ING BARINGS

Company results

Israel

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Check Point

Record margins …again

Previously: Strong Buy

Buy

22 October 2001

Software & computer services

19/10/01
US$31.9

Est fair value
US$41.3

Bloomberg
CHKP

Revenue and EPS were in line with expectations at US$118m and US$0.29 respectively. Despite the current slowdown the company continues to attain high margins. The VPN market still provides much room for growth. BUY.

Check Point's 3Q01 results were in line with expectations. For 4Q01 the company's guidance of US$120-125m revenues and EPS of US$0.28-0.30 is conservative in our view. We forecast revenues of US$128.5m and EPS of US$0.31.

Check Point remains the market leader in software firewall and VPN with market shares of 39% and 65% respectively (Infonetics, 2Q01). The firewall market is nearing saturation, particularly in the US where market penetration has reached over 94% in large enterprises. In Europe, penetration is between 40-80%. We expect a price war to ensue as players try to hold on to market share.

Remote access and site-to-site VPN penetration reached over 30% and 50% in medium and large US enterprises in 2000. Extranet VPN penetration is lower at 13% and 24% in the same markets. VPN penetration is lower in Europe and Asia Pacific.

At the current share price, a share buyback makes not just psychological sense but economic sense too.

Forecasts and ratios

Yr to	Sales (US$000)	EBITDA (US$000)	Net profit (US$000)	EPS (US$)	EPS (%ch)	EV/ EBITDA (x)	EV/ Sales (x)	PER (x)	PCF (x)	P/BV (x)
12/02F	613,626	391,187	358,576	1.34	7.6	15.6	9.9	23.8	20.0	7.1
12/01F	533,588	345,073	324,954	1.25	48.8	18.9	12.2	25.6	21.2	9.9
12/00F	425,283	232,942	221,213	0.84	116.9	29.6	16.2	38.0	29.2	16.4
12/99	219,567	100,526	95,781	0.39	28.9	71.5	32.7	82.5	54.7	27.0
12/98	141,941	71,365	69,877	0.30	N/A	102.8	51.7	106.3	105.7	42.3

Key ratios (%)

	2001F	2002F
Gross margin	94.7	94.6
EBITDA margin	64.7	63.8
Operating margin	63.9	63.0
Net margin	60.9	61.6
ROE	48.1	36.8
ROA	34.5	27.4

Performance (%)

	Absolute	Relative to Nasdaq
1mth	18.6	8.4
3mths	-20.0	-2.0
6mths	-60.1	-47.9
52 week (US$)	**High**	**Low**
	113.3	20.7

Share data

Market cap (US$m)	7,541
Share price (US$)	31.9
Previous fair value (US$)	43.3
Current fair value (US$)	41.3
Upside (%)	29

Share price performance (US$)

Source: Reuters

Valuation

Our valuation of Check Point is based on DCF calculations, which is an absolute valuation methodology. We maintained the risk premium used to obtain the required return at 100% of the risk-free rate. We have defined the risk-free rate as 10-year US Treasury bonds, which currently yield 4.7%.

To forecast the company's revenue growth we are guided by various sources, including market research and forecasts in the security markets, particularly in the Virtual Private Network (VPN) and firewall markets. Using these various studies as a framework, we forecast a compound annual growth rate (CAGR) between 2000-05 of 28.9%. Penetration rates in the various VPN markets in different geographic regions are expected to show a CAGR between 2000-05 of 22-35%. We forecast steadily declining prices in the VPN space as penetration rates increase.

These forecasts do not include Asia Pacific, which is estimated to grow at a faster rate since this is the region with the lowest VPN penetration (specific details in *Security Market* section below). Moreover, the CAGR figures do not include upgrades or expansion of branches, which we believe could ultimately result in a higher CAGR for the VPN market as a whole. According to a recent IDC forecast, the worldwide software security market will reach over US$14bn in 2005. Our 2005 revenue forecast for Check Point is US$1.5bn, which implies about a 10% share of the total software security market.

Due to higher penetration rates expected in the VPN market to 2005 and onwards, we forecast a steady decline in gross margins from recent levels of 95.5% to 80% in 2007. We expect operating margins to decline to about 46.5% in 2007 from this quarter's 65% level. Net margins, as a result of the above and an expected higher tax rate for Check Point (25.5% versus about 15.8% today), are forecast to reach 34.6% versus 61% expected in FY01 (see Figure 1).

Fig 1 Income statement forecast (US$000)

	2000	2001F	2002F	2003F	2004F	2005F	2006F	2007F
Revenue	**425,283**	**533,588**	**613,626**	**846,804**	**1,143,186**	**1,512,435**	**1,951,041**	**2,419,290**
Cost of sales	35,265	28,077	33,136	67,744	148,614	241,990	390,208	483,858
Gross profit	**390,018**	**505,511**	**580,490**	**779,060**	**994,571**	**1,270,445**	**1,560,832**	**1,935,432**
Net R&D expenses	30,309	33,589	36,818	59,276	80,023	105,870	136,573	169,350
Sales & marketing	110,003	108,291	131,930	186,297	251,501	332,736	429,229	532,244
General & administrative	20,409	22,827	25,159	38,106	51,443	68,060	87,797	108,868
Sequential growth	**229,297**	**340,804**	**386,585**	**495,380**	**611,604**	**763,779**	**907,234**	**1,124,970**
Net financial income (expenses)	29,147	44,918	42,848	55,847	71,950	90,951	113,382	140,898
Pre-tax income	**258,444**	**385,722**	**429,432**	**551,227**	**683,554**	**854,730**	**1,020,616**	**1,265,868**
Income taxes	37,231	60,768	70,856	96,464	133,293	183,767	239,845	322,796
Post-tax income	**221,213**	**324,954**	**358,576**	**454,763**	**550,261**	**670,963**	**780,771**	**943,072**
EPS (US$)	**0.84**	**1.25**	**1.34**	**1.66**	**1.96**	**2.33**	**2.65**	**3.12**
Shares outstanding – diluted (m)	263,710	260,336	267,000	273,675	280,517	287,530	294,718	302,086
Shares outstanding – basic (m)	233,050	238,985						
PER (x)	**38**	**26**	**23**	**21**	**18**	**15**	**14**	**11**
Margin analysis								
Gross (%)	91.7	94.7	94.6	92.0	87.0	84.0	80.0	80.0
Operating (%)	53.9	63.9	63.0	58.5	53.5	50.5	46.5	46.5
Net (%)	52.0	60.9	61.6	48.3	43.1	39.6	35.6	34.6

Source: Company data, ING Barings estimates

Fig 2 Discounted cash flow model (US$000)

	2001F	2002F	2003F	2004F	2005F	2006F	2007F
Revenues	533,588	613,626	846,804	1,143,186	1,512,435	1,951,041	2,419,290
EBIT	**340,804**	**386,585**	**495,380**	**611,604**	**763,779**	**907,234**	**1,124,970**
Previous EBIT estimates	*338,298*	*399,907*	*507,829*	*624,900*	*746,476*	*962,954*	*1,194,063*
Adjusted tax	53,692	63,786	86,692	119,263	164,213	213,200	286,867
Operating profit after tax	**287,112**	**322,798**	**408,689**	**492,341**	**599,567**	**694,034**	**838,103**
Depreciation	4,269	4,602	7,397	11,512	16,503	22,356	29,614
Capital expenditures	(6,347)	(6,136)	(9,315)	(13,718)	(16,637)	(19,510)	(24,193)
Change in working capital	(30,809)	(20,405)	(35,368)	(30,062)	(56,545)	(55,975)	(57,361)
Free cash flow	**254,225**	**300,859**	**371,403**	**460,074**	**542,888**	**640,905**	**786,163**
Terminal value	**12,865,983**						
Valuation model							
Long-term bond yield (%)		4.7					
Risk premium (of RFR,%)		100					
Risk premium		4.7					
Required return (%)		**9.4**					
Terminal growth (%)		**4.0**					
Tax for terminal value (%)		**36.0**					
FCF	**254,225**	**300,859**	**371,403**	**460,074**	**542,888**	**640,905**	**786,163**
NPV period	0.2	1.2	2.2	3.2	4.2	5.2	6.2
Discount factor (%)	98.2	89.8	82.1	75.0	68.6	62.7	57.3
PV	249,698	270,111	304,794	345,122	372,252	401,701	450,407
PV of FCF	2,394,086						
PV of terminal value	7,371,156						
NPV	9,765,242						
Net cash (debt) 2000	944,248						
Equity value	10,709,490						
Equity value per share (US$)	**41.33**						

Source: Company reports, ING Barings estimates

DCF fair value is US$41.3, slightly below the previous US$43.3

Recommendation changed to BUY from STRONG BUY

Our fair value has been slightly lowered to US$41.3, from US$43.3, because of lower sales expectations going forward. Since 28 September the shares have advanced 54% from US$20.7 (see our note of that date). Our fair value of US$41.3 implies a 29% upside from the current share price, and therefore we have lowered our recommendation from **STRONG BUY** to **BUY**. We believe that Check Point's highly regarded management team will maintain the company's market leadership in the firewall and VPN markets.

3Q01 results

The fall in revenue estimates is predominantly due to the 11 September attacks

As the company reported in its 3Q01 results preview on 3 October, revenues came in at US$118m and EPS was US$0.29. During the quarter, YoY revenue growth was a mere 1.7%, but this was an exceptional quarter because of the 11 September attacks. For the nine-month period, revenues increased 42.2% YoY, while net income and EPS increased 74.6% and 76.8% respectively. We estimate that Check Point's sales prior to the attack were proceeding at a run-rate of about US$125m, and including US$10m from deferred revenues, 3Q01 turnover could have been approximately US$135m. According to our estimates, revenues plummeted 70-80% immediately following the terrorist attacks on the US. The company estimates that US$15-20m in revenue shortfall was due to the freeze in business activities following the attacks.

Gross margins were unchanged from the last quarter at 95.5%, while operating and net margins were at a record-breaking 65% and 63%, respectively. Operating expenses were reduced from US$43.9m (20.2% of revenues) to US$35.9m (19.9% of revenues) with cost reductions of discretionary expenses coming from R&D and

SG&A. According to management, the company did not lay-off any employees but actually increased headcount by 25 during 3Q01.

Cash position increased by US$78.2m to US$944m

The company's cash position increased by US$78.2m during the quarter and is now at US$944m (US$3.64 per share diluted). Despite the higher cash position, financial income was down QoQ from US$11.6m to US$11.4m because of lower US interest-rates. The lower interest rate the company is receiving on its cash and the low share price raises the possibility of share buybacks.

Share buybacks make economic sense below US$35.8

Share buybacks are economically sensible when they allow a company to increase its EPS. Our calculations show that at current interest rates of 3.5% after tax, Check Point's breakeven share price is US$35.8, therefore buying back shares at a price lower than US$35.8 would increase EPS. For example, a buyback of US$100m at a price between US$20-33.5 would increase EPS by US$0.01 per year (after deducting the financial income forgone by investing the money in the buyback).

Figure 3 shows the increase in EPS per year as the company buys back shares at different prices and various amounts of money. Note that although a buyback theoretically makes economic sense at the current price level, the cash used becomes illiquid just as a dividend funnels cash from the company to its shareholders. Management must, therefore, look to other options for its cash that may bring a higher return to shareholders other than interest income or share buybacks.

Fig 3 EPS increase from share buybacks (US¢)

	Amount spent on buybacks (US$m)				
Share price (US$)	**100**	**200**	**300**	**400**	**500**
35	0	0	1	1	1
30	1	1	1	2	2
25	1	2	2	3	4
20	1	3	4	5	6
15	2	4	7	8	11
10	4	8	12	17	22

Source: ING Barings estimates

Deferred revenues were down by about US$9.3m, slightly lower than US$10m we expected. Deferred revenue now stands at US$100.3m and is made up of approximately 80% service revenues and 20% beta-type sales.

Company guidance and our forecasts

The company has lowered its guidance for 4Q01 and expects revenues of US$120-125m and EPS in the range of US$0.28-0.30. We believe this to be a very conservative estimate for several reasons:

- Some of the sales that were delayed because of the 11 September attacks were already received at the beginning of 4Q01.
- In the past, new product releases took between three-six months to catch on. Check Point's Next Generation (NG) products, released at the beginning of 3Q01, should help boost sales in 4Q01, especially as new hardware platforms (like Nokia's), which will have the NG software embedded, are to be released in the next few weeks.
- The fourth quarter is traditionally strong because IT managers spend their remaining budgets. Although this year may be different because of the economic slowdown, we believe there could still be a certain positive effect on sales.

We forecast 4Q01 revenues of US$128.5m and EPS of US$0.31

Therefore, we estimate that Check Point's revenues will be higher than management's guidance in 4Q01 at US$128.5m and estimate EPS to be higher at US$0.31. Although management did not give guidance for FY02, until the business environment clears, we have lowered our revenue estimates from US$651.3m to US$613.6m. But, in light of the company's sustained high gross margin level, we have increased our gross margin estimates from 93% to 94.6%. We have modelled operating and net margins at 63% and 61.6%, respectively. We estimate Check Point's FY02 EPS will be US$1.34.

Company highlights

- Check Point has achieved security performance of up to 3.2Gbps on a new "Secured by Check Point" appliance from Nortel Systems. Management expects that in FY02 performance levels will reach up to 10Gbps.
- Expanded relationship with new and existing hardware appliance vendors, such as Celestix, Nortel and Crossbeam (targeting the high-end – over 3Gbps). Nokia is expected to release a new appliance with Check Point's NG in a few weeks. The relationships with Compaq and Intrusion.com continue.
- The company launched a new web-based business portal that provides partners and users with an efficient single source for enterprise licensing of Check Point products, software subscriptions and support programs. This should also help Check Point understand its customer base and needs.
- To utilise the anticipated fast growth rate in Asia Pacific (see Security Market segment below), the company established a subsidiary in China in addition to its existing offices in Singapore, Australia and Japan.
- Check Point's Open Platform for Security (OPSEC) Alliance Program continues to grow to more than 300 internet security companies.

Security market

According to a report by IDC, published in August 2001, all security software markets – firewalls, encryption software, security authentication, authorisation and administration (3A), and anti-virus – grew 25% or more during 2000. Of these, firewall software showed the highest growth rate of 42% for the year. Overall, worldwide internet security software revenue increased 33% to US$5.1bn during 2000, and IDC forecast that the worldwide software security market revenues will increase to more than US$14bn by 2005. This implies a compound annual growth rate (CAGR) of about 23% for 2000-05.

Furthermore, IDC believes that North America will account for approximately 52% of worldwide internet security software revenue in 2005. Asia Pacific is forecast to be the fastest growing region for internet security software, with revenues increasing at a 2000-05 CAGR of about 32%. This growth should increase the region's market share from 12% in 2000 to 17% in 2005.

The US firewall market is saturated

On the other hand, a recent report published by Infonetics indicates that the firewall market is showing clear signs of reaching saturation point. This is particularly evident in the US large business segment where penetration is 94%. Small and medium sized businesses in the US were at 66% and 83% in 2000. The expected five-year CAGR in penetration rates in the US and Europe is very low. The implication of a saturated firewall market, in our view, is likely to be a price war between the US players in order to maintain market share. The next stage in the life cycle of the industry is usually categorised by a consolidation process.

High growth rates expected to continue in the VPN market

More importantly, Infonetics' research shows VPN penetration rate during 2000 in the various different segments and geographic regions and forecasts penetration of VPNs in 2005. The expected 5-year CAGR may be calculated from the survey and is shown in Figure 4. The average five-year growth rate in penetration in the various VPN segments is between 22-35%. Not surprisingly, the extranet VPN market (used to connect suppliers and customers to a network, usually for B2B transactions) is the least penetrated and, therefore, is due to show the fastest growth in the following five-year period. However, the CAGR is for penetration, and the figures do not include upgrades or expansion of branches, which we believe could ultimately result in a higher CAGR for the VPN market as a whole.

Highest growth rate expected in Asia Pacific region

Furthermore, it is important to note that the survey did not include Asia Pacific, which we anticipate will show higher future growth rates because of lower penetration in this region. For instance, Check Point's revenues from the rest of the world (including Asia Pacific but excluding the US and Europe) has been around 17-18%, while the US and Europe comprised around 47% and 36%, respectively.

Check Point estimates that VPNs have penetrated 15-20% of enterprises worldwide. The Infonetics survey shows a penetration rate of over 50% in remote access and site-to-site VPNs in large US enterprises. The research also shows a lower penetration rate in Europe, and we believe that penetration in Asia Pacific is even smaller.

Fig 4 VPN penetration figures (%)

Remote access VPN penetration		**2000**	**2005F**	**Forecast 5yr CAGR**
US	Small business	13	50	31
	Medium business	31	72	18
	Large business	52	86	11
Europe	France	10	47	36
	Germany	11	49	35
	Scandinavia	20	67	27
	Spain	16	50	26
	UK	23	55	19
Site-to-site VPN penetration				
US	Small business	11	42	31
	Medium business	33	72	17
	Large business	56	84	8
Europe	France	12	39	27
	Germany	13	41	26
	Scandinavia	19	57	25
	Spain	14	44	26
	UK	18	43	19
Extranet VPN penetration				
US	Small business	7	30	34
	Medium business	13	51	31
	Large business	24	61	21
Europe	France	6	33	41
	Germany	7	37	40
	Scandinavia	9	46	39
	Spain	8	51	45
	UK	10	40	32

Source: Infonetics Research

Market share

Market share studies are often confusing

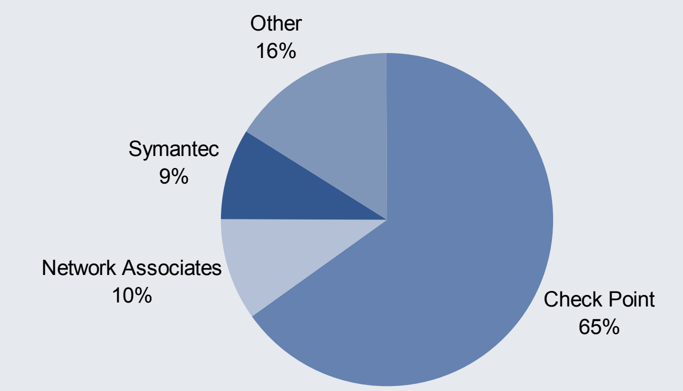
Market share studies are frequently unclear because the various market research companies use different definitions and assumptions for a particular market. The market research that suites a particular company most will often be quoted by that company to help support its own interests and objectives (particularly in marketing). This leads to further confusion as each market player quotes different market research showing it as the market leader.

The firewall and VPN markets are no exception; in fact, these markets are very much intertwined, which causes a wide variation in estimated market size and share from market forecasters. This is due to the different definitions market research companies use for the firewall and VPN markets. There is often a considerable overlap between the firewall and VPN markets due to the fact that certain products are considered dual-purpose, and their end-use as a firewall or VPN or both is frequently not known to the market research company.

Check Point dominates software VPN market with a 65% share

Although not a complete picture, the most relevant market share study to gauge Check Point's standing in the firewall and VPN markets, in our opinion, is the Infonetics study of firewall and VPN software markets (see Figure 5). This market research shows that Check Point clearly dominates the VPN software market by revenue to the end-user with a 65% stake during 2Q01; although, Check Point's market share has declined from its peak of 76% in 3Q00.

Fig 5 Worldwide VPN software market share by end-user revenue (2Q01)



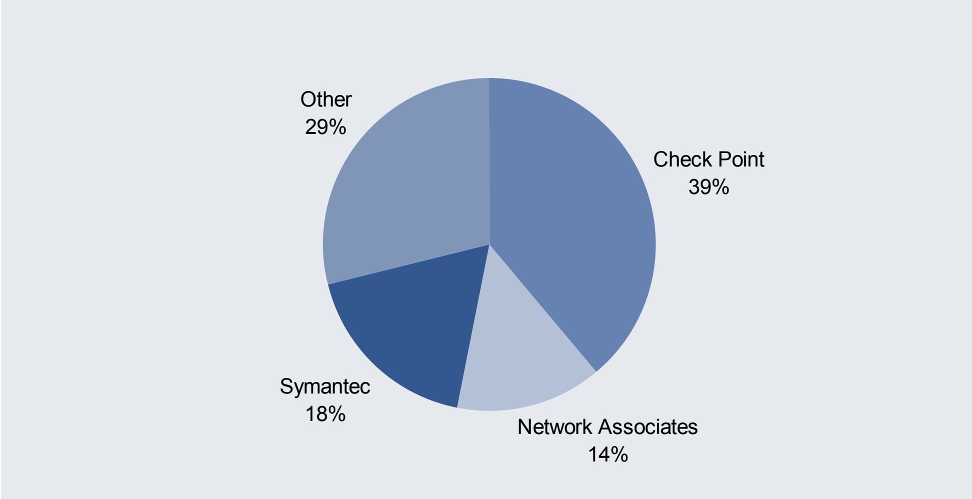
Source: Infonetics Research

Check Point's share of the firewall software market is 39%

Check Point also continues to lead the software firewall market by revenue to the end-user during 2Q01 with 39% market share. Here again, Check Point's market share has declined from the 52% high achieved during 2000.

Studying the available market share information on hardware appliances usually causes much confusion and does not often aid in deciphering market share in the wider definition of the firewall and VPN markets. First, this is because these market share reports do not specify which appliances use the various software solutions (like Check Point) on the hardware platform. Second, the firewalls and VPNs based on servers are not represented in these surveys.

Fig 6 Worldwide firewall software market share by end-user revenue (2Q01)



Source: Infonetics Research

In conclusion, the market share data and VPN penetration figures indicate to us that the current slowdown in Check Point's results are due to macroeconomic issues and not to a company or market specific problem.

Financials

Fig 7 Income statement (US$000)

	FY00	1Q01	2Q01	3Q01	4Q01F	FY01F	FY02F
Revenue	**425,283**	**145,010**	**142,071**	118,032	128,475	**533,588**	**613,626**
Cost of sales	35,265	10,078	6,464	5,368	6,167	28,077	33,136
Gross profit	**390,018**	**134,932**	**135,607**	**112,664**	**122,308**	**505,511**	**580,490**
Net R&D expenses	30,309	9,320	9,049	7,511	7,709	33,589	36,818
Sales & marketing	110,003	30,382	28,714	23,500	25,695	108,291	131,930
General & administrative	20,409	6,538	6,145	4,877	5,267	22,827	25,159
Operating income	**229,297**	**88,692**	**91,699**	**76,776**	**83,637**	**340,804**	**386,585**
Net financial income (expenses)	29,147	10,101	11,574	11,440	11,803	44,918	42,848
Pre-tax income	**258,444**	**98,793**	**103,273**	**88,216**	**95,440**	**385,722**	**429,432**
Income taxes	37,231	15,115	16,472	13,911	15,270	60,768	70,856
Post-tax income	**221,213**	**83,678**	**86,801**	**74,305**	**80,170**	**324,954**	**358,576**
Fully diluted EPS (US$)	0.84	0.32	0.33	0.29	0.31	1.25	1.34
Shares outstanding (m) - diluted (post split)	263,710	261,779	260,440	259,124	260,000	260,336	267,000
Margin analysis							
Gross (%)	91.7	93.1	95.5	95.5	95.2	94.7	94.6
Operating (%)	53.9	61.2	64.5	65.0	65.1	63.9	63.0
Net (%)	52.0	57.7	61.1	63.0	62.4	60.9	61.6

Source: Company data, ING Barings estimates