Goldman Sachs

Radware (RDWR)

RDWR (MO): 2Q results show continued positive momentum; valuation attractive

Analyst Comment

12:04 PM – July 29, 2002

Market Outperformer

Small–Cap Growth

Price: US$8.41

Israel

RDWR's 2Q rev of $10.6 mn was up 4.5% seq. vs. guidance of $10.5–11 mn. EPS was –$0.05 vs. guidance of –$0.07. Op results continued to improve. Mgmt guided to 3Q rev of $11 mn up 5% vs 2Q. We are maintaining our '02 rev est. of $43 mn, raising EPS to –$0.19 from –$0.25, and initiating '03 ests. of $50 mn/$0.04 with rev up 16% yoy. We believe that RDWR is well positioned to leverage its product suite and distribution into further growth in 2H2002. With $124 mn in cash (85% of the market cap) and minimal cash burn, we believe that valuation is attractive and downside limited.

Stock data	
52–week range	US$17.19–7.63
Yield	0.0%

Price performance	1M	3M	12M
Absolute	–3%	–18%	–49%
Rel to S&P 500	10%	2%	–20%

Capitalization	
Market cap	US$147.2mn
Latest net debt/(cash)	–
Free float	–
Shares outstanding	18mn

Forecasts/valuation	2002E	2003E
EPS	US$–0.19	US$0.04
P/E	–	210.2
Next quarter EPS	–0.04	–

MAINTAINING MOMENTUM IN A CHALLENGING ENVIRONMENT. 2Q results showed improvement, or at least a stabilization, in all key business metrics for the third straight quarter. In 2Q, RDWR was cash flow positive from operations and overall cash burn was only $350K. In addition, mgmt. again indicated that visibility and the deal pipeline is improving. We believe that this growing pipeline is being driven by RDWR's broad, feature rich, high–performance product portfolio, resulting in larger deal sizes for multiple product lines as well as a renewed focus on securing leading resellers in key regions that is only beginning to bear fruit in our view. As a result, we believe that RDWR is in position to show continued growth in 2H2002 (our new ests. assume 3% seq growth in 3Q and 5.5% in 4Q), maintain its current cash level, and return to consistent free cash flow in 2003.

VALUATION: COMPELLING BASED ON OPERATING TRENDS AND CASH. RDWR's operating business is being valued at $24 mn, or 0.55x our '02 revenue estimate, based on its market cap of $148 mn and cash balance of $124 mn. Given the solid 2Q results and growing pipeline in a challenging environment, as well as minimal cash–burn expectations, we believe that this valuation is attractive. We should also note that RDWR has significant operating leverage potential with 80%+ gross margins and 100% indirect sales model that should result in a strong EPS ramp as RDWR shows consistent sequential revenue growth.

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Full details

STRONG 2Q RESULTS ACROSS ALL BUSINESS METRICS – AGAIN. Radware reported a solid 2Q in a still challenging IT spending environment with improving, or at least stable, results across all key business metrics for the third consecutive quarter. Repeat orders were 45% in the quarter, flat with 1Q, and included sales to United Airlines, Fannie Mae, Reuters, Verizon, France Telecom, Sony and Telefonica. In addition, three of Korea's leading broadband and Internet service providers installed Radware's Web Server Director (WSD) for traffic management and security. Based on management comments, we would not be surprised to see Radware win a similar deal with a fourth provider in Korea. We should note that enterprises accounted for roughly 60% of revenue and service providers 40%. This is in line with recent quarters, although management indicated that the trend was moving toward enterprises.

Management also indicated that the number of deals in the pipeline as well as deal sizes continue to grow as customers begin to evaluate and purchase end−to−end solutions comprised of multiple products. Although Radware's revenue run−rate is relatively small, we view the results as a positive in light macro environment. Management also said that visibility continues to improve and guided to 5% sequential revenue growth in 3Q to $11 mn and EPS of −$0.04. While it seems Radware has turned the corner and trends are going in the right direction, it is still a tough environment and management will need to continue to execute well as they did in 1H2002 in order to sustain consistent growth especially in what could be a seasonally weak 3Q. NONETHELESS WE WOULD BE BUYERS OF THE STOCK AT CURRENT LEVELS GIVEN THE MINIMAL CASH BURN, IMPROVING PROFITABILITY, POTENTIAL REVENUE AND EARNINGS UPSIDE IN 2H2002, AND ATTRACTIVE VALUATION − WHICH SHOULD LIMIT DOWNSIDE.

Below we list the performance of key metrics during the quarter:

Revenue − Grew 4.5% sequentially to $10.6 mn, vs. guidance of $10.5−11 mn and slightly below our estimate of $10.8 mn.

Deferred revenue − was flat with 1Q according to management although they did not break−out this metric.

ASPs − were flat at $50K vs. 1Q, up from $45K in 4Q, and repeat sales were flat at 45% vs. 1Q, but up from 40% in 4Q.

Gross margins − remained solid at 81.6% in line with the past three quarters.

DSOs − according to our calculations, fell 1 day to 75 days versus 76 days in 1Q and 113 days in a dismal 3Q.

Operating expenses − were flat at $10.5 mn versus 1Q despite higher revenues, resulting in an operating loss of $1.9 mn versus $2.2 mn in 1Q.
The operating loss per share improved to −$0.11 from −$0.13 in 1Q.

Operating cash flow − was positive at $120K in 2Q.

Net loss per share − of −$0.05 was better than guidance of −$0.07 and up from −$0.08 in 1Q − this was driven by higher revenues, flat expenses and an increase in interest income of $230K.

Cash − fell $350K, versus a decline of nearly $1mn in 1Q, to $124.4mn or roughly $7.10 per share

TWEAKING 2002 ESTIMATES. We are modestly raising our 3Q revenue estimate to $10.9 mn, from $10.8 mn, up 3% sequentially and slightly below guidance of $11 mn. We are increasing our 3Q EPS estimate to −$0.04, in line with guidance, from −$0.07 due to lower expenses and higher interest income. For 4Q, we are maintaining our revenue estimate of $11.5mn up 5.5% sequentially and lowering our EPS to −$0.02 from −$0.04. We believe that acceleration in 4Q sequential growth will be driven by positive seasonal factors as well as continued increasing traction of RDWR's product suite and strengthening distribution and sale and marketing efforts. As a result for 2002, we are estimating revenue and EPS $43.1 mn and −$0.19 vs. our previous estimates of $43.2 mn and −$0.25.

Management indicated that it expects gross margins to trend lower over time, but remain close to current levels in the near term. We are maintaining or 2H2002 gross margin forecast of 81.3%, slightly below current levels. In addition, management expects to keep operating expenses roughly flat with 2Q levels, and only increase to the extent that sales commissions increase. Overall, we believe that Radware's strong operating leverage, cost controls, could result in further upside to our EPS estimate and a solid profitability outlook entering 2003.

For 2003 we are initiating estimates of $50.0 mn in revenue or 16% growth versus 2002 and EPS of $0.04 - which could prove conservative if RDWR surpasses revenue expectations or continues to control costs. We expect that RDWR will continue to show positive cash flow from operations in 2H2002 and consistent free cash flow in 2003. We are not projecting positive operating income in 2003. However, we should note that management expects to reach operating profitability on $12.5-13 mn in revenue - a revenue level which we forecast Radware reaching in 2H2003.

ESTIMATE CHANGES

	3Q02E	4Q02E	2002E	2003E
Revenue new ($000)	10,900	11,500	43,061	50,048
Revenue old ($000)	10,800	11,500	42,961	n/a
EPS new ($)	-0.04	-0.02	-0.19	0.04
EPS old ($)	-0.07	-0.04	-0.25	n/a

Source: Goldman Sachs Research estimates.

IT'S STILL TOUGH OUT THERE, BUT CONTINUED REVENUE RAMP SHAPING UP WELL BASED ON COMPANY SPECIFIC IMPROVEMENTS. We continue to believe that two key company-specific elements are largely responsible for the 3rd consecutive quarter of sequential growth and Radware's growing pipeline: (1) a refocused sales effort; and (2) its broad, feature-rich product line.
Clearly, IT spending remains a key growth driver; however, we believe these two factors position Radware to show consistent sequential growth in 2002 and continue gaining share, despite the uncertain IT spending environment.

RADWARE'S REFOCUSED SALES EFFORT IS RELYING LESS ON OEMS - WHICH WAS A MAJOR FOCUS OF RADWARE AND INVESTORS IN 2001 - AND MORE ON GARNERING LEADING RESELLERS AND BUILDING THE INTERNAL SALES FORCE. In our view, this effort has been a welcome move given that in the current environment, OEMs are likely more focused on internal issues. However, large resellers - which to some extent Radware may have been lacking in 2001 - can provide stronger sales leverage. In fact, according to management Radware's distribution agreement with Westcon in the US, which was announced in early 2002, and with Computerlinks in Europe are beginning to bear solid fruit and should lead to even stronger deal flow in the coming quarters. We also expect Radware to sign additional agreements with leading resellers in the coming quarters. Internally, Radware is increasing the number of quota carrying sales people, continues to open more regional offices, and hiring experienced senior managers in key regions, without a significant impact on fixed operating expenses.

RADWARE'S BROAD, HIGH-PERFORMANCE, FEATURE-RICH PRODUCT LINE - BASED ON ITS APPLICATION SWITCH II PLATFORM AND SYNAPPS ARCHITECTURE - ALLOWS IT TO OFFER AN END-TO-END SOLUTION. In our view, the second key element to Radware's growing deal flow and pipeline has been the growth in its product line as well as traction of more recently introduced products. Management has indicated that its Application Switch II, released in 3Q is helping drive demand, improving Radware's competitive position and increasing overall deal sizes. In addition, the functionality of its SynApps architecture has also been a key differentiator for Radware in competitive wins versus Cisco, Alteon, and F5. OVERALL, WITH SIX DISTINCT PRODUCT OFFERINGS, AND ROUGHLY 75% OF THE COMPANY'S INSTALLED BASED HAVING PURCHASED ONLY ONE OFFERING TO DATE, WE BELIEVED THAT RADWARE IS NOW IN A SOLID POSITION TO EXECUTE LARGER SALES INCLUDING MULTIPLE PRODUCTS. In 2Q, Radware also released Configware Insite, a management tool which controls application switching devices across the entire network. Management indicated that it is gaining solid initial traction and feedback from customers. We believe that this management tool is a key element in Radware's ability to sell larger deals which include a greater number of devices from multiple products lines. We expect Configware to continue to gain momentum in the coming quarters.

RDWR: US$ 8.41; BC2, MM1, MM2.
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