



Check Point Software

(NASDAQ: CHKP)

Outperform

Speculative Risk

Earnings/Ratings
Changes

Price Target
Downgrade

EPS Revision

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Price: 21.80 **Price Target: 26.00** ↓ 28.00
52-Wk High: 27.16 **52-Wk Low: 16.46**
Float (MM): 177.3 **Debt to Cap: 0.0%**
Shares Out (MM): 256.0 **Market Cap (MM): 5,581**
Dividend: 0.00 **Yield: 0.0%**
Tr. 12 ROE: NM **Est 3-Yr EPS Gr: 10.00%**
Trading Vol. (MM): 4.500
Institutional Own.: 39%

(FY Dec)	2003A	2004A	2005E	2006E
EPS	0.96	1.07	1.26	1.38
Prev.			1.22	1.36
P/E	22.71x	20.37x	17.30x	15.80x
Revenue Net (MM)	432.57	515.40	591.70	659.00
Prev.			590.40	
MktCap/Rev	12.90x	10.83x	9.43x	8.47x

EPS	Q1	Q2	Q3	Q4
2003	0.24A	0.24A	0.23A	0.26A
2004	0.25A	0.25A	0.27A	0.31A
2005	0.30A	0.31E	0.31E	0.34E
Prev.	0.29E	0.30E	0.30E	0.33E
2006	0.32E	0.34E	0.34E	0.38E
Prev.	0.31E	0.33E	0.33E	0.37E

Revenue Net (MM)	Q1	Q2	Q3	Q4
2003	104.85A	106.10A	106.32A	115.30A
2004	116.10A	126.90A	129.30A	143.00A
2005	137.70A	145.50E	148.50E	160.50E
Prev.	138.00E		147.00E	159.90E
2006	151.60E	161.50E	166.10E	182.10E
Prev.	151.50E	161.90E	164.30E	181.30E

EPS excludes non cash items

All values in USD unless otherwise noted.

License Sales Light - Product Mix & Business Model in Question

Event

CYQ1 results of \$137.7M/\$0.30 vs. RBC at \$138M/\$0.29 and the street at \$138.9M/\$0.29

Investment Opinion

Results. Overall results were roughly in line with our estimates, however, license revenues were considerably weaker than anticipated, growing 4% y/y to \$65.5M vs. our expectations of \$72.5 (9.7% shortfall). It's important to note that contribution from the Zone Labs acquisition is included in the 2005 results and were excluded from Q1/2004, which begins to question the core business growth rate. Check Point's License/Subscription/Support revenue breakout shifted to 48%/42%/10% from December 04 and year ago March 04 qtr at 54%/37%/9% and 54%/38%/8%. This indicates a substantially larger shift to subscriptions which include maintenance, indicating a shift in the business model and questioning the license growth rate. Subscription revenues were \$58.4M vs. RBC est. of \$53.5M as the company's new enterprise base subscription (EBS-effective Nov1, 2004) program kicked in. We believe approximately 50% of the customer base has switched from the old program to the new EBS program - but more importantly approximately 70% of the maintenance revenue stream has converted. The strong EBS conversion helped deferred revenue balance of \$150M outpaced our estimate of \$136M, showing considerable seq and y/y strength of 9% and 20.7%.

Bottom Line. Sales results were in-line but with a disappointing license contribution. However, the company did report slight EPS upside, in-line guidance, and a strong increase in deferred revenue. Going forward investors may struggle with the appropriate valuation for the business unless the company is able to demonstrate it can grow license revenues faster than Q1's 4% y/y. The company's new products have been expected to answer this question by injecting new growth into the business with recent product introductions, but the Q1 results are revealing a slower than expected ramp in contribution.

Other metrics. Gross and operating margins came in at 96% and 57.4%, above our estimates of 95.7%/57.3%. DSO declined seq. from 60 to 52 days, despite the increase in deferred revenues. Net of the change in deferred revenues DSO would have been 48.7, indicating good linearity in the quarter. Headcount finished approximately 1,400 and should finish the year at approximately 1,500.

Financial Statement Metrics						Q1 Comments
	4Q04	1Q05	1Q05	Seq.	Delta	
	Actual	Est	Actual	Change	From E.	
Inc. Stmt						
Products	77.1	72.5	65.5	-15%	-6.9	Still forecasting 54% 05 lic rev. Q1 contribution declined to 47.6/52.4 from 4Q04 at 53.9/46.1
Subscriptions	53.3	53.5	58.4	10%	4.9	Should grow as SmartDefense (now 15-20% of base) and ZL and are sold into installed base
Support, training	12.6	12.0	13.7	8%	1.7	
Ttl Rev (\$M)	143.0	138.0	137.7	-4%	-0.3	Guidance - 2Q05 (mid \$145M/\$0.305) maintain full yr guidance (\$592.5M/\$1.24 (EPS high-end)
EPS	0.31	0.29	0.30	-2%	0.01	\$0.01 upside from lower tax rate (\$0.005) and tax rate (\$0.003)
Shs. Out.	257.5	258.2	256.2	-1%	-2.1	Company continues aggressive share buyback (2.1M in qtr at cost of \$49.7M)
G. Mgn	95.8%	95.7%	96.0%	0.2%	0.3%	Near term gross margins stay strong - long term could be influenced by low end appliances
Op. Mgn	57.7%	57.3%	57.4%	-0.5%	0.1%	
Bal. Sht						
DSO	60.4	51.0	51.9	-8.5	0.9	DSO positive despite Q1 seasonality and increase in deferred
Ttl Cash (\$M)	1,577.8	1,663.5	1,631.1	53.4	-32.3	Share buyback of \$49.7M
Dfd Rev (\$M)	141.1	135.6	150.2	6%	14.6	Strong maintenance renewals on new EBS support model, Zone Labs, SmartDefense
Bookings (\$M)	159.4	132.4	146.7	-8%	14.3	Seq decline on seasonality
C. Flow						
Op. C. Flow	73.6	87.0	97.1	32%	10.1	Very strong number - deferred rev contributed \$9M

*Source: Company reports and RBC Capital Markets estimates

Revenue Metrics						Q1 Comments
	4Q04	1Q05	1Q05	Seq.	Delta	
	Actual	Est	Actual	Change	From E.	
Americas	65.8	63.5	60.6	-8%	-289%	
EMEA	58.7	56.6	57.8	-1%	125%	
Asia Pacific	18.6	17.9	19.3	4%	134%	US, EMEA, Asia grew 27, 18%, and 4% respectively, year over year
Headcount	1344	--	1400	56		Up slightly sequentially, likely to grow headcount by 100 y/y by 05 end
Gateways (000's)	386	--	402	16.0		Rev p/gateway declined to \$342K from \$371K, but lic rev ASP p/new gateway was flat to up 1%

*Source: Company reports and RBC Capital Markets estimates

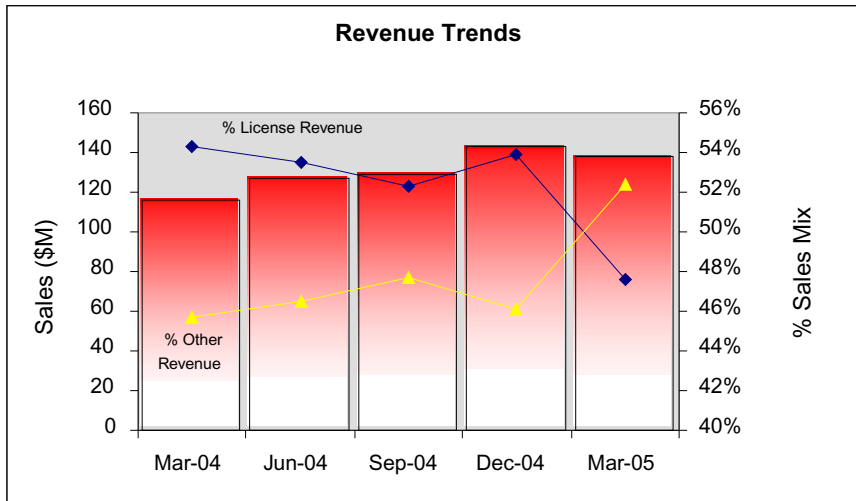
Shift in business model - or back-end loaded year? Exhibits below indicate breakout of company's new "emerging" products. By examining recent license revenue contribution trends, we believe the business model is shifting at Check Point (along with many other software companies) and favoring a subscription based revenue model. We believe many of the new products are also contributing a substantial portion of new bookings to deferred revenue and making it difficult for the company to demonstrate "product" revenue growth. We expect there is a disconnect between what investors have expected in sales driven by new customer growth, and revenues driven by sales of new products to existing customers. However, despite the trend shown in the chart below, the company continues to back its forecast of 54% product revenue contribution in 2005 - indicating that at a minimum new license strength is likely to be more back-end loaded in 2005 than previously expected, though the company will be under the spotlight to demonstrate this is the case vs. a shift in the broader underlying business model.

Exhibit 1. Emerging Products

2005 CHKP Analyst Day Breakout	
Core	Emerging Products (28% of rev)
Enterprise	-Web Security
-VPN-1 Pro	-Internal Security
	Branch offices
Mid-size	-VPN-1 Edge
-VPN-1 Express	High-end
	-GX, VSX
High-end	Small Office
-Provider-1	-Safe@
	Endpoint Security
	Consumer

Source: Company reports and RBC Capital Markets estimates

Exhibit 2. Revenue Trends



Source: Company reports and RBC Capital Markets estimates

Valuation

CHKP recently traded at 17x our CY 2005 EPS estimate (\$1.26) vs. the comp group mean of 24x. We are lowering our price target to \$26 (21x our 05 estimate) to take into account the pressure shares are likely to reflect as the street waits for the company to demonstrate its promised new product license growth. Our previous target was \$28. The company does continue to demonstrate good overall revenue growth with consistent upward revisions to EPS, and we believe as the company is able to add the final ingredient in license growth, shares are likely to trade towards the group mean of 24x. CHKP is rated Outperform with Speculative risk qualifier.

Price Target Impediment

Our price target could be at risk if IT spending or acceptance of company's products decline. Shares may trade with volatility. Margin pressure or failure to meet expectations may pressure share valuation. Back-end loaded quarter sales linearity increases risks of missing expectations. The company is likely to see increased pressure to demonstrate new product license growth, and could experience a decline in valuation should this not be achieved. These factors could impede achievement of our price target.

Company Description

Check Point is a leading provider of software- and appliance-based firewall/VPN technology. The company invented the stateful inspection technology that is utilized by more than 95% of Fortune 500 companies. Check Point was founded in 1993 with headquarters in Israel and U.S. based operations in Redwood City California.

Required Disclosures

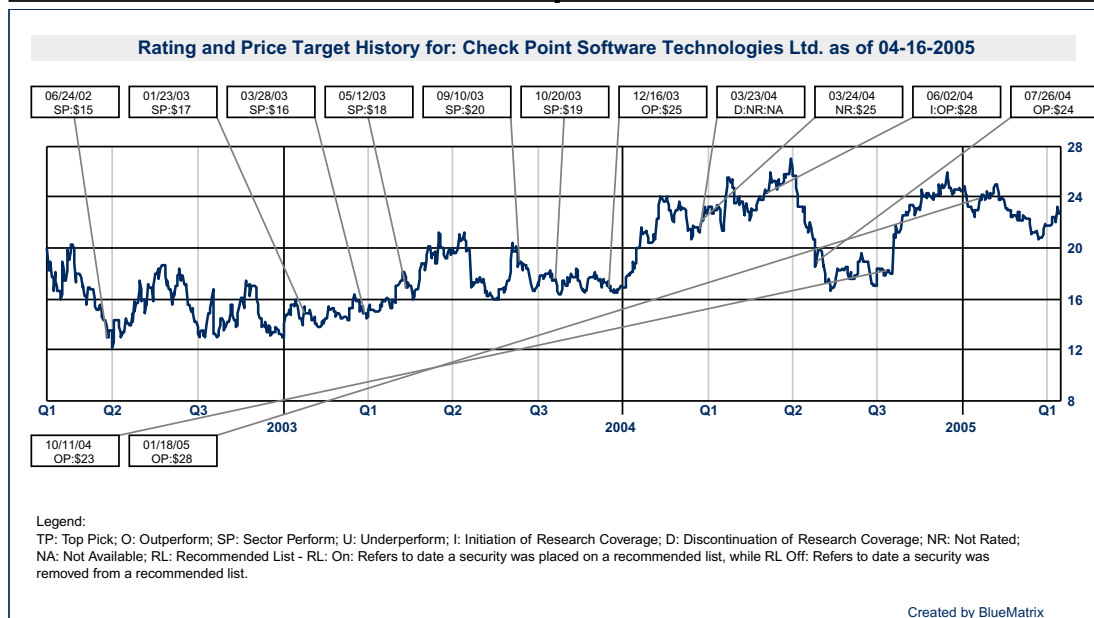
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	Count	Percent	Count	Percent
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Check Point Software	Fiscal 2003				Fiscal 2004				Fiscal 2005E				Fiscal 2006E				December Year End				
	Mar-03	Jun-03	Sep-03	Dec-03	Mar-04	Jun-04	Sep-04	Dec-04	Mar-05	Jun-05	Sep-05	Dec-05	Mar-06	Jun-06	Sep-06	Dec-06	2002	2003	2004	2005E	2006E
In mil except share data																					
Products and licenses	58.3	54.8	54.0	63.0	63.0	67.9	67.6	77.1	65.5	68.7	70.0	80.0	70.1	75.8	77.2	89.6	256.1	230.1	275.7	284.2	312.8
Software subscriptions	36.9	40.8	41.6	42.5	44.0	48.7	50.4	53.3	58.4	62.0	63.5	65.0	65.5	68.5	71.2	74.4	130.9	161.7	196.3	248.9	279.6
Support, training and consulting	9.7	10.6	10.7	9.8	9.0	10.3	11.3	12.6	13.7	14.3	15.0	15.5	16.0	17.2	17.8	18.2	40.0	40.8	43.4	58.5	69.1
Total Revenue	104.8	106.1	106.3	115.3	116.1	126.9	129.3	143.0	137.7	145.0	148.5	160.5	151.6	161.5	166.1	182.1	427.0	432.6	515.4	591.7	661.4
Cost of Revenue	5.113	4.621	4.597	4.592	4.934	6.443	6.187	5.989	5.6	6.1	6.2	6.4	6.4	7.3	7.5	7.3	20.7	18.9	23.6	24.3	28.4
Gross Profit	99.7	101.5	101.7	110.7	111.1	120.5	123.1	137.1	132.1	138.9	142.3	154.1	145.3	154.3	158.7	174.9	406.3	413.6	491.8	567.4	633.0
Research & Dev.	6.9	7.3	7.7	7.5	8.7	10.8	11.7	12.0	12.8	13.1	13.5	13.8	13.6	13.9	14.6	15.1	28.7	29.3	43.2	53.2	57.2
Sales & Marketing	26.7	26.8	27.6	30.0	28.6	34.4	33.3	36.5	34.1	35.5	37.1	39.3	36.3	38.5	40.3	44.1	104.6	111.0	132.8	146.0	159.2
General & Admin.	4.3	4.6	4.4	4.4	4.9	6.5	6.3	6.1	6.2	6.7	6.8	7.6	7.9	8.2	8.5	8.7	18.0	17.6	23.7	27.4	33.3
Operating Expenses	37.9	38.6	39.6	41.8	42.1	51.7	51.2	54.6	53.1	55.3	57.5	60.8	57.9	60.6	63.3	68.0	151.3	158.0	199.6	226.6	249.7
Operating Income (Exp)	61.8	62.9	62.1	68.9	69.0	68.7	71.9	82.5	79.0	83.6	84.8	93.3	87.4	93.7	95.3	106.9	255.0	255.7	292.2	340.7	383.3
Other income (expense)	11.3	10.5	10.9	10.7	10.8	10.6	11.5	12.0	12.4	12.5	12.6	12.7	12.7	12.8	13.0	13.5	49.3	43.5	44.8	50.2	52.0
Pretax Profit (Bef Chgs)	73.2	73.4	73.0	79.6	79.8	79.3	83.4	94.5	91.4	96.1	97.4	106.0	100.1	106.5	108.3	120.4	304.3	299.2	336.9	390.9	435.3
Inc. Taxes (Benefit)	13.1	13.2	14.6	14.4	14.8	13.5	14.2	15.8	15.1	16.3	16.6	18.0	18.0	19.2	19.5	21.7	49.2	55.3	58.2	66.0	78.4
Net Income	60.1	60.2	58.4	65.3	65.0	65.8	69.2	78.7	76.3	79.8	80.8	88.0	82.1	87.3	88.8	98.7	255.1	243.9	278.7	324.9	356.9
Diluted EPS	0.24	0.24	0.23	0.26	0.25	0.25	0.27	0.31	0.30	0.31	0.31	0.34	0.32	0.34	0.34	0.38	1.00	0.96	1.07	1.26	1.38
Dil. EPS-assum 36% tax	0.18	0.18	0.18	0.20	0.20	0.19	0.21	0.23	0.23	0.24	0.24	0.26	0.25	0.26	0.27	0.29	0.76	0.75	0.83	0.97	1.07
Diluted Avg Shares Out	253.195	255.199	256.106	255.834	259.829	266.800	258.341	257.459	256.2	256.9	257.7	258.4	259.2	259.9	260.7	261.4	254.7	255.1	260.6	257.3	260.3
% of Revenue																					
Products and licenses	55.6%	51.6%	50.8%	54.7%	54.3%	53.5%	52.3%	53.9%	47.6%	47.4%	47.1%	49.8%	46.2%	47.0%	46.5%	49.2%	60%	53%	53%	48%	47%
Software subscriptions	35.2%	38.4%	39.1%	36.8%	37.9%	38.4%	38.9%	37.2%	42.5%	42.8%	42.8%	40.5%	43.2%	42.4%	42.8%	40.8%	31%	37%	38%	42%	42%
Support, training and consulting	9.3%	10.0%	10.1%	8.5%	7.8%	8.1%	8.8%	8.8%	9.9%	9.9%	10.1%	9.7%	10.5%	10.6%	10.7%	10.0%	9%	9%	8%	10%	10%
Gross Margin	95.1%	95.6%	95.7%	96.0%	95.7%	94.9%	95.2%	95.8%	96.0%	95.8%	95.8%	96.0%	95.8%	95.5%	95.5%	96.0%	95%	96%	95%	96%	96%
Research & Dev.	6.5%	6.8%	7.2%	6.5%	7.5%	8.5%	9.0%	8.4%	9.3%	9.1%	9.1%	8.6%	9.0%	8.6%	8.8%	8.3%	7%	7%	8%	9%	9%
Sales & Marketing	25.5%	25.2%	26.0%	26.0%	24.6%	27.1%	25.7%	25.5%	24.7%	24.5%	25.0%	24.5%	24.0%	23.8%	24.2%	24.2%	24%	26%	26%	25%	24%
General & Admin.	4.1%	4.3%	4.1%	3.8%	4.2%	5.1%	4.9%	4.2%	4.5%	4.6%	4.6%	4.8%	5.2%	5.1%	5.1%	4.8%	4%	4%	5%	5%	5%
Operating Margin	59.0%	59.3%	58.4%	59.7%	59.5%	54.2%	55.6%	57.7%	57.4%	57.7%	57.1%	58.1%	57.6%	58.0%	57.4%	58.7%	60%	59%	57%	58%	58%
Effective tax rate	17.9%	18.0%	20.1%	18.0%	19%	17%	17%	17%	17%	17%	17%	17%	18%	18%	18%	18%	16%	18%	17%	17%	18%
Y/Y % Change																					
Products and licenses	-9.3%	-17.0%	-10.6%	-3.8%	8.2%	24.0%	25.1%	22.4%	4.0%	1.2%	3.5%	3.7%	7.0%	10.4%	10.3%	12.0%	-31.4%	-10.2%	19.8%	3.1%	10.0%
Software subscriptions	24.5%	25.2%	24.6%	20.2%	19.3%	19.5%	21.2%	25.4%	32.8%	27.4%	26.1%	22.0%	12.1%	10.5%	12.1%	14.4%	11.6%	23.5%	21.4%	26.8%	12.3%
Support, training and consulting	-9.4%	5.0%	10.1%	3.6%	-6.8%	-2.2%	5.8%	29.0%	51.5%	38.3%	32.3%	22.6%	16.7%	20.0%	18.5%	17.2%	8.2%	2.1%	6.3%	34.9%	18.1%
Total Revenue	0.3%	-2.3%	2.7%	4.6%	10.7%	19.6%	21.6%	24.1%	18.6%	14.2%	14.8%	12.2%	10.1%	11.4%	11.9%	13.5%	-19.1%	1.3%	19.1%	14.8%	11.8%
Net Income	-5.4%	-7.0%	-6.3%	1.2%	8.2%	9.4%	18.5%	20.6%	17.4%	21.1%	16.8%	11.8%	7.5%	9.5%	9.9%	12.2%	-20.8%	-4.4%	14.3%	16.6%	9.9%
Diluted EPS	-3.3%	-7.6%	-7.4%	0.0%	5.5%	4.6%	17.5%	19.8%	19.1%	25.8%	17.1%	11.4%	6.3%	8.2%	8.6%	10.9%	-19.0%	-4.6%	12.0%	18.0%	9.4%
Q/Q % Change																					
Products and licenses	-11.0%	-6.0%	-1.3%	16.6%	0.0%	7.8%	-0.4%	14.1%	-15.1%	4.9%	1.9%	14.3%	-12.4%	8.2%	1.8%	16.1%					
Software subscriptions	4.5%	10.4%	2.0%	2.2%	3.6%	10.6%	3.5%	5.8%	9.7%	6.1%	2.4%	2.4%	0.8%	4.5%	3.8%	4.5%					
Support, training and consulting	2.6%	9.0%	1.3%	-8.5%	-7.8%	14.4%	9.7%	11.5%	8.3%	4.4%	4.9%	3.3%	3.1%	7.4%	3.6%	2.2%					
Total Revenue	-4.9%	1.2%	0.2%	8.4%	0.7%	9.4%	1.9%	10.6%	-3.8%	5.3%	2.4%	8.1%	-5.5%	6.5%	2.9%	9.6%					
Net Income	-6.8%	0.2%	-3.0%	11.8%	-0.4%	1.2%	5.1%	13.7%	-3.0%	4.5%	1.4%	8.9%	-6.7%	6.3%	1.8%	11.1%					
Diluted EPS	-7.0%	-0.6%	-3.4%	11.9%	-1.9%	-1.4%	8.5%	14.1%	-2.5%	4.2%	1.1%	8.5%	-7.0%	6.0%	1.5%	10.8%					

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