

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.

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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.

	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
(US \$ in thousands, except per share data)					
Statement of Operations Data:					
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

	<u> </u>	<u> </u>	<u> </u>	<u> </u>	<u> </u>
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)
	<u> </u>	<u> </u>	<u> </u>	<u> </u>	<u> </u>
Net income (loss)	\$ 280	\$ 6,086	\$ (7,577)	\$ (2,113)	\$ 6,355
	<u> </u>	<u> </u>	<u> </u>	<u> </u>	<u> </u>
Basic net earnings (loss) per ordinary share	\$ 0.03	\$ 0.38	\$ (0.46)	\$ (0.13)	\$ 0.37
	<u> </u>	<u> </u>	<u> </u>	<u> </u>	<u> </u>
Diluted net earnings (loss) per ordinary share	\$ 0.02	\$ 0.35	\$ (0.46)	\$ (0.13)	\$ 0.34
	<u> </u>	<u> </u>	<u> </u>	<u> </u>	<u> </u>

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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
(US \$ in thousands, except per share data)					
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
(US \$ in thousands)					
Balance Sheet Data:					
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.

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 disruption in our operations would harm our business. The full impact on our workforce or business if some of our officers and employees will be called upon to perform military service, especially in times of national emergency, is difficult to predict.

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The rate of inflation in Israel and the change in the exchange rate between the New Israeli Shekel against the U.S. dollar and/or the U.S. dollar against the Euro is volatile, and may negatively impact our costs.

Most of our revenues are denominated in U.S. dollars or are dollar-linked, but we incur a portion of our expenses, principally salaries and related personnel expenses, in other currencies mainly in Israel, in New Israeli Shekels (NIS) and in Europe, in Euros. In 2004, we began selling in Euros in some European countries and intend to expand sales in Euros to additional European countries. We are exposed to the following risks: the rate of inflation in Israel may exceed the rate of devaluation of the NIS in relation to the dollar, the timing of this devaluation may lag behind inflation in Israel, or the NIS may increase in value relative to the dollar. In such events, the dollar cost of our operations in Israel will increase and our dollar-measured results of operations will be adversely affected. In addition, if the Euro increases in value relative to the dollar and sales in Euros do not exceed expenses incurred in Euros, the dollar cost of our operations in Europe will increase and our operating profit will be adversely affected. If the Euro decreases in value relative to the dollar and sales in Euros exceed expenses incurred in Euros, our operating profit will be negatively affected as a result of a decrease in the dollar value of our sales. In 2003, the value of the dollar decreased in relation to the NIS by 7.6%, the deflation rate in Israel was -1.9%, and the value of the dollar decreased in relation to the Euro by 17.0%. During 2003 we did not have any sales in Euro. Although these trends did not materially affect us, we had a slight increase in expenses as a result of the increase in the Euro exchange rate. We cannot provide assurances that we will not be materially adversely affected by the rate of inflation in Israel or exchange rate fluctuations in the future.

The tax benefits we may receive in connection with our approved enterprise program require us to satisfy prescribed conditions and may be terminated or reduced in the future. This would increase taxes.

The Investment Center has granted us an approval to establish an "approved enterprise" program at our Tel Aviv and Jerusalem facilities. An approved enterprise is eligible for tax benefits on taxable income derived from its approved enterprise programs. The benefits available to an approved enterprise are dependent upon the fulfillment of conditions stipulated in applicable law and in the certificate of approval. If we fail to comply with these conditions, in whole or in part, with respect to any approved enterprise program we establish, or if we voluntarily decide to cease the approved enterprise program with regard to our Jerusalem facility, we may be required to pay additional taxes for the period in which we benefited from the tax exemption or reduced tax rates and we would likely be denied these benefits in the future. One criterion for establishing the level of tax benefits is the percentage of holdings by foreign (i.e. non-Israeli) investors in our shares. A decrease in the level of foreign investors' holdings may increase our tax rate. The applicable law regarding "approved enterprise" programs will expire on June 30, 2004, unless its terms are extended. Accordingly, requests for new programs or expansions that are not approved on or before June 30, 2004 will not confer any tax benefits, unless the term of the law is extended. Our approved program and tax benefits thereunder may not continue in the future at their current levels or at any level. The termination or reduction of these tax benefits would likely increase our taxes. The amount, if any, by which our taxes would increase will depend upon the rate of any tax increase, the amount of any tax benefit reduction, and the amount of any taxable income that we may earn in the future.

Provisions of Israeli Law could delay, prevent, or make difficult, a change of control, thereby depressing the price of our ordinary shares.

Provisions of Israeli corporate law may have the effect of delaying, preventing or making more difficult a merger with, or acquisition of, us. The Israeli Companies Law generally provides that a merger be approved by both the board of directors of a company and a majority of the shares present and voting on the proposed merger at a meeting called upon with at least 21 days' notice. For purposes of the shareholder vote, unless a court rules otherwise, the merger will not be deemed approved if a majority of the shares not held by the other party to the merger (or by any person who holds 25% or more of the shares or the right to appoint 25% or more of the directors of the other party or its general manager) voted against the merger. Upon the request of any creditor of a party to the proposed merger, a court may delay or prevent the merger if it concludes that there is a reasonable concern that, as a result of the merger, the surviving company will be unable to satisfy the obligations of the surviving company. Finally, a merger may not be completed unless at least 70 days have passed since the filing of the merger proposal signed by both parties with the Israeli Registrar of Companies.

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The Companies Law also provides that an acquisition of shares in a public company must be made by means of a tender offer if, as a result of the acquisition, the purchaser will become a 25% or greater shareholder of the company unless there is already another 25% or greater shareholder of the company. Similarly, an acquisition of shares must be made by means of a tender offer if as a result of the acquisition the purchaser would become a 45% or greater shareholder of the company, unless there is already a majority shareholder of the company. In any event, if as a result of an acquisition of shares the acquirer will hold more than 90% of a company's shares, the acquisition must be made by means of a tender offer for all of the shares.

Finally, Israel tax law treats some acquisitions, such as stock-for-stock exchanges between an Israeli company and a foreign company, less favorably than U.S. tax laws. For example, Israeli tax law may, under certain circumstances, subject a shareholder who exchanges his ordinary shares for shares in another corporation, to taxation prior to the sale of the shares received in such stock-for-stock swap.

It may be difficult to enforce a U.S. judgment against us and/or our officers and directors, or to assert U.S. securities laws claims in Israel.

Service of process upon our directors and officers named herein may be difficult to effect within the United States because some of these people reside outside the United States. Any judgment obtained in the United States against us or these individuals or entities may not be enforceable within the United States.

There is doubt as to the enforceability of civil liabilities under the Securities Act and the Securities Exchange Act in original actions instituted in Israel. However, subject to specified time limitations, Israeli courts may enforce a U.S. final executory judgment in a civil matter, provided that:

- adequate service of process has been effected and the defendant has had a reasonable opportunity to be heard;
- the judgment and its enforcement are not contrary to the law, public policy, security or sovereignty of the State of Israel;
- the judgment was obtained after due process before a court of competent jurisdiction according to the rules of private international law prevailing in Israel;
- the judgment was not obtained by fraudulent means and does not conflict with any other valid judgment in the same matter between the same parties;
- an action between the same parties in the same matter is not pending in any Israeli court at the time the lawsuit is instituted in the U.S. court; and
- the U.S. court is not prohibited from enforcing the judgments of Israeli courts.

If a foreign judgment is enforced by an Israeli court, it generally will be payable in new Israeli shekels, which can then be converted into non-Israeli currency and transferred out of Israel. The usual practice in an action to recover an amount in non-Israeli currency is for the Israeli court to render judgment for the equivalent amount in new Israeli shekels at the rate of exchange on the date of payment, but the judgment debtor also may make payment in non-Israeli currency. Pending collection, the amount of the judgment of an Israeli court stated in new Israeli shekels ordinarily will be linked to the Israel Consumer Price Index plus interest at the annual rate (set by Israeli law) prevailing at that time. Judgment creditors bear the risk of unfavorable exchange rates.

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Some of our deposits and other investments may be in excess of insured limits and are not insured in other jurisdictions.

The majority of our cash and cash equivalents, and short-term and long-term bank deposits are invested in banks in the United States and in the U.K. Some of these deposits may be in excess of insured limits and are not otherwise insured. If one or more of these financial institutions were to become insolvent, the loss of these investments would have a material adverse effect on our financial condition.

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ITEM 4. Information on the Company

A. History and Development of the Company

Radware Ltd. was organized in May 1996 as a corporation under the laws of the State of Israel, and commenced operations in April 1997. Our principal executive offices are located at 22 Raoul Wallenberg St., Tel-Aviv 69710, Israel and our telephone number is 972-3-766-8666. As of January 1, 1999, we established a wholly-owned subsidiary in the United States, Radware Inc., which conducts the sales and marketing of our products in North America and is our authorized representative and agent in the United States. The principal offices of Radware Inc. are located at 575 Corporate Dr., Lobby 2, Mahwah, NJ 07430 and its telephone number is 201-512-9771. In 2000, we established subsidiaries in France, Germany, Sweden, the United Kingdom, the Netherlands and Australia, and a representative office in China. In 2001, we established subsidiaries in Italy and Japan and branches in Singapore and Korea. In 2003 we established a subsidiary in Singapore and a representative office in Taiwan. The purpose of our subsidiaries and representative offices is to conduct promotion and marketing activities as well as provide customer support in these regions.

For a discussion of our capital expenditures and divestitures, see [Item 5]Operating and Financial Review and Prospects[Liquidity and Capital Resources.]

B. Business Overview

General

We develop, manufacture and market Intelligent Application Switching (IAS) solutions that enable continuous application availability, optimize application performance and provide site wide security. We offer a broad range of solutions to service providers, e-commerce businesses and corporate enterprises to optimize operations of web and application servers, firewalls, virtual private networks ([VPN]), intrusion detection systems ([IDS]), Internet service providers ([ISP]) links, anti-virus gateways and cache servers.

Our Application Switching solutions enable our customers to manage their network infrastructure, bypass systems failures and scale their network infrastructure to accommodate increasing Internet protocol ([IP]) traffic. Our products improve the productivity of network infrastructures by intelligently distributing traffic within the network, optimizing the use of available network resources and protecting applications, networks and users at high speeds. Since our establishment our products have won a number of awards for performance, including Network Computing Editor's Choice, SC Magazine Recommended Buy Award, Network Computing Well-Connected, Internet World Best of Show, PC Magazine Editor's Choice and Network Magazine Product of the Year.

Our products are designed to improve the efficiency, security and flow of the applications of network operations through:

- [Health Monitoring;
- [Traffic Redirection and Load Balancing;
- [Bandwidth Management;
- [Intrusion Prevention; and
- [Denial of Service protection.

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Our products can be deployed either as independent solutions to address specific application needs at a particular location within a network or as an end-to-end integrated solution to manage traffic throughout a network.

Products

We offer our customers a diversified range of products that address different application needs. Our products enable our customers to enjoy continuous availability of their network resources by improving the network's fault tolerance, or resistance to software and hardware errors and system failures. In addition, our products provide scalability by enabling customers to expand capacity as traffic volumes dictate without having to upgrade or replace existing network resources. Our solutions can be implemented to optimize the functionality of various network resources, principally server farms providing Internet protocol applications, including Web sites, file transfer sites, e-mail servers, database servers, cache servers, firewalls, VPNs, IDSs and ISPs. We currently offer nine types of products, each designed to provide Application Switching solutions for different areas of the networks:

- *Web Server Director*® provides full availability, redundancy, security and optimized operation of servers □ in order to achieve high performing IP applications.
- *FireProof*® provides full availability, redundancy and maximized operation of security tools across the network.
- *Cache Server Director*® redirects end-user requests, when appropriate, to cache servers which store, or cache, content previously retrieved from the Internet, thereby optimizing performance, improving response time and conserving bandwidth.
- *LinkProof*® manages Internet traffic for networks, commonly referred to as multi-homed networks, which access the Internet through multiple connections via several ISPs, to provide fault tolerant and cost effective Internet connectivity.
- *LinkProof*® *Branch* manages the operation of multiple links across all remote office links, allowing large, multi-branched enterprises to control and reduce the costs of their connectivity and VPN between headquarters and branch offices.
- *DefensePro*□ protects against worms, viruses, malicious intrusions and Denial of Service attacks at 3 Gigabit speeds, preventing attacks in real-time for multi-layer application defense.
- *Peer Director*® controls, manages and optimizes Internet Routing. Peer Director enables service providers and large enterprises to control their Internet routing by enforcing policies on traffic redirection across the various Internet links. Administration and Internet connectivity costs are reduced, Internet performance is improved and administrators are empowered with better control of their connectivity links.
- *Content Inspection Director*□ provides fault tolerant and fully optimized anti-virus scanning and content filtering for trusted and cost effective content security.
- *CertainT*® *Transaction Accelerator* performs HTTP compression and multi Gigabit speed transactions, for high performance content serving and Secure Sockets Layer (□SSL□) encryption and decryption, providing secure and effective SSL processing.

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Each of our products is designed as a separate hardware unit dedicated to providing intelligent Application Switching solutions. These separate dedicated units are added to existing network structures and, because they do not need to be installed into any existing network devices, are capable of supporting networks ranging in size and traffic flow. By deploying separate dedicated hardware units that do not need to be installed into any existing network devices, we avoid introducing an independent source of system failure and help to increase the mean time between failures of our customers' networks.

Our products are compatible with any system that uses the Internet protocol and can operate with various network structures, configurations and operating systems. Our products support a wide variety of IP-based applications, including web services, e-mail, voice, multi-media database and file transfers. This enables organizations to continue to utilize and build upon their existing infrastructure without limiting their options for meeting future network needs. Our products are designed to be installed without impact to an existing network structure.

All of our products can be combined within a single network infrastructure, addressing all application needs. By controlling site wide traffic, Radware products ensure the full availability, performance and security of IP applications.

Under our Certainty Support offering (see *Product and Technical Management below*), we periodically provide software upgrades to our products, which are electronically sent to our customers and automatically uploaded onto our products.

Application Switch Platforms

In August 2000, we released the Application Switch, a new hardware platform for our products. The Application Switch is based on a multi-layered switching architecture, and enhances the performance of our products. In September 2001, we released the Application Switch II, which provides higher capacity for application switching and can make comprehensive Layer 4-7 switching decisions, at Gigabit speeds, based upon specific applications, destination requests or actual content passing through it. In February 2003, we released Application Switch III, our next generation hardware platform. Application Switch III is the industry's first 10 Gigabit Ethernet Layer 4-7 Switch, offering three times the capacity and five times the processing power of Application Switch II.

Web Server Director[®]

Our Web Server Director product enables the full availability, optimized operation and security of server farms. This provides reliable and high performing service of mission critical applications across networks and data centers. Web Server Director is designed to address different network environments, ranging from a single group of servers organized in a farm, to multiple groups of server farms, with each server farm located at a different geographically dispersed site in the network. The Web Server Director eliminates bottlenecks, failures and downtime from enterprise servers, ensuring the full operation of all IP applications such as web services, e-mail and online databases.

The Web Server Director can provide local or global traffic management:

□ *Local Solution.* As a local solution, Web Server Director intercepts traffic directed to a local server farm and distributes the traffic among the servers in the farm in order to bypass any off-line servers within the server farm, provide continuous availability of the applications provided by the server farm and optimize use of the capacity of the servers organized in the farm.

□ *Global Solution.* As a global solution, Web Server Director can distribute traffic among multiple groups of server farms located at geographically dispersed sites throughout a network. The Web Server Director distributes the traffic among the various server farms located at different sites throughout the network through the use of advanced measuring tools and traffic redirection methods, balancing traffic based upon a combination of a dynamic measurement of traffic and capacity at each server farm and the response time of each server farm.

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The Web Server Director also incorporates, either as standard or optional features, advanced health monitoring, traffic redirection, bandwidth management, intrusion prevention and Denial of Service protection to provide users with a dependable and cost effective IT infrastructure.

FireProof®

Our FireProof product was launched in 1998 as a firewall traffic management solution that loads balanced traffic amongst multiple firewalls. As companies began to implement more comprehensive security plans, FireProof developed into a security Application Switch which manages and optimizes multiple security resources deployed over the enterprise. FireProof ensures that security tools deployed in the network remain fully activated for accelerated defense performance. For example, companies deploy network security filters, firewalls, VPNs and IDSs to protect their networks from unauthorized access to sensitive information. FireProof Security Application Switch manages these resources and ensures that they are fully activated at all times. FireProof offers continuous availability of firewalls, VPNs and IDSs by load balancing and dynamically distributing traffic amongst these security devices. FireProof also automatically detects and protects against more than 1,300 malicious attack signatures, preventing the violation of online mission critical operations. This is achieved through the device's application security module, which monitors traffic in real time, identifying and intercepting malicious traffic. In addition, FireProof provides as an optional feature, Denial of Service (DoS) protection by preventing malicious DoS attacks at multi-Gigabit speeds. Radware's DoS Shield detects the occurrence of DoS/DDoS attacks with an advanced sampling algorithm and takes automatic actions to thwart the attacks.

Cache Server Director®

Our Cache Server Director product is a cache server management and traffic distribution system. Designed for organizations that employ cache server farms on their networks, Cache Server Director is designed to maximize the performance of cache server farms, optimize utilization of Internet access and storage resources and reduce bandwidth consumption.

Cache servers are designed to enhance the efficiency of data transmission by reducing the amount of redundant network traffic. Cache servers locally store, or cache, information previously retrieved from the Internet in dedicated storage systems. Future requests for the same information are retrieved directly from the cache server, thereby avoiding the need to traverse the entire network to retrieve the same data. Cache servers are frequently deployed in farms to provide redundancy and increased capacity. However, cache servers generally require a time-consuming user configuration procedure. Users that are not configured to a cache server will access the Internet directly. This results in less than optimal use of cache resources, delay in response time to the cache servers and unnecessary use of bandwidth to access data that was previously cached on the local network. Cache Server Director eliminates the need to configure individual users to the cache servers. Cache Server Director intercepts outgoing Internet requests according to predefined criteria and redirects them to the cache server where the requested information has previously been stored, thereby avoiding inefficient use of bandwidth and eliminating duplication of cached information on different servers.

In addition, Cache Server Director processes requests for non-cached data and distributes information retrieved from the Internet among available cache servers for storage. Cache Server Director distributes the retrieved information proportionately among the cache servers in order to optimize capacity and performance of the entire cache server farm. To further provide for optimal utilization of cache servers, Cache Server Director monitors user requests for popular Internet addresses and automatically transfers them to the least loaded cache server.

Cache Server Director provides full fault tolerance between cache servers. Should a cache server fail, Cache Server Director will redirect all requests to another cache server within a farm, providing users with uninterrupted access to the cache server farm. Similar to our other products, Cache Server Director offers full scalability to enable cost-effective growth, allowing customers to employ different cache servers with varying performance capabilities within a cache server farm managed by a Cache Server Director.

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Cache Server Director also provides, as an optional feature, Gigabit speed protection of cache servers against Denial of Service attacks and over 1,300 attack signatures.

LinkProof®

Our LinkProof family of products, comprised of LinkProof and LinkProof Branch, offer an Internet link Application Switch solution for multi-homed networks. In order to ensure continuous access to the Internet, enterprises frequently deploy, via several ISPs, multiple connections between their networks and the Internet, providing the network with alternative access points to the Internet in the event one connection fails. This network design is commonly referred to as a multi-homed network.

Using patented technology, LinkProof is deployed between a multi-homed network and the Internet access routers to ensure high availability and continuous access to and from the Internet, as well as optimal utilization of the available Internet access connections. LinkProof acts as an intelligent interface between the multi-homed network and the Internet. LinkProof receives all outgoing Internet traffic from the network and routes the traffic to the appropriate ISP based on availability, cost and current traffic load along the connection to the ISP. LinkProof continuously monitors the transport layer of the network environment to detect failures. In the event of a failure in a connection to one of the ISPs used by the multi-homed network, LinkProof automatically routes the traffic to an alternative ISP.

LinkProof also dynamically distributes outgoing and incoming Internet traffic through the several Internet connections available to a multi-homed network to provide optimal use of the network's Internet connections. Building on the proximity detection technology used in the Web Server Director family of products, LinkProof dynamically selects the most efficient Internet connection with respect to each Web site for either inbound or outbound Internet traffic. This technology enables LinkProof to monitor the performance of each of the ISP connections with respect to the requested Web site. Using this information, LinkProof makes the routing decision based on the availability of each Internet connection, as well as the network proximity of the Internet and the requested Web site through the various ISPs, thereby providing the optimal path for Internet traffic to and from the network.

LinkProof also provides, as an optional feature, Gigabit speed protection for the internal network against DoS attacks and over 1,300 attack signatures. The LinkProof family of products offers a multi-homing solution from an enterprise's headquarters to remote branch offices.

DefensePro

Introduced in December 2003, DefensePro protects against worms, viruses, DoS attacks and Trojans at 3-Gigabit speeds. Built upon a high capacity security switch, DefensePro monitors security threats across layers 2-7 traffic for full visibility of attack type and affected resources. Organizations today increasingly rely on web-based and mission critical distributed applications for running their business. Critical applications such as Customer Relationship Management and Enterprise Resource Planning, are accessed remotely from branch offices and manufacturing facilities over wide area networks. Coupled with this, the number and severity of attacks continue to grow. DefensePro addresses the need for an online security solution that bi-directionally scans all network traffic and delivers real-time protection from a wide variety of application level attacks such as worms, viruses, exploits and DoS attacks, at multi-Gigabit speeds. DefensePro performs bi-directional, stateful, deep packet inspection and accelerated signature matching to immediately block hidden worms, viruses, Trojans and intrusions. DefensePro offers multi-Gigabit speed protection for over 1,300 attack signatures with continuous security updates.

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Peer Director®

Our Peer Director product, which is designated mainly for the intelligent routing market, controls, manages and optimizes Internet routing. Peer Director enables service providers and large enterprises to control their Internet routing by enforcing policies on traffic redirection across the various Internet links.

The Peer Director gathers and analyzes real time statistics associated with Internet traffic carried on multiple links. Based on these statistics and in conjunction with customizable user-defined policies, Peer Director redistributes and optimizes traffic loads between the links through multiple sophisticated load balancing algorithms that are proprietary to Radware. Network administrators no longer need to manually monitor the availability of routers and ISP links. Peer Director automatically and dynamically achieves link optimization by redirecting users to the healthiest link, thereby avoiding traffic congestion that often plagues BGP (Border Gateway Protocol) routing schemes. Users benefit from improved performance and cost-efficient Internet service.

Peer Director also provides, as an optional feature, Gigabit speed protection for the internal network against DoS attacks and over 1,300 attack signatures.

Content Inspection Director

Content Inspection Director was introduced in October 2002 to deliver fault tolerant and fully optimized anti-virus scanning and content filtering. Content security devices consume a significant amount of network resources for application processing. As a result, bottlenecks often occur during inspection for malicious content. Radware's Content Inspection Director contains a pre-screening algorithm that allows for the differentiation between trusted and non-trusted content. The suspect content is directed to inspection devices such as anti-virus gateways and content filters, while trusted content bypasses the inspection devices and proceeds normally. Since a high percentage of Internet traffic is trusted content such as streaming, audio files and image files, offloading the trusted content may result in up to a 500 percent increase in performance.

Content Inspection Director achieves finer security granularity by defining inspection policies according to customer requirements. Content Inspection Director's flow management allows users to sequentially load balance several server clusters, whereby each one provides a different service based on source, destination, traffic type and physical port.

In addition, Content Inspection Director provides Gigabit speed protection against Denial of Service attacks and over 1,300 attack signatures.

CertainT® 100

The CertainT 100 Transaction Accelerator: Accelerates the end to end response time of web enabled applications through web compression, TCP offloading and SSL acceleration. While compressing web content for improved response time, CertainT 100 reduces bandwidth consumption as the compressed content tends to be 30-50% smaller than the original content, thereby resulting in significant cost savings.

To increase processing capabilities, multiple CertainT devices can be added to create CertainT 100 farms, which may accelerate the SSL encryption up to 35,000 transactions per second.

CertainT 100 prevents SSL attacks by blocking security transaction tampering and mitigating service failures. CertainT 100 decrypts traffic at critical points in the network, inspecting and directing traffic to security devices for security filtering. The identification and termination of illegitimate SSL sessions protects against malicious SSL packets and security violations.

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SynApps Architecture

All of our products are available with SynApps Architecture. This software architecture offers five modules which support various mission critical operations across the network. The five modules are: Health Monitoring; Traffic Redirection (these two components are an integral part of our products); Bandwidth Management, Intrusion Prevention and DoS Protection (these three components are optional add-on modules available with all our products).

Application Health Monitoring SynApps includes health monitoring tools that check physical and logical application resources. If a problem is detected, SynApps generates the proper alerts and overcomes the problem by redirecting users to alternate resources within the local or global network. SynApps health monitoring includes tools that check all Internet protocols, standard server agents employing Internet protocols, Transmission Control protocols, User Datagram Protocols and Web transactions, including content verification and bound health checks.

Traffic Redirection Traffic redirection capabilities ensure that users are directed to healthy and available resources locally or globally despite the inherent and unpredictable peaks in Internet traffic. This module redirects traffic to the least loaded server, data center, firewall or router, thus providing resource optimization.

Bandwidth Management SynApps Bandwidth Management allows companies to define and implement their own bandwidth management policies for applications running on servers, firewalls and cache servers, as well as expensive and critical Wide Area Network connections. Bandwidth management allows companies to guarantee that critical business traffic such as ERP (Enterprise Resource Planning) traffic or e-commerce transactions receive higher priority versus non-critical traffic.

Intrusion Prevention SynApps also provides the ability to detect network intrusion and prevent dangerous malicious attacks, thereby providing another line of defense for critical network resources that are managed by Radware products. The application security module helps protect networks and applications from more than 1,300 known attack signatures.

DoS Shield Introduced in February 2002, DoS Shield provides organizations with extensive DoS detection and protection capabilities while maintaining high network traffic capacity, sustaining Gigabit capacity. Using an advanced sampling algorithm, the DoS Shield detects when active attacks begin to consume large amounts of the network's bandwidth, and immediately blocks them. Legitimate traffic proceeds normally.

Configware

Our products can be managed with Configware, a proprietary management tool that is included with all of our products. Configware is designed with an easy to use, graphical user interface that allows our customers to benefit from our technology with minimal technical know-how or support. Configware can be installed either as a stand-alone software package or as a Web application, in conjunction with a Web server, to enable remote configuration through a Web browser. Configware enables real-time monitoring of, as well as historical analysis of, device functionality, traffic flows and traffic volumes. It furnishes a wide range of statistics for managing servers, thereby enabling efficient utilization of the server farm, including current server traffic volumes, peak traffic volumes, attached end-users per server and number of connection failures. Graphs and charts can be customized according to the customer's parameters. Configware also enables interactive monitoring and automatic notifications of failures or other data. Configware enables Web Server Director, Cache Server Director, LinkProof, FireProof, DefensePro, Peer Director, Content Inspection Director and CertainT-100 software to be updated remotely while the device is working. Almost all parameter changes are implemented immediately, with no need to reset the unit.

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Configware Insite

Configware Insite is a site-wide software management tool that enables unified administration, visibility and control of IP application performance across the enterprise. Unlike Configware, which manages each product separately, Configware Insite manages all our products with a site-wide view. Based on an easy-to-use site map interface, Configware Insite lets users draw their network, configure Radware Intelligent Application Switching devices and set-up the SynApps Services (as described above) to address end-to-end IP application service requirements. Configware Insite's statistics module provides real-time and historical views of actual application performance levels for monitoring site-wide operations and simple pinpointing of vulnerabilities and failures, affording complete visibility and control over the performance of Web and Application Servers, security tools, cache servers, anti-virus tools and Internet links.

Configware Insite provides real-time and historical views of all Radware Application Switching devices and SynApps services for complete visibility of site-wide IP application performance, facilitating trend analysis while extending comprehensive control of enterprise operations. The collected statistics enable administrators to identify network vulnerabilities and take proactive steps to mitigate service failures before they affect the site. Configware Insite offers a comprehensive set of user defined statistics that provide performance and bandwidth consumption data per device, including bi-directional traffic, failures, bottlenecks, resource management and client information. Based on this information, network administrators can decide to add resource capacities, tune bandwidth policies or relocate devices to better manage actual traffic loads and IP application performance requirements.

Customers

We have a globally diversified customer base consisting of corporate enterprises including banks, insurance companies, manufacturing and retail, government agencies, media companies and service providers, such as telecommunication carriers, ISPs and application service providers. We also offer our products to e-commerce businesses, such as e-commerce Web sites and publishing Web sites and portals, although sales to e-commerce businesses have not represented a significant portion of our revenue to date. Our range of Application Switching products offer business and industry solutions including site-wide security activation, business application solutions, connectivity and multi-homing solutions, e-commerce solutions and business continuity and disaster recovery solutions.

With the exception of our limited direct sales efforts to select customers, we sell our products through distributors who then sell our products to end users. We sell our products in North America both directly to customers and through indirect distribution channels. Outside North America, we sell our products exclusively through indirect distribution channels.

In 2003, approximately 48% of our sales were in the Americas (principally in the United States) and 52% were outside the Americas, of which approximately 26% of our sales were in EMEA (Europe, Middle East and Africa) and 26% were in Asia-Pacific. Other than the United States, no single country accounted for more than 10% of our sales for 2003.

For the year ended December 31, 2003, one single customer accounted for 11% of our sales. For the years ended December 31, 2002 and 2001, no single customer accounted for more than 10% of our sales. As of December 31, 2003, one single customer represented 15% of the trade receivables balance. As of December 31, 2002, no single customer represented more than 10% of the trade receivables balance.

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Sales and Marketing

Sales. We market and sell our products mainly through an indirect sales channel that consists primarily of distributors located in North America, Europe and Asia. In addition, we generate direct sales to select customers in North America. Our distributors are supported by our sales managers who are also responsible for recruiting potential distributors and for initiating and managing marketing projects in their assigned regions. The sales managers are supported by our internal sales support staff who help generate and qualify leads for the sales managers. As of December 31, 2003, we employed a total of 50 sales managers and sales staff in the Americas with locations in various states. We also employed 42 sales managers and sales staff based in Israel and other subsidiaries and representative offices, who are responsible for developing and maintaining distribution channels outside the Americas. We have subsidiaries in the United States, Australia, France, Germany, the United Kingdom, Italy, Japan and Singapore, as well as representative offices and branches in China, Taiwan and Korea. These offices promote and market our products and provide customer support in their respective regions.

Marketing Strategy. Our marketing strategy is to enhance brand recognition and maintain our reputation as a provider of technologically advanced, quality Intelligent Application Switching solutions. We seek to build upon our marketing and branding efforts globally to achieve greater worldwide sales. Our sales force and marketing efforts are principally directed at developing brand awareness and providing sales support to our distributors. We participate in major trade shows and offer support to our distributors who participate in regional trade shows and events. We also invest in web based advertising campaigns. In addition to our independent marketing efforts, we invest in joint marketing efforts with our distributors, value added resellers and other companies that have formed strategic alliances with us. We have entered into co-marketing arrangements with companies in other complementary Internet segments, including Symantec Corporation, NetScreen Technologies Inc., Citrix Systems, Inc., Oracle Corporation, BEA Systems, Inc., BMC Software Inc., Aladdin Knowledge Systems Ltd., SurfControl plc, Secure Computing Corporation, Quest Software, Inc., Microsoft Corporation, WatchGuard Technologies Inc., KaVaDo Inc., Teros, Inc., Internet Security Systems, Inc. and Hewlett Packard Company.

Strategic Alliances and Original Equipment Manufacturer Agreements. We have entered into strategic alliances and original equipment manufacturer agreements with other software and hardware vendors, including Mercury Interactive Corporation, Comverse Technology, Inc. and NEC Corporation, as well as mutual channel information sharing arrangements. We believe that these companies have significant customer relationships and offer products which complement our products. Our agreements allow these companies to distribute our products on a world-wide non-exclusive basis with discounts based upon the volume of orders received. There usually is no requirement for a minimum sales quota. The products are branded with the names of these companies or co-branded with our name as well. These agreements are standard distributor agreements, purchase agreements, OEM (original equipment manufacturer) agreements or other specific agreements and are terminable by either party at will. We plan to further invest in the development of strategic alliances in order to provide greater access to our target markets and enhance our brand name.

Technical Management

Our technical team, which consists of 54 employees worldwide as of December 31, 2003, assists our customers and distributors with the initial installation, set-up and ongoing support of our products, trains distributors and customers to use our products and provides software and product upgrades for our products. In addition, our technical team trains and certifies our distributors to provide limited technical support in each of the geographical areas in which our products are sold, and is directly responsible for remote support. Our Certainty Support Program provides offerings which allow customers to constantly upgrade their products and obtain optimized performance by purchasing the following five optional features: extended warranty, software upgrades, 24x7 help-desk (directly to our customers and through our distributors), on-site support and unit replacement.

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Research and Development

In order to maintain our share of the Application Switching market, we place considerable emphasis on research and development to expand the capabilities of our existing products, develop new products and improve our existing technologies and capabilities. We believe that our future success will depend upon our ability to maintain our technological expertise, enhance our existing products and introduce, on a timely basis, new commercially viable products that will continue to address the needs of our customers. Accordingly, we intend to continue devoting a significant portion of our personnel and financial resources to research and development. In order to identify market needs and to define appropriate product specifications, as part of the product development process we seek to maintain close relationships with current and potential distributors, customers and vendors in related industry segments.

As of December 31, 2003, our research and development staff consisted of 80 employees. Research and development activities take place at our facilities in Israel. We employ established procedures for the requirement management, development and quality assurance of our new product developments. Our research and development organization is divided according to our existing products. Each product group is headed by a group leader and includes team leaders and software engineers. In addition, we have a hardware and infrastructure group responsible for the development of the Radware platforms/infrastructure serving all product groups, which consists of a group leader, team leaders, and hardware and software engineers. We furthermore have a quality assurance department, which assists all product groups, and includes a group leader and quality control engineers and technicians. We occasionally use third party subcontractors for the development of portions of research and development projects.

Manufacturing and Suppliers

USR Technologies and Electronics (2003) Ltd. (☐USR☐) manufactures the circuit boards which are the principal hardware component used in our products.

USR supplies us with finished circuit boards for final assembly. The other components and subassemblies included in our products are supplied to USR from a limited group of suppliers and subcontractors. USR monitors each stage of the circuit board production process, including the selection of components and subassembly suppliers. USR is ISO 9002 certified, indicating that its manufacturing processes adhere to established quality standards.

We install our proprietary software onto the circuit boards we receive from USR. Quality assurance testing, final assembly and packaging and shipping operations are performed primarily at our facility in Jerusalem, Israel.

Until February 2003, the circuit boards were manufactured by RND, an affiliated company controlled by Messrs. Yehuda and Zohar Zisapel, principal shareholders of our company. On February 2, 2003, USR purchased substantially all the assets, rights and liabilities (including assignment of agreements, transfer of employees, etc.) of RND. These rights and liabilities included agreements for the supply to us of services and circuit boards. Accordingly, beginning February 2, 2003, the services and circuit boards once obtained from RND are supplied to us by USR.

Proprietary Rights

We rely on patent, trademark and trade secret laws, as well as confidentiality agreements and other contractual arrangements with our employees, distributors and others to protect our technology. We have a policy that requires our employees to execute employment agreements, including confidentiality and non-compete provisions.

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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". We do not currently own any registered copyrights.

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, and pending patent applications and provisional patents in connection with several features used in our products. These applications may not result in any patent being issued, and, if issued, the patents may not provide adequate protection against competitive technology and may not be held valid and enforceable if challenged. In addition, other parties may assert rights as inventors of the underlying technologies, which could limit our ability to fully exploit the rights conferred by any patent that we receive. Our competitors may be able to design around any patent we receive and other parties may obtain patents that we would need to license or circumvent in order to exploit our patents.

The protective steps we have taken may be inadequate to deter misappropriation of our technology and information. We may be unable to detect the unauthorized use of, or take appropriate steps to enforce, our intellectual property rights. Some of the countries in which we sell our products do not protect intellectual property to the same extent as the United States and Israel. In addition, our competitors may independently develop technologies that are substantially equivalent or superior to our technology. Any licenses for intellectual property that might be required for our services or products may not be available on reasonable terms.

Competition

Our industry is characterized by intense competition. Our principal competitors in the sale of Application Switching solutions include hardware-based solution providers, such as Cisco Systems, Inc., Nortel Networks Corporation, and Foundry Networks, Inc. and PC-based solution provider, F-5 Networks, Inc. We expect to face increasing competition as new competitors enter our market and multinational corporations purchase players in the market. 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

Some of our competitors have substantially greater financial, personnel and other resources, and may offer a broader range of products than we do. These competitors may be able to respond more quickly to new or emerging technologies or changes in customer requirements. They may also benefit from greater economies of scale, offer more aggressive pricing, devote greater resources to the promotion of their products, bundle their products or incorporate an existing Application Switching solution into existing products.

We believe that our success will depend primarily on our ability to provide more technologically advanced and cost-effective Application Switching solutions, and more responsive customer service and support, than our competitors. However, we cannot assure you that the products we offer will compete successfully with those of our competitors. Furthermore, should competition intensify, we may have to reduce the prices of our products which will negatively impact our business and financial condition.

Israeli Office of Chief Scientist

For the period up to December 31, 1999, we received royalty-bearing grants from the Office of the Chief Scientist of the Ministry of Industry and Trade of the Government of Israel in the aggregate amount of \$1.6 million. By December 31, 2001, we repaid the full amount by way of royalties. Nevertheless, the remaining provisions of the Law for the Encouragement of Research and Development in the Industry, 1984, and the regulations promulgated thereunder, or the Research and Development Law, are still applicable even after the repayment of royalties.

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Under the Research and Development Law, research and development programs that meet specified criteria and are approved by the research committee of the Office of the Chief Scientist of the Ministry of Industry and Trade of the Government of Israel are eligible for grants of up to 50% of certain approved expenditures of such programs, as determined by said committee.

In exchange, the recipient of such grants is required to pay the Office of the Chief Scientist royalties from the revenues derived from products incorporating know-how developed within the framework of each such program or derived therefrom (including ancillary services in connection therewith), up to an aggregate of 100 % 150% of the dollar-linked value of the total grants received in respect of such program, plus interest. The Research and Development Law generally requires that the product developed under a program be manufactured in Israel .. However, upon the approval of the Chief Scientist, some of the manufacturing volume may be performed outside of Israel, provided that the grant recipient pays royalties at an increased rate, which may be substantial, and the aggregate repayment amount is increased to 120%, 150% or 300% of the grant, depending on the portion of the total manufacturing volume that is performed outside of Israel. Effective April 1, 2003, the Research and Development Law also allows for the approval of grants in cases in which the applicant declares that part of the manufacturing will be performed outside of Israel or by non-Israeli residents and the research committee is convinced that doing so is essential for the execution of the program. This declaration will be a significant factor in the determination of the Office of Chief Scientist whether to approve a program and the amount and other terms of benefits to be granted. For example, the increased royalty rate and repayment amount will be required in such cases.

The Research and Development Law also provides that know-how developed under an approved research and development program may not be transferred to third parties in Israel without the approval of the research committee. Such approval is not required for the export of any products resulting from such research or development. The Research and Development Law further provides that the know-how developed under an approved research and development program may not be transferred to any third parties outside Israel.

The Research and Development Law imposes reporting requirements with respect to certain changes in the ownership of a grant recipient. The law requires the grant recipient and its controlling shareholders and interested parties to notify the Office of the Chief Scientist of any change in control of the recipient or a change in the holdings of the means of control of the recipient that results in a non-Israeli becoming an interested party directly in the recipient and requires the new interested party to undertake to the Office of the Chief Scientist to comply with the Research and Development Law. In addition, the rules of the Office of the Chief Scientist may require prior approval of the Office of the Chief Scientist or additional information or representations in respect of certain of such events. For this purpose, "control" is defined as the ability to direct the activities of a company other than any ability arising solely from serving as an officer or director of the company. A person is presumed to have control if such person holds 50% or more of the means of control of a company. "Means of control" refers to voting rights or the right to appoint directors or the chief executive officer. An "interested party" of a company includes a holder of 5% or more of its outstanding share capital or voting rights, its chief executive officer and directors, someone who has the right to appoint its chief executive officer or at least one director, and a company with respect to which any of the foregoing interested parties owns 25% or more of the outstanding share capital or voting rights or has the right to appoint 25% or more of the directors. Accordingly, any non-Israeli who acquires 5% or more of our ordinary shares will be required to notify the Office of the Chief Scientist that it has become an interested party and to sign an undertaking to comply with the Research and Development Law.

The funds available for Office of the Chief Scientist grants out of the annual budget of the State of Israel were reduced in 1998, and the Israeli authorities have indicated in the past that the government may further reduce or abolish Office of the Chief Scientist grants in the future. Even if these grants are maintained, we cannot presently predict what would be the amounts of future grants, if any, that we might receive.

[Back to Contents](#)**C. Organizational Structure**

As of January 1, 1999, we established a wholly-owned subsidiary in the United States, Radware Inc., which conducts the sales and marketing of our products in North America. We also have subsidiaries in Australia, France, Germany, Sweden, The Netherlands, the United Kingdom, Italy, Japan and Singapore. We have also established representative offices in China, and Taiwan and a branch in Korea. All the above subsidiaries are wholly-owned, except for our subsidiary in Australia, in which we currently hold 91% (of which 8% were purchased in January 2003 and 8% were purchased in March 2004). We have an option to purchase the remaining 9%, which are currently held by a local Australian company. Our subsidiaries include:

Name of Subsidiary	Country of Incorporation
Radware Inc.	New Jersey, United States of America
Radware UK Limited	United Kingdom
Radware France	France
Radware Srl	Italy
Radware ITM Solutions B.V.	The Netherlands
Radware GmbH	Germany
Nihon Radware KK	Japan
Radware Australia Pty. Ltd.	Australia
Radware Sweden AB	Sweden
Radware Singapore Pte. Ltd.	Singapore

Yehuda Zisapel is a co-founder and principal shareholder of Radware. Yehuda Zisapel is also the Chairman of the Board of Directors of Radware. Individually or together with his brother, Zohar Zisapel, he is also a founder, director and/or principal shareholder of several other companies which, together with Radware and our subsidiaries listed above are known as the RAD-Bynet Group. These corporations include:

AB-NET Communications Ltd.	Ceragon Networks Ltd.	WISAIR Inc.
Axerra Networks Inc.	Ebeat Software and Internet Services	Sanrad Inc.
BYNET Data	Ltd.	RAD-OP, Inc.
Communications Ltd.	Infogate On Line Ltd.	RADView Software Ltd.
BYNET Electronics Ltd.	Modules Inc.	RADVision Ltd.
BYNET SEMECH (outsourcing) Ltd.	RAD-Bynet Properties and Services	RADWIN Ltd.
Bynet System Applications Ltd.	(1981) Ltd.	RADVision Ltd.
	RADCOM Ltd.	Silicom Ltd.
	RAD Data	RiT Technologies Ltd.
	Communications Ltd.	

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The group also includes several other holdings, real estate companies and pharmaceutical companies. The above list does not constitute a complete list of the investments of Messrs. Yehuda and Zohar Zisapel.

In addition to engaging in other businesses, members of the RAD-Bynet Group are actively engaged in designing, manufacturing, marketing and supporting data communications products, none of which currently compete with our products. Some of the products of members of the RAD-Bynet Group are complementary to, and may be used in connection with, our products. See also Item 7 [□ Related Party Transactions](#).

D. Property, Plants and Equipment

Our headquarters and principal administrative, finance, research and development and marketing operations are located in approximately 23,345 square feet of leased office space in Tel Aviv, Israel. The lease expires in October 2005, and we have an option to extend the lease for an additional period of five years. The facilities are leased from affiliated companies owned by Messrs. Yehuda and Zohar Zisapel [□ see Item 7 \[□□ Major Shareholders and Related Parties Transactions\]\(#\)](#). [□](#) We also sublease approximately 5,482 square feet of space in Jerusalem for our manufacturing facility from USR. The sublease with respect to 2,150 square feet expires in March 2004 and we have an option to renew for an additional term of five years. The parties are currently negotiating a new lease in the same area for the period beginning in April 2004. The sublease with respect to the remaining 3,332 square feet expires in March 2004 and we have an option to renew for an additional term of two years. The parties are currently negotiating a new lease in the same area for the period beginning in April 2004. In the United States, we lease approximately 10,201 square feet in Mahwah, New Jersey from an affiliate. The lease will expire in July 2005. We also lease 5,306 square feet from an unaffiliated party in Costa Mesa, California. The lease expires at the end of March 2004 and we have entered into a new lease for 5,496 square feet, effective as of April 1, 2004, which will expire in March 2009. We also lease 2,236 square feet in Dallas, TX which is renewed on a monthly basis. In addition we lease facilities for the operation of our subsidiaries and representative offices in several locations in the United States, Europe and Asia Pacific. We may need additional space if we expand our business and believe that we will be able to obtain space as needed.

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ITEM 5. Operating and Financial Review and Prospects

General

Our discussion and analysis of our financial condition and results of operation are based upon our consolidated financial statements, which have been prepared in accordance with generally accepted accounting principles in the United States. Our operating and financial review and prospects should be read in conjunction with our financial statements, accompanying notes thereto and other financial information appearing elsewhere in this annual report.

We commenced operations in April 1997. Since then, we have focused on developing and enhancing our products, building our worldwide direct and indirect distribution network and establishing and expanding our sales, marketing and customer support infrastructure.

Most of our revenues are generated in U.S. dollars or are dollar-linked and the majority of our expenses are incurred in dollars and, as such, we use the dollar as our functional currency. Our consolidated financial statements are prepared in dollars and in accordance with generally accepted accounting principles in the United States.

Revenues. Our revenues are derived primarily from sales of our products and, to a lesser extent, from sales of post-contract customer support through our Certainty Support program. We generally recognize product revenue when persuasive evidence of an arrangement exists, delivery has occurred, the fee is fixed or determinable and collectibility is probable. Post-contract customer support, which represents mainly software subscriptions and unit replacements, is recognized ratably over the contract period, which is typically one year. We provide a warranty for up to 12 months at no extra charge.

Cost of Sales. Our cost of sales consists primarily of the cost of circuit boards and other components used in the assembly and manufacture of our products, salaries and related personnel expenses for those engaged in the final assembly and maintenance service of our products and other overhead costs.

Research and Development Expenses. Research and development expenses consist primarily of salaries and related personnel expenses, costs of subcontractors and prototype expenses related to the design, development, testing and enhancement of our products. All research and development costs are expensed as incurred. We believe that continued investment in research and development is critical to attaining our strategic product objectives.

Marketing and Selling Expenses. Marketing and selling expenses consist primarily of salaries, commissions and related personnel expenses for those engaged in the sales, marketing of our products as well as related trade shows, advertising, promotional, web site maintenance and public relations expenses.

General and Administrative Expenses. General and administrative expenses consist primarily of salaries and related personnel expenses for executive, accounting and administrative personnel, professional fees, bad debt expenses and other general corporate expenses.

Operating expenses also include amortization of stock-based compensation, which is allocated among research and development expenses, marketing and selling expenses and general and administrative expenses, based on the division in which the recipient of the option grant is employed. Amortization of stock-based compensation results from the granting of stock options to employees with exercise prices per share determined to be below the deemed fair market value per share of our ordinary shares on the dates of grant. The stock-based compensation is being amortized to operating expenses over the vesting period of the individual options.

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Loss in respect of an investment. Until 2002, we invested in convertible debentures of a development stage company. In 2001, the investment balance was written-off and a provision with respect to expected closing costs was recorded. The provision was utilized during 2002.

Financing Income (Expenses), Net. Financing income (expenses), net consists primarily of interest earned on short-term and long-term bank deposits, and investment in bonds and commercial papers of proceeds from the issuance of our shares to the public and from cash generated from our operations in fiscal year 2003, and from income and expenses from the translation of monetary balance sheet items denominated in non-dollar currencies.

Taxes. Israeli companies are generally subject to income tax at the corporate rate of 36 %, and are subject to capital gains tax at a rate of 25% for capital gains (other than gains deriving from the sale of listed securities) derived after January 1, 2003. However, we have established an approved enterprise program (the "Program"), which will be eligible for the tax benefits for operational profit, described below under the heading "Corporate Tax Rate." These benefits should result in part of our income being tax exempt or taxed at a lower rate for some time after we begin to report taxable income. The tax rate will depend upon the percentage of our income derived at that time from the approved enterprise program. The tax benefits depend on our meeting the requirements of the Program and there is no assurance we will be able to obtain such benefits. We may incur, for accounting purposes, tax expenses in 2004 which we anticipate to be less than a rate of 10%. The income tax expenses might be higher than the actual tax payments due to exercise of non qualified options by our employees, since the tax benefit resulting from the exercise of such stock options will be credited to additional paid-in-capital, when realized.

Market trends. The general deterioration of the economy worldwide and economic uncertainty in the telecommunications market 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 have recently introduced a new security switch, the DefensePro, and intend to invest in creating an infrastructure 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, that the revenues from the sale of DefensePro will justify the investment, and that the sales of the DefensePro will increase our sales.

Critical Accounting Policies

Our consolidated financial statements are prepared in accordance with accounting principles generally accepted in the United States ("U.S. GAAP"). These accounting principles require management to make certain estimates, judgments and assumptions based upon information available at the time that they are made, historical experience and various other factors that are believed to be reasonable under the circumstances. These estimates, judgments and assumptions can affect the reported amounts of assets and liabilities as of the date of the financial statements, as well as the reported amounts of revenues and expenses during the periods presented.

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In many cases, the accounting treatment of a particular transaction is specifically dictated by GAAP and does not require management's judgment in its application. There are also areas in which management's judgment in selecting among available alternatives would produce a materially different result. The Company's management has reviewed these critical accounting policies and related disclosures with the Company's Audit Committee. See Note 2 to our Consolidated Financial Statements, which contains additional information regarding our accounting policies and other disclosures required by GAAP.

Our management believes the significant accounting policies which affect its more significant judgments and estimates used in the preparation of its consolidated financial statements and which are the most critical to aid in fully understanding and evaluating our reported financial results include the following:

- Revenue recognition;
- Accounting for doubtful accounts;
- Inventory valuation; and
- Legal contingencies.

Revenue recognition. We generally recognize product revenue when persuasive evidence of an arrangement exists, delivery has occurred, the fee is fixed or determinable and collectibility is probable. Post-contract customer support, which represents mainly software subscriptions and unit replacements, is recognized ratably over the contract period, which is typically one year. We provide a warranty for up to 12 months at no extra charge. We record an allowance for estimated sales returns in the same period as the related revenues are recorded. This estimate is based on historical sales returns, analysis of historical credit data and other known factors. The estimate, however, may not accurately predict future returns. If the historical data used to calculate these estimates does not properly reflect future returns, additional provision for sales returns may be required, and revenues in that period could be adversely affected.

Accounting for doubtful accounts. Our accounts receivable are mainly derived from sales to customers located primarily in North America, Europe and Asia. We perform periodic credit evaluations of our customers' financial condition. We maintain an allowance for doubtful accounts for estimated losses, which may result from the inability of its customers to make required payments. Management exercises judgment as to its ability to collect outstanding receivables. Allowances for doubtful accounts are made based upon a specific review of all significant outstanding invoices. For those invoices not specifically reviewed, allowances for doubtful accounts are made based upon the age of the receivable. In determining the allowance, we analyze our historical collection experience and current economic trends. If the historical data used to calculate the allowances for doubtful accounts do not reflect the future ability to collect outstanding receivables, additional allowances for doubtful accounts may be needed and the future results of operations could be materially affected.

Inventory valuation. At each balance sheet date, we evaluate our inventory balance for excess quantities and obsolescence. This evaluation includes an analysis of sales levels by product and projections of future demand. In addition, we write off inventories that are considered obsolete. Remaining inventory balances are adjusted to the lower of cost or market value. If future demand for our old or new products, or market conditions are less favorable than our projections, additional inventory write-downs may be required and would be reflected in cost of sales for such period.

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Legal contingencies. As discussed in [Item 8 Financial Information] under the caption [Legal Proceedings,] in December 2001, the Company was named as a defendant in a class action complaint alleging violations of the federal securities laws in the United States District Court, Southern District of New York, together with approximately 300 additional issuers. As of December 31, 2003, management had accrued its estimate of the probable costs for the resolution of this complaint. We have approved a Memorandum of Understanding ([MOU]) and related agreements, which set forth the terms of a settlement between us, the plaintiff class and the vast majority of the other approximately 300 issuer defendants. It is anticipated that any potential financial obligation of ours to plaintiffs due pursuant to the terms of the MOU and related agreements will be covered by existing insurance. Therefore, management, based on the opinions of our legal advisors handling the claim, does not expect that the settlement will involve any payment by the Company. Accordingly, no provision for such contingency was provided in our financial statements. The MOU and related agreements are subject to a number of contingencies, including the negotiation of a settlement agreement and approval by the Court. The Company cannot be certain as to whether or when a settlement will occur or be finalized and are unable at this time to determine whether the outcome of the litigation will have a material impact on our results of operations or financial condition in any future period.

As discussed in [Item 8 Financial Information,] under the caption [Legal Proceedings,] in March 2003, F5 Networks Inc. filed a patent infringement lawsuit against us and two other companies. Management, based upon the opinion of our legal advisors handling the claim, believes that it is not possible to determine the outcome of this lawsuit, therefore, no provision for such contingency was provided in our financial statements. As additional information becomes available, management will reassess the potential liability related to the pending litigation and may provide an estimate of the probable cost of this litigation. Such estimates of the probable cost could have a material impact on our future results of operations and financial position.

[Back to Contents](#)**A. Operating Results**

The following table sets forth, for the periods indicated, certain financial data expressed as a percentage of sales:

	Year ended December 31, 2000	Year ended December 31, 2001	Year ended December 31, 2002	Year ended December 31, 2003
Revenues	100.0%	100.0%	100.0%	100.0%
Cost of revenues	16.0	17.8	18.2	18.0
Gross profit	84.0	82.2	81.8	82.0
Operating expenses:				
Research and development	14.2	19.1	17.9	15.3
Marketing and selling	64.3	69.2	68.7	54.3
General and administrative	8.1	10.5	9.7	7.6
Total operating expenses	86.6	98.8	96.3	77.2
Operating profit (loss)	(2.6)	(16.6)	(14.5)	4.8
Financing income, net	19.4	14.6	9.7	6.9
Income (loss) before taxes on income	16.8	(2.0)	(4.8)	11.7
Taxes on income	(1.0)	(0.9)	□	□
Loss in respect of an investment in an affiliate	□	(14.6)	□	□
Minority interest in losses (earnings)	□	0.1	□	(0.1)
Net income (loss)	15.8%	(17.4)%	(4.8)%	11.6%

Executive Summary □ Year Ended December 31, 2003

Sales in 2003 were approximately \$54.8 million, an increase of approximately 25% compared with sales of approximately \$43.7 million in 2002. The cost of sales as percentage of revenues remained at a similar level for 2001, 2002 and 2003. As a result of our ability to continue growth based on our existing infrastructure, we decided to keep our operating expenses flat throughout the year (between \$10.5 to \$10.7 million per quarter) while increasing efficiency. As a result of the increase in sales without increase of expenses, there has been a sequential increase in our operating profit in each quarter of 2003, and 2003 ended with an operating profit of \$2.7 million, compared to an operating loss of \$6.3 million in 2002. The financing income, which is derived mainly from interest income on short-term and long-term bank deposits, a structured note and investments in bonds and commercial papers, decreased as a result of the decline in interest rates. In 2004, in order to increase investment in the development of new products, and in order to support continued growth in our sales and enhance market acceptance for our new DefensePro product (our new security switch) and related services, our research and development and sales and marketing expenses are expected to increase by 10% or more compared to 2003. Such expenses do not include the risk of litigation expenses □ see in this Item □ *Legal Contingencies* □ under *Critical Accounting Policies* □, and *General and Administrative Expenses* □ under *Year ended December 31, 2003 Compared with Year Ended December 31, 2002, and Legal Proceedings* □ under Item 8.

There is no assurance that we will be successful in marketing and selling the DefensePro, that the revenues from the sale of DefensePro will justify the investment, and that the sales of the DefensePro will increase our sales. Market acceptance of the DefensePro may have a material effect on our revenues in 2004. Since most of the investment in the DefensePro launch and infrastructure is irrespective of actual sales, if we are not successful in selling the DefensePro and related services it may have a negative effect on operating profit.

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Year Ended December 31, 2003 Compared with Year Ended December 31, 2002

Sales. Sales in 2003 were approximately \$54.8 million, an increase of approximately 25% compared with sales of approximately \$43.7 million in 2002. The growth in sales during 2003 is primarily attributable to the expansion of our sales and marketing activities, the introduction of new products and a new platform, and a slight improvement in the market environment and corporate spending.

Cost of Sales. Cost of sales was approximately \$9.9 million in 2003, compared with cost of sales of approximately \$7.9 million in 2002. This increase is primarily attributable to the increase in sales. Cost of sales as a percentage of sales slightly decreased to 18.0% in 2003, compared to cost of sales of 18.2% in 2002. Manufacturing costs for our new platform released in 2003 are higher than the costs for older platforms. The gross margin for this platform, however, remains the same as a result of higher pricing.

Research and Development (R&D) Expenses. research and development expenses were approximately \$8.4 million in 2003, an increase of 7.5% compared with research and development expenses of approximately \$7.8 million in 2002. The increase is primarily due to new hiring of R&D personnel, and to the increase in the dollar cost of our salaries for our research and development staff caused by the increase in value of the NIS against the dollar. All these salaries were paid in NIS. We expect the R&D expenses to increase in 2004 due to the recruitment of additional personnel, partly to support our new DefensePro product.

Sales and Marketing Expenses. Sales and marketing expenses were approximately \$29.8 million in 2003, a slight decrease of 1% compared with sales and marketing expenses of approximately \$30.0 million in 2002. During 2003, we maintained flat expenses in sales and marketing, utilizing the investment in our sales and marketing infrastructure during previous years. We anticipate increasing sales and marketing expenses for 2004 primarily related to the launch of our new product, Defense Pro, which adds new potential customers, and due to investment in new geographical markets.

General and Administrative Expenses. General and administrative expenses were approximately \$4.1 million in 2003, a decrease of approximately 2.3% compared with general and administrative expenses of approximately \$4.2 million in 2002. This decrease is primarily attributable to the decrease in our doubtful debts expense. We have a lawsuit for patent infringement, which may result in significant legal expenses. Such expenses may affect the level of our general and administrative expenses for 2004. In addition, we cannot estimate the outcome of such litigation.

Financing Income, Net. Financing income, net was approximately \$3.7 million in 2003, a decrease of approximately 12% compared with financing income, net of approximately \$4.2 million in 2002. This decrease is primarily attributable to the reduction in the interest rate in the markets. As a result, we received lower interest income on part of our cash and cash equivalents and short-term and long-term investments derived primarily from the cash we raised in our public offerings in 1999 and 2000.

Year Ended December 31, 2002 Compared with Year Ended December 31, 2001

Sales. Sales in 2002 were approximately \$43.7 million, an increase of approximately 1% compared with sales of approximately \$43.3 million in 2001. The growth in sales during 2002 is primarily attributable to the expansion of our sales and marketing activities, as well as the release of new products. Our sales in each quarter beginning in the fourth quarter of 2001 have increased quarter over quarter, after a significant decrease in revenues in the third quarter of 2001 relative to the first two quarters of 2001. As a result of the challenging market environment and the stagnation of the global economy, we did not experience the same increase in revenues in 2002 compared to 2001 as we had experienced in the past.

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Cost of Sales. Cost of sales was approximately \$7.9 million in 2002, compared with cost of sales of approximately \$7.7 million in 2001. This increase is primarily attributable to the increase in sales. Cost of sales as a percentage of sales increased to 18.2% in 2002, compared to cost of sales of 17.8% in 2001. The increase in the cost of sales is related primarily to the higher production cost of our new hardware platforms.

Research and Development Expenses. Research and development expenses were approximately \$7.8 million in 2002, a decrease of 5.8% compared with research and development expenses of approximately \$8.3 million in 2001. The decrease is primarily due to the decrease in the dollar cost of our salaries for our research and development staff caused by the devaluation of the NIS against the dollar. All these salaries were paid in NIS. As of the year 2000, we did not apply for any grants from the Government of Israel for participation in our Research and Development expenses.

Sales and Marketing Expenses. Sales and Marketing expenses were \$30.0 million in 2001 and 2002, representing 69% of revenues in each year.

General and Administrative Expenses. General and administrative expenses were approximately \$4.2 million in 2002, a decrease of approximately 7.1% compared with general and administrative expenses of approximately \$4.5 million in 2001. This decrease is primarily attributable to the decrease in our doubtful debts expense.

Financing Income, Net. Financing income, net was approximately \$4.2 million in 2002, a decrease of approximately 33% compared with financing income, net of approximately \$6.3 million in 2001. This decrease is primarily attributable to the reduction in the interest rate in the markets. As a result, we received lower interest income on our cash and cash equivalents and short-term and long-term investments derived primarily from the cash we raised in our public offerings in 1999 and 2000.

B. Liquidity and Capital Resources

Since our inception, we have financed our operations through a combination of issuing debt and/or equity securities, including two public offerings, research and development and/or marketing grants from the Government of Israel and cash generated by operations. In November 1997, we raised approximately \$4.0 million in a private placement of our convertible debentures to unaffiliated