

22 January 2003

Ilana Treston
+972 3 607-2007

ilana_treston@ml.com

DSP Group

Another Strong Quarter on 2.4GHz Strength

BUY

Reason for Report: Earnings Update

Volatility Risk:
HIGH**Company**

Local DSPG; USD17.07; C-1-9

12-Month Price Objective: 20.00USD (23-Oct-2002)

EPS (Dec): 2001A USD0.42; 2002E USD0.71; 2003E USD0.81

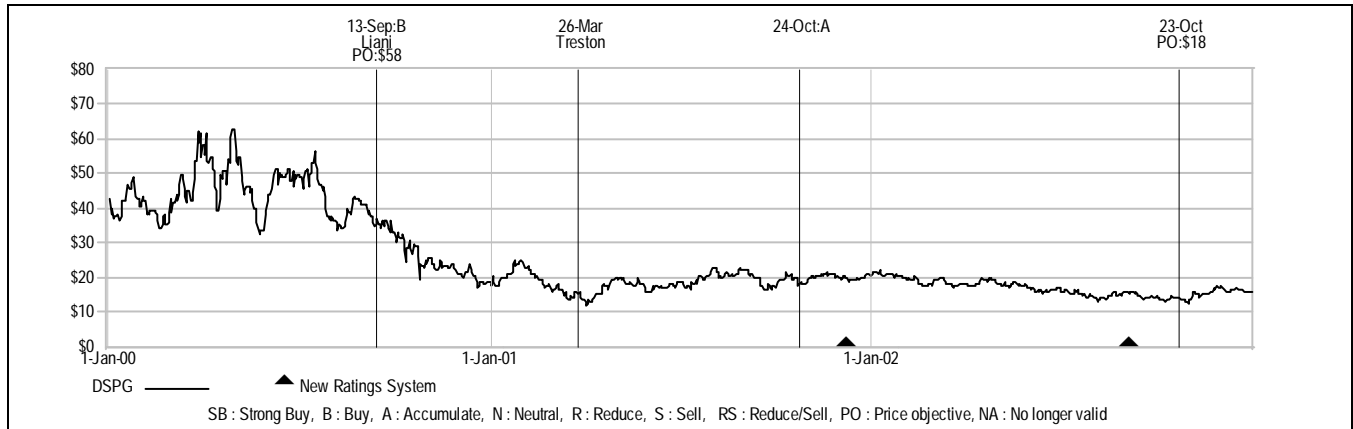
P/E (Dec): 2001A 40.8; 2002E 23.7; 2003E 21.1

- DSP Group reported 4Q:02 earnings slightly higher than our estimates: revenues of \$28.1 million (13.7% YoY growth) and EPS of \$0.13 (18.2% YoY growth) compared to our estimate of \$26.8 million and \$0.11, respectively.
- Year 2002 results showed revenues reaching \$125.16 million (39.9% YoY growth), higher than our \$123.15 million estimate. EPS for continuing operations were of \$0.45 (7.1% YoY growth), excluding an impairment charge (on AUDC stock), they were \$0.71, and EPS for all operations (including their share of pre-spin-off Ceva profits were \$0.80.
- We are maintaining our 2003 revenue and EPS forecasts of \$147.6m and \$0.81, respectively, even though we are slightly above management guidance of \$144m and around \$0.76. We believe growth should remain robust thanks to new product introductions throughout the year.
- The company continues to experience strong demand for their 2.4GHz cordless phone chipset, only introduced in Q1:02 and whose contribution to revenues rose from 60% of Q3 sales to 65% of 4Q sales.
- Furthermore, management expects to see revenues from its new 1.9 GHz product beginning in late 2003. In addition, they are strengthening ties between R&D and marketing in order to generate new product ideas for 2004 and 2005.
- In addition, we believe that DSP Group continues actively to seek expansion opportunities through acquisition, putting to use its over \$200m in cash. Such a move could have a profound impact on DSPG's revenues and profitability in 2003.
- We maintain our Buy recommendation for DSPG on the back of its strong performance and future growth potential in existing and new areas.
- DSPG is trading at 21x and 17x our 2003e and 2004e earnings forecasts, respectively. This is well below the average for the semiconductor space of between 30-35x. Still, we believe this current level of valuation is reasonable and stock price upside will be driven by earnings growth.
- Our \$20 price objective reflects a 2003E P/E of 25x, a PEG ratio of 1.6, and a price to book of 2.0x. While these measures compare well with peers, we believe the real story lies in the company's potential expansion over time, enhancing returns on investments. Risks are the success and pace of new product innovations.

Refer to important disclosures at the end of this report.

Merrill Lynch Global Securities Research & Economics Group
Global Fundamental Equity Research Department**Investors should assume that Merrill Lynch is seeking or will seek investment banking or other business relationships with the companies in this report.**

DSPG Price Chart



Prior to 8 Dec. 2001, the Investment Opinion System included: Buy, Accumulate, Neutral, Reduce and Sell. From 8 Dec. 2001 to 6 Sep. 2002, the Investment Opinion System included: Strong Buy, Buy, Neutral, and Reduce/Sell. On 8 Dec. 2001 Buy ratings became Strong Buy, Accumulate became Buy, and Reduce and Sell became Reduce/Sell. On 6 Sep. 2002, Strong Buy and Buy ratings became Buy, and Reduce/Sell became Sell. Any exceptions to these rating revisions are reflected in the chart. All price objectives for Neutral and Sell rated securities established before 6 Sep. 2002 were eliminated as of that date. The current Investment Opinion System is contained at the end of the report. Dark Grey shading indicates security is restricted with the opinion suspended. Light Grey shading indicates security is under review with the opinion withdrawn.

Investment Rating Distribution: Technology Group (as of 31 December 2002)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	44	19.47%	Buy	6	13.64%
Neutral	154	68.14%	Neutral	26	16.88%
Sell	28	12.39%	Sell	4	14.29%

Investment Rating Distribution: Global Group (as of 31 December 2002)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	1110	43.46%	Buy	391	35.23%
Neutral	1236	48.39%	Neutral	319	25.81%
Sell	208	8.14%	Sell	43	20.67%

* Companies in respect of which MLPF&S or an affiliate has received compensation for investment banking services within the past 12 months.

[DSPG] The securities of the company are not listed but trade over-the-counter in the United States. In the US, retail sales and/or distribution of this report may be made only in states where these securities are exempt from registration or have been qualified for sale. MLPF&S or its affiliates usually make a market in the securities of this company.

[DSPG] MLPF&S or an affiliate expects to receive or intends to seek compensation for investment banking services from this company within the next three months.

In Germany, this report should be read as though Merrill Lynch has acted as a member of a consortium which has underwritten the most recent offering of securities during the last five years for companies covered in this report and holds 1% or more of the share capital of such companies.

The analyst(s) responsible for covering the securities in this report receive compensation based upon, among other factors, the overall profitability of Merrill Lynch, including profits derived from investment banking revenues.

OPINION KEY: Opinions include a Volatility Risk Rating, an Investment Rating and an Income Rating. **VOLATILITY RISK RATINGS**, indicators of potential price fluctuation, are: A - Low, B - Medium, and C - High. **INVESTMENT RATINGS**, indicators of expected total return (price appreciation plus yield) within the 12-month period from the date of the initial rating, are: 1 - Buy (10% or more for Low and Medium Volatility Risk Securities - 20% or more for High Volatility Risk securities); 2 - Neutral (0-10% for Low and Medium Volatility Risk securities - 0-20% for High Volatility Risk securities); 3 - Sell (negative return); and 6 - No Rating. **INCOME RATINGS**, indicators of potential cash dividends, are: 7 - same/higher (dividend considered to be secure); 8 - same/lower (dividend not considered to be secure); and 9 - pays no cash dividend.

Copyright 2003 Merrill Lynch, Pierce, Fenner & Smith Incorporated (MLPF&S). All rights reserved. Any unauthorized use or disclosure is prohibited. This report has been prepared and issued by MLPF&S and/or one of its affiliates and has been approved for publication in the United Kingdom by Merrill Lynch, Pierce, Fenner & Smith Limited, which is regulated by the FSA; has been considered and distributed in Australia by Merrill Lynch Equities (Australia) Limited (ACN 006 276 795), a licensed securities dealer under the Australian Corporations Law; is distributed in Hong Kong by Merrill Lynch (Asia Pacific) Ltd, which is regulated by the Hong Kong SFC; and is distributed in Singapore by Merrill Lynch International Bank Ltd (Merchant Bank) and Merrill Lynch (Singapore) Pte Ltd, which are regulated by the Monetary Authority of Singapore. The information herein was obtained from various sources; we do not guarantee its accuracy or completeness. Additional information available.

Neither the information nor any opinion expressed constitutes an offer, or an invitation to make an offer, to buy or sell any securities or any options, futures or other derivatives related to such securities ("related investments"). MLPF&S and its affiliates may trade for their own accounts as odd-lot dealer, market maker, block positioner, specialist and/or arbitrageur in any securities of this issuer(s) or in related investments, and may be on the opposite side of public orders. MLPF&S, its affiliates, directors, officers, employees and employee benefit programs may have a long or short position in any securities of this issuer(s) or in related investments. MLPF&S or its affiliates may from time to time perform investment banking or other services for, or solicit investment banking or other business from, any entity mentioned in this report.

This research report is prepared for general circulation and is circulated for general information only. It does not have regard to the specific investment objectives, financial situation and the particular needs of any specific person who may receive this report. Investors should seek financial advice regarding the appropriateness of investing in any securities or investment strategies discussed or recommended in this report and should understand that statements regarding future prospects may not be realized. Investors should note that income from such securities, if any, may fluctuate and that each security's price or value may rise or fall. Accordingly, investors may receive back less than originally invested. Past performance is not necessarily a guide to future performance.

Foreign currency rates of exchange may adversely affect the value, price or income of any security or related investment mentioned in this report. In addition, investors in securities such as ADRs, whose values are influenced by the currency of the underlying security, effectively assume currency risk.