# NICE Systems (ADR) (NICE)

## NICE (MP): In–line Q; acquisition adds execution risk to slowing organic growth

**Analyst Comment**

**4:48 PM – July 31, 2002**

**Market Performer**

Small–Cap Growth

Price: US$11.75

**Israel**

| Stock data | |
|---|---|
| 52–week range | US$17.75–10.51 |
| Yield | 0.0% |

| Price performance | 1M | 3M | 12M |
|---|---|---|---|
| Absolute | –1% | –6% | –19% |
| Rel to S&P 500 | 8% | 10% | 6% |

| Capitalization | |
|---|---|
| Market cap | US$190.3mn |
| Latest net debt/(cash) | – |
| Free float | – |
| Shares outstanding | 16mn |

| Forecasts/valuation | 2002E | 2003E |
|---|---|---|
| EPS | US$0.01 | US$0.55 |
| P/E | 1175.0 | 21.4 |
| Next quarter EPS | 0.03 | – |

**NICE reported 2Q rev/EPS of $38.2m/$0.00 vs. our ests of $38.0m/–$0.02 and rev guidance of $37–39m. Rev rose 6% seq, with product revenue up 5% seq. Op income was –$900K vs our est. of –$1.2m. NICE also agreed to acquire Thales Contact Solutions (TCS) which appears complementary, had trailing 12–mnth rev of $71m, and will boost NICE's share in the CEM and security segments. However, we believe it adds execution risk and an overhang to what appears to be slowing organic growth and thin profitability. In our view, NICE is fully valued at current levels.**

ACQUISITION SYNERGISTIC, BUT INCREASES RISK PROFILE. NICE announced that it will acquire TCS which provides call logging and recording solutions. TCS appears synergistic and increases NICE's mrkt share, but adds integration risk and could be an overhang until investors see the full impact on results which may not be until 2H03. Also, we believe that Thales has not grown in recent quarters and is not profitable. As a result, we believe guidance for 10–15% rev growth in '03 suggests that our previous organic growth expectations were too high. Mgmt also indicated that it expects the acq. to be accretive to '03 organic EPS of $0.80–0.90. We view these expectations as aggressive. For NICE standalone, mgmt. guided to flat seq revs in 3Q, $40mn+ in 4Q and '02 EPS of $0.10. This just gets NICE to the low–end of '02 guidance of 20– 30%, and growth is clearly slowing. For '02 we are lowering our rev est for NICE to $152.5m from $155.6m and maintaining our EPS est. of $0.01. For '03 we are estimating combined rev/EPS of $244mn/$0.55.

VALUATION: At 0.9x our est. of combined '02 rev. of $222m, and 20x our '03 EPS est. of $0.55, we believe NICE is fully valued given our concerns about growth, execution risk and profitability. We also believe that what many investors perceive as positive operating leverage could have the opposite effect if there are revenue shortfalls. We should also note that NICE's cash balance, which lent some downside support in our view, will fall to $3.80/share, post the transaction.

### Full details

ACQUISITION APPEARS SYNERGISTIC LONGER–TERM, BUT ADDS EXECUTION RISK TO SLOWING ORGANIC GROWTH OUTLOOK. NICE's in–line 2Q, which showed an improvement in profitability was overshadowed by the acquisition of TCS.

A brief review of the acquisition details:

Thales Contact Solutions (TCS):

TCS (formerly a unit of Racal acquired by Thales Group in June 2000) is based in the UK and provides call logging and recording solutions.

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According to NICE, TCS' trailing 12-month revenue was $71mn roughly half of NICE's revenue, gross margins are in the low-50s with service accounting for no more than 5-10% of revenue, and the company showed a small operating loss in 1Q02 - but management indicated that these results are not based on GAAP accounting. In addition, similar to NICE the unit has also recently completed a restructuring program.

Terms:

NICE is paying $30mn in cash, 2.2mn shares, and $25m over 3 yrs if Thales hits certain financial goals which management did not divulge. This is roughly 0.8x trailing 12-month revenue excluding the $25mn earn-out and 1.1x including it. The deal is expected to close late in 4Q02.

Key synergies:

Thales is stronger in Europe, the public safety market, and mid-sized call centers relative to NICE. Management indicated that they see relatively little overlap between the companies and rarely see each other in head-to- head bids. NICE has a much larger service operation that it can offer to current Thales customers. Their platforms are interoperable and NICE will offer a combined platform by 2H03. The combination gives NICE 24% (#1 market share) in the overall call logging and recording markets. In addition, Thales did roughly $26mn in the security segment over the last 12 months just slightly below NICE's trailing 12-month revenues in this segment which should significantly increase its critical mass in the security/public safety market. Overall gross margin should improve as well, as the combined company can outsource a greater absolute level of product and over time get more favorable terms from the contract manufactures.
Management expects $7mn in cost synergies in 2003.

2003 guidance for the combined company:

Management is forecasting 10-15% growth in 2003 off of combined 2002 revenue which we estimate will be $222mn, gross margins to increase to 54- 56% in 2003 from 47-48% in 2002 for NICE standalone, and net margins of 5- 7%. It expects the acquisition to be accretive to its organic EPS expectations in 2003 of $0.80-0.90 - however it expects the majority of the positive impact in the back-half of 2003.

Our take:

While the acquisition does present some clear synergies and adds significant critical mass, we believe it increases NICE's risk profile (given the relatively large size of the acquisition compared to NICE), especially in light of what appears to be slowing growth and high expectations. Specifically, although management has indicated that visibility is improving, they guided for flat sequential growth in a seasonally weak 3Q with limited visibility beyond the current quarter. In addition, management guided for 10-15% revenue growth in 2003 including the potential synergies it expects to reap in the back half of 2002. Clearly, it now appears that our prior Street-low expectations for organic revenue of $180mn in 2003 - or 18% off of our new lower 2002 revenue estimate of $152.5mn was too high. As we have said for some time, we feel that overall longer term organic growth within NICE's contact center business may be slowing, and we think with this acquisition the company may be looking to acquire some growth in order to offset such a slowdown. Finally, we are also concerned that NICE's cash position has been reduce by 1/3 and that the company may not generate meaningful cash or perhaps even burn cash in 2003 if it misses its targets.

We should also note that management's top-line expectations may still be aggressive in light of the challenging environment and the integration risk - although management believes this will be relatively minimal. We remind investors that the positive operating leverage that is apparent in NICE's business model could have the opposite effect if revenues slow further or there is a shortfall. At the very least, we expect the macro environment, the acquisition and high expectation to remain an overhang and cause investors to be in a 'wait and see' mode at least for the next 3-4 quarters or until we see the full impact of the combination on results. Finally, we should also note that NICE's cash balance, which lent some downside support in our view, will fall to $3.80/share, post the transaction.

IN−LINE 2Q WITH IMPROVING GROSS MARGINS BUT OPERATING PROFITABILITY IS STILL ELUSIVE. NICE reported 2Q revenue of $38.2mn up 6% sequentially and in the middle of guidance of $37−39mn. Product revenue was $32.8mn up 5% sequentially and service revenue was $5.4mn up 10% sequentially and accounted for 14% of revenue. CEM segment revenues were $29mn and the security segment contributed $9mn up from $8mn in 1Q. Gross margins on product sales were 56.5% up from 54.5% in 1Q and service margins improved to −5.7% from −14.2%. Management expects improving gross margins due to greater levels of software, and outsourcing. In addition, it expects break even service margins by year−end. The operating loss narrowed to −$840K versus −$2.2mn in 1Q due to the higher revenues and gross margins. Financial income was $1.0mn and according to management benefited by roughly $400K from the Israeli shekel. Net income was $52K.

NEW REVENUE ESTIMATES ARE AT THE LOW−END OF GUIDANCE, BUT MAY STILL PROVE AGGRESSIVE. Management guided to flat 3Q revenue, $40mn or more in revenue in 4Q and full−year EPS of $0.10. They also indicated that visibility continues to improve; however, it expects seasonal weakness in 3Q and visibility beyond 3Q is limited. Our new 2002 estimate for NICE standalone are as follows:

ESTIMATE CHANGES

| | 3Q02E | 4Q02E | 2002E |
|---|---|---|---|
| Revenue new ($000) | 38,250 | 40,000 | 152,534 |
| Revenue old ($000) | 39,000 | 42,500 | 155,565 |
| EPS new ($) | 0.03 | 0.06 | 0.01 |
| EPS old ($) | 0.01 | 0.10 | 0.01 |

Source: Goldman Sachs Research estimates.

Our revenue estimate, which is in−line with guidance, assumes 20% year−over year growth − just at the low−end of original guidance of 20−30% revenue growth. Our full−year gross margin estimate is 47.8% in line with guidance.
Our operating loss estimate for full−year 2002 is −$2.9mn and we expect NICE to show a thin ($350K) operating profit in 4Q. Our EPS is $0.01 below guidance of $0.10; however, EPS is very sensitive to small changes in net income.

For 2003, we are forecasting revenue of $244mn. Our revenue estimate assumes 10% growth from our estimate of combined NICE and Thales revenue of $222mn in 2002. Management guided for 10−15% growth in 2003. We are estimating 10% organic growth for NICE and 10% growth from Thales. This is well below our previous expectations of 15−20% organic growth and we have little reason to assume Thales will grow any faster. Our gross margin assumption of 53% is below the guidance range of 54−56% and our operating expense estimate of 49% of revenue is above the guidance range of 47−48%.
This results in EPS of $0.55, well below management’s guidance of EPS accretive to organic expectations of $0.80−0.90. OVERALL, WE BELIEVE THAT MANAGEMENT GUIDANCE FOR BOTH 2H02 AND ESPECIALLY 2003 COULD PROVE AGGRESSIVE AND DOES NOT FULLY TAKE INTO CONSIDERATION THE MACRO ENVIRONMENT, THE SLOW−DOWN IN ORGANIC GROWTH, AND THE FULL EXTENT OF INTEGRATION. WE EXPECT THESE FACTORS COMBINED WITH THE GUIDANCE TO REMAIN AN OVERHANG NEAR−TERM.

COMBINED SECURITY GROUP COULD CAPITALIZE ON NEW, LARGER OPPORTUNITIES, BUT WILL TAKE TIME TO RAMP. In 1Q NICE combined the NICEVision (Digital video recording and logging) and ISS (digital surveillance solutions for government and security installations) units. Revenue from this combined unit was roughly $9 mn, or 24% of total revenue in 2Q. According to management, the deal pipeline is growing in this segment and visibility continues to improve. Thales will add another $6−7mn in revenue per quarter to this segment proving significant critical mass.

Overall, we believe that the digital audio/video surveillance market targeted on security applications, is a large and growing market, that offers a larger opportunity than it has in the past. In our view, the security market and the digital video market in particular, will be the fastest growing area in 2003. However, we note that historically, NICE has been much less active and has much lower market share, in the security area, than some of its key competitors, such as Verint. We believe that NICE will have to execute well and begin to gain brand recognition in this highly competitive area. Moreover, we believe that larger deal sizes in this relatively hot but emerging segment could require more attention and resources and, therefore, costs and also result in longer sales cycles. In addition, the majority of Thales security revenue is in the slower growing less lucrative (relative to network monitoring, etc.) public safety market.

BALANCE SHEET: ACQUISITION DEPLETES CASH; DSOs STILL HIGH. Despite the $840K mn operating loss, NICE was cash flow positive from operations (by less than $1mn according to management). Total cash was $90.5mn or $6.50 per share. However, NICE will pay $30mn in cash to Thales Group for TCS, reducing cash to $60mn or $3.80 per share. In addition, NICE may have to pay and additional $25mn (or 40% of the $60mn) over the next 3 years if Tales hits certain financial goals. DSOs improved one day to 96 according our calculations, but remain relatively high.

**NICE: US$ 11.75**

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