Zacks Small-Cap Research

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Ken Nagy, CFA

www.zacks.com
111 North Canal Street, Chicago, IL 60606

Commtouch Software (CTCH-NASDAQ)

CTCH: Solid Quarter, Mobile Holds Potential- OUTPERFORM

Current Recommendation	**Outperform**
Prior Recommendation	N/A
Date of Last Change	09/13/2009
Current Price (02/10/12)	$3.38
Target Price	**$4.50**

OUTLOOK

Commtouch Software a provider of email defense and URL filtering solutions to enterprise customers and OEM distribution partners. The firm's "in the cloud" technology has the ability to analyzes 2.5 billion messages a day, which is far superior to the competition's static solutions which have little chance of catching new outbreaks. During late 2008, the Company released its URL filtering services. The web has more than double the revenue potential of the messaging market. The firm's OEM business model gives Commtouch the advantage of recurring revenue, higher margins and less exposure to the end markets. We see value in the shares of Commtouch and rate it outperform.

SUMMARY DATA

52-Week High	**$3.98**
52-Week Low	**$2.93**
One-Year Return (%)	**-5.63**
Beta	**0.93**
Average Daily Volume (sh)	**7,309**
Shares Outstanding (mil)	**24**
Market Capitalization ($mil)	**$83**
Short Interest Ratio (days)	**0.51**
Institutional Ownership (%)	**7**
Insider Ownership (%)	**N/A**
Annual Cash Dividend	**$0.00**
Dividend Yield (%)	**0.00**
5-Yr. Historical Growth Rates	
Sales (%)	**23.5**
Earnings Per Share (%)	**48.1**
Dividend (%)	**N/A**
P/E using TTM EPS	**13.5**
P/E using 2011 Estimate	**13.0**
P/E using 2012 Estimate	**10.2**
Zacks Rank	**3**

Risk Level	**Moderate**
Type of Stock	**Small-Growth**
Industry	**Internet-Servcs**

ZACKS ESTIMATES

Revenue
(in millions of $)

	Q1 (Mar)	Q2 (Jun)	Q3 (Sep)	Q4 (Dec)	Year (Dec)
2009	3.5 A	3.7 A	3.9 A	4.0 A	15.2 A
2010	4.1 A	4.1 A	4.6 A	5.4 A	18.2 A
2011	5.5 A	5.7 A	5.9 A	6.1 E	23.2 E
2012					27.0 E

Earnings per Share
(EPS is operating earnings before non recurring items)

	Q1 (Mar)	Q2 (Jun)	Q3 (Sep)	Q4 (Dec)	Year (Dec)
2009	$0.03 A	$0.04 A	$0.05 A	$0.05 A	$0.17 A
2010	$0.04 A	$0.05 A	$0.05 A	$0.06 A	$0.21 A
2011	$0.06 A	$0.06 A	$0.07 A	$0.07 E	$0.26 E
2012					$0.32 E

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WHATS NEW

On November 2, 2011, Commtouch Software, reported financial results for its third quarter and nine months ended September 30, 2011.

Commtouch reported mixed results with year over year third quarter revenues increasing $1.254 million or 27.3 percent to $5.855 million from $4.601 million for the comparable quarter of 2010. Third quarter 2011 GAAP net income dropped 16.1 percent or $170,000 to $887,000 from $1.057 million during the three months ended September 30, 2010.
The decrease was primarily due to slightly lower gross margin as well as a $711,000 year over year increase in total operating expense and an income tax provision of $275,000 in the third quarter of 2011 compared to an income tax benefit of $128,000 for the comparable quarter of 2010.

Still, non-GAAP net income for the third quarter of 2011 increased year over year by 13.1% to $1.773 million and non-GAAP earnings per diluted share for the third quarter of 2011 were $0.07 compared to $0.06 for the three months ended September 30, 2010.

Gross margin decreased moderately year over year from 84.4 percent to 82.6 percent for the three months ended September 30, 2011.

This marked the Company's third consecutive quarter of increasing operating margin as a result of increased revenue growth, execution of efficiency and improved synergies from acquisitions.

Based on a weighted average number of diluted common shares of 24.726 million, GAAP basic net income per share resulted in $0.04 per share. This compared to diluted net income per share of $0.04 on a weighted average number of diluted shares of 24.581 million during the three months ended September 30, 2010.

Commtouch's balance sheet continued to improve with cash and equivalents increasing by $4.214 million since the beginning of the year to $17.646 million and working capital improving by $1.487 million to $15.080 million for the period ended September 30, 2011.

Although results for the three months were mixed, Commtouch saw growing demand for its products, including the signing of a new agreement with a global communications leader, as well as increasing contracts with existing customers.

Additionally, management reaffirmed its guidance for its fiscal 2011 full year results and continues to expect revenues and net income to be in the mid-range of its previously provided guidance of revenues of between $22.5 million and $23.5 million, and net income of between $6.2 million and $6.7 million on a non-GAAP basis.

It should also be noted that in October, 2011, Mr. Shlomi Yanai was appointed as the Company's chief executive officer.

Mr. Yanai was previously the vice president of corporate development strategy at SafeNet, were he led strategic decisions regarding product and solution partnerships, as well as mergers and acquisitions. Moreover, Mr. Yanai expects to further develop untapped potential and leverage the Company's strong key assets which include its top tier customer base in cloud technology, its strong market traction in the internet security space and its top quality global team.

Mobile Holds Promise
The Company's GlobalView URL Filtering for Mobile products solution is the industry's first engine for the deployment of the secure web browsing, parental control and compliance applications for Android devices such as smart phones and tablets and is designed to provide real-time protection to end-users while browsing the web from mobile devices.

With substantial increases in mobile vulnerabilities, the mobile security client software market is expected to advance at a CAGR (Compound Annual Growth Rate) of 40 percent from 2010 to 2015.

Correspondingly, the Company continues to build on strategic assets by broadening the use of its cloud security platform and expanding into the mobile space.

Along the same lines, Commtouch expects to expand its solutions to other leading mobile operating systems besides the Android as well as expand its mobile offerings for other products besides URL filtering.

INVESTMENT THESIS

Netanya, Israel based Commtouch Software is a provider of email defense and URL filtering solutions to OEM distribution partners, including real-time anti-spam, Zero-Hour virus outbreak detection and Global View Mail Reputation services, as well as a URL Filtering service and Zombie Detection solution. The Company offers its solutions to security, networking and service providers, who then integrate them into their offerings to all market segments, including consumer, SMB, enterprise and service providers.

The solutions are also available for integration with security, content filtering, anti-virus and other filtering solutions through alliances and strategic technology partnerships. At the core of Commtouch's email defense offerings is Commtouch's proprietary Recurrent Pattern Detection (RPD) technology which, in general terms, analyzes messages associated with mass email outbreaks and directs the blocking of such emails, without the need to analyze individual messages. This all takes place in Commtouch's "cloud" infrastructure, which also forms the core of Commtouch's other products. At the core of Commtouch's URL filtering solutions is its "data cloud" architecture. The solution various feeds from worldwide sources – including Commtouch's own -- pertaining to URLs, and provides a ranking of the URLs tailored to the needs of each customer.

CTCH offers software development kits comprising various components, which enable third-party vendors to integrate its technologies anti-virus applications, content filtering solutions, firewall systems, security servers, and other network appliances. All of the solutions include a software element that is implemented within the vendor's own product, and a service component, that pulls updates in real time from the Commtouch Detection Center. The company's messaging security technologies can filter email at either the network perimeter, the gateway, or even at the end-customer desktop, depending on how it is integrated into the vendor's product. Its Detection Center collects information from various sources about new attacks, analyzes the input using Commtouch patented technology, identifies and detects spam/viruses, classifies the data, matches its stored information against incoming queries for spam/virus detection from its partners' devices, and replies in back with a prioritized resolution.

The game has changed. Profit is the new motive.
While the early days of virus release were more for notoriety or to be mischievous, today's spammers and hackers are motivated by profit. These new attacks could use a botnet or a zombie service to send hundreds of millions of email messages instantly. Specific examples include pump and dump schemes

or directing traffic to sites which they may earn a commission for click throughs. Static solutions are not effective against such programs. A real time service based solution is the best way to control the problem.

According to the market research firm Gartner there are short-term and long-term drivers when considering technology selection for security tools.

Short-term drivers:
• Prioritizing, choosing and maintaining security technologies continue to be top issues for enterprises because companies and government agencies face pressures to demonstrate compliance with the spirit and the letter of the law.

• Security spending is driven by a variety of pressing concerns. The most immediate is the need to "keep the bad guys out" through defensive measures, such as next-generation firewalls.

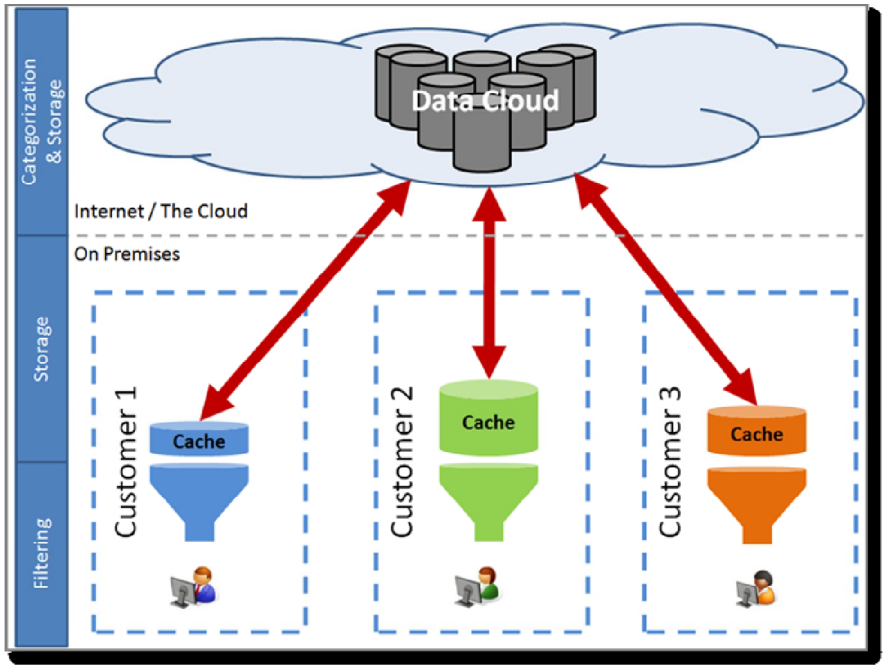
• Compliance with government regulations, such as SOX, continue to play a significant role in security spending decisions. Investment is often justified because the downside of breaches and failure is so great.

Long-term drivers:
• The need to have security tools in place to protect against malicious attacks and unintentional security incidents, such as leakage of sensitive corporate information, will remain. New risks in mobile and remote workplaces.

• A changing vulnerability and threat landscape and continuing requirements for compliance-related initiatives are driving vulnerability management programs to expand. Vulnerability management consists of a combination of technologies and processes to improve security posture.

• Increased regulations — such as SOX and HIPAA — dealing with reliability will continue to drive additional IT spending across the board, including information security.

How it works
As the user browses the web security device sends the requested URL to the Commtouch URLF solution within microseconds, its smart client checks the local cache for information. If it finds the relevant classification in the cache it extracts the necessary information, enabling integrating partners to determine if that URL should be allowed or blocked. (fully or partially) if the information does not reside in the local cache it quickly sends out a request to the to the data cloud and receives the latest available classification. The Commtouch Data cloud can be simultaneously accessed by hundreds of millions of users at one time.



The OEM Business Model

The OEM model has inherent advantages. Among them high margins, marketing risk to the end-customer is reduced, 90% of OEM's renew, and the firm has the ability to cross sell. Further, market consolidation, such as IBM's acquisition of Cobion, will strengthen Commtouch's hold on the market since other OEM venders are unlikely to buy from competitors.

Time Period	Impact
0 months	Contract is signed
3-6 months	Integration, first cash
12-18 months	Revenues begin to accelerate
18-24 months	Full revenue potential reached

Internet

In the 4th quarter of 2008 Commtouch introduced its URL filtering services. Where the firm once only monitored email/messaging space, it now has footprints in the more lucrative space of filtering web sites. The firm's technology analyzes and categorizes the source of URLs being accessed by such customers, mainly in order to prevent 1) the possibility of malware attacks being propagated by malicious URLs, 2) access to non-business related websites by employees and 3) access by children to inappropriate websites.

WORLD INTERNET USAGE AND POPULATION STATISTICS						
World Regions	Population (2009 Est.)	Internet Users Dec. 31, 2000	Internet Users Latest Data	Penetration (% Population)	Growth 2000-2009	Users % of Table
Africa	991,002,342	4,514,400	65,903,900	6.70%	1359.90%	3.90%
Asia	3,808,070,503	114,304,000	704,213,930	18.50%	516.10%	42.20%
Europe	803,850,858	105,096,093	402,380,474	50.10%	282.90%	24.20%
Middle East	202,687,005	3,284,800	47,964,146	23.70%	1360.20%	2.90%
North America	340,831,831	108,096,800	251,735,500	73.90%	132.90%	15.10%
Latin America/caribbean	586,662,468	18,068,919	175,834,439	30.00%	873.10%	10.50%
Oceania/Austraila	34,700,201	7,620,480	20,838,019	60.10%	173.40%	1.20%
World Total	**6,767,805,208**	**360,985,492**	**1,668,870,408**	**24.70%**	**362.30%**	**100.00%**

*source: World Internet Stats

In our opinion the internet is still growing and has a relatively low 24.7% penetration rate compared to the population. Especially if one considers Asia which has approximately 56% of the world's population yet remains only 18.5% penetrated. Another trend to consider in assessing the Commtouch growth rate is the explosion of handheld devices such as IPhones and Blackberries. There are in effect more and more devices being connected and each new connection is a new risk element in the chain.

Service Providers: The Next Growth Leg

Customer loss, operational cost increases, brand damage and even potential lawsuits are just some of the possible consequences service providers face as a result of spam emanating from their networks. Because the problem differs significantly from that of inbound spam, the potential hazards of outbound spam require a distinctive approach to protect service providers against this rapidly growing threat.

Commtouch messaging security solutions rely on its patented Recurrent Pattern Detection™ (RPD) technology, which analyzes billions of messages per day to identify outbreaks the moment they occur. In order to provide accurate protection from outbound spam, Commtouch has enabled local RPD technology within the Outbound Spam Engine. Outbound email is scanned by the Outbound Spam Engine for globally recurring patterns, locally recurring patterns and replies to scams. This allows the engine to track a sender's traffic statistics, such as mails per period of time and spam/ham ratio. Once a sender reaches a certain threshold set by the service provider, the Commtouch Engine blocks the spam and alerts the service provider with the sender address. Samples of the blocked emails are also provided for analysis.

Benefits Include:

- Secures service provider's reputation – Blocking outbound spam at the right time will prevent the network from being blocked and will improve the reputation of the service provider.
- Saves money –Reduces expenses associated with resolving blocked IPs, handling angry customers, and increasing existing hardware and support staff.
- Improves customer satisfaction – Commtouch's near zero false positive rate allows customers to benefit from a high level of service with no disruptions while protecting them from scams.
- Differentiates service offering – A unique anti-scam component adds valuable protection for customers.

Asset Purchase

On July 27, 2010 Commtouch announced that it had signed a definitive Asset Purchase Agreement to acquire the assets, products, licenses, and operations of the Command antivirus division of Authentium, Inc., a Florida-based company.

Authentium was a privately held company based in Palm Beach Gardens, Florida. In 2002, Authentium acquired Command Software, a security firm that was founded in 1984 and focused on anti-malware technology. Authentium also had another division, known as SafeCentral, which was not acquired by Commtouch.

Commtouch's strategy is to increase its leadership in the Internet Security sphere. Antivirus provides a significant growth opportunity that is highly synergetic with the company's business. Command Antivirus is a natural fit for Commtouch, employing a business model compatible with Commtouch's – OEM to security vendors and direct to Service Providers.

The Command Antivirus offering provides detection using a highly scalable, multi-layered approach. This market-leading antivirus is a natural addition to Commtouch's offering of broad email and Web security suites that provide customers with operational simplicity, reduced TCO and technical consolidation.

Command's OEM customer base included companies such as Google, McAfee and Microsoft, among many others. Command also had over 1,000 customers of its CSAM (Command Anti-Malware) product. All of Command's customers are now customers of Commtouch.

VALUATION

CTCH remains well positioned to achieve solid revenue growth and operating leverage as, virus problems become more complex given the company's competitive advantage led by innovation and the OEM business model. The firm has four things that separate it from the pack in our opinion.

- A technologically superior product.
- A service based OEM business model that assures recurring revenues and high margins with less end market risk.
- A strong balance sheet with low debt.
- A growth platform in URL filtering that looks to be double the size of the message market.

The company is trading at a reasonable 14.1x TTM EPS versus an industry average of 26.3x.

We value the company based on the average of our P/E multiple (16.9x 2011 estimated EPS) and our two stage intrinsic model. The group average forward P/E is between 18x-22x. We feel CTCH should trade at a premium to its peers, given the fact that the company has high growth/ high margin products.

The intrinsic value is essentially a sum of the company's future earnings, minus any long-term debt. Dividing the intrinsic value by the number of shares outstanding yields an intrinsic stock price. We used the following inputs:

- A 10-year period with an earnings growth rate of 10.0% (average forecast) and a discount rate of 12.45%.

- A continuing period assumed to go on forever, with earnings growing at 5% and a discount rate of 12.23%.

With these inputs we arrive at a target price of $4.50.

RISKS

- The company is headquartered in Israel and faces political risk.

- Future growth depends on the adoption rate of technology and a delay could result in revenues and earnings dropping below expectations.

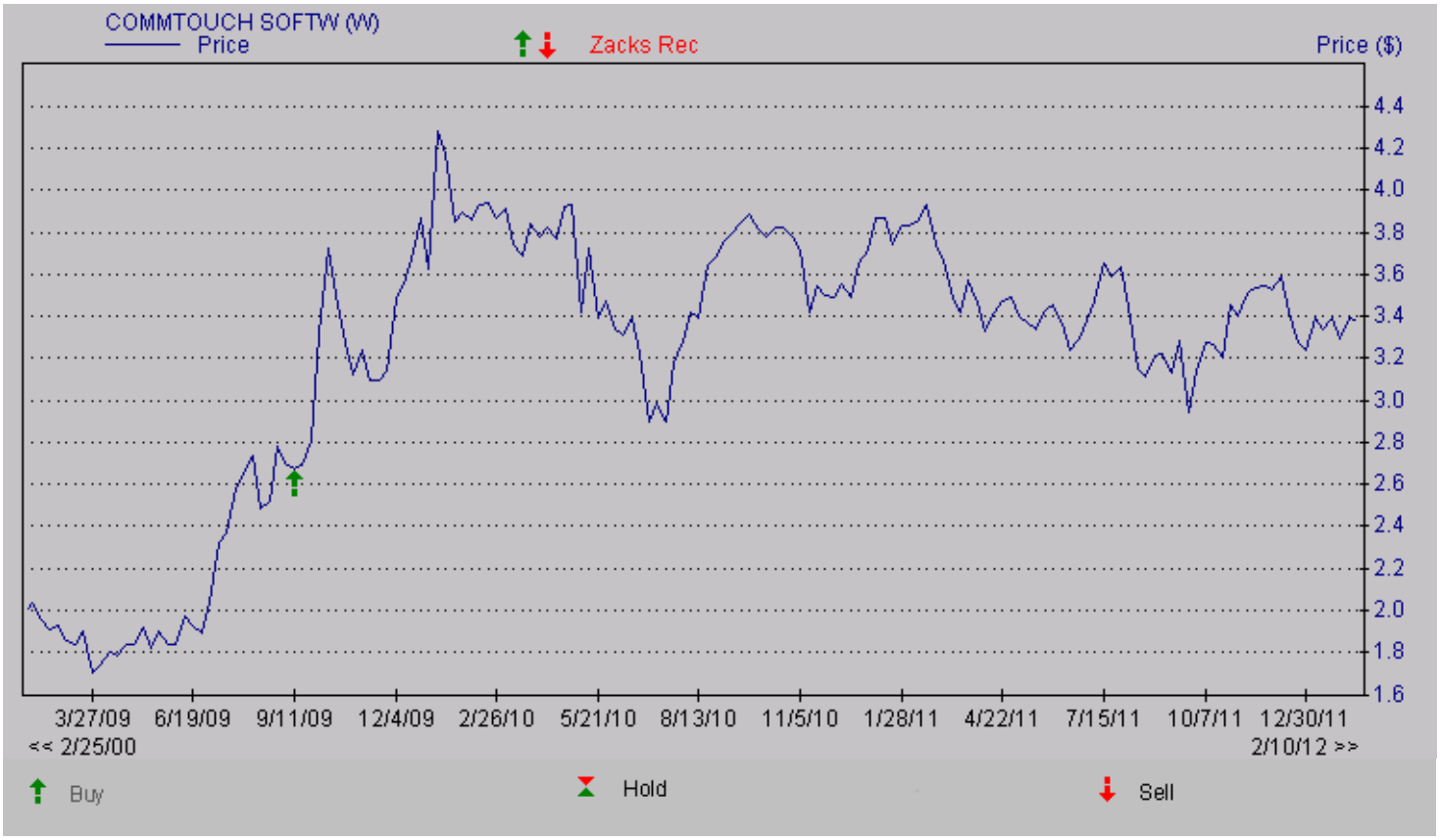
- The Nature of the business forces the firm to stay ahead of hackers and spammers. While these law breakers were thought of as jokesters in the past, they are more and more motivated by profit and greed.

PROJECTED INCOME STATEMENT

INCOME STATEMENT ($ Millions)	Sep-10 Q3 10	Dec-10 Q4 10	Mar-10 Q1 10	Jun-11 Q2 11	Sep-11 Q3 11	Dec-11 Q4 11 E	FY 2007	FY 2008	FY 2009	FY 2010	FY 2011 E	FY 2012 E
REVENUE												
Net Revenue	**4.6**	**5.4**	**5.5**	**5.7**	**5.9**	**6.1**	**11.3**	**14.1**	**15.2**	**18.2**	**23.2**	**27.0**
Sequential Growth		*17%*	*20%*	*3%*	*3%*	*4%*						
OPERATING EXPENSES												
Cost of Revenues	0.73	0.82	0.96	0.89	0.96	0.96	1.4	1.8	2.2	2.8	3.8	4.1
% of Revenue	*15.8%*	*15.2%*	*17.3%*	*15.6%*	*16.4%*	*15.7%*						
Gross Profit -	**3.87**	**4.56**	**4.56**	**4.81**	**4.90**	**5.15**	**9.8**	**12.3**	**13.0**	**15.4**	**19.4**	**23.0**
Proforma Gross Margin	*84.2%*	*84.8%*	*82.7%*	*84.4%*	*83.6%*	*84.3%*	*87.5%*	*87.1%*	*85.4%*	*84.6%*	*83.8%*	*85.0%*
R&D + Engg	0.75	1.12	1.17	1.31	1.27	1.35	1.9	2.8	2.7	3.1	5.1	4.6
% of Revenue	*16.2%*	*20.8%*	*21.3%*	*22.9%*	*21.7%*	*22.1%*	*16.9%*	*19.9%*	*17.4%*	*17.0%*	*22.0%*	*17.0%*
SG&A	1.62	1.96	1.99	1.97	1.89	2.04	5.3	6.0	6.3	6.8	7.9	10.6
% of Revenue	*35.2%*	*36.5%*	*36.1%*	*34.5%*	*32.3%*	*33.4%*	*47.1%*	*42.6%*	*41.3%*	*37.6%*	*34.0%*	*39.2%*
GW Amort, Restructuring, other								-	-	-		
% of Revenue												
Total Operating Expenses	2.36	3.08	3.16	3.27	3.16	3.39	7.2	8.8	8.9	9.9	13	15
% of Revenue	*51.4%*	*57.2%*	*57.3%*	*57.4%*	*54.0%*	*55.6%*	*64.0%*	*62.5%*	*58.7%*	*54.6%*	*56%*	*56%*
Operating Income -	**1.51**	**1.48**	**1.40**	**1.5**	**1.7**	**1.8**	**2.64**	**3.47**	**4.05**	**5.46**	**6.42**	**7.78**
Operating Margin	*32.8%*	*27.6%*	*25.4%*	*26.9%*	*29.6%*	*28.8%*	*23%*	*25%*	*27%*	*30%*	*28%*	*29%*
NON-OPERATING ITEMS												
Non operating Income/Expense	0	0	0	0	0	0	0.52	0.34	0.06	-0.06	-0.07	0.25
% of Revenue	*1.28%*	*-0.97%*	*-0.25%*	*0.63%*	*-1.54%*	*0.00%*	*4.62%*	*2.41%*	*0.40%*	*-0.30%*	*-0.29%*	*0.93%*
Tax Provision	-0.1	-1.0	0.0	0.0	0.0	0.0	0.020	0.010	0.010	0.000	0.000	0.030
Effective Tax Rate												
Net Income -	**1.56**	**1.43**	**1.39**	**1.57**	**1.64**	**1.76**	**3.14**	**3.80**	**4.10**	**5.41**	**6.36**	**8.00**
Net Income Margin	*33.9%*	*26.6%*	*25.1%*	*27.6%*	*28.1%*	*28.8%*	*27.9%*	*27.0%*	*27.0%*	*29.8%*	*27%*	*30%*
EARNINGS PER SHARE												
EPS - Basic	$0.06	$0.06	$0.06	$0.06	$0.07	$0.07	$0.13	$0.15	$0.17	$0.24	$0.27	$0.34
EPS - Diluted	$0.06	$0.06	$0.06	$0.06	$0.07	$0.07	$0.11	$0.14	$0.17	$0.21	$0.26	$0.32

Ken Nagy, CFA Zacks Investment Research 11/2/2011

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