

RADWARE LTD  
Form 20-F  
March 16, 2004

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UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

FORM 20-F

REGISTRATION STATEMENT PURSUANT TO SECTION 12(b) OR (g) OF THE  
SECURITIES  
EXCHANGE ACT OF 1934 *[FEE REQUIRED]*  
OR

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES  
EXCHANGE ACT OF 1934 *[NO FEE REQUIRED]*  
For the fiscal year ended December 31, 2003

OR

TRANSACTION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE  
SECURITIES  
EXCHANGE ACT OF 1934 *[NO FEE REQUIRED]*  
For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number 0-30324

RADWARE Ltd.

(Exact name of Registrant as specified in its charter)

Israel

(Jurisdiction of incorporation or organization)

22 Raoul Wallenberg St., Tel Aviv 69710, Israel

(Address of principal executive offices)

Securities registered or to be registered pursuant to Section 12(b) of the Act:  
Title of each class                      Name of each exchange on which registered

None

None

Securities registered or to be registered pursuant to Section 12(g) of the Act:  
Ordinary Shares, NIS 0.1 par value per share

(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:

**17,704,183 Ordinary Shares, NIS 0.1 par value per share**

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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 to follow.

Item 17 Item 18

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Except for the historical information contained herein, the statements contained in this annual report are forward-looking statements, within the meaning of the Private Securities Litigation Report Act of 1995 with respect to our business, financial condition and results of operations. Actual results could differ materially from those anticipated in these forward-looking statements as a result of various factors, including all the risks discussed in [Risk Factors](#) and elsewhere in this annual report.

We urge you to consider that statements which use the terms [believe](#), [do not believe](#), [expect](#), [plan](#), [intend](#), [estimate](#), [anticipate](#), and similar expressions are intended to identify forward-looking statements. These statements reflect our current views with respect to future events and are based on assumptions and are subject to risks and uncertainties. Except as required by applicable law, including the securities laws of the United States, we do not intend to update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

As used in this annual report, the terms [we](#), [us](#), [our](#), the [Company](#), and [RADWARE](#) mean RADWARE Ltd. and its subsidiaries, unless otherwise indicated.

We have registered trademarks for [Web Server Director](#), [Cache Server Director](#), [FireProof](#), [LinkProof](#), [Triangulation](#), [Smart Nat](#), [Get Certain](#), [CertainT](#), and [Peer Director](#) and we have trademark applications pending for [SynappsArchitecture](#), [CID Content Inspection Director](#), [UpLink](#), [Radware](#), [DefensePro](#) and [StringMatch Engine](#). All other trademarks and tradenames appearing in this annual report are owned by their respective holders.

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**PART I**

**ITEM 1. Identity of Directors, Senior Management and Advisors**

Not applicable.

**ITEM 2. Offer Statistics and Expected Timetable**

Not applicable.

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The following tables present our consolidated statement of operations and balance sheet data for the periods and as of the dates indicated. We derived the statement of operations for the years ended December 31, 2001, 2002 and 2003, and the balance sheet data as at December 31, 2002 and 2003 from our consolidated financial statements included in Item 18 in this annual report. The selected consolidated statement of operations financial data for the years ended December 31, 1999 and 2000 and the balance sheet data for the years ended December 31, 1999, 2000 and 2001 are derived from our audited financial statements not included in this annual report. You should read the selected consolidated financial data together with the section of this annual report entitled "Operating and Financial Review and Prospects" and our consolidated financial statements included in Item 18 in this annual report. Please see notes 2N and 11C of the notes to our consolidated financial statements for an explanation regarding the computation of basic and diluted net earnings (loss) per ordinary share.

	<b>Year ended December 31, 1999</b>	<b>Year ended December 31, 2000</b>	<b>Year ended December 31, 2001</b>	<b>Year ended December 31, 2002</b>	<b>Year ended December 31, 2003</b>
<b>(US \$ in thousands, except per share data)</b>					
<b>Statement of Operations Data:</b>					
Revenues	\$ 14,141	\$ 38,353	\$ 43,327	\$ 43,663	\$ 54,780
Cost of revenues	2,269	6,123	7,709	7,946	9,854
Gross profit	11,872	32,230	35,618	35,717	44,926
Operating expenses:					
Research and development	2,099	5,465	8,293	7,809	8,398
Less □ participation by the Chief Scientist of the Government of Israel	466	□	□	□	□
Research and development, net	1,633	5,465	8,293	7,809	8,398
Marketing and selling, net	9,678	24,622	29,986	30,019	29,753
General and administrative	1,137	3,127	4,543	4,219	4,120
Total operating expenses	12,448	33,214	42,822	42,047	42,271
Operating profit (loss)	(576) 856	(984) 7,434	(7,204) 6,312	(6,330) 4,240	2,655 3,740

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Financing income,  
net

Income (loss) before taxes on income	280	6,450	(892)	(2,090)	6,395
Taxes on income	□	(387)	(389)	□	□
Loss in respect of an investment in an affiliate	□	□	(6,333)	□	□
Minority interest in losses (earnings)	□	23	37	(23)	(40)
Net income (loss)	\$ 280	\$ 6,086	\$ (7,577)	\$ (2,113)	\$ 6,355
Basic net earnings (loss) per ordinary share	\$ 0.03	\$ 0.38	\$ (0.46)	\$ (0.13)	\$ 0.37
Diluted net earnings (loss) per ordinary share	\$ 0.02	\$ 0.35	\$ (0.46)	\$ (0.13)	\$ 0.34

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	Year ended December 31, 1999	Year ended December 31, 2000	Year ended December 31, 2001	Year ended December 31, 2002	Year ended December 31, 2003
<b>(US \$ in thousands, except per share data)</b>					
Weighted average number of ordinary shares used in computing basic net earnings (loss) per ordinary share (in thousands)	11,175	15,874	16,423	16,655	17,184
Weighted average number of ordinary shares used in computing diluted net earnings (loss) per ordinary share (in thousands)	12,472	17,602	16,423	16,655	18,666

	1999	2000	December 31, 2001	2002	2003
<b>(US \$ in thousands)</b>					
<b>Balance Sheet Data:</b>					
Cash and cash equivalents, short-term bank deposits and marketable securities	\$ 68,747	\$ 130,824	\$ 125,680	\$ 52,274	\$ 62,882
Long-term bank deposit, long-term marketable securities and structured note	□	□	□	73,027	76,139
Working capital	68,303	132,418	124,911	50,690	60,477
Total assets	74,734	150,095	144,461	142,998	158,114
Shareholders' equity	69,419	135,931	128,938	127,357	140,246

**Risk Factors**

*Our business, operating results and financial condition could be seriously harmed due to any of the following risks. The trading price of our ordinary shares could decline due to any of these risks.*

**We have incurred losses in the past, and may incur losses in the future.**

While we were profitable in 2003, we have incurred losses in each of the years 2001 and 2002. In 2003, we had net income of approximately \$6.4 million. We incurred net losses of approximately \$2.1 million in 2002, and \$7.6 million in 2001. In 2000, we had net income of approximately \$6.1 million. We will need to generate increased revenues as well as manage our costs to maintain and increase profitability. We cannot assure you that we will be able to maintain and/or increase profitability.

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Our net profit for 2003 derives also from financial income in an amount of approximately \$3.7 million. We cannot assure you that we will be able to generate financing income in the future or that such financing income will remain at the same level.

Our revenues may not grow or continue at their current level. In addition, our operating expenses may increase. Our decision to increase operating expenses and the scope of such increase will depend upon several factors, including the market situation and the results that our past expenditures produce. We may make additional expenditures in anticipation of generating higher revenues which we may not realize, if at all, until some time in the future. If our revenues do not increase as anticipated, or if our expenses increase at a greater pace than revenues, we may not be profitable or, if we are profitable, we may not be able to sustain or increase profitability on a quarterly or annual basis.

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**The general deterioration of the economy worldwide, the slow-down in expenditures by service providers, e-commerce and businesses and other trends in our industry could have a material adverse effect on our results of operations.**

Our business is dependent on current and anticipated market demand for our products. Beginning in late 2000, market demand was negatively impacted by the general deterioration of the global economy and the economic uncertainties in the telecommunications market. These conditions, and the uncertainties surrounding the growth rates of economies worldwide, resulted in a curtailment of capital investment by companies in our target markets and caused our revenue growth to increase at a significantly slower pace during 2001 and 2002 relative to prior years. In 2003, the market remained substantially flat. Due to the past volatility of the market it is difficult to predict the conditions of our market going forward. In addition, we believe that market conditions cause our customers and potential customers to be more conservative in planning their spending. If the global conditions deteriorate, and companies in our target markets continue to reduce capital expenditures, we may experience a reduction in sales, as well as downward pressure on the price of our products. In addition, if the market continues to be flat and customers continue to experience low visibility we may not be able to increase our sales. Each of the above scenarios would have a material adverse effect on our business, operating results and financial condition.

**We may experience significant fluctuations in our quarterly financial performance because of the factors discussed below and seasonal fluctuations in our sales.**

Our quarterly operating results have varied significantly in the past and may vary significantly in the future as a result of various factors, many of which are outside of our control. These factors include: our limited order backlog, our dependence upon our suppliers, our need to develop and introduce new and enhanced products and the long sales cycles and implementation periods of our products. In addition, our quarterly operating results have been, and are likely to continue to be, influenced by seasonal fluctuations in our sales. Because our sales have grown significantly since inception, these fluctuations may not be apparent from our historical financial statements. However, we believe that our sales and sales growth have been, and will continue to be, affected by the seasonal purchasing patterns of some of our customers. For example, we believe that our sales may be reduced from the levels which we might otherwise have been able to attain during the third quarter of 2004 because of the slowdown in business activities during the summer months in Europe, and that our sales during the fourth quarter of 2004 may be increased because some of our customers tend to make greater capital expenditures towards the end of their own fiscal years. Because of these anticipated fluctuations, our sales and operating results in any quarter may not be indicative of future performance and it may be difficult for investors to properly evaluate our prospects.

**If the market for Application Switching solutions does not continue to develop, we will not be able to sell enough of our products to maintain profitability.**

The Application Switching market is rapidly evolving and we cannot assure you that it will continue to develop and grow. Market acceptance of Application Switching solutions is not proven and may be inhibited by, among other factors, a lack of anticipated congestion and strain on existing network infrastructures and the availability of alternative solutions. If demand for Application Switching solutions does not continue to grow, we may not be able to sell enough of our products to maintain and increase profitability.

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**Our future success depends on market acceptance of our new products.**

We have recently introduced a new security switch, the DefensePro, and intend to invest in creating an infrastructure for sales and marketing and related services to support the sales of this product. There is no assurance that we will be successful in marketing and selling the DefensePro product, that the revenues from the sale of DefensePro will justify the investment, or that the sales of DefensePro will increase our sales.

**Competition in the market for Application Switching solutions is intense. As a result, we may lose market share and we may be unable to maintain profitability.**

The Application Switching solutions market is highly competitive and we expect competition to intensify in the future. We may lose market share if we are unable to compete effectively with our competitors. Our principal competitors in the Application Switching solutions market include: Cisco Systems, Inc., Nortel, F5 Networks, Inc. and Foundry Inc. In addition, we face new competitors in the Application Security space, with respect to certain products and specific security features included in our products. Such competitors include Internet Security Systems, Inc., and Netscreen Technologies, Inc. We expect to continue to face additional competition as new participants enter the market. Larger companies with substantial resources, brand recognition and sales channels may form alliances with or acquire competing Application Switching solutions and emerge as significant competitors. Competition may result in lower prices or reduced demand for our products and a corresponding reduction in our ability to recover our costs, which may impair our ability to maintain and increase profitability.

**Some of our competitors have greater resources than us, which may limit our ability to effectively compete with them.**

Some of our competitors have greater financial, personnel and other resources than us, which may limit our ability to effectively compete with them. These competitors may be able to:

- respond more quickly to new or emerging technologies or changes in customer requirements;
- benefit from greater economies of scale;
- offer more aggressive pricing;
- devote greater resources to the promotion of their products; and/or
- bundle their products or incorporate an Application Switching component into existing products in a manner that renders our products partially or fully obsolete.

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**We must develop new products and enhancements to existing products to remain competitive. If we fail to develop new products and product enhancements on a timely basis, we may lose market share.**

The market for Application Switching solutions is characterized by rapid technological change, frequent new product introductions, changes in customer requirements and evolving industry standards. Accordingly, our future success will depend to a substantial extent on our ability to:

- invest significantly in research and development;
- develop, introduce and support new products and enhancements on a timely basis;  
and
- gain and consecutively increase market acceptance of our products.

We are currently developing new products and enhancements to our existing products. We may not be able to successfully complete the development and market introduction of new products or product enhancements. If we fail to develop and deploy new products and product enhancements on a timely basis, or if we fail to gain market acceptance of our new products, our revenues will decline and we may lose market share to our competitors.

**We have a limited order backlog. If revenue levels for any quarter fall below our expectations, our earnings will decrease.**

We have a limited order backlog, which makes revenues in any quarter substantially dependent on orders received and delivered in that quarter. A delay in the recognition of revenue, even from one customer, may have a significant negative impact on our results of operations for a given period. We base our decisions regarding our operating expenses on anticipated revenue trends, and our expense levels are relatively fixed, or require some time for adjustment. Because only a small portion of our expenses varies with our revenues, if revenue levels fall below our expectations, our earnings will decrease.

**We depend upon independent distributors to sell our products to customers. If our distributors do not succeed in selling our products, our revenues will suffer.**

We sell our products primarily to independent distributors, including value added resellers, original equipment manufacturers and systems integrators. These distributors resell our products to our ultimate customers. We currently have over 200 active independent distributors and resellers that sell our products. We are highly dependent upon our distributors' active marketing and sales efforts. Our distribution agreements generally are non-exclusive, one-year agreements with no obligation on the part of our distributors to renew the agreements. Typically, our distribution agreements do not prevent our distributors from selling products of other companies, including products that may compete with our products, and do not contain minimum sales or marketing performance requirements. As a result, our distributors may give higher priority to products of other companies or to their own products, thus reducing or discontinuing their efforts to sell our products. We may not be able to maintain our existing distribution relationships. If our distributors terminate their relationships with us, we may not be successful in replacing them. In addition, we may need to develop new distribution channels for new products and we may not succeed in doing so. For example, in some regions, we may need to find distributors who specialize in Internet security products for our new DefensePro product. Any changes in our distribution channels, or our inability to establish distribution channels for new products, will impair our ability to sell our products and result in the loss of revenues.

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**Our products generally have long sales cycles and implementation periods, which increases our costs in obtaining orders and reduces the predictability of our earnings.**

Our products are technologically complex and are typically intended for use in applications that may be critical to the business of our customers. Prospective customers generally must make a significant commitment of resources to test and evaluate our products and to integrate them into larger systems. As a result, our sales process is often subject to delays associated with lengthy approval processes that typically accompany the design and testing of new equipment. The sales cycles of our products to new customers can last as long as twelve months from initial presentation to sale. This delays the time in which we recognize revenue, and results in our having to invest significant resources in marketing and sales.

Long-sales cycles also subject us to risks not usually encountered in a short sales cycle, including our customers' budgetary constraints, internal acceptance reviews and cancellation. In addition, orders expected in one quarter could shift to another because of the timing of our customers' procurement decisions. Furthermore, customers may defer orders in anticipation of new products or product enhancements introduced by us or by our competitors. These factors complicate our planning processes and reduce the predictability of our earnings.

**We must manage our anticipated growth effectively in order to maintain profitability.**

We have actively expanded our operations in the past and may continue to expand them in the future in order to gain market share in the evolving market for Application Switching solutions. This expansion has required, and may continue to require, managerial, operational and financial resources.

We cannot assure you that we will continue to expand, or that we will be able to offer and expand our operations successfully. If we are unable to manage our expanding operations effectively, our revenues may not increase, our cost of operations may rise and we may not be profitable.

As we grow we may need new or enhanced systems, procedures or controls. The transition to such systems, procedures or controls, as well as any delay in transitioning to new or enhanced systems, procedures or controls, may seriously harm our ability to accurately forecast sales demand, manage our product inventory and record and report financial and management information on a timely and accurate basis.

**Our success depends on our ability to attract, train and retain highly qualified sales, technical and customer support personnel.**

As we grow, we may need to increase our research and development, sales and marketing, and support staff. Our products require a sophisticated marketing and sales effort targeted at several levels within a prospective customer's organization. The installation of Application Switching solutions, the integration of these solutions into existing networks and ongoing support can be complex. Accordingly, we need highly-trained sales, marketing and customer support personnel. Competition for qualified sales personnel, as well as technical and customer support personnel is intense, and we may not be able to hire sufficient personnel to support our research and development and sales and marketing efforts. Our success depends upon our ability to attract, train and retain highly qualified personnel.



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**We are dependent on Roy Zisapel, our Chief Executive Officer and President, the loss of whom would negatively 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 highly dependent on the services of Roy Zisapel, our Chief Executive Officer and President. Although we have employment contracts with our senior management and key personnel, we do not carry life insurance on our senior management or key personnel. Any loss of the services of Roy Zisapel, other members of senior management or other key personnel could negatively affect our business.

**Undetected hardware and software errors may increase our costs and impair the market acceptance of our products.**

Our products have occasionally contained, and may in the future contain, undetected errors, especially when first introduced or when new versions are released, either due to errors we fail to detect or errors in components supplied by third parties. These errors tend to be found from time to time in new or enhanced products after the commencement of commercial shipments. Our customers integrate our products into their networks with products from other vendors. As a result, when problems occur in a network, it may be difficult to identify the product that has caused the problem. Regardless of the source of these errors, we will need to divert the attention of our engineering personnel from our product development efforts to address the detection and correction of these errors. In the past, we have not incurred significant warranty or repair costs, nor have we been subject to liability claims for damages related to product errors or experienced any material lags or delays as a result of these errors. However, we cannot assure you that we will not incur these costs or liabilities or experience these lags or delays in the future. Any insurance policies that we may have may not provide sufficient protection should a claim be asserted. Moreover, the occurrence of errors, whether caused by our products or the products of another vendor, may result in significant customer relations problems and injure our reputation, thus impairing the market acceptance of our products.

**If USR Technologies and Electronics (2003) Ltd. (["USR"]) is not able to provide us with adequate supplies of the principal component used in our products, we may not be able to deliver sufficient quantities of our products to satisfy demand.**

We rely on USR to supply us with circuit boards. These circuit boards are the principal component, which we use in the manufacture of our products. If we are unable to acquire circuit boards from USR on acceptable terms, or should USR cease to supply us with circuit boards for any reason, we may not be able to identify and integrate an alternative source of supply in a timely fashion or at the same costs. Any transition to one or more alternate suppliers would likely result in delays, operational problems and increased costs, and may limit our ability to deliver our products to our customers on time for such transition period.

**Our profitability could suffer if third parties infringe upon our proprietary technology.**

Our profitability could suffer if third parties infringe upon our intellectual property rights or misappropriate our technologies and trademarks for their own businesses. Our success depends upon the protection of our proprietary software installed in our products, our trade secrets and our trademarks. To protect our rights to our intellectual property, we rely on a combination of trademark and patent law, trade secret protection, confidentiality agreements and other contractual arrangements with our employees, affiliates, distributors and others. In the United States, we have registered trademarks for ["Web Server Director@," ["Cache Server Director@," ["FireProof@," ["LinkProof@," ["Triangulation@, ["Smart Nat@," ["Get Certain@," ["CertainT@, and ["Peer Director@]. We have trademark applications pending for ["Synapps Architecture, ["CID ["Content Inspection Director, ["UpLink, ["Radware, ["DefensePro and ["StringMatch Engine. In addition, we have registered patents in the United States for our triangle redirection method used for the global load balancing and for our mechanism for efficient management and optimization of multiple links used in our LinkProof product. We also have pending patent applications and provisional patents in connection with several features used in our products. The protective steps we have taken may be inadequate to deter misappropriation of our proprietary information. We may be unable to detect the unauthorized use of our proprietary technology or take appropriate steps to enforce our intellectual property rights. Effective trademark, patent and trade secret protection may not be available in every country in which we offer, or intend to offer, our products. Failure to adequately protect our intellectual property could devalue our proprietary content and impair our ability to compete effectively. Furthermore, defending our intellectual property rights could result in the expenditure of significant financial and managerial resources.



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**Our products may infringe on the intellectual property rights of others.**

Third parties may assert against us infringement claims or claims that we have violated a patent or infringed a copyright, trademark or other proprietary right belonging to them. For example, we are a defendant in a patent infringement case, which was brought by F5 Networks, Inc. in U.S. District Court for the Western District of Washington on March 19, 2003. F5's patent is directed to system and method for load balancing using HTTP Cookies. By its Complaint, F5 seeks damages and permanent injunctive relief. We believe that there are credible invalidity and non-infringement defenses and, options to avoid the patent, all of which are being pursued vigorously. However, at this stage it is not possible to determine the outcome of this lawsuit.

**Our non-competition agreements with our employees may not be enforceable in certain jurisdictions. If any of these employees leaves our company and joins a competitor, our competitor could benefit from the expertise our former employee gained while working for us.**

We currently have non-competition agreements with all of our employees. These agreements prohibit our employees, in the event they cease to work for us, from directly competing with us or working for our competitors. The laws of the U.S., Israel and other countries in which we have employees, may limit or prohibit our ability to enforce these non-competition agreements, or may allow us to enforce them only to a limited extent. In the event that we are unable to enforce any of these agreements, competitors that employ our former employees could benefit from the expertise our former employees gained while working for us.

**Our efforts to increase our presence in additional markets may not be profitable.**

We currently offer our products in over 50 countries in addition to North America. We intend to enter additional geographic markets to expand our sales efforts worldwide. In fiscal years 2002 and 2003, our sales outside the Americas represented approximately 50% and 52%, respectively, of our total sales. Our ability to penetrate new markets is subject to risks inherent to these markets. The risks may impair our ability to generate profits from our increased sales efforts outside North America. In addition, any future political or economic instability in these or other foreign countries could significantly reduce demand for our products.

**Mr. Yehuda Zisapel, who beneficially owns approximately 15.32% of our ordinary shares, may exert significant influence in the election of our directors and over the outcome of matters requiring shareholder approval.**

As of March 10, 2004, Mr. Yehuda Zisapel, Chairman of our board of directors, beneficially owns an aggregate of 2,732,477 ordinary shares, representing approximately 15.32% of the ordinary shares outstanding as of March 10, 2004. In addition, Roy Zisapel, Mr. Yehuda Zisapel's son, is our Chief Executive Officer, President and a director. Roy Zisapel owns 210,163 ordinary shares and options to purchase 1,026,800 ordinary shares, of which 426,800 are fully vested as of March 10, 2004. In addition, Mr. Yehuda Zisapel has the right to vote the ordinary shares issuable upon exercise of options while held by the trustee under our share option plan. As a result, these shareholders may exert significant influence in the outcome of various actions that require shareholder approval. For example, these shareholders could exert significant influence over the election of all of our directors, delay or prevent a transaction in which shareholders might receive a premium over the prevailing market price for their shares and prevent changes in control or management.

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**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 any future earnings to finance operations and to expand our business and, therefore, do not expect to pay any cash dividends in the foreseeable future.

**If we are characterized as a passive foreign investment company, our U.S. shareholders may suffer adverse tax consequences.**

Generally, if for any taxable year 75% or more of our gross income is passive income, or at least 50% of our assets are held for the production of, or produce, passive income, we would be characterized as a passive foreign investment company, or PFIC, for U.S. federal income tax purposes. This characterization could result in adverse U.S. tax consequences to our U.S. shareholders, including having gain realized on the sale of our ordinary shares treated as ordinary income, as opposed to capital gain income, and having potentially punitive interest charges apply to such sales proceeds. U.S. shareholders should consult with their own U.S. tax advisors with respect to the U.S. tax consequences of investing in our ordinary shares.

We reasonably believe we were not a PFIC for our 2003 tax year. It is possible that the Internal Revenue Service will attempt to treat us as a PFIC for 2003 or prior years. The tests for determining PFIC status are applied annually and it is difficult to make accurate predictions of future income and assets, which are relevant to this determination. Accordingly, there can be no assurance that we will not become a PFIC in 2004 or in subsequent years. For a discussion of the rules relating to passive foreign investment companies and related tax consequences, please see the section of this annual report entitled "Taxation" United States Federal Income Tax Considerations.

**Conditions in Israel affect our operations and may limit our ability to produce and sell our products.**

We are incorporated under Israeli law and our principal offices and manufacturing and research and development facilities are located in Israel. Political, economic and military conditions in Israel directly affect our operations. A state of hostility, varying in degree and intensity, has led to security and economic problems for Israel. Since October 2000, there has been a high level of violence between the Palestinians and Israel, which has led to a crisis in the entire peace process and has affected Israel's relationship with its Arab citizens and several Arab countries. We do not believe that the political and security situation has had a material impact on our business to date, however, there is no assurance that this will always be the case in the future. We could be adversely affected by any major hostilities involving Israel, the interruption or curtailment of trade between Israel and its trading partners or a significant downturn in the economic or financial condition of Israel.

Furthermore, several countries restrict business with Israel and Israeli companies, and additional countries or companies may restrict doing business with Israel and Israeli companies as the result of the aforementioned hostilities.

**Most of our directors and officers as well as many of our Israeli employees are obligated to perform annual military reserve duty in Israel. We cannot assess the potential impact of these obligations on our business.**

Our directors, officers and employees who are male adult citizens and permanent residents of Israel under a certain age are, unless exempt, obligated to perform approximately 31 days of annual military reserve duty, depending upon their age and prior position in the army. They may also be further subject to being called to active duty at any time under emergency circumstances. Directors, officers, and key employees falling within these requirements include Roy Zisapel, our Chief Executive Officer and President, Meir Moshe, our Chief Financial Officer, Amir Peles, our Chief Technical Officer, and Assaf Ronen, our Vice President, Research and Development. Our operations could be disrupted by the absence, for a significant period, of one of more of these officers or other key employees due to military service, and any disrupti