

Downgrade to Neutral



Merrill Lynch

Downgrade on macro (telco) spending concerns

We downgrade AudioCodes to Neutral from Buy and lower Q4 and FY09/FY10 estimates on increasing macro concerns regarding global telco spending on network infrastructure. The downgrade comes in conjunction with our industry note also published today, titled "*Positioning for the near-term*" where we lower PO's on other telco infrastructure exposed stocks. At 8x CY09E PE, AudioCodes' valuation seems attractive, but the stock lacks positive catalysts and its relatively high debt load and emerging market profile could keep a lid on the PE multiple.

Lower price objective to \$4 from \$7

We also lower our price objective from \$7 to \$4, based on ~0.8x 2009 EV/S which is slightly below comps at 0.9x, with the discount predicated on AudioCodes' higher debt load. At the end of F2Q08, AudioCodes had \$147mn in total cash which includes \$121mn in convertible debt and \$12mn in bank loans, leaving net cash at a relatively low level of only \$14mn, or 33c/share. We believe our choice of EV rather than PE approach is the appropriate technique for smaller-cap stocks under the current capex-constrained environment.

Still like long-term prospects

Our downgrade is not a statement on the overall Voice over IP market which we think is still in secular growth, with AudioCodes' having an impressive position. We highlight here the company's strong partnerships with Tier-1 VoIP players such as Nortel, Microsoft and Avaya provides strong long-term growth potential. Also, the company recently (July) reiterated its 2008 guidance of \$180-185mn in sales and for EPS to be at higher end of its 34c-37c forecast. Recent cost cuts at the company's Netrake session border controller division should also support op. margins which currently at ~9% could climb over 11% by 2010.

Estimates (Dec)

(US\$)	2006A	2007A	2008E	2009E	2010E
EPS	0.16	(0.01)	0.18	0.23	0.31
GAAP EPS	0.46	0.10	0.13	0.23	0.31
EPS Change (YoY)	-48.4%	NM	NM	27.8%	34.8%
Consensus EPS (Bloomberg)			NA	NA	NA
Dividend Rate	0	0	0	0	0

Valuation (Dec)

	2006A	2007A	2008E	2009E	2010E
P/E	21.5x	NM	19.1x	15.0x	11.1x
GAAP P/E	7.5x	34.4x	26.5x	15.0x	11.1x
Dividend Yield	0%	0%	0%	0%	0%
EV / EBITDA*	9.0x	12.0x	7.6x	6.7x	6.0x
Free Cash Flow Yield*	1.0%	6.3%	9.9%	11.6%	12.1%

* For full definitions of *iQmethod*SM measures, see page 7.

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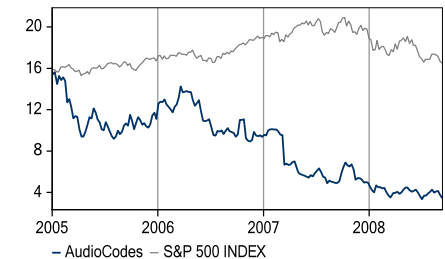
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Stock Data

Price	US\$3.44
Price Objective	US\$7.00 to US\$4.00
Date Established	11-Sep-2008
Investment Opinion	C-1-9 to C-2-9
Volatility Risk	HIGH
52-Week Range	US\$2.50-7.04
Mrkt Val / Shares Out (mn)	US\$142 / 41.4
ML Symbol / Exchange	AUDC / NAS
Bloomberg / Reuters	AUDC US / AUDC.OQ
ROE (2008E)	4.5%
Total Dbt to Cap (Jun-2007A)	41.1%
Est. 5-Yr EPS / DPS Growth	25.0% / 0%



Quarterly Earnings Estimates

	2007	2008
Q1	-0.04A	0.03A
Q2	-0.01A	0.04A
Q3	0.02A	0.05E
Q4	0.04A	0.06E

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Refer to important disclosures on page 8 to 9. Analyst Certification on Page 6. Price Objective Basis/Risk on page 6.

iQprofileSM AudioCodes

iQmethodSM – Bus Performance*

(US\$ Millions)	2006A	2007A	2008E	2009E	2010E
Return on Capital Employed	6.7%	3.6%	5.6%	6.4%	7.1%
Return on Equity	4.5%	-0.3%	4.5%	5.8%	7.4%
Operating Margin	10.0%	4.6%	8.8%	10.0%	10.6%
Free Cash Flow	1	9	14	16	17

iQmethodSM – Quality of Earnings*

(US\$ Millions)	2006A	2007A	2008E	2009E	2010E
Cash Realization Ratio	0.6x	NM	2.5x	2.3x	1.7x
Asset Replacement Ratio	0.6x	0.3x	0.8x	1.0x	1.0x
Tax Rate	6.7%	NM	8.7%	10.0%	10.0%
Net Debt-to-Equity Ratio	22.9%	6.1%	14.5%	14.2%	13.2%
Interest Cover	5.9x	2.9x	6.5x	8.1x	9.7x

Income Statement Data (Dec)

(US\$ Millions)	2006A	2007A	2008E	2009E	2010E
Sales	147	158	186	204	227
% Change	27.2%	7.4%	17.4%	9.9%	11.2%
Gross Profit	88	92	107	115	126
% Change	27.8%	4.8%	15.6%	7.8%	9.9%
EBITDA	20	15	24	27	30
% Change	27.2%	-25.5%	58.1%	14.2%	11.6%
Net Interest & Other Income	3	2	0	0	1
Net Income (Adjusted)	7	(1)	8	10	14
% Change	-48.8%	NM	NM	30.5%	34.9%

Free Cash Flow Data (Dec)

(US\$ Millions)	2006A	2007A	2008E	2009E	2010E
Net Income from Cont Operations (GAAP)	20	5	6	10	14
Depreciation & Amortization	6	8	8	7	6
Change in Working Capital	(16)	6	6	6	3
Deferred Taxation Charge	0	0	0	0	0
Other Adjustments, Net	(5)	(6)	1	0	0
Capital Expenditure	(3)	(3)	(6)	(7)	(6)
Free Cash Flow	1	9	14	16	17
% Change	-87.5%	550.4%	56.8%	17.2%	4.9%

Balance Sheet Data (Dec)

(US\$ Millions)	2006A	2007A	2008E	2009E	2010E
Cash & Equivalents	83	110	123	123	123
Trade Receivables	31	26	30	32	37
Other Current Assets	19	25	25	27	31
Property, Plant & Equipment	8	7	7	7	7
Other Non-Current Assets	196	185	188	196	205
Total Assets	337	353	373	386	404
Short-Term Debt	0	0	0	0	0
Other Current Liabilities	36	38	36	37	39
Long-Term Debt	121	121	148	149	149
Other Non-Current Liabilities	16	18	14	17	19
Total Liabilities	172	177	198	202	207
Total Equity	165	177	172	181	194
Total Equity & Liabilities	337	353	370	383	401

* For full definitions of iQmethodSM measures, see page 7.

Company Description

AudioCodes (AUDC) designs and develops systems, boards and processors for Voice over IP (VoIP) networks. The company's products include VoIP media gateways, session border controllers and call-logging communication boards. Products are sold directly to carriers, or indirectly via partners such as Nortel, Alcatel-Lucent, Ericsson and others.

Investment Thesis

AudioCodes is a small-cap profitable pure-play on the secular growth in Voice over IP deployments by carriers and enterprises. While the stock was negatively impacted in 2007 from a slowdown in the VoIP market and consolidation among its customers, we expect a recovery in 2008 as VoIP deployments accelerate and as AudioCodes restructuring shows benefits in operating margins.

Stock Data

Average Daily Volume 101,119

AudioCodes - good house in a bad neighborhood

We are downgrading AudioCodes to Neutral from Buy. With the stock down 33% YTD, the downgrade clearly appears retrospective. However we are increasingly concerned about the risk from weaker telco capex, which coupled with AudioCodes' high debt load makes it difficult to justify a Buy rating. Note our downgrade appears in conjunction with our industry piece, also published today, titled, "*Positioning for the near-term*" where we detail our concerns and lower the PO on several telco-capex exposed vendors.

Our downgrade is not a statement on the overall Voice over IP market which we believe remains in secular growth. AudioCodes has established an impressive position in mid and low density media gateways, and the company's strong roster of Tier-1 relationships (Nortel, Microsoft, Avaya) clearly lay the foundation for long-term growth. Our main concern is purely macro which makes it more likely, at-least near-term, for the company to beat estimates. In the current volatile market environment, even a modest shortfall can cause rapid declines in the stock which is really what gives us most concern on not just AudioCodes, but all of our telco capex –exposed stocks.

We maintain our F3Q08 estimates, but lower F4Q08 by 1c to \$0.11; lower FY09 by 6c to \$0.42; and lower FY10 by 10c to \$0.48. The summary of estimate changes is shown below.

Table 1: AudioCodes Summary of Estimate Changes

\$mn	SALES			EPS (Pro-forma)			Consensus	
	Old	New	Change	Old	New	Change	Sales	EPS
FY08E								
Q3E	47.48	47.48	0.00	0.10	0.10	0.00	\$46.7	\$0.09
Q4E	49.38	48.90	(0.47)	0.11	0.11	0.00	\$48.2	\$0.10
Total	\$186.24	\$185.77	(\$0.47)	\$0.37	\$0.36	(\$0.01)	\$184.2	\$0.35
YoY	17.7%	17.4%		94.0%	90.5%			
FY09E								
Q1E	\$50.22	\$49.39	(\$0.83)	\$0.11	\$0.10	(\$0.01)	\$48.1	\$0.09
Q2E	52.22	50.38	(1.85)	0.12	0.10	(0.02)	\$50.4	\$0.10
Q3E	54.31	51.39	(2.93)	0.13	0.10	(0.03)	\$52.3	\$0.11
Q4E	57.03	52.93	(4.10)	0.13	0.11	(0.02)	\$54.9	\$0.13
Total	\$213.78	\$204.08	(\$9.70)	\$0.48	\$0.42	(\$0.06)	\$206.9	\$0.44
YoY	14.8%	9.9%		30.5%	14.9%			
FY10E	\$244.60	\$227.01	(\$17.59)	\$0.58	\$0.48	(\$0.10)	--	--
YoY	14.4%	11.2%		20.3%	14.1%			

Source: Merrill Lynch Estimates; Thomson First Call

Lowering PO to \$4 from \$7

We also lower our price objective from \$7 to \$4, based on ~0.8x 2009E EV/S which is slightly below comps at 0.9x, with the discount predicated on AudioCodes' higher debt load (At the end of F2Q08, AudioCodes had \$147mn in total cash which includes \$121mn in convertible debt and \$12mn in bank loans, leaving net cash at a relatively low level of only \$14mn, or 33c/share.)

From a PE perspective, AudioCodes trades at 9x CY09E PE which is well-below the median comp at 17.6x. However, we believe in the current environment, investors increasingly focus on AudioCodes' low net-cash of 13% of sales, versus median comps at 37% cash as percentage of market cap.

11 September 2008

Table 2: AudioCodes comparable valuation.

Stock	Ticker	Mkt Cap (\$M)	Stock Price	Net Cash/Mkt Cap	PE		EV/S	
					2008E	2009E	2008E	2009E
Sonus	SONS	\$868	\$3.20	45%	120.0	50.0	1.4	1.2
Harmonic	HLIT	\$761	\$8.03	37%	11.8	13.5	1.3	1.2
Acme Packet	APKT	\$351	\$6.00	34%	26.0	20.8	2.0	1.7
Alvarion	ALVR	\$390	\$6.56	38%	39.2	17.6	0.8	0.7
Ceragon	CRNT	\$332	\$9.00	33%	16.6	12.5	1.0	0.8
Median				37%	26.0	17.6	1.3	1.2
AudioCodes (Consensus)	AUDC	\$163	\$3.79	13%	10.8	8.5	0.8	0.7
AudioCodes (MLE)	AUDC	\$163	\$3.79	13%	10.5	9.1	0.8	0.7

Source: Merrill Lynch Estimates; Company reports; First Call. Note SONS, APKT, ALVR and CRNT are Not Rated.

Table 3: AudioCodes Pro-forma Income Statement Model

\$mn, FY Ends Dec	Mar-08	Jun-08	Sep-08E	Dec-08E	Mar-09E	Jun-09E	Sep-09E	Dec-09E	2007	2008E	2009E	2010E
Revenues	\$43.74	\$45.65	\$47.48	\$48.90	\$49.39	\$50.38	\$51.39	\$52.93	\$158.24	\$185.77	\$204.08	\$227.01
QoQ Growth	2.1%	4.4%	4.0%	3.0%	1.0%	2.0%	2.0%	3.0%	7.4%	17.4%	9.9%	11.2%
YoY Growth	19.7%	18.7%	17.5%	14.1%	12.9%	10.4%	8.2%	8.2%	66.08	79.22	89.19	100.75
Cost of Goods	18.45	19.37	20.37	21.03	21.34	22.07	22.61	23.18	92.16	106.55	114.89	126.26
Gross Profit	25.29	26.28	27.11	27.87	28.05	28.31	28.78	29.75				
Operating Expenses:												
R&D	9.52	9.36	9.42	9.60	9.90	10.10	10.20	10.30	37.70	37.91	40.50	42.40
S&M	10.57	10.96	11.00	11.00	11.00	11.10	11.20	11.30	38.38	43.53	44.60	48.60
G&A	2.26	2.17	2.20	2.20	2.30	2.35	2.40	2.40	8.77	8.82	9.45	11.10
Total Opex	22.35	22.49	22.62	22.80	23.20	23.55	23.80	24.00	84.85	90.26	94.55	102.10
QoQ Growth	4.2%	0.6%	0.6%	0.8%	1.8%	1.5%	1.1%	0.8%				
Operating Income	2.94	3.79	4.49	5.07	4.85	4.76	4.98	5.75	7.31	16.29	20.34	24.16
Financial Income, net	1.18	0.96	0.96	0.96	0.96	0.97	0.98	0.99	5.17	4.07	3.91	4.06
Interest Expense	(0.63)	(0.63)	(0.63)	(0.63)	(0.63)	(0.63)	(0.63)	(0.63)	(2.50)	(2.50)	(2.50)	(2.50)
Other Income (loss)	(0.28)	(0.35)	(0.25)	(0.25)	(0.25)	(0.25)	(0.25)	(0.25)	(1.10)	(1.13)	(1.00)	(1.00)
Total Financial/Other Income (loss)	0.28	(0.02)	0.09	0.09	0.09	0.10	0.11	0.12	1.57	0.44	0.41	0.56
Pre-Tax Income	3.22	3.77	4.57	5.16	4.94	4.86	5.08	5.86	8.88	16.73	20.74	24.72
Income Taxes	0.14	0.14	0.46	0.52	0.49	0.49	0.51	0.59	0.56	1.26	2.07	2.47
Net Income	3.08	3.63	4.12	4.64	4.45	4.37	4.57	5.28	8.32	15.47	18.67	22.25
Fully Diluted EPS	\$0.07	\$0.09	\$0.10	\$0.11	\$0.10	\$0.10	\$0.10	\$0.11	\$0.19	\$0.36	\$0.42	\$0.48
Shares Outstanding (Basic)	43.08	41.41	41.91	42.41	42.91	43.41	43.91	44.41	42.94	42.20	43.66	44.91
Shares Outstanding (Fully Diluted)	43.51	41.89	42.39	42.89	43.39	43.89	44.39	44.89	43.74	42.67	44.14	45.39
Shares Outstanding (incl convert)	43.51	41.89	49.07	49.57	50.07	50.57	51.07	51.57	47.14	46.01	50.82	52.07
Margin Analysis (as % of Sales)												
Gross Margin	57.8%	57.6%	57.1%	57.0%	56.8%	56.2%	56.0%	56.2%	58.2%	57.4%	56.3%	55.6%
Total Operating Expense	51.1%	49.3%	47.7%	46.6%	47.0%	46.7%	46.3%	45.3%	53.6%	48.6%	46.3%	45.0%
R&D Expense	21.8%	20.5%	19.8%	19.6%	20.0%	20.0%	19.8%	19.5%	23.8%	20.4%	19.8%	18.7%
S&M Expense	24.2%	24.0%	23.2%	22.5%	22.3%	22.0%	21.8%	21.4%	24.3%	23.4%	21.9%	21.4%
G&A Expense	5.2%	4.7%	4.6%	4.5%	4.7%	4.7%	4.7%	4.5%	5.5%	4.7%	4.6%	4.9%
Operating Margins	6.7%	8.3%	9.4%	10.4%	9.8%	9.5%	9.7%	10.9%	4.6%	8.8%	10.0%	10.6%
Tax Rate	4.3%	3.8%	10.0%	10.0%	10.0%	10.0%	10.0%	10.0%	6.3%	7.5%	10.0%	10.0%
Net Income	7%	8%	9%	9%	9%	9%	9%	10%	5%	8%	9%	10%
Est. Options Expense	1.80	1.80	2.00	2.00	2.10	2.10	2.10	2.10	7.70	7.60	8.40	8.40
EPS incl. Options Exp.	\$0.03	\$0.04	\$0.05	\$0.06	\$0.05	\$0.05	\$0.06	\$0.07	(\$0.01)	\$0.18	\$0.23	\$0.31

Source: Merrill Lynch Estimates

Price objective basis & risk

AudioCodes (AUDC)

We rate AudioCodes Neutral with a 12-month price objective of \$4 per share, based on 0.8x 2009E EV/S which is slightly below comps at 0.9x, with the discount predicated on AudioCodes higher debt load. From a PE perspective, AudioCodes trades at 9x CY09E PE which is well-below median comp at 17.6x. However, we believe in the current environment, investors increasingly focus on AudioCodes low net-cash of 13% as % of sales, versus median comps at 37% cash as percentage of market cap.

Risks to our price objective: 1) Small cap tech stocks are out of favor currently which could limit the upside in AudioCodes stock, 2) The company's low net cash (excluding convertible debt due Nov 2009) increases risk of capital raising. 3) The company has limited visibility, as demonstrated by Q1 2007 warning, 4) Slower than expected growth in VoIP, 5) Reliance on 3rd party OEM and resellers, and 6) Emerging market risk.

Analyst Certification

I, Vivek Arya, hereby certify that the views expressed in this research report accurately reflect my personal views about the subject securities and issuers. I also certify that no part of my compensation was, is, or will be, directly or indirectly, related to the specific recommendations or view expressed in this research report.

US-Telecom and Data Networking Equipment Coverage Cluster

Investment rating	Company	ML ticker	Bloomberg symbol	Analyst
BUY				
	Akamai Tech	AKAM	AKAM US	Garrett A. Bekker III
	Amdocs	DOX	DOX US	Tal Liani
	BigBand Networks	BBND	BBND US	Tal Liani
	Check Point	CHKP	CHKP US	Garrett A. Bekker III
	Cisco Systems	CSCO	CSCO US	Tal Liani
	Citrix Systems	CTXS	CTXS US	Garrett A. Bekker III
	McAfee	MFE	MFE US	Garrett A. Bekker III
	Motorola	MOT	MOT US	Tal Liani
	Palm, Inc.	PALM	PALM US	Vivek Arya
	QUALCOMM	QCOM	QCOM US	Tal Liani
	RSCH in Motion	RIMM	RIMM US	Vivek Arya
	Voltaire Ltd	VOLT	VOLT US	Tal Liani
NEUTRAL				
	ADC Telecomm	ADCT	ADCT US	Tal Liani
	AudioCodes	AUDC	AUDC US	Vivek Arya
	CIENA	CIEN	CIEN US	Tal Liani
	F5 Networks	FFIV	FFIV US	Tal Liani
	Harmonic Inc	HLIT	HLIT US	Vivek Arya
	Juniper Networks	JNPR	JNPR US	Tal Liani
	NETGEAR	NTGR	NTGR US	Stanley Kovler
	Symantec Corp	SYMC	SYMC US	Garrett A. Bekker III
UNDERPERFORM				
	Adtran	ADTN	ADTN US	Vivek Arya
	Nortel Networks	NT	NT US	Vivek Arya
	Radware Ltd	RDWR	RDWR US	Stanley Kovler
	Tellabs	TLAB	TLAB US	Tal Liani
	VeriSign Inc.	VRSN	VRSN US	Garrett A. Bekker III
REVIEW				
	Tekelec	TKLC	TKLC US	Vivek Arya

iQmethodSM Measures Definitions

Business Performance	Numerator	Denominator
Return On Capital Employed	$\text{NOPAT} = (\text{EBIT} + \text{Interest Income}) * (1 - \text{Tax Rate}) + \text{Goodwill}$	Total Assets – Current Liabilities + ST Debt + Accumulated Goodwill
	Amortization	Amortization
Return On Equity	Net Income	Shareholders' Equity
Operating Margin	Operating Profit	Sales
Earnings Growth	Expected 5-Year CAGR From Latest Actual	N/A
Free Cash Flow	Cash Flow From Operations – Total Capex	N/A
Quality of Earnings		
Cash Realization Ratio	Cash Flow From Operations	Net Income
Asset Replacement Ratio	Capex	Depreciation
Tax Rate	Tax Charge	Pre-Tax Income
Net Debt-To-Equity Ratio	Net Debt = Total Debt, Less Cash & Equivalents	Total Equity
Interest Cover	EBIT	Interest Expense
Valuation Toolkit		
Price / Earnings Ratio	Current Share Price	Diluted Earnings Per Share (Basis As Specified)
Price / Book Value	Current Share Price	Shareholders' Equity / Current Basic Shares
Dividend Yield	Annualised Declared Cash Dividend	Current Share Price
Free Cash Flow Yield	Cash Flow From Operations – Total Capex	Market Cap. = Current Share Price * Current Basic Shares
Enterprise Value / Sales	$\text{EV} = \text{Current Share Price} * \text{Current Shares} + \text{Minority Equity} + \text{Net Debt} + \text{Sales}$	
	Other LT Liabilities	
EV / EBITDA	Enterprise Value	Basic EBIT + Depreciation + Amortization

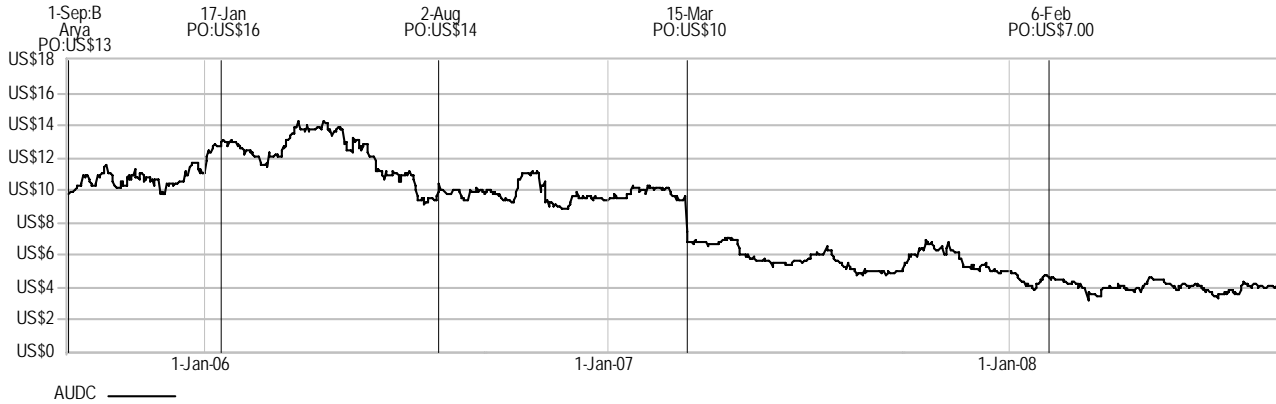
iQmethodSM is the set of Merrill Lynch standard measures that serve to maintain global consistency under three broad headings: Business Performance, Quality of Earnings, and valuations. The key features of *iQmethod* are: A consistently structured, detailed, and transparent methodology. Guidelines to maximize the effectiveness of the comparative valuation process, and to identify some common pitfalls.

iQdatabase[®] is our real-time global research database that is sourced directly from our equity analysts' earnings models and includes forecasted as well as historical data for income statements, balance sheets, and cash flow statements for companies covered by Merrill Lynch.

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Important Disclosures

AUDC Price Chart



B : Buy, N : Neutral, S : Sell, U : Underperform, PO : Price objective, NA : No longer valid

Prior to May 31, 2008, the investment opinion system included Buy, Neutral and Sell. As of May 31, 2008, the investment opinion system includes Buy, Neutral and Underperform. Dark Grey shading indicates that a security is restricted with the opinion suspended. Light grey shading indicates that a security is under review with the opinion withdrawn. The current investment opinion key is contained at the end of the report. Chart is current as of August 31, 2008 or such later date as indicated.

Investment Rating Distribution: Telecommunications Group (as of 01 Jul 2008)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	92	50.83%	Buy	20	26.32%
Neutral	49	27.07%	Neutral	13	35.14%
Sell	40	22.10%	Sell	8	24.24%

Investment Rating Distribution: Global Group (as of 01 Jul 2008)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	1664	47.42%	Buy	441	29.46%
Neutral	803	22.88%	Neutral	224	31.46%
Sell	1042	29.70%	Sell	217	22.84%

* Companies in respect of which MLPF&S or an affiliate has received compensation for investment banking services within the past 12 months. For purposes of this distribution, a stock rated Underperform is included as a Sell.

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Investment rating	Total return expectation (within 12-month period of date of initial rating)	Ratings dispersion guidelines for coverage cluster*
Buy	≥ 10%	≤ 70%
Neutral	≥ 0%	≤ 30%
Underperform	N/A	≥ 20%

* Ratings dispersions may vary from time to time where Merrill Lynch Research believes it better reflects the investment prospects of stocks in a Coverage Cluster.

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