

UBS Investment Research
AudioCodes Ltd.
Rating **Reduce 2**
Prior: Neutral 2
Price target **US\$10.50**
Unchanged
Price **US\$13.19**

RIC: AUCD.O BBG: AUCD US

20 September 2004

Downgrade to Reduce 2 from Neutral 2 -- Too High, Too Fast

■ Not a statement on business trends

While we are confident AUCD's will report another solid Q3 which ends September, and in addition we are comfortable with our high end estimates for the quarter as well as for the year, we are still unable to justify current valuation and accordingly changing our rating to Reduce 2 from Neutral 2

■ Enterprises and carriers increasing spending on VoIP

We believe AUCD's is well positioned to benefit from the increased spending on VoIP systems and technologies. While we estimate that most operators are still trialing the technology, we believe that an increasing number are moving to deployments which should become more material in the 2005-2006 timeframe.

■ Upside to numbers already priced in

We note that our Q3-04 and Q4-04 estimates are the highest among the seven published estimates on IBES. We are comfortable with our forecasts based on business trends experienced in Q2 and entering Q3. For 2005 we are more conservative at the low end of expectations. We believe the company beating expectations for the rest of this year is already baked into the share price.

■ Valuation: Maintain \$10.50 price target

Our target is derived by applying a 2005e PE of 30x which is based on our estimate for the company's organic top-line growth rate.

Trading data

52-wk. range	US\$15.30-7.27
Market cap.	US\$0.58bn
Shares o/s	44.0m
Free float	72%
Avg. daily volume ('000)	321
Avg. daily value (US\$m)	3.7

Balance sheet data 12/04E

Shareholders' equity	US\$0.11bn
P/BV (UBS)	5.0x
Net cash (debt)	US\$0.09bn

Forecast returns

Forecast price appreciation	-20.4%
Forecast dividend yield	0.0%
Forecast stock return	-20.4%
Market return assumption	7.5%
Forecast excess return	-27.9%

EPS (UBS, US\$)

	12/04E			12/03
	From	To	Cons.	Actual
Q1	-	(0.00)	0.00	(0.07)
Q2	-	0.02	0.02	(0.06)
Q3	-	0.04	0.03	(0.04)
Q4	-	0.07	0.05	(0.06)
12/04E	-	0.13	0.11	-
12/05E	-	0.35	0.37	-

Highlights (US\$m)	12/02	12/03	12/04E	12/05E	12/06E
Revenues	27	44	83	113	-
EBIT	(17)	(9)	4	9	-
Net income (UBS)	(14)	(8)	6	10	-
EPS (UBS, US\$)	(0.36)	(0.22)	0.13	0.35	-
Net DPS (UBS, US\$)	0.00	0.00	0.00	0.00	-

Profitability & Valuation	5-yr hist. av.	12/03	12/04E	12/05E	12/06E
EBIT margin %	-0.7	-20.3	5.1	7.9	-
ROIC (EBIT) %	-9.9	-401.8	57.6	42.5	-
EV/EBITDA x	-	-17.9	56.8	33.3	-
PE (UBS) x	-	-24.9	>100	37.3	-
Dividend yield %	-	0.0	0.0	0.0	-

Source: Company accounts, Thomson Financial, UBS estimates. UBS EPS is adjusted by adding back goodwill amortization.

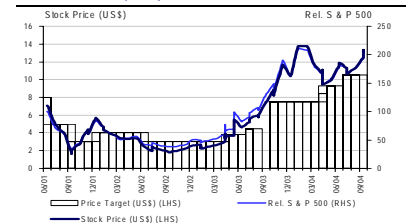
Valuations: based on an average share price that year, (E): based on a share price of US\$13.19 on 17 Sep 2004; Source: Company accounts, Thomson Financial, UBS estimates. UBS EPS is stated before goodwill, exceptionals and other special items.

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Performance (US\$)



Source: UBS

www.ubs.com/investmentresearch

ANALYST CERTIFICATION AND REQUIRED DISCLOSURES BEGIN ON PAGE 4

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Downgrading based on valuation

We are downgrading AudioCodes to Reduce 2 from Neutral 2. We stress that this change in rating does NOT imply that we estimate business trends have worsened at AUDC's but rather our valuation analysis as well as UBS's rating scale drive it. We further note that we would not be surprised to witness further strength in AUDC's share price as investors look for ways to gain exposure to the VoIP sector. However, at present we are unable to justify a higher price target without reverting back to "bubble era" valuation metrics.

Comfortable with our 2004 High-End Estimates

In fact, as we show below our current Q3-04e and Q4-04e estimates for the company are ahead of consensus and are currently at the high-end among the seven estimates published by IBES. While our 2005 estimates also defer from the consensus for next year however we are the low-end of estimates.

Table 1: Our Forecasts Versus Consensus (US\$m except per share)

	Q3-04		2004		2005	
	UBS	Consensus	UBS	Consensus	UBS	Consensus
Revenues	23.0	22.6	83.1	81.9	112.7	118.6
EPS	4c	3.3c	14c	11c	35c	37c

Source: UBS estimates and IBES

In our opinion and based on comments made by management on their Q2 conference call on July 21, 2004 the company ended the quarter with improved visibility and a higher backlog. As a reminder Q2 reported revenues of \$19.1m exceeded guidance of \$18.0m and we estimate Q3 could be on track for a similar performance. Our research suggests that during the quarter AUDC has been selected to supply systems to a cable telephony project for Israel's cable company HOT. Lucent has been selected as the overall network integrator of the a project. While we estimate the revenue contribution from this win is relatively small (less than \$5m) strategically we view it as an important win as it is the first one for AUDC in the cable telephony sector.

Rating Scale

Our \$10.50 price target implies a -27.8% forecasted excess return (FER) from Friday's closing share price of \$13.19. Following is a table showing the calculation of our FER:

Table 2: FER Calculation

Current absolute return based on our \$10.5 price target	-20.4%
US 2yr treasury (2.4%) + 5% market return assumption	7.4%
Forecasted excess return -20.4%-7.4%	-27.8%

Source: UBS

In the table below we present both the share price and the theoretical target price that are applicable for UBS's rating scale:

Table 3: Rating based on share price or theoretical target prices

	Share Price	Target Price
Buy	Share price < \$8.95	Target Price > \$15.7
Neutral	\$8.95 < Share Price < \$10.78	\$13.0 < Target Price < \$15.7
Reduce	\$10.78 < Share Price	\$13.0 < Target Price

Source: UBS rating scale and our calculations

Valuation and Price Target

Even though AUDC's is well positioned to benefit from the increased spending on VoIP solutions and has an arsenal of products and technologies to compete, we believe the shares are over-valued trading at 37x our 2005 EPS estimate. Looking at EV/EBITDA ratios the stock seems more expensive at 68x this year's estimate and almost 25x next year. Given the fact that at this stage we are unable to justify increasing our price target sufficiently (at least 25% to maintain a Neutral recommendation) from the one we set when the company reported Q2-04 results we are downgrading our rating to Reduce 2 from Neutral 2 and maintaining our 12-month price target of \$10.50. Our price target is based on an '05e PE 30x, based on our estimated 30% top-line organic growth rate.

Table 4: Valuation Metrics

Share price	\$13.19
Market cap.	\$555
Net cash	\$91
EV	\$464
PE '04e	92.4
PE '05e	37.2
EV/Sales '04e	5.6
EV/Sales '05e	4.1
EV/EBITDA '04e	68.2
EV/EBITDA '05e	24.7

Source: UBS estimates, Bloomberg and company reports

Table 5: Comparable Valuation Metrics

Company	Ticker	Price		P/E		EV/Revenue	
		17/9/04	Mkt Cap	CY04E	CY05E	CY04E	CY05E
NMS Communications	NMSS	\$5.34	\$263	41.1	13.0	2.0	1.5
Brooktrout	BRKT	\$9.07	\$127	Negative	64.8	1.2	1.0
Sonus Networks	SONS	\$5.96	\$1,490	66.2	38.0	6.9	5.2
Average				53.6	38.6	3.3	2.6
AudioCodes	AUDC	\$13.19	\$555	92.4	37.2	5.6	4.1

Source: AUDC – UBS estimates, others - IBES

■ **AudioCodes Ltd.**

Audiocodes develops and markets VOIP compression technology applications. The company's product line includes Voice over Packet chip processors, VoIP PCI and cPCI communication boards, VoIP media gateway modules, and Analog Media Gateway.

■ **Statement of Risk**

The VoIP sector is attracting increased attention by investors which could overlook current forecasts and base valuation on periods beyond our forecasts horizon in such a case valuations could become even richer.

There are relatively few pure VoIP companies with the breadth and depth of products offered by AUDC. There is always the risk that a larger company vying to enter the sector would acquire AUDC.

■ **Analyst Certification**

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UBS Investment Research: Global Equity Ratings Definitions and Allocations

UBS rating	Definition	UBS rating	Definition	Rating category	Coverage ¹	IB services ²
Buy 1	FSR is > 10% above the MRA, higher degree of predictability	Buy 2	FSR is > 10% above the MRA, lower degree of predictability	Buy	44%	33%
Neutral 1	FSR is between -10% and 10% of the MRA, higher degree of predictability	Neutral 2	FSR is between -10% and 10% of the MRA, lower degree of predictability	Hold/Neutral	48%	31%
Reduce 1	FSR is > 10% below the MRA, higher degree of predictability	Reduce 2	FSR is > 10% below the MRA, lower degree of predictability	Sell	7%	28%

1: Percentage of companies under coverage globally within this rating category.

2: Percentage of companies within this rating category for which investment banking (IB) services were provided within the past 12 months.

Source: UBS; as of 30 June 2004.

KEY DEFINITIONS

Forecast Stock Return (FSR) is defined as expected percentage price appreciation plus gross dividend yield over the next 12 months.

Market Return Assumption (MRA) is defined as the one-year local market interest rate plus 5% (an approximation of the equity risk premium).

Predictability Level The predictability level indicates an analyst's conviction in the FSR. A predictability level of '1' means that the analyst's estimate of FSR is in the middle of a narrower, or smaller, range of possibilities. A predictability level of '2' means that the analyst's estimate of FSR is in the middle of a broader, or larger, range of possibilities.

Under Review (UR) Stocks may be flagged as UR by the analyst, indicating that the stock's price target and/or rating are subject to possible change in the near term, usually in response to an event that may affect the investment case or valuation.

Rating/Return Divergence (RRD) This qualifier is automatically appended to the rating when stock price movement has caused the prevailing rating to differ from that which would be assigned according to the rating system and will be removed when there is no longer a divergence, either through market movement or analyst intervention.

EXCEPTIONS AND SPECIAL CASES

US Closed-End Fund ratings and definitions are: Buy: Higher stability of principal and higher stability of dividends; Neutral: Potential loss of principal, stability of dividend; Reduce: High potential for loss of principal and dividend risk.

UK and European Investment Fund ratings and definitions are: Buy: Positive on factors such as structure, management, performance record, discount; Neutral: Neutral on factors such as structure, management, performance record, discount; Reduce: Negative on factors such as structure, management, performance record, discount.

Core Banding Exceptions (CBE): Exceptions to the standard +/-10% bands may be granted by the Investment Review Committee (IRC). Factors considered by the IRC include the stock's volatility and the credit spread of the respective company's debt. As a result, stocks deemed to be very high or low risk may be subject to higher or lower bands as they relate to the rating. When such exceptions apply, they will be identified in the Companies Mentioned table in the relevant research piece.

Companies mentioned

Company Name	Reuters	Rating	Price
AudioCodes Ltd. ^{2b,16}	AUDC.O	Reduce 2	US\$13.19
Lucent Technologies ^{2a,4,6a,6b,7,8,17}	LU.N	Neutral 2	US\$3.27

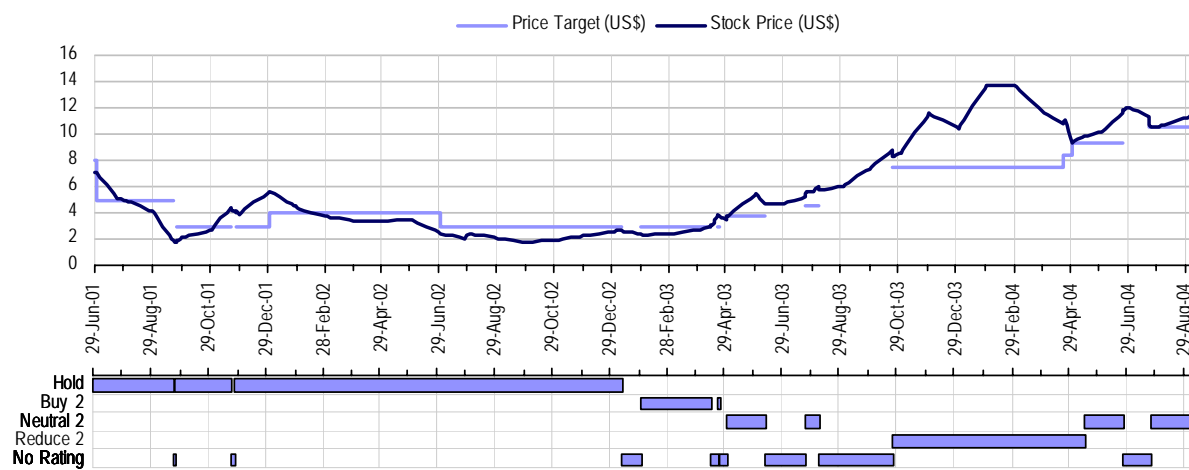
Price(s) as of 17 September 2004. Source: UBS.

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Unless otherwise indicated, please refer to the Valuation and Risk sections within the body of this report.

AudioCodes Ltd. (US\$)



Source: UBS; as of 17 September 2004.

Note: On October 13, 2003, UBS adopted new definition criteria for its rating system. (See 'UBS Investment Research: Global Equity Ratings Definitions and Allocations' table for details.) Between January 11 and October 12, 2003, the UBS ratings and their definitions were: Buy 1: Excess return potential > 15%, smaller range around price target; Buy 2: Excess return potential > 15%, larger range around price target; Neutral 1: Excess return potential between -15% and 15%, smaller range around price target; Neutral 2: Excess return potential between -15% and 15%, larger range around price target; Reduce 1: Excess return potential < -15%, smaller range around price target; Reduce 2: Excess return potential < -15%, larger range around price target. Prior to January 11, 2003, the UBS ratings and definitions were: Strong Buy: Greater than 20% excess return potential, high degree of confidence; Buy: Positive excess return potential; Hold: Low excess return potential, low degree of confidence; Reduce: Negative excess return potential; Sell: Greater than 20% negative excess return potential, high degree of confidence. Under both ratings systems, excess return is defined as the difference between the FSR and the one-year local market interest rate.

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