This 3DAdvisors Report Covers:
✓ **Insider Trading**: Insider Trading Behavior
✓ **Accounting**: Quality of Earnings Issues
✓ **Governance:** Corporate Governance Issues

Executive Behavior Suggests Continued Tough Times
Comverse Technology, Inc. (NASDAQ:CMVT)

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Comverse Technology, Inc. designs, develops, manufactures, markets and supports systems and software for multimedia communications and information processing applications. The Company's products are used in a broad range of applications by wireless and wireline telecommunications network operators and service providers, call centers and other government, public and commercial organizations worldwide. Through Comverse, Inc., the Company provides enhanced services products that enable telecommunications service providers to offer a variety of revenue- and traffic-generating services accessible to large numbers of simultaneous users. Through Ulticom, Inc., the Company provides service-enabling signaling software for wireline, wireless and Internet communications. Through Verint Systems Inc., the Company provides analytic software-based solutions for communications interception, digital video security and surveillance and enterprise business intelligence.

Summary of 3DAdvisors Findings for CMVT

- **Governance:** Odd parachute for CEO Kobi Alexander
- **Governance:** Other areas of Alexander's contract fraught with potential conflicts
- **Accounting:** Non-operating items help drive earnings
- **Accounting:** A variety of questionable accounting disclosures
- **Insider Trading:** Insider trading behavior does not inspire confidence
- **Other:** Additional pressures give executive behavior context

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Discussion of 3DAdvisors Findings

The declining state of the Comverse Technology business model over the past three years is no secret. Many of the factors effecting the huge 42% year-over-year revenue decline between F/Y 2002 and 2003 are, no doubt, reflected in the current share price, even given the 12-month rally that has propelled Comverse shares from their lows in the $9 range to their current above-$20 price. Executive behavior suggests, however, that significant issues remain that may prevent any further recovery in the stock, perhaps more than some analysts seem to be expecting. The clues come from various management behaviors we have observed: an insider trading profile that strongly suggests management has no confidence in further price appreciation; a very unusual and self-serving executive compensation plan for the CEO; earnings repeatedly propped up by non-operating items and generous tax incentives; and a variety of questionable accounting disclosures, to name just the most nagging issues. And as a backdrop, the Company continues to be faced with a range of industry and business model challenges, none of which are likely to go away anytime soon.

Governance: An odd parachute for CEO Kobi Alexander

A check into CEO Kobi Alexander's employment agreement did not give us the feeling that his trust level, with regards to future events surrounding Comverse, is extremely high. The agreement dates back to 1994 and provides for a Trust Account to be set up, by the Company, for his benefit. The account was established to provide for the full payment of his severance benefits upon any termination of his employment. According to the agreement, the account must be established at a New York City-based bank or trust company designated by Alexander. The Company bears the cost of this trust arrangement. To date, Comverse has accrued $3 million, for Alexander's benefit, to cover for this contingency.

Under Israeli law, the Company is obligated to make severance payments to employees of its Israeli subsidiaries. Consequently, the Company is also accruing related severance liabilities for such employees. The twist here is that Alexander, being the U.S.-based CEO of the parent, is not entitled to such accruals. Indeed, other U.S.-based executives do not receive the same treatment that he does in this regard. In addition, Israeli subsidiary employees do not enjoy the protection from potential creditors that Alexander receives as beneficiary of a trust created for the sole purpose of payment of the personal severance benefits. We wonder what makes him feel the need for such protection from creditors?

Governance: Other aspects of Alexander's contract fraught with potential conflicts

Alexander's employment agreement provides him the option to purchase a 7.5% interest in each Company subsidiary, partnership, joint venture or any entity that Comverse holds over 50% of. Disclosure of this fact has been toned down in recent years. We thought this to be very interesting in light of the fact that Comverse has taken two subsidiaries public since 2000, selling minority stakes. We had wondered why the Company, which did not appear to need the cash, had bothered with such small public offerings where minority stakes have been sold. In 2000, for instance, Comverse sold 28.4% of its then wholly owned subsidiary, Ulticom (ULCM). In May of 2002, the Company sold 21.4% of its wholly owned stake of Verint (VRNT). Based on Alexander's employment agreement, it would seem that Alexander stands to benefit from the fact that a public market now exists for the 7.5% stake that he had options for, in each company. Indeed, Alexander has sold $5.2 million worth of the now-public Ulticom shares since the IPO, and this in addition to the $14.7 million he has received from selling Comverse shares between October of 2003 and January of 2004.

Alexander is not the only Comverse employee who has been offered options on various company subsidiaries or other entities. The Company discloses "other employees, including certain executive officers of the Company, have been granted options to acquire shares of certain subsidiaries and affiliates of the Company…such awards are not tied to the performance of the respective subsidiaries or affiliates." The Company goes on to state (we presume at the insistence of independent auditors) that "These options provide the option holders with a potentially larger equity interest in the respective subsidiaries and affiliates than in the Company, which under certain circumstances, could cause the option holders' interests to conflict with those of the Company's shareholders generally."

We are intrigued at the broad nature of the various subsidiary options available to Alexander as they, by definition, encompass virtually any entity that Comverse creates or acquires. This would include then, the two investment companies formed, in 1997, by Comverse and George Soros' Quantum Industrial Holdings LTD where the Company has invested $63 million and may be called upon to commit an additional $21.6 million in the future.

Another interesting aspect to Alexander's employment agreement is the fact that his bonus is structured so that it is "not less than three percent of the Company's consolidated after tax net income in each year." Now this does not mean much currently (with the Company showing losses) but in the year ending 2001, he received a $7.5 million bonus on a salary of $645,000. We found this open-ended bonus situation interesting as we did the fact that the last reference to Alexander's employment agreement was in the Company's 1996 10K. The contract itself is attached as an exhibit to the Company's 1994 K. We had to go back to the pre-Edgar paper filings to get a copy.

Accounting: Non-operating items help drive earnings

Comverse added $38 million to income, in F/Y 2002 (year-end January 31), by re-purchasing its 1.5% Convertible Debentures (due 2005) during the period. This amounted to almost 20 cents/share for the period. Through Q3 F/Y 2003, the Company has continued to book gains from the repurchase of the convertibles to the tune of $10.2 million, or about five cents/share. In all fairness, it should be stated that the Company is not being vague with regards to disclosing this non-core contribution. What we find interesting, however, with regards to the deal, is that in May of 2003, Comverse replaced the majority of the $475 million in converts that it had repurchased by issuing $420 million in new ones. So it would seem that the exercise of repurchasing the converts was driven more by the gains gotten from the deal than by the desire to pare down long-term debt.

Accounting: A variety of questionable accounting disclosures

Comverse discloses that revenues from "certain development contracts are recognized using the Percentage-of-Completion method on the basis of physical completion to date or using actual costs incurred to total expected costs under the contract." So they can recognize the revenues in one of two ways. Other than indicating this company discretion with regards to the booking of related Percentage of Completion revenues, Comverse offers no detail whatsoever as to its level of unbilled receivables.

One interesting, and possibly connected, point concerns the quality of Comverse's receivables. The Company does not disclose its Allowance for Doubtful Accounts in any of its 10Q filings, the only references to the Allowance show up in the 10K's. Interestingly enough, the F/Y 2002 "K" revealed that Comverse had moved it's A/R Allowance up to over 21% of gross A/R's with no explanation, quite a move higher when one considers that, for the four years prior, Comverse's A/R Allowance has ranged from 6% to 11.6% of gross A/R's. The fact that, since 1/31/2003 (F/Y end 2002), the Company has not revealed it's A/R Allowance, and since that Allowance had jumped to 21% of A/R's the last time it was reported, raises serious questions about the quality of Comverse's receivables. Given the fact that Percentage of Completion accounting exists, we are left to assume that unbilled receivables exist in spite of the lack of their disclosure. Consequently, we are also led to wonder if somehow the high Allowance came as a result, at least in part, of increasing questions from independent auditors as to the collectability of suspected unbilled receivables.

Another area where Comverse offers only obfuscated detail is that of foreign exchange effects. Currency effects are consistently netted in with "Interest and Other Income" and no detail as to their direct effects on income, for any period, is provided. The only reference, in F/Y 2002 for instance, was that part of the change in Net Interest and Other Income came from "change in foreign currency of approximately $48.5 million due primarily to the strengthening of the euro during fiscal 2002". The fact that the swing would have amounted to about $0.25 per share should not go unnoticed, especially in conjunction with the fact that Comverse got another $0.20 per share during the period from repurchases of convertible debentures (see above). Without these two effects, Comverse's results would have appeared quite more Draconian than the $(0.69) per share loss reported in 2002.

So far, through Q3 of 2003, there has been no improvement in the Company's disclosure of currency effects. Through Q3, all the Company would say is that Interest and Other Income was down, sequentially, for the period partially because of "a decrease in foreign currency gains of approximately $14.8 million during the nine-month period." Conference call transcripts will reveal that approximately $7 million, or about $0.036 per share may have come from currency effects for the nine months. Any discussion about currency effects on costs seems carefully avoided by the Company as well. When reading conference call transcripts, we have noted with interest certain analyst questions that regularly surface concerning currency effects on expenses. The Company answers here are generally vague.

Comverse engages a relatively high level of capital market transactions where swings in gains and losses are large when compared to the size of the Company's business in general. And again, like the above issues, disclosure of such dealings is rather obscure. Available for Sale securities include (in order of magnitude) U.S. Government corporation and agency bonds, corporate debt securities and mortgage and asset-backed securities. This portfolio's estimated fair value (as of 1/1/03…the last 10K) was $386 million. During the year however, gross realized gains on sales of these securities totaled just $3.6 million vs. gross realized losses of $13.6 million. The net effect was a loss of $10 million, or $(0.05) per share for the period. This was a reversal from the prior year (ended 1/31/02) where gross realized gains exceeded losses by $6.4 million. It would seem that the transactions involving the Company's securities portfolio incorporate elements of risk, over and above its business model issues, that would indicate that they have been reaching for excess returns.

Insider Trading: Insider trading behavior does not inspire confidence

As the Company struggles with its business model, the actions of insiders do not seem to exude confidence that the shares will continue to hold their value, which has doubled in the past year. Too many of them have converged to sell recently re-priced options that had plenty of time left on them before expiration. In all, five of them sold just under 600,000 shares in January at prices in the $18 to $19 range. This comes on the heels of October sales totaling just under 990,000 shares. The fact that insiders have heavily sold during the past two post-earnings release windows should not go unnoticed. The last time we saw this kind of activity at Comverse was back in late 2000/early 2001 when the shares traded at prices over $100. The sales, at that time, proved to be extremely prescient.

An interesting side-bar to the sales is the fact that Comverse had re-priced four series of options, carrying strike prices of $14.75, $16.05, $46.50 and $85, with new ones exercisable at $10.52 each, using an exchange ratio of 0.85 new options for each turned in. Expiration dates for the new options ranged from 2007 and 2011 with the majority expiring at the long end of the range. The re-pricing deal proved serendipitously beneficial to insiders, even more than it originally appeared to shareholders at the time of the related vote. When the deal was voted on, shareholders agreed to allow the re-pricing to go through so that each option with a strike price of 120% of the current market price, at the closing date, would be eligible for re-pricing. At the time of the vote, Comverse shares were in the $22 - $23 range, meaning that only options with a strike price of $27 or better would be re-priced. By the closing date (6/20/02) however, Comverse shares had fallen to $10, allowing for all options with a strike of $12 or better to be eligible. That sharp drop in the shares allowed for Comverse insiders to re-price more than double the amount of options initially intended by shareholders at the time of the vote.

This convergence of insider behavior, occurring in each of the past two earnings windows, gains significance when one considers the timeliness of their trading in the past and the fact that three of the executives have trimmed over 50% of their positions. We will be keeping a close eye out to see if this pattern persists in the approaching window just after the March 10 Q4 release.

- **Zeev Bregman (42)** – CEO Comverse Inc., Director. On January 14th, Bregman sold 100,000 shares at just under $19 per share. Since assuming his current role with the Company in January 2001, Bregman has shied away from making many transactions, having only sold once before in October 2003 (150,000 shares at $17.30), which can probably be attributed to the stock's slide from over $100 in early 2001 to roughly $10 in late 2002. **Oddly enough, Bregman must feel the stock has appreciated enough to sell 50% of his actionable holdings in the two windows (October and January).**

- **Kobi Alexander (51)** – Founder, CEO, Director. Like Bregman, Alexander has been relatively quiet for a CEO with a sizeable position. He sold 720,000 shares combined into the stock's rebound at $10 on July 2003 and $17 in October 2003. More recently, he dumped 274,740 shares on January 13th and 14th at $18.43 to $19.20. Most unusual about the recent activity is Alexander didn't sell any shares while the stock traded at higher levels in 1999 through mid-2001, yet has now dumped nearly 1 million shares as the stock rebounds from its lows. **During the past two windows, he has dropped his actionable position by 18%**.

- **Itsik Danziger (54)** – Director, former President. In 1999, 2000 and 2003, Danziger sold on average roughly 200,000 shares. Again, what concerns us most here is that this group of insiders is willing to unload equally as large or larger quantities than they have in the past at considerably higher prices. On January 13th, Danziger sold 150,000 shares at just over $18 per share, and this on the heels of his 202,500-share sale in October. **After having sold just 60,000 shares in 2001 and no shares in 2002, he has now reduced his entire position by 63% with his sales during the past two windows.**

- **David Kreinberg (38)** – Executive V.P., CFO. From 2000 to 2003, Kreinberg had sold a total of 55,000 just shares. During the past two earnings windows, he has dropped 142,000 shares. Recently, he sold 55,000 shares on January 12th as the stock traded between $18.55 and $18.73. **Not only was this his largest sale since filing in May 1999, but he also trimmed his position by 63%.**

- **Sam Oolie (67)** – Director. While not by any dramatic margin, on January 8th Oolie made his largest sale dating back five years when he dumped 20,000 shares at roughly $18.30 per share. This actually happens to be his first sale since 2001.

<u>Other: Additional pressures give executive behavior context</u>

Restructuring, and more restructuring. It is clear that Comverse continues to suffer from its expansion efforts during the boom years. In the Q3 earnings conference call, Kobi Alexander stated that the overall voice mail market (core to Comverse) has fallen from about $1.8 billion to just $450 million. Comverse bit the bullet on $66.7 million in restructuring charges in F/Y 2002 and this after logging similar charges totaling $63.5 million the prior year. Even after the restructuring activity, the company continues to maintain that it "may endeavor selectively to reduce its existing facilities commitments as circumstances may warrant."

Tax incentives going away. The Company has disclosed several times that various generous tax and cost reimbursement incentives coming from the Israeli government could be in jeopardy. Comverse discloses that its "ability to obtain benefits under various discretionary funding programs has declined and may continue to decline." As an "approved enterprise" under Israel's Encouragement of Capital Investments Law, Comverse receives certain R&D reimbursements from the Office of the Chief Scientist of the Ministry of Industry and Trade of the State of Israel (OCS). These reimbursements have indeed been in a state of decline. In F/Y 2001, Comverse received $21.5 million in such reimbursements from the OCS. Those reimbursements totaled just $10.5 million annually by 1/31/03. Through nine months of F/Y 2003, they trailed off even more, totaling just $6.8 million, and only $1.8 million of that number coming from Q3.

These R&D incentives do not come without strings. The Company must leave associated developed technologies in Israel and must also pay future royalties to the OCS in return for the funding. This certainly complicates any sales of technology assets in the future.

Stock Options Expensing will be Material. Comverse's outstanding share count increases rather dramatically each year. From 186.2 million as of 1/31/3002, outstanding shares are expected to be at over 200 million by the end of F/Y 2004 (1/31/2005). The effects, on earnings, from potential options expensing are very large: Thorough Q3 of F/Y 2003, the $(0.05) loss would have been $(0.66) with options expensing taken into account.