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ISRAEL
Technology

NICE Systems (USD 9.60) 1 - Overweight

Company Update

More Consolidation: Witness Buys Eyretel

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Investment Conclusion

□ The Eyretel acquisition by Witness follows the consolidation process that NICE ignited last year when it acquired TCS. While NICE is likely to face somewhat tougher competition in the quality monitoring niche, this remains a relatively small portion of NICE's overall business. Therefore, we would expect this latest acquisition to have little or no impact on NICE's core business areas.

FY Dec	2002A	2003E		2004E		Change %	
		Currency USD	Actual	Old	New	Old	New
Revenue (m)	162.5	246.8	246.8	275.8	275.8	52%	12%
Net Income (m)	-34.0	14.2	14.2	25.5	25.5	NM	79%
EPS	-2.46	0.90	0.90	1.50	1.50		67%
Consensus							
EV/Revenues	0.37		0.25		0.22		
P/E	NM		10.67		6.40		

Summary

- Witness acquired UK-based peer Eyretel for \$60m in cash, or \$23.5m net of EYR's own cash balance.
- Despite 150% premium offered to EYR shareholders, the deal reflects a relatively low EV/Revs multiple of 0.33.
- NICE continues to be the leading digital recording player with total market share in the range of 23%-25%, now followed by Witness with 16%-18%, and Verint with 14%-16%.

Market Data

Market Cap (m)	129.8
Shares Outstanding (m)	13.5
Float (%)	87%
Net Div Yield (%)	-
Convertible	No
Share per ADR	1.0

Financial Summary

Five – Year EPS CAGR (%)	NM
Return on Equity FY02 (%)	NM
Current BVPS	\$10.82
Net Cash Per Share	\$4.58

Company Rating

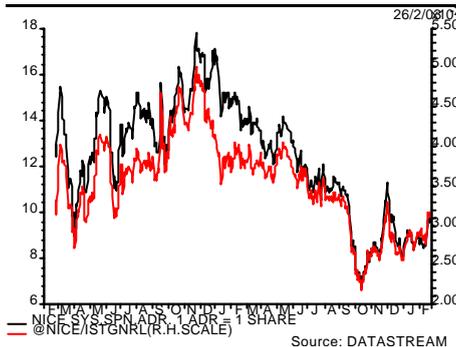
New: 1 - Overweight
Old: 1 - Overweight

Target (USD)

New: 13.70
Old: 13.70

Sector View: 2 - Neutral

Stock Overview



Reuters	NICE
Bloomberg	NICE.OQ
ADR	-
Performance	1M 3M 12M
Absolute %	15 2 -30
Rel. Market %	18 14 -7
Rel. Sector %	17 8 -29
52 Week Range	14.55 - 6.7

Investment Conclusion

The Eyretel acquisition by Witness follows the consolidation process that NICE ignited last year when it acquired Thales Contact Solutions (TCS). While NICE is likely to face somewhat tougher competition in the quality monitoring (QM) niche, this remains a relatively small portion of NICE's overall business. Therefore, we would expect this latest acquisition to have little or no impact on NICE's core business areas. Based on attractive valuation (see 'Valuation' on next page), we reiterate our 1-Overweight rating on NICE shares.

Witness Acquires Eyretel for \$60M

NICE's software-based competitor in the quality monitoring (QM) segment, Witness Systems (NASDAQ: WITS), has acquired its UK-based peer Eyretel Plc (LSE: EYR) for \$59.8m in cash.

Both Witness and Eyretel provide multimedia recording and mainly software-based analysis solutions, focused primarily on the contact centre QM space. Witness specifically focuses on a software niche called agent optimization, which includes workforce management and quality control applications for contact centres.

Witness and Eyretel have similar turnover levels, and as a consolidated player will have yearly sales of about \$130-140m, mostly in the contact centre software market. Although both Witness and Eyretel enjoy relatively high

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gross margins (80% and 57%, respectively), they are yet to break-even from operations (the high gross margins reflect the software-based solutions offered by both companies).

Transaction Value – Eyretel has \$36.3m in cash, no debt. Hence, Witness will be paying for Eyretel (ex-cash) about \$23.5m only. Even though Witness is offering Eyretel shareholders a seemingly attractive 150% premium to Eyretel's market value on Feb 20, the deal reflects a relatively low EV/Revenues multiple of 0.33 (based on Eyretel's sales in the year to Sept 30, 2002). This is about half the multiple at which NICE acquired TCS (based on the adjusted \$47m transaction value and TCS' sales of close to \$70m in 2002).

Little Overlap – The parties seem to have little geographic and distributor overlap. Witness has commanded leading market share in the North American QM market; Eyretel was a relatively strong QM player in Europe and in Asia. Therefore, this acquisition further enhances the leadership of these software-based players in this niche segment of the broader recording industry. The U.S. accounts for more than 90% of Witness' sales, while roughly 50% and 24% of Eyretel's customer base is in Europe and in Asia, respectively. The combined organization will consequently be more balanced with 25-30% of its business in Europe, 10% in Asia and the rest in North America.

Beyond the geographic complementation, it is not clear yet to what extent will Witness leverage Eyretel's product offering, and where will management focus its cost savings efforts in order not only to grow the business, but to turn it profitable as well. Theoretically, it would be possible to cross-sell Witness' elearning management and performance analysis solutions, and Eyretel's product and services in compliance recording.

Consolidation Continues

This acquisition is not surprising. Eyretel has been in the M&A market for a while. The question was who will take it. Arguably, being Witness the acquirer represents somewhat less of a threat for NICE than would have otherwise been if a close business partner such as Cisco Systems (NASDAQ: CSCO), or a major competitor such as Verint Systems (NASDAQ: VRNT) bought it. Nevertheless, we expect NICE to face tougher competition from Witness primarily in QM-focused deals, and to a lesser extent in the broader contact centre recording market. Witness will continue to lack the strong hardware-based recording platform on top of which NICE integrates its application software offering.

NICE's acquisition of TCS in November 2002 ignited the consolidation process in the fragmented digital call recording and QM industry. The Eyretel acquisition is the second major move and reduces the market fragmentation further: we estimate, based on Datamonitor figures published in 2002, that NICE continues to be the leading digital recording player with total market share in the range of 23%-25%, now followed by Witness with 16%-18%, and Verint with 14%-16%. There are several other smaller players as well.

Also according to Datamonitor research, the Witness-Eyretel combination would become the market share leader in the contact centre QM and compliance market, with about 29% of that specific niche.

Is Verint going to make the next major M&A move in the contact centre market? We doubt it. With 64% of its business in the growing digital security and surveillance markets, we believe any major M&A efforts by Verint will be likely focused on expanding its communications interception (wiretapping) and video surveillance technologies and market presence.

Valuation

NICE trades at a P/E of 10.7x (based on our FY03 EPS estimate) and an EV of 0.25x our FY03 revenue estimate. These multiples are significantly lower than most of NICE peers (for example, Verint trades at a P/E of 31). We think this valuation gap is excessive and does not accurately reflect the ability of NICE to grow and generate earnings and cash. We therefore reiterate our 1-Overweight rating and \$13.7 price target, reflecting a P/E ratio of 15x our FY03 EPS estimate of \$0.90 (at the top of company guidance).

Company description

NICE Systems is a leading manufacturer of computer telephony integration (CTI)-based digital recording and retrieval systems and Communications Intelligence (COMINT) systems.

Company Name	Disclosure(s)*	Reuters Ticker	Price (26-02-2003)	Rating
Nice Systems	C	NICE	(US\$ 9.60)	1 - Overweight

Related Stocks	Disclosure(s)*	Reuters Ticker	Price(26-02-2003)	Rating
Cisco Systems	C	CSCO	(US\$ 14.42)	2 - Equal weight
Verint Systems Inc	A/C	VRNT	(US\$ 16.10)	1 - Overweight

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The analysts responsible for preparing this report have received compensation based upon various factors including the Firm's total revenues, a portion of which is generated by investment banking activities.

A - Lehman Brothers Inc. and/or an affiliate has managed or co-managed within the past 12 months a public offering of securities for this company.

C - Lehman Brothers Inc. makes a market in the securities of this company.

Risk Disclosure: NICE's ability to meet our estimates depends on a successful integration of TCS, and the realization of inherent synergies and cross-selling opportunities between the merging parties. The inability to sustain the emerging profitability and cash flow generation in 2003 and beyond would likely trim NICE's market value.

Other Material Conflicts: None.

Key to Investment Opinions:**Stock Rating**

1 - Overweight - The stock is expected to outperform the unweighted expected total return of the industry sector over a 12-month investment horizon.

2 - Equal weight - The stock is expected to perform in line with the unweighted expected total return of the industry sector over a 12-month investment horizon.

3 - Underweight - The stock is expected to underperform the unweighted expected total return of the industry sector over a 12-month investment horizon.

RS - Rating Suspended - The rating and target price have been suspended temporarily to comply with applicable regulations and/or firm policies in certain circumstances including when Lehman Brothers is acting in an advisory capacity in a merger or strategic transaction involving the company.

Sector View

1 - Positive - sector fundamentals/valuations are improving

2 - Neutral - sector fundamentals/valuations are steady, neither improving nor deteriorating

3 - Negative - sector fundamentals/valuations are deteriorating

Stock Ratings From February 2001 to August 5, 2002 (sector view did not exist):

This is a guide to expected total return (price performance plus dividend) relative to the total return of the stock's local market over the next 12 months.

1=Strong Buy - expected to outperform the market by 15 or more percentage point.

2=Buy - expected to outperform the market by 5-15 percentage points

3=Market Perform - expected to perform in line with the market, plus or minus 5 percentage points

4=Market Underperform - expected to underperform the market by 5-15 percentage points

5=Sell - expected to underperform the market by 15 or more percentage points.

Stock Ratings Prior to February 2001 (sector view did not exist):

1=Buy - expected to outperform the market by 15 or more percentage point

2=Outperform - expected to outperform the market by 5-15 percentage points

3=Neutral - expected to perform in line with the market, plus or minus 5 percentage points

4=Underperform - expected to underperform the market by 5-15 percentage points

5=Sell - expected to underperform the market by 15 or more percentage points

V=Venture - return over multiyear timeframe consistent with venture capital; should only be held in a well diversified portfolio

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33% have been assigned a 1-Overweight rating which, for purposes of mandatory regulatory disclosures, is classified as a Buy rating. 29% of companies with this rating are investment banking clients of the Firm.

43% have been assigned a 2-Equal weight rating which, for purposes of mandatory regulatory disclosures, is classified as a Hold rating, 12% of companies with this rating are investment banking clients of the Firm.

24% have been assigned a 3-Underweight rating which, for purposes of mandatory regulatory disclosures, is classified as a Sell rating, 47% of companies with this rating are investment banking clients of the Firm.

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