

April 24, 2002  
Technology Research

# Check Point Software Technologies Ltd.

CHKP Announced Q1:02 Results In-Line With Lower Pre-Announced Expectations; We Maintain Our Market Perform Rating

**Investment Conclusion:** *We continue to view Check Point<sup>a</sup> as the franchise name in the firewall/VPN sector and one of the premier companies in our Internet security coverage area. However, we are concerned about customer demand given the weak IT environment and weak demand drivers (i.e., little demand for more bandwidth, headcount declines, etc.). We maintain our Market Perform rating.*

## Key Points

- **Check Point announced Q1:02 revenues and earnings yesterday, in-line with lower pre-announced expectations.** Revenues for Q1:02 were \$104.6 million, down 15% sequentially and 28% year-over-year. Our original revenue estimate for Q1:02 was \$121.3 million. Operating EPS for Q1:02 was \$0.25, down 18% sequentially and 23% year-over-year. Our original EPS estimate for Q1:02 was \$0.29.
- **In Q1:02, while the number of orders and pricing remained stable compared to last quarter, order sizes decreased.** Large orders (over \$10K) represented 52% of total revenues in Q1:02 compared to 57% of total revenues in Q4:01. Check Point attributed the reduction in order sizes to continued weak IT spending. While Check Point saw healthy interest and activity in the quarter, customers continued to postpone full-scale implementation of projects.
- **Check Point's low-end S-Box appliance gained strong traction in its first quarter of availability.** The company shipped more than 3,600 units in the quarter. This low-end appliance is sold through Check Point's Sofaware affiliate based in Israel. SofaWare financials are consolidated in CHKP's financial statements. In Q1:02, SofaWare revenues represented less than 1% of Check Point's total revenues and its expenses were approximately \$400-500K.
- **CHKP's balance sheet was solid with strong cash flow in Q1:02.** Operating cash flow was \$78.4 million versus \$63.5 million of net income. CHKP's total cash balance grew by \$78 million (or 7.5%) to \$1.1 billion. DSOs of 54 days improved by three days. Deferred revenue declined by less than \$1 million (or 1%) to approximately \$95 million.
- **We are revising our estimates.** We are lowering our 2002 revenue estimate to \$463.5 million from \$472.2 million and our EPS estimate to \$1.07 from \$1.09. We are also lowering our 2003 revenue estimate to \$589.0 million from \$603.2 million, however, raising our EPS estimate to \$1.32 from \$1.28.

**CHKP: \$18.20**  
**Rating: Market Perform**

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Change In...	Yes/No	Was	Is
Rating:	No		MP
Operating EPS F2002E:	Yes	\$1.09	\$1.07
Operating EPS F2003E:	Yes	\$1.28	\$1.32
Rev F2002E:	Yes	\$472.2	\$463.5
Rev F2003E:	Yes	\$603.2	\$589.0
12-Month Price Target:	Yes	\$32.00	NE
52-Week Range (NASDAQ)			\$80.16-19.56
FD Shares Outstanding			259.0 MM
Market Cap			\$4,713.8 MM
Avg Daily Volume (000)			1,682
Book Value/Share 3/02			\$3.80
5yr Hist. EPS Growth Rate			35%
5yr Proj. EPS Growth Rate			20%
ROA 2002E:			25%
Dividend/Yield			NONE/ NA
Price/Book Value 3/02:			4.8x
Net Cash/Share 3/02:			\$4.27
<b>FY December</b>	<b>F2001 A</b>	<b>F2002 E</b>	<b>F2003 E</b>
Operating EPS:			
1Q	\$0.32	\$0.25 A	\$0.30
2Q	\$0.33	\$0.25 E	\$0.32
3Q	\$0.29	\$0.27 E	\$0.33
4Q	\$0.30	\$0.30 E	\$0.36
Year	\$1.24	\$1.07	\$1.32
P/E	NM	17.0x	13.8x
<b>Rev (MM):</b>	<b>F2001 A</b>	<b>F2002 E</b>	<b>F2003 E</b>
1Q	\$145.0	\$104.6 E	\$134.3
2Q	\$142.1	\$109.8 E	\$142.4
3Q	\$118.0	\$118.0 E	\$149.5
4Q	\$122.5	\$131.0 E	\$162.9
Year	\$527.6	\$463.5	\$589.0
Mkt Cap/Rev	NM	10.2x	8.0x

## QUARTERLY HIGHLIGHTS

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**Check Point announced Q1:02 revenues and earnings yesterday, in-line with lower pre-announced expectations.** Revenues for Q1:02 were \$104.6 million, down 15% sequentially and 28% year-over-year. Our original revenue estimate for Q1:02 was \$121.3 million. Operating EPS for Q1:02 was \$0.25, down 18% sequentially and 23% year-over-year. Our original EPS estimate for Q1:02 was \$0.29.

**In Q1:02, while the number of orders and pricing remained stable compared to last quarter, order sizes decreased.** Large orders (over \$10K) represented 52% of total revenues in Q1:02 compared to 57% of total revenues in Q4:01. Check Point attributed the reduction in order sizes to continued weak IT spending. While Check Point saw healthy interest and activity in the quarter, customers continued to postpone full-scale implementation of projects. Additionally, many deals in the pipeline that were expected to close in March were delayed due to conservative spending by customers.

**Check Point's low-end S-Box appliance gained strong traction in its first quarter of availability.** The company shipped more than 3,600 units in the quarter. Of these units, 60% were sold to new customers and the remaining 40% were sold to existing CHKP enterprise customers who bought these appliances for their remote employees. The S-Box has three different price points ranging from \$300-\$1,300 per unit. This low-end appliance is sold through Check Point's SofaWare affiliate based in Israel. Check Point owns approximately 60% of SofaWare. SofaWare financials are consolidated in CHKP's financial statements. In Q1:02, Sofaware revenues represented less than 1% of Check Point's total revenues and its expenses were approximately \$400-500K. Sofaware's balance sheet represented less than 0.1% of Check Point's balance sheet.

**Revenue from the appliance platforms grew in Q1:02 to over 40% of total revenues.** Nokia continues to generate the vast majority of this revenue.

**CHKP's balance sheet was solid with strong cash flow in Q1:02.** Operating cash flow was \$78.4 million versus \$63.5 million of net income. CHKP's total cash balance grew by \$78 million (or 7.5%) to \$1.1 billion. DSOs of 54 days improved by three days. Deferred revenue declined by less than \$1 million (or 1%) to approximately \$95 million.

**The company announced two new VPN products in April.** Check Point introduced VPN-1 Net, a dedicated VPN solution that enables simple, secure and fast connectivity. Additionally, the company announced VPN-1 Pro, an integrated VPN and firewall solution with advancements in ease-of-deployment and management. These products could generate upside to our numbers.

**In Q1:02, Check Point had more than 225,000 total customer installations of which 127,000 of them (or 55%) were for VPN deployments.**

## REVENUE ANALYSIS

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**License revenue fell as a percentage of total revenues from 67% to 63%.** In Q1:02, license revenues of \$65.9 million declined by 20% sequentially and 39% year over year. Services and subscription revenue of \$38.9 million declined by 4% sequentially, however, grew 7% year over year. As a result, services and subscription represented 37% of total revenues up from 33% last quarter and from 25% a year ago.

**Revenue from the appliance platforms grew in Q1:02 to over 40% of total revenues.** Nokia continues to generate the vast majority of this revenue.

**Geographical breakdown was similar to last quarter.** In Q1:02, revenues from North America represented 42% of total revenues, Europe represented 40% and Asia Pacific represented 18% of total revenues, similar to last quarter.

## OPERATING ANALYSIS

**Gross margins declined by 60 basis points sequentially to 95.6% in Q1:02**, however, grew by 250 basis points year-over-year.

**Operating margins declined by 21% sequentially from 65.0% in Q4:01 to 60.0% in Q1:02.** Operating expenses declined by approximately \$1 million, or 3% sequentially. Headcount remained flat in Q1:02 and Check Point ended the quarter with approximately 1,200 employees. We expect sales and marketing expenses to grow in absolute dollars over the next few quarters in order to support expansion into more VPN-oriented products.

**Tax rate.** We are modeling a 16% tax rate for 2002. The tax rate for Q1:02 was 15.2%. The company's guidance for tax rate 2002 is 15-17%.

## BALANCE SHEET ANALYSIS

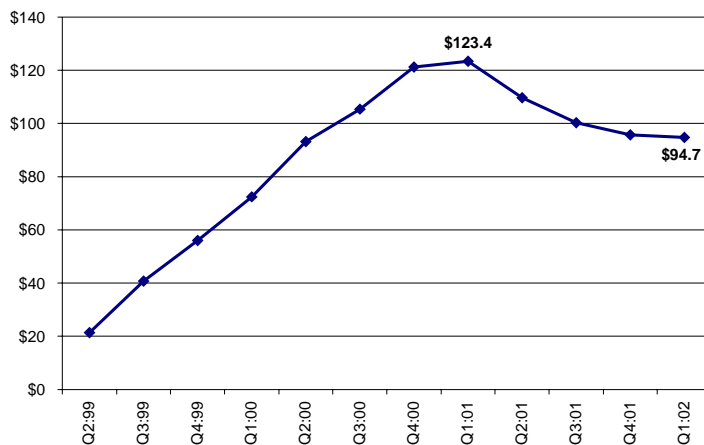
**Check Point's cash balance grew by \$78 million or 7.5% to \$1.1 billion at the end of Q1:02.** The company generated operating cash flow of \$78.4 million in Q1:02 versus \$84 million in Q4:01.

**DSOs declined by three days to 54 days in Q4:01** from 57 days in Q4:01 (versus 64 in Q3:01) as collections improved.

**Deferred revenue declined by less than \$1 million (or 1%) to approximately \$95 million at the end of Q1:02.** Deferred revenue has declined for the last four quarters from \$123.4 million at the end of Q1:01 to \$94.7 million at the end of Q1:02. Deferred revenues consist of: 1) the portion of maintenance revenue that will be recognized over the remaining term of a contract, and 2) product revenues that have not yet been recognized due to certain contingencies in a contract. The majority of the deferred revenue balance is comprised of maintenance revenue. Check Point management commented that they expect deferred revenues to fluctuate plus/minus \$5 million per quarter in the near term.

Check Point Deferred Revenue

(in millions)	<u>Q3:99</u>	<u>Q4:99</u>	<u>Q1:00</u>	<u>Q2:00</u>	<u>Q3:00</u>	<u>Q4:00</u>	<u>Q1:01</u>	<u>Q2:01</u>	<u>Q3:01</u>	<u>Q4:01</u>	<u>Q1:02</u>
<b>Deferred Revenue</b>	<b>\$40.8</b>	<b>\$56.0</b>	<b>\$72.4</b>	<b>\$93.2</b>	<b>\$105.4</b>	<b>\$121.2</b>	<b>\$123.4</b>	<b>\$109.6</b>	<b>\$100.3</b>	<b>\$95.7</b>	<b>\$94.7</b>
<i>Q/Q Change</i>	<i>\$19.4</i>	<i>\$15.2</i>	<i>\$16.4</i>	<i>\$20.7</i>	<i>\$12.2</i>	<i>\$15.8</i>	<i>\$2.2</i>	<i>(\$13.7)</i>	<i>(\$9.3)</i>	<i>(\$4.6)</i>	<i>(\$1.0)</i>
<i>as a %</i>	<i>90%</i>	<i>37%</i>	<i>29%</i>	<i>29%</i>	<i>13%</i>	<i>15%</i>	<i>2%</i>	<i>-11%</i>	<i>-9%</i>	<i>-5%</i>	<i>-1%</i>



Source: Company Reports

## OUTLOOK

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**We are revising our estimates.** We are lowering our 2002 revenue estimate to \$463.5 million from \$472.2 million and our EPS estimate to \$1.07 from \$1.09. We are also lowering our 2003 revenue estimate to \$589.0 million from \$603.2 million, however, raising our EPS estimate to \$1.32 from \$1.28.

# Company Info

## **The Company**

Check Point Software, located in Redwood City, CA, provides Internet and network security software products that enable connectivity with security and manageability. Check Point's Secure Virtual Network (SVN) platform provides a secure Internet environment that enables secure and seamless Internet connectivity between networks, systems, applications and users across the Internet, intranets and extranets. The company's market-leading firewall and VPN technology provide easy to use software solutions that enable system administrators to define and enforce an integrated, centrally managed enterprise-wide network security policy. Check Point's products address the increasing demand for network security solutions, which has been fueled by the rapid growth of the Internet and the emergence of corporate intranets.

## **Investment Thesis**

Check Point is a market leader in the rapidly expanding market for VPNs, firewalls, and security servers, which enable corporations to use the information and networking resources of the Internet with confidence. Check Point's product leadership, leverage to indirect distribution, strong brand, and aggressive management can sustain rapid and profitable growth.

## **Investment Risks**

Among the risks are competition from security focused companies as well as companies focused on providing hardware and software to the enterprise network market, including Cisco Systems(a), IBM, Microsoft(a), and from other emerging and established companies such as AT&T.

**Our rating system is based upon 12-month price targets that assume a flat market.**

For stocks with market cap of \$2 billion or greater:

**Strong Buy** describes stocks that we expect to appreciate by 25% or more.

**Buy** describes stocks that we expect to appreciate by 10-25%.

**Market Perform** describes stocks that we expect to change plus or minus 10%.

**Market Underperform** describes stocks that we expect to decline by more than 10%.

For stocks with market cap of less than \$2 billion:

**Strong Buy** describes stocks that we expect to appreciate by 50% or more.

**Buy** describes stocks that we expect to appreciate by 20-50%.

**Market Perform** describes stocks that we expect to change plus or minus 20%.

**Market Underperform** describes stocks that we expect to decline by more than 20%.

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### **Dane E. Lewis**

Dane, a principal and senior research analyst, focuses on infrastructure systems and software providers with specific attention on network storage and Internet security companies. Before joining Robertson Stephens, Dane was a manager at Arthur Andersen in its technology consulting practice. He received his BS in business administration from the University of California, Berkeley, and his MBA from the Anderson School at UCLA.

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**CHECK POINT SOFTWARE**  
Earnings Model

FY December	-----2001-----				-----2002E-----				-----2003E-----				Year	
	Q1	Q2	Q3	Q4	Q1A	Q2	Q3	Q4	Q1	Q2	Q3	Q4		Year
<b>REVENUES</b>														
License	\$108,710	\$102,071	\$80,616	\$82,095	\$373,492	\$65,887	\$74,016	\$83,468	\$292,334	\$86,226	\$93,251	\$96,212	\$108,305	\$385,995
	0.1%	-6.1%	-21.0%	1.8%	-19.7%	4.7%	7.3%	12.8%	23.5%	3.3%	8.1%	5.3%	10.3%	23.2%
Q/Q Growth														
Y/Y Growth	80.7%	48.2%	-8.6%	-24.4%	-39.4%	-32.4%	-8.2%	1.7%	-21.7%	30.9%	35.2%	32.7%	29.8%	32.0%
Services & Subscription	36,300	40,000	37,416	40,435	154,151	38,696	44,032	47,565	171,143	48,083	49,117	51,274	54,560	203,033
	14.2%	10.2%	-6.5%	8.1%	-4.3%	5.6%	7.8%	8.0%	4.6%	1.1%	2.2%	4.4%	6.4%	4.1%
Q/Q Growth														
Y/Y Growth	101.7%	83.5%	34.6%	27.2%	6.6%	2.1%	17.7%	17.6%	11.0%	24.3%	20.2%	16.4%	14.7%	18.6%
<b>TOTAL REVENUE</b>	\$145,010	\$142,071	\$118,032	\$122,530	\$527,643	\$104,583	\$118,048	\$131,033	\$463,477	\$134,309	\$142,368	\$149,486	\$162,865	\$589,028
Q/Q Growth	3.3%	-2.0%	-16.9%	3.8%	-14.6%	5.0%	7.5%	11.0%	-12.2%	2.5%	6.0%	5.0%	9.0%	27.1%
Y/Y Growth	85.5%	56.7%	1.7%	-12.7%	-27.9%	-22.7%	0.0%	6.9%	-12.2%	28.4%	29.6%	26.6%	24.3%	27.1%
<b>COST OF SALES</b>	10,078	6,464	5,368	4,661	26,571	4,615	5,430	6,421	21,407	6,715	7,261	7,833	8,697	30,506
COGS % of Sales	6.9%	4.5%	4.5%	3.8%	5.0%	4.4%	4.6%	4.9%	4.6%	5.0%	5.1%	5.2%	5.3%	5.2%
<b>GROSS PROFIT</b>	134,932	135,607	112,664	117,869	501,072	99,968	112,618	124,613	442,069	127,594	135,107	141,653	154,168	558,522
Gross Margin	93.1%	95.5%	95.5%	96.2%	95.0%	95.6%	95.4%	95.1%	95.4%	95.0%	94.9%	94.8%	94.7%	94.8%
<b>OPERATING EXPENSES</b>														
Sales & Marketing	30,382	28,714	23,500	26,490	109,086	25,033	27,505	30,269	108,723	31,563	33,172	34,681	37,459	136,874
S&M % of Sales	21.0%	20.2%	19.9%	21.6%	20.7%	23.9%	23.3%	23.1%	23.5%	23.5%	23.3%	23.2%	23.0%	23.2%
R & D	9,320	9,049	7,511	7,341	33,221	7,399	8,027	8,517	31,630	8,864	9,396	9,866	10,586	38,713
R&D % of Sales	6.4%	6.4%	6.4%	6.0%	6.3%	7.1%	7.0%	6.5%	6.8%	6.6%	6.6%	6.6%	6.5%	6.6%
General & Administrative	6,538	6,145	4,877	4,442	22,002	4,837	5,194	5,503	20,586	5,775	5,979	6,129	6,515	24,398
G&A % of Sales	4.5%	4.3%	4.1%	3.6%	4.2%	4.6%	4.4%	4.2%	4.4%	4.3%	4.2%	4.1%	4.0%	4.1%
Total Operating Expenses	46,240	43,908	35,888	38,273	164,309	37,269	40,727	44,289	160,939	46,202	48,547	50,676	54,560	199,985
Op Ex % of Sales	31.9%	30.9%	30.4%	31.2%	31.1%	35.6%	34.5%	33.8%	34.7%	34.4%	34.1%	33.9%	33.5%	34.0%
Operating Income	88,692	91,699	76,776	79,596	336,763	62,699	71,891	80,323	281,130	81,391	86,560	90,977	99,608	358,537
Operating Margin	61.2%	64.5%	65.0%	65.0%	63.8%	60.3%	60.9%	61.3%	60.7%	60.6%	60.8%	60.9%	61.2%	60.9%
Interest Income	10,101	11,574	11,440	11,645	44,760	12,227	12,454	13,232	50,612	13,821	14,421	15,057	15,726	59,026
Pretax Income	98,793	103,273	88,216	91,241	381,523	74,926	84,590	93,556	331,742	95,213	100,981	106,035	115,334	417,562
Pretax Margin	68.1%	72.7%	74.7%	74.5%	72.3%	71.6%	71.7%	71.6%	71.6%	70.9%	70.9%	70.9%	70.8%	70.9%
Provision for income taxes	15,115	16,472	13,911	14,105	59,603	11,390	12,587	14,969	52,481	15,234	16,157	16,966	18,453	66,810
Tax Rate	15.3%	15.9%	15.8%	15.5%	15.6%	15.2%	16.0%	16.0%	15.8%	16.0%	16.0%	16.0%	16.0%	16.0%
Net Income	83,678	86,801	74,305	77,136	321,920	63,536	71,056	78,587	279,262	79,979	84,824	89,069	96,880	350,752
Net Margin	57.7%	61.1%	63.0%	63.0%	61.0%	60.9%	60.2%	60.0%	60.3%	59.5%	59.6%	59.6%	59.5%	59.5%
<b>OPERATING EPS</b>	\$0.32	\$0.33	\$0.29	\$0.30	\$1.24	\$0.25	\$0.27	\$0.30	\$1.07	\$0.30	\$0.32	\$0.33	\$0.36	\$1.32
Y/Y Growth	141.0%	101.2%	22.9%	-2.9%	46.9%	-23.3%	-23.8%	-5.3%	-13.6%	23.4%	25.8%	22.9%	20.8%	23.1%
<b>Shares Outstanding</b>	261,779	260,440	259,124	258,893	260,059	259,042	261,639	262,947	260,991	264,262	265,583	266,911	268,246	266,250
<b>Revenue Mix</b>														
License	75.0%	71.8%	68.3%	67.0%	63.0%	63.0%	62.7%	63.7%	63.1%	64.2%	65.5%	65.2%	66.5%	65.5%
Service	25.0%	28.2%	31.7%	33.0%	37.0%	37.0%	37.2%	36.3%	36.9%	35.8%	34.5%	34.3%	33.5%	34.5%
<b>BALANCE SHEET</b>														
Cash & Short-term Investments	\$764,528	\$868,082	\$944,248	\$1,029,233	\$1,106,729	\$77,496	\$62,699	\$62,699	\$62,699	\$1,106,729	\$77,496	\$62,699	\$62,699	\$62,699
Change in cash	\$106,829	\$103,554	\$76,166	\$84,985	\$77,496	\$62,699	\$62,699	\$62,699	\$62,699	\$77,496	\$62,699	\$62,699	\$62,699	\$62,699
A/R	\$86,597	\$86,889	\$77,101	\$74,294	\$62,699	\$62,699	\$62,699	\$62,699	\$62,699	\$62,699	\$62,699	\$62,699	\$62,699	\$62,699
DSO	54	61	64	57	54	54	54	54	54	54	54	54	54	54
Deferred Revenue	\$123,375	\$109,647	\$100,316	\$95,703	\$94,749	\$94,749	\$94,749	\$94,749	\$94,749	\$94,749	\$94,749	\$94,749	\$94,749	\$94,749
Change in deferred revenue	1.8%	-11.1%	-8.5%	-4.6%	-1.0%	-1.0%	-1.0%	-1.0%	-1.0%	-1.0%	-1.0%	-1.0%	-1.0%	-1.0%

(1) Non-operating items not included in operating EPS.

Source: Company reports & Robertson Stephens estimates