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AUDC - Q2 2019 AudioCodes Ltd Earnings Call

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PRESENTATION

Operator

Greetings and welcome to the AudioCodes Second Quarter 2019 Earnings Call.

(Operator Instructions) As a reminder, this conference is being recorded.

I would now like to turn the conference over to your host, Mr. Rob Fink, investor relations for AudioCodes.

Thank you. You may begin.

Rob Fink - *Hayden IR, LLC - EVP and General Manager of New York Office*

Thank you. I would like to welcome everyone to the AudioCodes Second Quarter of 2019 Earnings Conference Call.

Hosting the call today are Shabtai Adlersberg, President and Chief Executive Officer; and Niran Baruch, Vice President, Finance, and Chief Financial Officer.

Before we begin, we would like to remind you that the information provided during this call may contain forward-looking statements relating to AudioCodes' business outlook, future economic performance, product introductions, plans and objectives related thereto. And statements concerning assumptions made or expectations as to any future events, conditions, performance or other matters are forward-looking statements as the term is defined under the U.S. federal securities law. Forward-looking statements are subject to various risks, uncertainties and other factors that could cause actual results to differ materially from those stated in such statements. These risks, uncertainties and factors include but are not limited to the effects of the global economic conditions and conditions in general and in AudioCodes' industry and target markets, in particular shifts in supply and demand, market acceptance of new products and demand for existing products; the impact of competitive products and pricing on AudioCodes' and its customers' products and markets; timely products and technology development; upgrades and the ability to manage changes in the market conditions as needed; possible need for additional financing; the ability to satisfy covenants in the company's loan agreements; possible disruptions from the acquisitions; the ability of AudioCodes to successfully integrate the products and operations from acquired companies into AudioCodes' business; and other factors detailed in AudioCodes' filings with the SEC, the U.S. Securities and Exchange Commission. AudioCodes assumes no obligation to update in this information.

In addition, during the call, AudioCodes will refer to non-GAAP net income and net income per share. AudioCodes has provided a full reconciliation of non-GAAP net income and net income per share to its net income and net income per share according to GAAP in the press release that is posted on its website.

Before I turn the call over to management, I would like to remind everyone that this call is being recorded and an archived webcast will be made available on the investor relations section of the company's website at the conclusion of this call.



With all that said, I would like to turn the call over to Shabtai.

Shabtai, please go ahead.

Shabtai Adlersberg - *AudioCodes Ltd. - Co-Founder, President, CEO & Director*

Thank you, Rob. Good morning and good afternoon, everybody. I would like to welcome all to our second quarter 2019 conference call.

With me this morning is Niran Baruch, Chief Financial Officer and Vice President for Finance of AudioCodes. Niran will start off by presenting a financial overview of the quarter. I will then review the business highlights and summary for the quarter, and then we will discuss trends and developments in our business and industry. We will then turn it into the Q&A session.

Niran?

Niran Baruch - *AudioCodes Ltd. - CFO & VP of Finance*

Thank you, Shabtai. And hello, everyone.

As usual, on today's call, we will be referring to both GAAP and non-GAAP financial results. The non-GAAP P&L metrics exclude recurring noncash items. The earning press release that we issued earlier this morning contains a reconciliation of supplemental non-GAAP financial information that I will be presenting today.

Revenues for the second quarter were \$49.5 million, an increase of 6.3% from the prior quarter and a 13.8% increase when compared to the second quarter last year. Service revenues for the second quarter were \$16.7 million, accounting for 33.6% of total revenues. Deferred revenues balance as of June 30, 2019, was \$55.8 million compared to \$52 million as of March 31, 2019.

Revenues by geographical region for the quarter were split as follows: North America 41%, Central and Latin America 5%, EMEA 14% and Asia Pacific 14%. Our top 15 customers in aggregate represented 63% of revenues in the quarter, of which 55% are attributed to our 10 largest distributors.

Gross margin for the quarter was 63.3% compared to 62.3% in Q2 2018. Non-GAAP gross margin for the quarter was 63.5% compared to 62.8% in Q2 2018.

Operating income for the quarter was \$5.9 million compared to an operating income of \$3.3 million in Q2 2018. On a non-GAAP basis, quarterly operating income was \$7 million or 14.1% of revenues compared to an operating income of \$4.4 million in Q2 2018.

Net income for the quarter was \$4.8 million or \$0.16 per share compared to net income of \$2.4 million or \$0.08 per share in Q2 2018. On a non-GAAP basis, quarterly net income was \$6.8 million or \$0.22 per share compared to net income of \$4.1 million or \$0.14 per share in Q2 2018.

Our balance sheet remained strong. At the end of June 2019, cash, cash equivalents, bank deposits and marketable securities totaled \$69.1 million.

Day sales outstanding as of June 30, 2019, were 46 days. Operating cash flow generated during the quarter was \$8.4 million.

During the quarter, we acquired approximately 473,000 of our ordinary shares for a total consideration of approximately \$7.1 million. As of June 30, 2019, and since we began to repurchase our shares in August 2014, we have acquired an aggregate of 18.1 million shares for an aggregate consideration of approximately \$102 million. In May 2019, our Board of Directors approved the submission of a new application to the Israeli court requesting approval of an additional repurchase program for \$12 million of ordinary shares following the expiration of the existing program. The application also requests the court to permit us to declare a dividend of any part of this amount. The new application has been submitted, and a decision is expected during August 2019.



Now to provide an update on our guidance.

We now expect revenues for 2019 to be in the range of \$194 million to \$198 million compared to the previous range of \$191 million to \$197 million that we updated following the close of the first quarter 2019. We anticipate non-GAAP diluted earning per share to be in the range of \$0.82 to \$0.86 compared to our previously revised range of \$0.77 to \$0.82.

I will now turn the call back over to Shabtai.

Shabtai Adlersberg - *AudioCodes Ltd. - Co-Founder, President, CEO & Director*

Thank you, Niran.

We're pleased to report record financial results for the second quarter of 2019. All in all, this was one of our best quarters ever and quite successful on many fronts. Key highlights I would like to mention are the following.

First, we're sitting in a very strong market, a market that develop fast, and we AudioCodes have got a great market position in it. We will discuss mark-to-market trends and data that were key factors in our success during the past 3 to 4 years and which provide strong support for continued success in the next 5 to 7 years. I'd like to mention that we are very successful in creating new partnerships. We will talk about that. Our second quarter '19 financial performance was great. We'll discuss that. We will review some of the key activity areas for us such as Microsoft Teams, cloud-related activities, service providers' all-IP migration performance, our services and more. I'll just add that, entering second half of 2019, we plan to introduce new area of investment that we believe will be very significant in the future. I'm talking mainly about the meeting space, where we believe that we can take advantage of our assets that we have today. And adding more capabilities, products and services, we believe that we will be successful in a completely new area for us.

Now let's talk a bit about the market. Actually if one looks into market forecasts of size of the market, the UCaaS, UC as a Service, market, it's a fast-growing market these days. Just to highlight some data points from Frost & Sullivan and [Stephens]: In 2018, the market size was about 14 billion, and we add about 13 million to 14 million users. Now if we go forward to 2022, which is just 3 years ahead, the market will almost double to 27 billion. And the number of users will be somewhere around 26 million, 27 million, so we're talking about a very fast-developing market both in terms of revenues. It's no question that, that market attracts a lot of companies, a lot of vendors. And we have seen -- in the first half of 2019, during the first quarter and second quarter, we see that the competition in the UC as a Service market and the contact center as a service market is heating up. There's growing emphasis on collaboration and video first and meeting first versus communications in the past. We just saw in the second quarter successful IPO of company Zoom, and also we have seen Slack going public. So a lot of activity of companies trying to get into the market. And I've mentioned the names we've worked with and which are competing for market share: Microsoft, RingCentral, Zoom, Cisco, Google, Amazon, Slack and more.

At the same time, the enterprise market, if we look into the service provider market. We've seen that the migration process to all IP ramps up. As in the previous quarter, we have seen that activity mainly in North America and some countries in Europe. For us, mainly it's Germany, Italy and the Netherlands. We've seen continued trends of voice.ai, which disrupts the contact center markets. We've been very active on that. We've added capabilities. We have added technologies. We won many new projects. And we believe we are making the right steps and the right investments to be successful also on the voice.ai market. So very strong action.

And I'll just mention one data point, one more data point, that last week, Microsoft in their Inspire conference announced that now Teams has about 13 million daily active users as of the end of June 2019 and compared that to only 3 million in August 2018. So very steep rise, very strong demand for Teams in the market.

Now let's talk a bit about the new partnerships that we have created. We became engaged substantially with 2 more new partners. In fact, understanding that while the world of UC as a Service is developing fast and most of the players and software vendors will lack connectivity products and which also lack the deployment and integration services offering in their portfolio, it is only natural that they will turn to a player like us. So they need to create partnership with a voice infrastructure partner just like us. Make us -- that fact makes us unique and natural partner for such

collaboration with many partners. During the second quarter, we have engaged with 2 new such partners in discussion of our products, unique features, capabilities, road maps, collaboration and go to market. This is an ongoing trend for us, and we will continue in the next foreseeable future as many of these UC as a Service players do need to ensure connectivity and integration partners as the market evolves with new requirements and need to support deployments worldwide.

Touching on the highlights of our financial performance. In revenue, we grew 13.8% compared to the year ago quarter. That's pretty much above our initial guidance for the year which stood at 10%. EBITDA grew to \$7.4 million in the quarter compared to \$4.8 million in the previous year, an increase of 54%; same for our net income, which grew 66% on a year-by-year basis. Most important, we continued to improve our operational efficiency compared to the year ago quarter. Operating margin improved from 10.2% in the second quarter last year to 14.1% in the second quarter of this year. This is a direct result of growing revenue on a consistent basis while keeping expenses at a controllable level.

Based on the initial backlog for the third quarter of 2019 and the business activity we have witnessed so far in July, we anticipate the continued trend of improved financial performance for the third quarter and the whole year. As seen in 2018 and first half 2019, we continue to see strong underlying trends in both the all-IP migration market and UCaaS adoption mainly in the Microsoft Teams space. That should keep the momentum going on in our business in coming quarters. As such, we have strong confidence that 2019 is to become another strong year for growth on the heels of previous 3 years, and that's hence the updated guidance.

Talking a bit about the business side.

Networking. So key to our success in the quarter was our consistent progress in our networking business, which grew 16.6% year-over-year to \$47 million. The networking business now accounts for 95% of our business in the quarter. As presented in the past, the major factors supporting this growth is the strength of the UC-SIP business, which grew above 20%. In our UC-SIP business we've continued to see that, as far as mainly the session border controller market, MSBR and our management suite. We also [felt nice parts] in second quarter in the Microsoft Teams space. We'll talk about that later on.

At the same time, we've enjoyed very strong demand for our gateway business, which grew more than 10% compared to the year ago quarter. Again this is substantially due to the continuous evolution of the global migration of the PSTN to all IP.

So as we mentioned in -- on previous calls, for practical purposes, we are the partner of choice for CPE products and many of the leading all-IP UC and UC as a Service application in the enterprise and service provider space. We are confident that we should be able to maintain this leading position in our CPE business in coming years.

As mentioned again, connectivity. Connectivity is key in our DNA. As I've mentioned in the investor call previously in first quarter of this year, connectivity solution which embed a combination of group of business line including gateways, session border controllers and the multi-service business routers enjoyed strong momentum in the past 12 months. Just mentioned some data points: In 2016, '17 and '18, connectivity revenues were, respectively, \$104 million, \$116 million and \$131 million. In the second quarter of 2019, connectivity revenue reached \$38.6 million, a gain of about 25% year-over-year. For the complete year of 2019, we now estimate the 2019 connectivity revenue will top \$155 million, providing growth of more than 17% on annual basis.

Sales were very good in the quarter. We actually hit on almost all targets worldwide; remarkably well performed certain regions including North America which was also noteworthy for a large booking that was not still shipped in the quarter. We've seen a very nice performance in Germany, in the DACH region, in the Benelux, Netherlands and Belgium, Italy and a few more countries. So all in all, a great quarter from the sales point of view.

We -- our biggest projects concentrate in key 3 key areas. One is still Microsoft Skype for Business markets, where we have deployed both in the U.S., Benelux, Latin America and Germany with large enterprises. We also enjoyed nice opportunities of contact center deals a few hundred to thousands each in the U.S., in Europe and in India. And then business services, we enjoy a very large number of projects in -- mainly in Europe, in Mexico and in South Africa. So all in all, a very successful quarter in terms of sales.



Touching on our Microsoft performance in the second quarter, definitely better performance than the first quarter of the year. We've seen slow start simply because [capital] business is still not growing. And we estimate that it will not grow far beyond where it is today, but we've seen nice move on the Teams side. So all in all we grew about 20% over the previous year quarter. And I should say that the market was heating up, as I mentioned before, on the UC as a Service market collaboration. And we've just mentioned names like Zoom and Google and Amazon and Slack will present strong competition in the conferencing meeting space, and therefore we see a lot of intensive activity of Microsoft in the market with Teams.

And as I mentioned before, second quarter in this year was better than the first one. We have seen 25% increase. We believe that customer are still evaluating Teams as a full UCaaS solution. And Microsoft road map for additional features is still pending. So we believe that we will see substantially faster ramp-up or a success entering into 2020, but so far, so good on that front. We've seen -- and we are communicating with [the founders], so we get some data about voice minutes that were growing for Teams. So we know that at this stage there are a few thousands of tenants that already carry voice traffic to the -- from the PSTN towards Teams. So all in all we have seen a very nice growth in traffic. I'll mention numbers later. Also, our session border controller is now officially approved on Azure. And even more than that, it's approved as a Microsoft IP co-sale on Azure. And that means that Microsoft sales teams will get compensated for the session border controller consumption on Azure; and that will be a big driver, we believe, to push our sales of SBC on Azure more than before.

Also, we enjoy very nice success with our phones that were developed specifically for Teams. We do have a star product, the C450HD phone, which is acknowledged but -- by many customer it can be very useful. And we've seen very strong interest and shipping of that product.

In terms also I've mentioned that we're growing Teams 25% quarter-over-quarter. Most of -- in terms of market share. So most of the sales went into North America, about 45%. We've seen another 25% or more, actually 30%, in Western Europe. And then the rest -- the nice thing about it, by the way, is that Teams sells all over the world. And I would [tend to saying] that, that is right now one solution that is sold substantially better worldwide than other competing products and that's a great advantage. We'd also say that the majority of sales in that area of Teams are primarily phones and SBCs, so we do not expect a major diversion in terms of product sales from the move from Skype for Business to Teams. I've just mentioned that, in terms of number of users enabled on Teams, we have seen a more than doubling at the end of the second quarter from the end of the first quarter. And also we've seen a very strong rise in number of businesses that were enabled, more than 50% in number of businesses that were enabled, at the end of the second quarter compared to the first quarter.

Now I'll touch a bit on our activities migrating into the cloud. As we all know, a major trend in the industry is the major shift of enterprises and service providers worldwide to cloud services and operations. In the past 24 months and more so going forward, we are investing major efforts and deploy our One Voice portfolio to align with these enterprise and service provider and SaaS customers. Our Mediant Cloud Edition SBC uniquely supports critical scalability, dynamic elasticity and a -- the reliability in private and public clouds, which give us a perfect solution for small to large cloud installation and presents advantage over competition. Since the introduction of the Mediant SBC and One Voice Operations Center in Azure marketplace on April, we have seen consistent and significantly increasing trials and daily downloads by enterprises worldwide.

Moving to AWS. We recently announced the (inaudible) SBC with Amazon Chime Voice Connector. This enables [ACV-access] contact center solution and UC system, including Microsoft Teams, customers to connect to Amazon's SIP trunking services. The SBC is available for a deployment on prem or in AWS and will soon be listed in the AWS marketplace.

We now plan to have the complete One Voice solution available in Azure, AWS and Google Cloud Platform with same code base and feature parity. We're now working intensively [to make this start], as we have customers awaiting proof of concepts and deployments. We believe that the availability for our ever-expanding One Voice portfolio [in laying] public clouds position us as ideal partner to enterprise UC as a Service and contact center as a service.

Touching a bit on our very strong success in the service provider market in the quarter. This was a record quarter ever. We grew 100% over the year ago quarter. We grew 40% over the previous quarter, so all in all a great performance. I'll just mention that we have announced previously that Deutsche Telekom is a strong partner of ours. So we've seen large ramp-up from Deutsche Telekom in the quarter. Another strong European service provider was also a customer. We note 2 new design wins in Europe, 1 in Germany, 1 in Scandinavia. And also we have continued to invest in our SD-WAN solution just to be able to support better connectivity and SLA in the network.



I'll touch also services, [which to some of our investor] seen in the first quarter of this year performance an increase of only 3.4% year-over-year. It's a problem. So we'd like to say that, in the second quarter, we have substantially recovered from that there. Services grew 23.5%. So all in all if you combine the two -- and we all know there are some shifts of projects and some recognition rules and services that make this course and the growth not flat but could be a bit active. So all in all -- but if you combine first quarter and second quarter and we look at the first half performance, then we have seen very steady performance of 13.4% growth in our services.

And with that, I believe I have completed my introduction. And I'd like to move the call to the Q&A session. Operator?

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from the line of Rich Valera with Needham & Company.

Richard Frank Valera - *Needham & Company, LLC, Research Division - Senior Analyst*

Shabtai, I'd like to follow up on the Microsoft commentary you provided. So it sounds like Skype for Business isn't really growing, but Teams is. But you suggested that the Teams sort of voice offering isn't really mature yet and you see some features coming on that, so can you just talk about what maybe you think is still needed in Teams to make that really take off and sort of how you view the trajectory of that Teams business for the balance of the year?

Shabtai Adlersberg - *AudioCodes Ltd. - Co-Founder, President, CEO & Director*

Yes. So again, Teams presents a big, big promise. And -- but we're talking here about very large enterprises, and these enterprises usually do make their homeworks. And before they make sure that a complete set of features that they have been used to in Skype for Business is still not implemented in Teams, they will not make the move. But we do know -- and we work already with a few enterprises which already took the leap and basically are doing that. So we're simply waiting on Microsoft on committed road map to complete and deliver those missing feature in the second half, but we'd like to say that some of these customers still are trialing, starting to deploy and all in all report good performance and quality. So we do expect the same feature to continue into the second quarter, meaning Skype for Business -- and by the way, there are enterprises which say, "We do not want to move all of our operations into the cloud. We'll stay with Skype for Business. Or we'll have some mixed operations." So we still expect Skype for Business to be a good market for us and -- but still not ramping, growing fast. On the other hand, Teams is growing very nicely. And we believe that, if the missing feature will be completed the second half, we will be fully ready for a strong ramp-up beginning this 2020.

Richard Frank Valera - *Needham & Company, LLC, Research Division - Senior Analyst*

Got it. And then in your prepared remarks you also made reference to the fact that, I think, you expect product sales to be roughly similar into Teams environments relative to Skype for Business environments. Is that correct? Can you just provide a little color on how you think product sales will be into those respective Microsoft environments?

Shabtai Adlersberg - *AudioCodes Ltd. - Co-Founder, President, CEO & Director*

Right. So on Skype for Business, the key products that we are selling are, on one hand, connectivity, which is gateways and SBCs. We're selling phones. And obviously we're selling some management software and solution. On the cloud area, you still need connectivity. You still need to reach headquarter and branch offices from the cloud, so SBC will continue to be sold and actually will reflect in many cases the role of gateways. Instead of connecting to the PSTN, to the central offices, you will be connecting to clouds. And phones will keep being used, although we all know that along the years we will see some reduction in the percentage of phones being sold versus headsets. We -- as I mentioned earlier in the call,

we do see a lot of interest in the meeting space. So we are expecting more devices to be sold in that area, meaning conference phones; different sizes of conferencing devices such as for other rooms or meeting rooms, large rooms. There will be a lot of equipment. So all in all, I do not think that transition from Skype for Business to Teams will change dramatically or in any way the percentage of products, other products, sold versus -- Teams versus Skype for Business.

Richard Frank Valera - *Needham & Company, LLC, Research Division - Senior Analyst*

Great. That's helpful. And then when you were talking about the UC landscape, you mentioned a lot of major companies, including some that have UC offerings, that you were working with. Of those, I knew Microsoft and I knew Cisco, but you mentioned a number of others that I hadn't really heard before as customers. Can you repeat that list and kind of talk about your relationship with some of those companies that haven't been sort of regular mentions in recent conference calls?

Shabtai Adlersberg - *AudioCodes Ltd. - Co-Founder, President, CEO & Director*

So obviously we're tied up by nondisclosure agreements. So we can talk freely, as you have mentioned, about Microsoft and Cisco. We also announced a few months ago a partnership with Amazon selling our SBC in conjunction with their SIP trunk services. There are a few more names that we sell -- UCaaS players. And I think I've mentioned before that -- take analog gateways, which is a very common product that needs to be sold to support offices. And many of the players lack them. So we've seen business in the past with companies such as 8x8 and Vonage and RingCentral and a few more. And there are a few more names but I'm not allowed to talk about. So all in all, everybody needs infrastructure and there are only a few companies who can accomplish that. So not competing with them, becoming a very natural partner to all of these companies.

Richard Frank Valera - *Needham & Company, LLC, Research Division - Senior Analyst*

Got it. And I take it that the 2 new partners you signed this quarter fall into that nondisclosure agreement.

Shabtai Adlersberg - *AudioCodes Ltd. - Co-Founder, President, CEO & Director*

Yes, yes.

Richard Frank Valera - *Needham & Company, LLC, Research Division - Senior Analyst*

Fair enough. And then just looking at the updated guidance for the year. To get to the midpoint of your EPS guides, you basically kind of flatline at \$0.22 per quarter for the next sort of 2 quarters. That would kind of get you to the midpoint. And I mean historically you've tended to always have some improvement in the back half EPS-wise, so are we just being kind of conservative? Was maybe Q2 a bit of an unusual degree of upside from some lumpiness? Or how should we think about that back-half EPS?

Shabtai Adlersberg - *AudioCodes Ltd. - Co-Founder, President, CEO & Director*

Okay. All in all I'll tell you that, a, we intend -- in view of the increased potential activity with partners going forward for the next 18 months, we will definitely add resources on -- I mentioned that it's going to be controlled and -- but we still need to add resources to support activities. Also there are some moving parts in our OpEx. It has to do with locations. It has to do with onetime [whether] company event in the second quarter. We'll have some amount of some change in the U.S. dollar exchange rates versus shekel, the Israeli shekel. So lately, the Israeli shekel becomes very strong. That will affect our financials for the third and fourth quarter. We are hedged about 50%. So all in all, there are some moving parts. We would like to act conservatively. We believe we will grow, but all in all I think we are in good shape to try and beat that flat number that you mentioned.

Operator

Our next question comes from the line of [David Kreinberg] with [Globis Capital].

Unidentified Analyst

Shabtai, congratulations on a great quarter. I just missed one thing. What was the gross deferred revenue number again for the -- at the end of the quarter?

Shabtai Adlersberg - *AudioCodes Ltd. - Co-Founder, President, CEO & Director*

Again can you repeat, [David], gross...

Unidentified Analyst

What was the gross deferred revenue number?

Shabtai Adlersberg - *AudioCodes Ltd. - Co-Founder, President, CEO & Director*

Oh, deferred revenues. I think it was -- it grew from about \$55 million to...

Unidentified Company Representative

[56]...

Shabtai Adlersberg - *AudioCodes Ltd. - Co-Founder, President, CEO & Director*

From \$56 million to...

Unidentified Company Representative

[52 to 56]...

Shabtai Adlersberg - *AudioCodes Ltd. - Co-Founder, President, CEO & Director*

Okay. Again I'm being corrected. Deferred revenue grew from \$52 million to \$56 million.

Unidentified Analyst

\$52 million was the end of Q1. So it sequentially grew from \$52 million to \$56 million, but I believe that number at the end of Q2 '18 was \$42.6 million. So is that right, you grew 30% year-over-year on the deferred revenues? Is that correct?

Shabtai Adlersberg - *AudioCodes Ltd. - Co-Founder, President, CEO & Director*

Yes, that is correct, yes.

Operator

Thank you. Ladies and gentlemen, that concludes our question-and-answer session. I'll now turn the floor back to Mr. Adlersberg for any final comments.

Shabtai Adlersberg - *AudioCodes Ltd. - Co-Founder, President, CEO & Director*

Thank you, operator.

I would like to thank everyone who attended our conference call today. We've continued good business momentum and execution in the first half of 2019. We believe we are on track to achieve another year of growth for our business and top the initial guidance provided at the beginning of the year. We look forward to your participation in our next quarterly conference call.

Thank you very much. Have a nice day.

Operator

Thank you. This concludes today's teleconference. You may disconnect your lines at this time. Thank you for your participation.

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