanced debriefing at an affordable price. During 2004, we completed the development of the NCDR and it is now being proposed to several customers. The NCDR will be marketed jointly by us and Smiths, utilizing Smiths' better access to some of the world markets, especially in the U.S.

INTEGRATED TRAINER AIRCRAFT AVIONICS PACKAGE

Following our selection by the IAF to provide the ACE(TM) for their advanced trainer, the A-4 Skyhawk, we were awarded a follow on program aimed at total replacement of the aging avionics package of the A-4 aircraft with a new, upgraded package. The new avionics package replaces the current weapon delivery and navigation system of the aircraft with a new state of the art system that will significantly improve the A-4 capabilities, increase its' reliability and

provide it with advanced training capabilities.

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The upgraded system includes INS, GPS, head up display, or HUD, camera, central weapon delivery and navigation processor based on enhanced flight monitoring unit, which is the core of the ACE(TM) system and a control and display unit.

The upgraded A-4 prototype began its planned flight testing phase on schedule and the serial production line is operating at full capacity. We plan to complete the upgrade of all the IAF A-4 fleet during 2005.

We believe that this program places us among the few companies that performed a complete aircraft avionics system upgrade. As a result of the A-4 system development, we have proposed similar, very cost effective, trainer aircraft avionics packages to other customers. The A-4 avionics package provides, at a very affordable price, a complete and modern avionics suite tailored for trainer aircraft. We have already launched marketing efforts to promote this package for different customers.

FLIGHT DATA RECORDERS AND SUPPORTING GROUND ANALYSIS

GENERAL

Our fleet maintenance management solutions are based on our existing programs and products developed and supplied over the course of the past two years. These programs include airborne data collection and recording equipment (such as FACE(TM) or DAS) as well as ground support software packages (such as PERFORMS) that provide the infrastructure for efficient data logging and analysis to support fleet maintenance management.

FATIGUE ANALYSIS AND AUTONOMOUS AIR COMBAT EVALUATION SYSTEM - FACE(TM)

The FACE(TM) system is an avionics system designed to acquire, process and record data from various aircraft systems as well as from strain gauges (sensors) affixed to an aircraft structure. This data is used to streamline and manage the ongoing monitoring and maintenance of an aircraft and its systems. The FACE(TM) system communicates with a squadron's ground support logistic station, enabling downloading of data from an aircraft, analyzing the data, managing ongoing maintenance, creating and modifying the set-up configuration files and determining data for recording, as well as providing an interface to other applications.

The FACE(TM) system is capable of communicating in real time with a voice and data recorder, which is a crash survival unit known as a "black box" manufactured by Smiths, for the purpose of recording flight safety related data. We are currently upgrading the FACE(TM) systems supplied to the Royal Netherlands Air Force for its F-16 aircraft between the years 1996 and 1999 with this capability. During 2004 we supplied FACE(TM) systems for the F-16 fleets of the Portuguese Air Force and the U.S. Navy, and we plan to supply FACE(TM) systems to the Jordanian Air Force for its F-16 fleet starting in 2005.

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DATA ACQUISITION SYSTEM - DAS

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The DAS is an advanced avionics data acquisition system designed to acquire, process and record data from various aircraft systems. We jointly developed and marketed the DAS with Smiths for the new IAF F-16I aircraft. DAS consists of two sub-systems, a data acquisition unit, or DAU, and an enhanced crash survival memory unit, or ECSMU. The DAU interfaces to numerous data systems and data channels in the aircraft and acquires, processes and records data, mostly for maintenance purposes. The ECSMU is a "black box" capable of recording digital data and digitized audio transferred through the DAU. DAS is a form fit replacement for the CSFDR system, which is currently installed on most F-16 aircraft worldwide. DAS has been offered as a substitute in various projects that require a flight data recorder with advanced capabilities and growth potential.

The DAS is designed to meet all commercial aviation requirements for "black box" recorders, thus expanding its market potential. During 2004, we started supplying production DAS units to the IAF and entered into contracts to supply DAS units to the Polish Air Force and the Korean Air Force starting in 2005.

PERFORMS (PROCESSING, EVALUATING, AND REPORTING OF FORCE MANAGEMENT DATA SOFTWARE)

Starting in mid-2001 we have been the primary sub-contractor to Lockheed Martin Aerospace in the development of a new aircraft data logging and analysis software package. The new product, known as PERFORMS, is designed to replace the aging and hard to support data processing station, or DPS, that was developed to provide data logging and fatigue analysis for all F-16 aircraft users. PERFORMS is a Windows 2000(R) based software package, utilizing a state of the art graphics user interface, and provides all the required infrastructure to perform any type of analysis on data acquired by all F-16 airborne flight data recorders.

The analysis includes fatigue monitoring, engine usage monitoring and other applications that may be added, as required by different users. The recorded data is downloaded to the station and stored in a commercial off the shelf database with an interface for "plug-in" applications, allowing those applications to access the data, manipulate and analyze it and provide a variety of maintenance management tools. The program is managed by Lockheed Martin Aerospace and is supplied to F-16 users in evolving software "builds" delivered every 12 months starting in April 2003. Under the agreement, we were granted a non-exclusive license to use the developed software in support of our FACE(TM) and DAS products to supply the application to our flight data recorder customers.

The first PERFORMS delivery in June 2003, exposed us to F-16 users at a higher level than we had ever previously experienced. This exposure led us to initiate business development activities with regard to PERFORMS add-on packages. Since 2004, we present this activity to the F-16 user's community in seminars and conferences.

Updated and upgraded PERFORMS software packages were delivered during 2004 and are scheduled for delivery in 2005. Various air force customers already use the software, and we expect to receive requests to support the installation and operation of the software from these users.

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In the early 1980s we started to develop, manufacture and sell an armament interface unit which controls the various weapon stations of an aircraft based on commands from the main on-board computer. The unit interfaces between the digital commands of the main controller and the analog weapons stations, performing a unique hybrid task. The armament interface unit was designed for IAI's worldwide upgrade programs. Later versions of the system are designed for installation in attack helicopters as well as in fighter aircraft. We are currently in the process of supplying a derivative of the system to IAI for a F-5 upgrade program in Spain and are proposing the system and its offshoots for multiple other applications in Israel and abroad. One of the major potential sales channels for the armament interface unit is IAI, through its upgrade programs and other ongoing projects.

We also provide complete armament testing solutions for aircraft using a variety of weapons management systems. The test unit verifies the serviceability of the armament management system during periodic maintenance or prior to installation of sophisticated weapons.

VIDEO CAMERAS FOR AIRBORNE AND GROUND VEHICLES

The recent acquisition of the Vectop Ltd.'s assets in February 2005 provides us with a new product line. Airborne cameras are integral part of any training and debriefing system airborne onboard military platforms. Our customers include major Israeli integrators (such as IAF, IAI and Elbit) as well as foreign customers. In 2005, our products in this line include:

EYE WITNES

An airborne HUD camera, sold to many customers in different configurations represents a significant part of the future revenues related to the assets purchased from Vectop Ltd.

NIGHT WITNESS

A night vision camera installed on any night vision goggles to enable the recording of the pilot's view through the night vision goggles, is a unique capability that has been integrated in several fighter aircraft and helicopter programs.

ARMOR SENTRY

A video camera developed for ground armored vehicles and tanks. This system is being delivered to the Israeli ground forces for installation in the new "Merkava" battle tank and is generating interest in foreign markets.

SNIPER WITNESS

The Sniper Witness enables sniper training facilities to better analyze the activities of the trainees as well as accurately debrief the operation resulting in better training. The system is based on a miniature video camera attached to the sniper sight and portable video recorder. The system is used by the Israeli armed forces training facility and is currently being demonstrated to other forces around the world.

INERTIAL AND GPS BASED NAVIGATION SOLUTIONS

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During 2003, we developed low cost navigation systems based on a ring laser gyro, or RLG, and GPS. Our RLG based system is now qualified and operational as part of the IAF A-4 upgrade program. This development provided us with the know-how to further develop navigation solutions based on other sensors.

During 2005, we plan to integrate two different sensors into our navigation system, which is based on attitude sensors and fiber optic gyros. Navigation systems based on these sensors are significantly more cost effective and provide good performance at a low price.

We are offering our customers the existing RLG Navigation System, or RNS, as part of our avionics packages and as a stand alone system and we plan to propose the new navigation systems by the end of 2005.

UNMANNED AERIAL VEHICLES (UAV) AVIONICS

We identified the UAV avionics market as a fast growing area that will gradually replace the manned military airborne avionics market. This market has many common aspects with the manned avionics product lines; however, it requires slightly different technology and understanding of the various requirements.

Typically, a UAV avionics package needs to be smaller, lighter, more reliable and inexpensive than its comparable manned aircraft suite. The major advantage of UAV avionics systems is the envisioned large number of UAVs.

We initiated efforts to penetrate this market during 2001. Since then we have entered into a contract with IAI, to develop and provide them with an Input Output Controller, or IOC, a unit that is part of our data acquisition systems product line, for IAI's next generation UAV. We are continuing our efforts to widen our participation in this important program as well as in other programs.

During 2004, we developed and delivered a miniature avionics module to IAI. This unit is aimed at the miniature UAV market and provides complete avionics capabilities in a single, miniaturized unit. This product can be proposed to other customers and we have initiated marketing activities for that purpose.

AUTOMATIC TESTING SOLUTIONS

GENERAL

Our business expansion into the automatic test equipment, or ATE, market is based on our existing products as well as the added value we deliver with the dedicated expertise and the wide-range experience we have acquired in this area. We rely on the preference indicated by OEMs to outsource the acquisition of ATE and have positioned our company as a strategic supplier/partner to provide ATEs and test solutions. We offer our ATEs with our own Advanced Test Environment, including all the required development tools. After a long period of inactivity in this market, we see some growing interest, especially from small maintenance houses rather than airlines, especially in the U.S.

CATS(R) - COMMERCIAL AVIATION TEST STATIONS

The Commercial Aviation Test Stations, or CATS(R), is a family of multi-purpose, computerized automatic test equipment that meets the specific needs of airlines and third party maintenance companies. The CATS(R) stations

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test and repair a variety of electronic units in existing commercial aircraft, incorporating tools for testing, troubleshooting, and performing diagnostic procedures. CATS(R) replaces or augments test stations from aircraft manufacturers or avionics OEM suppliers, while automating multiple manual test procedures.

MANUFACTURING SERVICES

In 2000 we began providing manufacturing services to OEMs located in Israel and the United States, using the excess manufacturing capacity at our Beit-She'an plant. We offer manufacturing turnkey solutions, either in "build to print" or "build to specification" modes. To date, we have provided our manufacturing services to Smiths, IAI, RAFAEL, and other Israeli companies, both in the defense and commercial sectors.

TEST AND REPAIR STATIONS

We operate a test and repair shop based on the use of our CATS(R) tester in Beijing, China through CACS, our 80% owned Chinese subsidiary. CACS was established as a joint venture company with Tianzu Forest Development Company, which owns the remaining 20% equity interest. Pursuant to the joint venture agreement, Tianzu Forest Development provided the facilities for CACS' operations while we provided CATS(R) testers and test program set services.

SALES AND MARKETING

STRATEGY

Our sales and marketing strategy is based on the following principles:

- o Maintaining our business focus on avionics for the military market and our family of testing solutions for the commercial and military markets.
- o Expanding our product line by adding new products and applications to our existing products by using our current development programs as the basis for new developments.
- o Expanding our customer base by including our products in solutions and integrated systems. This approach was successful both in Chile where, in 2002, we were awarded a contract to provide a complete debriefing solution for the F-16 aircraft purchased by the Chilean Air Force, and with the IAF, to whom we supply complete weapon delivery and navigation system for the A-4 aircraft.

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- o Establishing marketing channels with system integrators and major aircraft manufacturers such as The Boeing Company, Lockheed Martin Aerospace, Smiths, IAI and RAFAEL.
- o Expanding large potential markets, especially in the military and the unmanned combat air vehicle areas, and developing new marketing channels aimed directly at these customers.

As part of this strategy, we have entered into a number of strategic relationships and have focused our marketing and sales efforts to support these relationships.

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LOCKHEED MARTIN AEROSPACE. Our sales of avionics products focus mainly on the F-16 aircraft manufactured by Lockheed Martin Aerospace, the most popular fighter aircraft in the Western world today. In February 1999, we signed a memorandum of understanding with Lockheed Martin pursuant to which we will provide certain avionics systems for the F-16 aircraft under the PM-V Program. In September 1999, the U.S. and the State of Israel signed a letter of acceptance pursuant to which the U.S. will provide the IAF with 50 F-16I aircraft and an option for an additional 52 aircraft, which was exercised in June 2001 for a total of 102 F-16I aircraft. In cooperation with Smiths, we are developing and supplying the data acquisition system that includes the advanced data acquisition unit and an enhanced crash survivable memory unit, which will be manufactured in our Beit-She'an facility. We are currently negotiating with Lockheed Martin with respect to the development of additional capabilities of this system for different applications.

In addition, in March 2001 we signed an agreement with the Aircraft Structural Integrity Program Group of Lockheed Martin pursuant to which we are assisting in the development of a fatigue analysis system based on a PC computer for analyzing structural fatigue of the F-16 aircraft. As the main subcontractor, our principal task is to develop the software for the fatigue analysis system. The fatigue analysis system will utilize data collected from the data acquisition unit and our FACE(TM) system, as well as other systems used by air forces operating F-16 aircraft. This five year development program will end in March 2006.

SMITHS AEROSPACE ELECTRONIC SYSTEMS. In February 1999, we entered into an agreement with Smiths that outlines joint marketing activities for our FACE(TM) system and Smiths' voice and data recorder for F-16 A/B aircraft. Smiths is a worldwide leader in avionics systems for fighter and commercial aircraft. The two systems successfully passed flight tests conducted on the Royal Netherlands Air Force's F-16 aircraft by Lockheed Martin and the Royal Netherlands Air Force. The FACE(TM) system and the voice and data recorder complement each other and are intended to replace outdated data recording systems, mechanical strain recorders and flight load recorders. No sales under this agreement have been made to date.

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In June 2000, we signed a memorandum of understanding with Smiths pursuant to which the parties agreed to establish a team for worldwide marketing, developing and manufacturing of the data acquisition system and its associated ground support that is intended to grow into an infrastructure for recording, processing and managing all data types available on board the aircraft. No sales of the systems have been made to date under this agreement. We cannot assure you that we will successfully negotiate a definitive agreement with a customer nor can we provide at present any forecast that the agreement with Smiths will result in future sales of avionics systems.

In October 2003, we signed a teaming agreement with Smiths. The teaming agreement establishes cooperation in connection with the products developed jointly by Smiths and us for the PM-V Program and its derivatives. In addition, the agreement details commitments made by Smiths to purchase production services from us in the coming years.

During 2004, we expanded our cooperation with Smiths to include our newly developed Net Centric Digital Recorder and have jointly offered this product to potential customers.

Smiths was a principal customer in 2002 and 2003 and we expect that it

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will be one of our principal customers in 2005. In addition to the PM-V cooperation with Smiths, we are currently supplying the Royal Netherlands Air Force with an integration package for our FACE(TM) System and Smiths' black box for its F-16 MLU fleet. A similar package is also being supplied to the Portuguese Air Force.

ISRAEL AIRCRAFT INDUSTRIES. IAI was our fourth largest customer in 2004, accounting for approximately 8% of our total annual revenues. We are actively supplying avionics and test equipment to four different divisions of IAI. We have identified the Israeli government-owned aerospace industries as a potential customers and cooperation entities. In particular the Lahav and Malat divisions of IAI, major aircraft integrators, require our services as avionics and test equipment providers. During 2004, in the IAF avionics upgrade program, where we are the prime contractor, we have cooperated with IAI, as our sub-contractor, to support various parts of this program.

RAFAEL ARMAMENT DEVELOPMENT AUTHORITY LTD. RAFAEL was one of our largest Israeli customers in 2004. Our sales to RAFAEL during 2004 were primarily for test equipment and build to print services. The addition of the Solid State Recording, or SSR, family of products to the products we supply to RAFAEL adds our own developed products to these sales. We expect that the SSR will result in significant sales to RAFAEL.

MARKETING

Our chairman and president, Herzle Bodinger, our chief executive officer, Adar Azancot, and our vice president business development, Zvi Alon, lead our marketing efforts. We currently employ four other persons in marketing our core business products and plan to employ an additional person. Our engineering department supports our marketing staff with respect to product pricing and technical demonstrations. In addition, we have sales consultants, agents and representatives in Europe, South America, China and India who receive commissions for sales effected through them.

The Israeli Ministry of Defense has historically supported and continues to support our marketing efforts through its Export and Defense Assistance division, or SIBAT, through various projects for the Israeli Defense Forces and its related divisions. The Israeli Ministry of Industry and Commerce supports our marketing efforts via its Industrial Cooperation Authority through the exploitation of "offset commitments" by Lockheed Martin Aerospace and The Boeing Company to the State of Israel. Such future assistance is not guaranteed.

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PRINCIPAL CUSTOMERS

Generally, we complete a few transactions each year, each in an amount comprising approximately 10% of our revenues for such year. As a result, each year a significant portion of our revenues is derived from a small number of customers. The following table sets forth our principal customers for the years 2003 and 2004:

	2003	2004
	-----	-----
Smiths Electronic Systems.....	22%	5%
The Boeing Company.....	14%	10%

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Israeli Ministry of Defense.....	11%	19%
Israel Aviation Industries.....	12%	6%
Portuguese Air Force.....	19%	17%
U.S. Navy.....	-	11%

Although we are striving to increase the number of our customers, we anticipate that a significant portion of our future revenues will continue to be derived from sales to a small number of customers.

Like many companies deriving a substantial portion of their revenues from government contracts, we are subject to business risks, including changes in governmental appropriations and changes in national defense policies and priorities. Although many of the programs in which we participate as a contractor or subcontractor may extend for several years, our business is dependent upon annual appropriations and funding of new and existing contracts. Most of the contracts are subject to termination for the convenience of the customer, pursuant to which the customer pays only for reimbursement of costs incurred and the applicable profit on work performed. We cannot assure you that the Israeli Government or any other government will continue to fund the purchase of our products over the long term.

MARKETS

We sell our products to various air forces and companies. Our main market is in Israel with 35% of our sales in 2004, 26% in 2003 and 14% in 2002. The second largest market is the U.S. with 33% of our sales in 2004, 42% in 2003 and 64% in 2002. Western Europe is our third largest market with 21% of our sales in 2004, 28% in 2003 and 15% in 2002. Sales to the rest of the world accounted for 10%, 4% and 7% of our sales in 2004, 2003 and 2002, respectively.

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COMPETITION

The markets for our products are highly competitive, and we may not be able to compete effectively in those markets. Our principal competitors in the avionics market are Harris, Rockwell Collins, Honeywell, Elbit Systems Ltd., IAI, R.S.L. Ltd., TEAK and Elisra Systems Ltd. We expect to continue to face competition from these and other competitors. Most of our competitors are larger, have greater resources including financial, technological, marketing and distribution capabilities, and enjoy greater market recognition than we do. These competitors may be able to achieve greater economies of scale and may be less vulnerable to price competition than us. We may not be able to offer our products as part of integrated systems to the same extent as our competitors or successfully develop or introduce new products that are more cost effective or offer better performance than those of our competitors. Failure to do so could adversely affect our business, financial condition and results of operations.

EXPORT POLICY

Exports of military related products are subject to the military export policy of the State of Israel. Current Israeli Government policy encourages export to approved customers of military products similar to those manufactured by us, provided that such export does not run counter to Israeli policy or national security considerations. We must obtain a permit to initiate a sales proposal and ultimately an export license for the transaction is required. We cannot assure you that we will obtain export permits or licenses in the future or that governmental policy with respect to military exports will not be

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altered. However, to date we have not encountered any significant difficulties in obtaining necessary permits or licenses for sale of our products.

FIXED PRICE CONTRACTS

Most of our contracts, especially with the Government of Israel, its agencies and other foreign governments, are generally fixed-price contracts. Under fixed-price contracts, the price is not subject to adjustment by reason of the costs incurred in the performance of the contracts, as long as the costs incurred and work performed fall within governmental guidelines. Under our fixed-price contracts, we assume the risk that increased or unexpected costs may reduce our profits or generate a loss. This risk can be particularly significant under a fixed-price contract for research and development involving a new technology.

Our books and records may be subject to audits by the Israeli Ministry of Defense and other governmental agencies including the U.S. Department of Defense. These audits may result in adjustments to contract costs and profits. To date, we have not incurred any liability as a result of such audits.

PROPRIETARY INFORMATION

We were granted a patent for our ACE(TM) system in both Israel and the United States (No. 5467274.) Nevertheless, we generally do not consider patent protection significant to our current operations and rely upon a combination of security devices, copyrights, trademarks, trade secret laws and contractual restrictions to protect our rights in our products. Our policy is to require employees and consultants to execute confidentiality agreements upon the commencement of their relationships with us. These measures may not be adequate to protect our technology from third-party infringement, and our competitors might independently develop technologies that are substantially equivalent or superior to ours. Additionally, our products may be sold in foreign countries that provide less protection for intellectual property rights than that provided under U.S. or Israeli laws.

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The Israeli Government usually retains certain rights to technologies and inventions resulting from our performance as a prime contractor or subcontractor under Israeli Government contracts and may generally disclose such information to third parties, including other defense contractors. When the Israeli Government funds research and development, it may acquire rights to proprietary data and title to inventions; we may retain a non-exclusive, royalty-free license for such inventions. However, if the Israeli Government purchases only the end product, we may retain the principal rights and the Government may use the data and take an irrevocable, non-exclusive, royalty-free license.

MANUFACTURING AND SUPPLY

Our main production facilities are located in Beit-She'an, Israel. The plant is equipped to handle most of our manufacturing processes and testing requirements. For several specific processes we utilize subcontractors. This approach is a key to our flexibility and versatility.

We stress quality control in our product realization process. Commencing with customer requirements and expectations via raw material inspection through completion, specifications are repeatedly checked. We maintain a quality assurance team that participates in every stage of the design and manufacture of our products. Our quality management standards are certified by the Standards

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Institute of Israel, or SII, pursuant to ISO 9001 for hardware design and production and ISO 9000.3 for software, both since 1995. SII performs quality system audits twice a year and various customers perform audits four to six times a year. In April 2001, SII certified our Environmental Management System pursuant to ISO 14001. Our Quality Management System was revised to comply with ISO 9001:2000. This process was concluded in June 2003.

According to the standard warranty incorporated in most of our sales contracts, we warrant that our products will be free from defects in design, materials or workmanship, and guarantee repair or replacement of defective parts for the twelve months following delivery of a product to the customer. We also provide maintenance services to customers who sign maintenance contracts.

SOURCE AND AVAILABILITY OF RAW MATERIALS

We acquire most of the components for the manufacturing of our products from a limited number of suppliers and subcontractors, most of whom are located in Israel and the United States. Certain of these suppliers are currently the sole source of one or more components upon which we are dependent. Since many of our purchases require long lead-times, a delay in supply of an item can significantly delay the delivery of a product. To date, we have not experienced any particular difficulty in obtaining timely deliveries of necessary components. See Item 3D "Risk Factors." We depend on a limited number of suppliers of components for our products and if we are unable to obtain these components when needed, we would experience delays in manufacturing our products and our financial results could be adversely affected.

C. ORGANIZATIONAL STRUCTURE

We had one active subsidiary in 2004, Beijing Huarui Aircraft Components Maintenance and Services Co., an 80% owned subsidiary based in China that is engaged in aircraft repair services.

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D. PROPERTY, PLANTS AND EQUIPMENT

FACILITIES

We own a 30,000 square feet building in Beit-She'an, Israel. The building, which includes manufacturing facilities, warehouse space and a portion of our development facilities, is situated on land leased from the Israel Land Authority for a period of 49 years until 2034. The plant has sufficient capacity to meet our current requirements. If volume was to increase significantly, we would be able to increase the number of workers or shifts at the plant, or use more subcontractors.

Our executive offices and research and development facilities are located in a 12,500 square foot office facility in Netanya, Israel. The lease for this facility expires in January 2006 and we have an option to extend the lease until January 2008.

Our Chinese subsidiary, CACS, conducts its business in an approximately 16,000 square foot facility in Beijing that includes offices and test and repair facilities. The land for this facility was leased by Beijing Tianzu Forestry Company or Tianzu, the minority shareholder in CACS, from the Chinese government for 30 years. Under a joint venture agreement, and in consideration for its equity investment in CACS, Tianzu granted CACS usage rights in the land, constructed the buildings and granted CACS the ownership of these buildings.

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However, the transfer of the title to the land and the buildings has not been completed, which may prevent the disposition of these assets should CACS desire to do so. Although Tianzu is legally obligated to complete such transfer of title to the land and the buildings, we can not guarantee that such transfer will be completed, or that we will not be required to initiate litigation in order to enforce our rights to receive title to the land and buildings.

The aggregate annual rent for our offices in Israel and China was approximately \$152,000 in 2004.

ITEM 5. OPERATING AND FINANCIAL REVIEW AND PROSPECTS

A. OPERATING RESULTS

THE FOLLOWING DISCUSSION AND ANALYSIS SHOULD BE READ IN CONJUNCTION WITH OUR CONSOLIDATED AUDITED FINANCIAL STATEMENTS AND THE NOTES THERETO, INCLUDED ELSEWHERE IN THIS ANNUAL REPORT.

OVERVIEW

We develop, manufacture and sell automated test equipment and avionics products for military and commercial use mainly in Israel, Europe and the United States. We also provide test and repair services using our CATS(R) testers and test program sets through our Chinese subsidiary, CACS. In addition, we provide manufacturing services to third parties engaged mainly in the avionics market.

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CRITICAL ACCOUNTING POLICIES

Our critical accounting policies, including the assumptions and judgments underlying them, are disclosed in the notes to our consolidated financial statements. These policies have been consistently applied in all material respects and address such matters as revenue recognition. While the estimates and judgments associated with the application of these policies may be affected by different assumptions or conditions, we believe the estimates and judgments associated with the reported amounts are appropriate in the circumstances.

The significant accounting policies listed in Note 2 of our consolidated financial statements that we believe are the most critical to aid in fully understanding and evaluating our financial condition and results of our operations under generally accepted accounting principles are discussed below.

INTANGIBLE ASSETS. Costs of producing our TPS software library, which is integrated with our test station, incurred subsequent to achieving technological feasibility, were capitalized, and are amortized by the greater of the amount computed using the: (i) ratio that current gross revenues from sales of the software to the total of current and anticipated future gross revenues from sales of that software, or (ii) the straight-line method over the estimated useful life of the product. We assess the recoverability of these intangible assets at each balance sheet date by determining whether the amortization of the asset over its remaining life can be recovered through undiscounted future operating cash flows from the specific software products sold. The use of different assumptions with respect to the expected cash flows from our assets and other economic variables may lead to different conclusions regarding the recoverability of our assets' carrying values and to the potential need to record an impairment loss for our intangible assets. As of December 31, 2004, no impairment was required.

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IMPAIRMENT OF LONG-LIVED ASSETS. We are required to assess the impairment of long-lived assets whenever events or changes in circumstances indicate that the carrying value may not be recoverable. We assess the impairment of our assets based on a number of factors, including any significant changes in the manner of our use of the respective assets or the strategy of our overall business and significant negative industry or economic trends. Upon determination that the carrying value of a long-lived asset may not be recoverable, based upon a comparison of expected future cash flows (undiscounted and without interest charges) to the carrying amount of the asset, an impairment charge is recorded. Under different assumptions with respect to the recoverability of our long-lived assets, our determination may be different, which may negatively affect our financial position and results of operations. As of December 31, 2004, no impairment was required.

SHARE-BASED COMPENSATION. We account for stock-based compensation using the intrinsic value model. Accordingly, we measure compensation cost as the excess, if any, of the closing market price of our stock at the date of grant over the exercise price of the option granted. We recognize compensation cost for stock options, if any, ratably over the vesting period. We disclose pro forma data assuming we had accounted for employee stock option grants using the fair value-based method. We account for options and warrants issued to non-employees. We use the Black-Scholes option pricing model to value warrants granted to non-employees. This policy will change effective with our reporting period beginning July 1, 2005.

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REVENUE RECOGNITION. Our revenues are derived from sales of automated test equipment and avionics products and from long-term fixed price contracts for ATE, avionics and ground debriefing systems. In addition, we lease ATE and provide manufacturing, development and product support services. Product revenue is recognized when there is persuasive evidence of an arrangement, the fee is fixed or determinable, delivery of the product to the customer has occurred and the collection of the fee is probable. If the product requires specific customer acceptance, revenue is deferred until customer acceptance occurs or the acceptance provisions lapse.

Revenues from long-term fixed price contracts are recognized by the percentage-of-completion method in accordance with the "Input Method." We apply this method when the total of the costs and revenues of the contract can reasonably be estimated. The percentage of completion is determined based on the ratio of actual costs incurred to total costs estimated to be incurred over the duration of the contract. With regard to contracts for which a loss is anticipated, a provision is made for the entire amount of the estimated loss at the time such loss becomes evident. Estimated gross profit or loss from long-term contracts may change due to changes in estimates resulting from differences between actual performance and original forecasts. Such changes in estimated gross profit or loss are recorded in results of operations when they are reasonably determined by management on a cumulative catch-up basis.

Revenues from services are recognized when the service is performed.

Revenue under operating leases of equipment are recognized ratably over the lease period.

Revenues from certain arrangements may include multiple elements within a single contract. Our accounting policy separates multiple deliverables into individual accounting units with determinable fair values. Our arrangements are accounted for as one unit of accounting.

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LOANS TO EMPLOYEES AND PROVISION FOR LITIGATION. We have an outstanding balance of loans due to us from our former chief executive officer and a former officer. Both officers claim that they are not obliged to repay the loans. There are pending legal actions between us and each of the former officers concerning, among other things, the repayment of the loans. According to our legal consultants, we have a strong case with regard to our claims for repayment of the outstanding loans. We recorded a provision for the loans receivable in the amount that we believe is sufficient to reflect the recoverability of the asset, based on management's estimation. In addition, we have several additional legal proceedings outstanding. We have recorded provisions for litigation for claims that were estimable and for which there is a high probability that we will be held responsible based on our legal consultants' opinions and management's estimations.

FAIR VALUE OF WARRANTS. In July 2004, we consummated a private placement, whereby we issued 1,800,000 shares, an aggregate of \$3 million principal amount of convertible notes and warrants (including additional investment rights) to purchase an aggregate of 2,037,500 ordinary shares to investors for a total consideration of \$5.7 million, net of issuance expenses. The consideration was allocated based on the respective fair values of the ordinary shares, notes and warrants. The fair value of the warrants and the additional investment rights was based on a valuation prepared by an independent, valuation expert using the Black-Scholes pricing model.

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SIGNIFICANT EXPENSES

COST OF REVENUES. Cost of revenues consists primarily of manufacturing costs, depreciation of fixed assets, software development costs, impairment losses on long-lived assets and amortization of capitalized software.

MARKETING, SELLING, GENERAL AND ADMINISTRATIVE EXPENSES. Marketing and selling expenses consist primarily of expenses for sales and marketing personnel, sales commissions, marketing activities, public relations, promotional materials, travel expenses and trade show exhibit expenses. General and administrative expenses consist primarily of salaries and related expenses for executive, accounting, administrative personnel, professional fees, provisions for doubtful accounts, and other general corporate expenses.

FINANCIAL INCOME (EXPENSES), NET. Financial expenses consist of interest and bank expenses, interest on convertible note, amortization of beneficial conversion feature on convertible note and currency remeasurement losses. Financial income consists of interest on cash and cash equivalent balances, currency remeasurement gains and gain on restructuring of debt.

YEAR ENDED DECEMBER 31, 2004 COMPARED WITH YEAR ENDED DECEMBER 31, 2003

REVENUES. Our revenues increased 15% to \$14.1 million in 2004 from \$12.3 million in 2003. The increase in our revenues is primarily attributable to the increase of revenues from sales of our Ground Debriefing System, or GDS, to Smith, and sale of FACE(TM) systems to the Portuguese Air Force and the U.S. Navy. We expect that this growth rate will continue in 2005 and that such growth will be generated primarily from sales to our traditional products and from the new products acquired in the purchase of the assets of Vectop Ltd.

COST OF REVENUES. Cost of revenues increased 7% to \$10.3 million in 2004 from \$9.6 million in 2003 mainly due to increased revenues. In 2005 we expect

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that our cost of revenues will increase consistent with the expected increase in revenues.

GROSS PROFIT. Our gross profit increased 44% to approximately \$ 3.9 million in 2004 from \$2.7 million in 2003. Our profit margin increased to 27% in 2004 from 22% in 2003. The increase in gross profit and profit margin are due to the increase of sales volume and the larger mix of off the shelf products like the FACE(TM).

RESEARCH AND DEVELOPMENT EXPENSES. In 2003 and 2004 we did not incur any research and development expenses. We made a strategic decision not to engage in internal research and development activities but, rather, entered into development projects through customers' orders. In 2005, we expect that we will continue to enter into new development projects and develop products through customer orders and will not initiate internally funded research.

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MARKETING, SELLING, GENERAL AND ADMINISTRATIVE EXPENSES. Marketing, selling, general and administrative expenses increased 7% to \$2.9 million in 2004 from \$2.7 million in 2003. While we are continuing our cost savings measures, we have increased our sales efforts in our existing and new markets, which has resulted in increased marketing and selling expenses. We expect that our total marketing, selling, general and administrative expenses will decrease slightly in 2005.

FINANCIAL INCOME (EXPENSES), NET. Our financial expenses, net, were \$248,000 in 2004 and our financial income, net was \$708,000 in 2003. Our financial expenses in 2004 were attributable primarily to the interest payable on the \$3 million of convertible notes issued in 2004 while the financial income in 2003 was primarily attributable to an approximate \$1 million gain on our restructuring of debt with our banks.

YEAR ENDED DECEMBER 31, 2003 COMPARED WITH YEAR ENDED DECEMBER 31, 2002

REVENUES. Our revenues increased 18% to \$12.3 million in 2003 from \$10.4 million in 2002. The increase in our revenues is primarily attributable to the increase of revenues from the sale of GDS and DAS to Smiths for the PM-V Program and sale of FACE(TM) systems to the Portuguese Air Force.

COST OF REVENUES. Cost of revenues increased 4% to \$9.6 million in 2003 from \$9.2 million in 2002 mainly due to increased revenues and impairment losses recognized on some of our long-lived assets.

GROSS PROFIT. Our gross profit increased 132% to approximately \$2.7 million in 2003 from \$1.2 million in 2002. Our profit margin increased to 22% in 2003 from 11% in 2002. The improved margins reflects our reaching a sales level that provides for better utilization of our fixed overhead costs.

RESEARCH AND DEVELOPMENT EXPENSES. In 2003 we did not incur any research and development expenses as compared to 2002 when we expended \$122,000 for research and development. We made a strategic decision not to engage in internal research and development activities but, rather, enter into development projects through customers' orders.

MARKETING, SELLING, GENERAL AND ADMINISTRATIVE EXPENSES. Marketing, selling, general and administrative expenses decreased 13% to \$2.7 million in 2003 from \$3.1 million in 2002 mainly due to cost saving measures taken by us to reduce our overhead.

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FINANCIAL INCOME (EXPENSES), NET. Our financial income, net was \$708,000 in 2003 and our financial expenses, net was \$364,000 in 2002. Our financial income in 2003 was primarily attributable to an approximate \$1 million gain on our restructuring of debt with our banks.

CONDITIONS IN ISRAEL

We are incorporated under the laws of, and our principal executive offices and manufacturing and research and development facilities are located in, the State of Israel. Accordingly, we are directly affected by political, economic and military conditions in Israel. Specifically, we could be adversely affected by any major hostilities involving Israel, a full or partial mobilization of the reserve forces of the Israeli army, the interruption or curtailment of trade between Israel and its present trading partners, and a significant downturn in the economic or financial condition of Israel.

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Since the establishment of the State of Israel in 1948, a number of armed conflicts have taken place between Israel and its Arab neighbors, and a state of hostility, varying from time to time in intensity and degree, has led to security and economic problems for Israel. In 1979 Israel signed a peace agreement with Egypt under which full diplomatic relations were established. In October 1994 a peace treaty was signed between Israel and Jordan which provides, among other things, for the commencement of full diplomatic relations between the two countries. To date, there are no peace treaties between Israel and Syria or Lebanon.

Since 1993, several agreements have been signed between Israel and the Palestinian representatives concerning conditions in the West Bank and Gaza and outlining several interim Palestinian self-government arrangements. The implementation of these agreements have been subject to difficulties and delays.

Since September 2000, relations between Israel and the Palestinian Authority have deteriorated and there has been a marked increase in violence, civil unrest and hostility, including armed clashes, between the State of Israel and the Palestinians, and acts of terror have been committed inside Israel and against Israeli targets in the West Bank and Gaza. Recently, the Israeli government has resolved to unilaterally evacuate all the Jewish settlements in Gaza Strip, and few settlements in the West Bank. In addition, following the death of Yasser Arafat the Palestinian Authority has established new regime who declared it will take active actions against terrorism and caused the Palestinian terror organizations to commit to halt execution of acts of terror in Israel. Such commitment has not been observed. There is no indication as to how long the current hostilities will last or whether there will be any further escalation. Any further escalation in these hostilities or any future armed conflict, political instability or violence in the region may have a negative effect on our business condition, harm our results of operations and adversely affect our share price.

Furthermore, there are a number of countries that restrict business with Israel or Israeli companies. Restrictive laws or policies of those countries directed towards Israel or Israeli businesses may have an adverse impact on our operations, our financial results or the expansion of our business.

In addition, some of our executive officers and employees in Israel are obligated to perform up to 36 days, depending on rank and position, of military reserve duty annually and are subject to being called for active duty under

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emergency circumstances. If a military conflict or war arises, these individuals could be required to serve in the military for extended periods of time. Our operations could be disrupted by the absence for a significant period of one or more of our executive officers or key employees or a significant number of other employees due to military service. Any disruption in our operations could adversely affect our business.

To date, no executive officer or key employee has been recruited for military service for any significant time period. Any further deterioration of the hostilities between Israel and the Palestinian Authority into a full-scale conflict might require more significant military reserve service by some of our employees, which may have a material adverse effect on our business.

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ECONOMIC CONDITIONS

In recent years Israel has been going through a period of recession in economic activity, resulting in low growth rates and growing unemployment. Our operations could be adversely affected if the economic conditions in Israel continue to deteriorate. In addition, due to significant economic measures proposed by the Israeli Government, there have been several general strikes and work stoppages in 2003 and 2004, affecting all banks, airports and ports. These strikes have had an adverse effect on the Israeli economy and on business, including our ability to deliver products to our customers.

The domestic security situation in Israel and the global slowdown in demand for high-tech imports continued to be the main factors affecting economic activity in Israel in 2002 and 2003. Nevertheless, in the second half of 2003, the business sector's activity showed signs of recovery, based on the rise in export and private consumption. Toward the end of 2003, budgetary restraints were exercised as a result of the economic program. The economic program placed large emphasis on reducing the national budget deficit and on measures expected to lead to its permanent reduction, and therefore increased the credibility of the Israeli fiscal policy.

During 2004, the expansion of the economic activity and growth that the Israeli economy experienced since the second half of 2003, continued and unemployment decreased slightly. During this period inflation reached a rate of 1.2%, and the level expected by the Bank of Israel for the next 12 months is between 1% and 3%. Interest rates have remained level throughout the year at approximately 4.1%.

The Israeli government's monetary policy contributed to relative price and exchange rate stability in recent years, despite fluctuating rates of economic growth and a high rate of unemployment. There can be no assurance that the Israeli government will be successful in its attempts to keep prices and exchange rates stable.

TRADE RELATIONS

Israel is a member of the United Nations, the International Monetary Fund, the International Bank for Reconstruction and Development and the International Finance Corporation. Israel is a member of the World Trade Organization and is a signatory to the General Agreement on Tariffs and Trade. In addition, Israel has been granted preferences under the Generalized System of Preferences from the United States, Australia, Canada and Japan. These preferences allow Israel to export the products covered by such programs either duty-free or at reduced tariffs.

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Israel and the EEC, known now as the "European Union," concluded a Free Trade Agreement in July 1975 that confers some advantages with respect to Israeli exports to most European countries and obligates Israel to lower its tariffs with respect to imports from these countries over a number of years. In 1985, Israel and the United States entered into an agreement to establish a Free Trade Area. The Free Trade Area has eliminated all tariff and some non-tariff barriers on most trade between the two countries. On January 1, 1993, an agreement between Israel and the European Free Trade Association, known as the "EFTA," established a free-trade zone between Israel and the EFTA nations. In November 1995, Israel entered into a new agreement with the European Union, which includes a redefinition of rules of origin and other improvements, such as allowing Israel to become a member of the Research and Technology programs of the European Union. In recent years, Israel has established commercial and trade relations with a number of other nations, including Russia, China, India, Turkey and other nations in Eastern Europe and Asia.

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Israel receives significant amounts as economic assistance from the United States. In the last several years Israel has received from the U.S. approximately \$3 billion per year. We cannot assure you that U.S. economic assistance will continue, or that the amounts received will not be reduced. If U.S. economic assistance is eliminated or reduced significantly, the Israeli economy could suffer material adverse consequences which may have material adverse impact on our financial condition and results of operations.

CORPORATE TAX RATE

Under the Israeli Income Tax Ordinance [New Version], 1980 we are subject to corporate tax at the rate of 35% of taxable income for 2004, 34% for 2005, 32% for 2006 and 30% for 2007 onwards.

As of December 31, 2004, our net operating loss carry-forwards for Israeli tax purposes were approximately \$44.4 million.

IMPACT OF CURRENCY FLUCTUATION AND OF INFLATION

For many years prior to 1986, the Israeli economy was characterized by high rates of inflation and devaluation of the Israeli currency against the dollar and other currencies. However, since the institution of the Israeli Economic Program in 1985, inflation, while continuing, has been significantly reduced and the rate of devaluation has substantially diminished. Because governmental policies in Israel linked exchange rates to a weighted basket of foreign currencies of Israel's major trading partners, the exchange rate between the NIS and the dollar remained relatively stable during reported periods.

The following table sets forth, for the periods indicated, information with respect to the rate of inflation in Israel, the rate of devaluation of the NIS against the U.S. dollar, and the rate of inflation in Israel adjusted for such devaluation:

YEAR ENDED DECEMBER 31, -----	ISRAELI INFLATION RATE % -----	ISRAELI DEVALUATION RATE % -----	ISRAELI INFLATION ADJUSTED FOR DEVALUATION % -----
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2000	0	(2.7)	2.8
2001	1.4	9.3	(7.8)
2002	6.8	7.3	0.7
2003	(1.9)	(7.6)	(6.1)
2004	1.2	(1.6)]	(2.8)

Since most of our sales are quoted in dollars and in other foreign currencies, and a significant portion of our expenses are incurred in NIS, our results are adversely affected by a change in the rate of inflation in Israel when such change is not offset (or is offset on a lagging basis) by a corresponding devaluation of the NIS against the dollar and other foreign currencies. We do not use any hedging instruments in order to protect ourselves from currency fluctuation and of inflation risks.

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B. LIQUIDITY AND CAPITAL RESOURCES

We have historically met our financial requirements primarily through cash generated by operations, funds generated by our public offering in 1985, private placements of our ordinary shares and issuance of debt securities, loans from our principal shareholders, short-term loans and credit facilities from Bank Hapoalim B.M. and Bank Leumi Le-Israel B.M., our Banks, research and development grants from the Government of Israel and the Israel-U.S. Binational Industrial Research and Development Foundation, and investment grants for approved enterprise programs and marketing grants from the Government of Israel.

As a result of continuing losses during the period 1999 through 2002 that amounted to \$58.5 million, we were forced to incur significant debt and issue equity securities. During the four years ended December 31, 2003, we relied predominantly on Howard Yeung and our other principal shareholders, and to a lesser extent on new investors to provide us with working capital. During this period, they provided us with \$13.1 million in equity capital, convertible debt and loans. In July 2004 we raised \$5.88 million from institutional and accredited investors.

On April 23, 2002, we entered into a loan agreement with Mr. Yeung, according to which he provided us with a \$550,000 loan facility. The purpose of the facility was to provide us with short term working capital and in 2002 we utilized \$350,000 of the facility.

At an extraordinary meeting of shareholders held on June 9, 2002, our shareholders approved the terms of a purchase agreement between us and certain investors, pursuant to which such investors purchased 1,938,775 of our ordinary shares at a price of \$0.49 per share, which was equal to 70% of the average closing price of the ordinary shares for the ten (10) trading days prior to June 9, 2002. In addition, pursuant to the approval of our shareholders, we issued to such investors warrants to purchase 4,302,041 of our ordinary shares. Such warrants have a term of five years and are exercisable during the first 36 months after issuance at an exercise price of \$2.00 per share, and during the subsequent 24 month period, at an exercise price which will be equal to the higher of: (i) \$2.00 per share or (ii) 50% of the average closing price during the ten (10) trading days prior to an exercise date. The warrants contain certain anti-dilution provisions that could reduce the exercise price of the warrants in the event that we issue securities at a price below the exercise prices of the warrants our shareholders also approved the conversion of the \$1,350,000 of loans granted by Mr. Yeung, into 2,755,102 of our ordinary shares at a price of \$0.49 per share, which was equal to 70% of the average closing

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price of our ordinary shares for the ten trading days prior to the date of shareholder approval. As part of the transaction, we issued to Mr. Yeung on June 30, 2002 warrants to purchase 8,265,306 ordinary shares. Such warrants will be outstanding for five years and will be exercisable during the first 36 months at an exercise price of \$2.00 per share, and during the subsequent 24 month period, at an exercise price which shall be equal to the higher of: (i) \$2.00 per share or (ii) 50% of the average closing price of our ordinary shares during the ten (10) trading days prior to the exercise date.

Under the terms of the purchase agreements, we also agreed to provide the investors and Mr. Yeung with certain registration rights.

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On June 22, 2003, we signed a memorandum of agreement with our Banks, which agreement was approved by our shareholders at an extraordinary general meeting of shareholders that was held on July 22, 2003. Pursuant to an agreement that was finalized on September 24, 2003, we restructured \$3,451,000 of our outstanding debt to the Banks. We repaid \$1,100,000 on account of our debt to the Banks, and the Banks forgave \$1,100,000 of debt and received warrants to purchase 3,781,995 of our ordinary shares, at an exercise price that is equal to the nominal (par) value of our shares, in lieu of \$1,251,000 of our debt. These warrants expire on March 24, 2006 and may not be exercised for a period of 21 months unless transferred pursuant to the call or put options described below. The Banks also granted us an additional short-term line of credit of \$500,000 to finance our cash flow requirements during 2003. As part of the agreement our controlling shareholder, Mr. Howard P. L. Yeung, agreed to grant the Banks a put option allowing the Banks to require him to purchase the above warrants for the consideration of \$1,251,000, exercisable within a period of 45 days commencing on March 24, 2005 and the Banks granted Mr. Yeung a call option allowing him to require the Banks, during a period of 18 months, commencing as of September 24, 2003, and in the event that the Banks will not exercise their put option, during ad