Zacks Small-Cap Research

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Commtouch Software (CTCH-NASDAQ)

CTCH: The Business Model Evolves- OUTPERFORM

Current Recommendation	**Outperform**
Prior Recommendation	N/A
Date of Last Change	09/13/2009
Current Price (02/15/13)	$3.70
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. The business model is evolving.

SUMMARY DATA

52-Week High	**$3.87**
52-Week Low	**$2.36**
One-Year Return (%)	**17.09**
Beta	**0.61**
Average Daily Volume (sh)	**97,167**
Shares Outstanding (mil)	**25**
Market Capitalization ($mil)	**$92**
Short Interest Ratio (days)	**0.10**
Institutional Ownership (%)	**6**
Insider Ownership (%)	**N/A**
Annual Cash Dividend	**$0.00**
Dividend Yield (%)	**0.00**
5-Yr. Historical Growth Rates	
Sales (%)	**16.9**
Earnings Per Share (%)	**25.3**
Dividend (%)	**N/A**
P/E using TTM EPS	**17.6**
P/E using 2012 Estimate	**21.8**
P/E using 2013 Estimate	**12.8**
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)
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	6.0 A	23.0 A
2012	5.9 A	5.7 A	5.6 A	5.9 E	23.0 E
2013					27.0 E

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

	Q1 (Mar)	Q2 (Jun)	Q3 (Sep)	Q4 (Dec)	Year (Dec)
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 A	$0.26 A
2012	$0.06 A	$0.05 A	$0.03 A	$0.03 E	$0.17 E
2013					$0.29 E

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WHATS NEW

Commtouch Software Sees New Bookings

On November 6, 2012, Commtouch Software reported financial results for its third quarter and nine months ended September 30, 2012. Commtouch reported solid progress with new booking sales more than doubling year over year and accelerated execution on its next generation mobile and SaaS security solutions.

While the increased new booking sales are expected to provide an enhanced foundation for growth in 2013, the enhanced performance of next generation mobile and SaaS security solutions highlight the Company's strategic advances.

Still, third quarter 2012 revenues amounted to $5.558 million compared to $5.855 million for the comparable quarter of 2011.

The decline in revenue was primarily a result of the low level of new bookings in the previous fiscal year and a modest decline in the level of activity among select customers who experienced a slowdown in their own underlying businesses.

Second quarter 2012 GAAP net income fell $868,000 to $19,000 from $887,000 during the three months ended September 30, 2011.

The drop was primarily due to the impact of acquisition related costs as well as the planned higher level of investment in sales, marketing and engineering expenses associated with the ongoing support of Commtouch's "Software-as-a-Service" strategy rollout and upcoming launch.

It should be noted that during the third quarter, Commtouch announced the acquisition of FRISK Software International's Antivirus business.

The acquisition is expected to help accelerate the Company's strategy to deploy an expanded range of antivirus solutions for the OEM and service provider market, including private label solutions.

Still, while gross margin improved year over year to 83.5 percent from 82.6 percent for the three months ended September 30, 2011, total operating expenses increased year over year by $887,000.

Sequentially, gross margin improved from 82.1 percent for the three months ended June 30, 2012.

The improvement to gross margin on a year over year and sequential basis was primarily a result of management's continued steps to optimize cost.

Based on a weighted average number of diluted common shares of 24.845 million, GAAP diluted net income per share resulted in $0.00 per share for the third quarter fiscal 2012. This compares to diluted net income per share of $0.04 on a weighted average number of diluted shares of 24.726 million during the three months ended September 30, 2011.

Non-GAAP net income for the third quarter of 2012 fell year over year by $1.029 million to $744,000 and non-GAAP earnings per diluted share for the third quarter of 2011 fell to $0.03 compared to $0.07 for the three months ended September 30, 2011.

For the nine months ended September 30, 2012, year over year revenues improved by $59,000 to $17.125 million from $17.066 million for the first nine months of fiscal 2011.

Still, GAAP net income for the nine months fell by $1.291 million year over year to $2.032 million for the

nine months ended September 30, 2012. This compares to $3.323 million for the comparable nine months ended September 30, 2011.

Gross margin for the nine months held steady at 82.6 percent while total operating expenses increased year over year by $1.436 million.

Based on a weighted average number of diluted shares of 24.984 million shares, diluted net income per share resulted in net income of $0.08 per diluted share during the first nine months of fiscal 2012. This compared to a diluted net income per share of $0.13 on a weighted average number of diluted shares of 24.678 million shares during the nine months ended September 30, 2011.

On a non-GAAP basis, net income for the first nine months of 2012 dropped year over year by $1.091 million to $3.639 million and non-GAAP earnings per diluted share for the first nine months of 2012 was $0.15 compared to $0.19 for the nine months ended September 30, 2011.

Although cash and equivalents dropped sequentially by $2.489 million to $17.334 million, cash usage during the quarter included a $1.0 million pre-paid supplier agreement, $828,000 related to the company's share repurchase program activity during the quarter, as well as increased capital expenditures related to the execution of the company's new SaaS strategy and higher acquisition related expenses.

Additionally, operating cash flow for the third quarter was steady on a sequential basis at $1.4 million.

Still, cash used for operating cash activities during the quarter included $1.0 million as part of a pre-payment plan to secure a long-term technological supplier agreement.

It should further be noted that this technological supplier agreement is projected to yield cost effective results in terms of reducing the company's cost of revenue and increasing gross margin.

Moreover, Commtouch’s global sales and marketing infrastructure sustained impressive results and continues to set the stage for renewed revenue growth.

The Company’s focused sales and marketing efforts generated major successes including a significant $2.2 million contract win in Latin America as well as increased sales traction across international and U.S. based customers.

Matter of fact, Commtouch has successfully secured more new business wins over the last two quarters than the preceding 12 months combined and also has more than doubled its new bookings year-to-date.

Along the same lines, management expects these multi-year contract wins to begin to significantly contribute more to the Company’s revenue growth and profitability in the coming quarters.

Likewise, it should be noted that customer renewal activity during the quarter was solid with more than 95 percent of eligible customers renewing.

Similarly, management remains centered on winning new customers and driving its backlog and believes it is making excellent progress with regards to setting the stage for growth and improved profitability in 2013.

It should further be noted that Commtouch made significant progress towards its strategic evolution into a cloud-driven 'security as a service' solutions provider.

This cloud based platform provides the Company’s clients an extended range of offerings and addresses new markets which will allow Commtouch to sell more.

The Company remains on track with the planned rollout of its new Mobile Security SDK product for Android devices in the current quarter as well as its next generation cloud-based 'security as a service' offerings for web and email which are targeted for release in the first half of 2013.

However, based on the Company's year to date revenues and the projected influence of the acquisition of FRISK Software International's Antivirus business, which closed on October 1, 2012, as well as current expectations for the remainder of 2012, Commtouch updated its current outlook for 2012.

The company lowered its full year guidance to approximately $23 million, which is in line with its 2011 levels. This compares to previous guidance of between 2% and 6% revenue growth for its full year 2012 over 2011 heights. Management expects to return to sequential revenue growth beginning in the current fourth quarter of 2012.

Additionally, Commtouch now expects non-GAAP net income for the full year 2012 to be greater than $4.0 million as the company accounts for the initial ramp of the FRISK business as well as higher costs associated with the company's investment and integration around FRISK within Commtouch.

Finally, In May 2012, Commtouch announced the authorized initiation of a stock repurchase program of the Company's ordinary shares in the open market, in an amount in cash of up to $2.5 million. The action reflects the confidence of the management team and the board of directors in the long term growth prospects of the Company. During the quarter ended September 30, 2012, the Company had repurchased approximately 297,000 shares at an aggregate cost of approximately $828,000. Furthermore, as of September 30, 2012, approximately 495,000 shares have been repurchased through the program at an aggregate cost of approximately $1.4 million.

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.

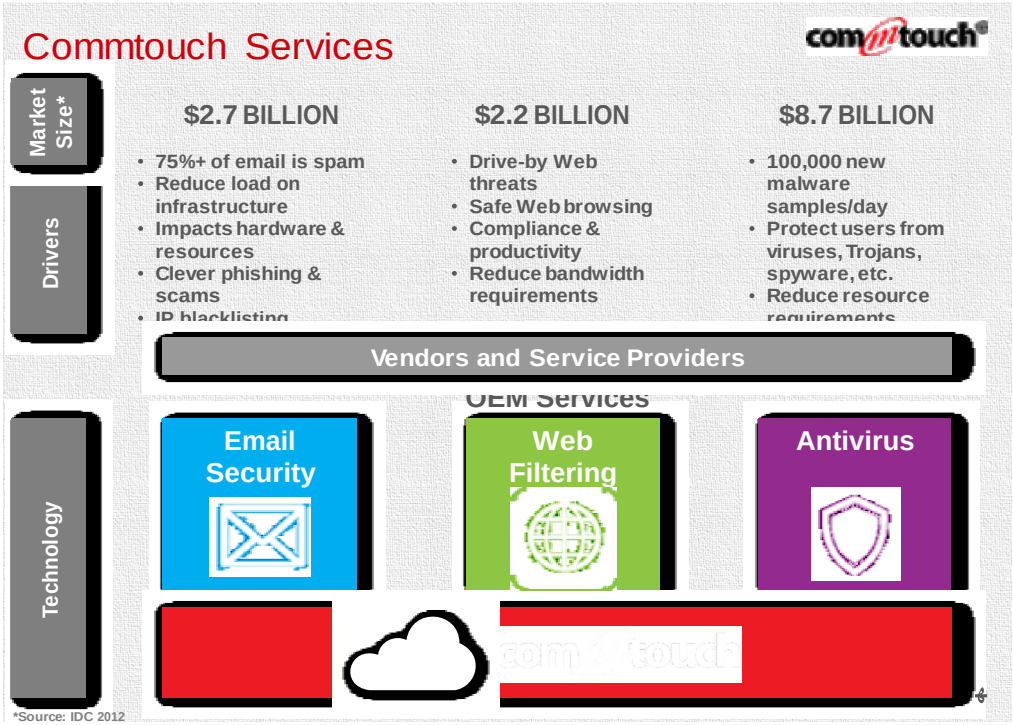
Correspondingly, the Company continues to build on strategic assets by broadening the use of its cloud security platform and expanding into the mobile space.

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

Commtouch, headquartered out of Netanya, Israel, is a provider of internet security and cloud based services, supplying white label internet cloud-based (SaaS) 'Security as a Service' protection solutions to security OEM's and service providers worldwide.

The Company offers messaging security, web security and AV (Anti-virus) protection to customers based primarily in North America, Europe, Israel and Asia and currently protects over 350 million end users across 190 countries with its award winning patented technology and six global data centers.



Commtouch's product line is designed for easy integration and provides speed, accuracy, adaptability, low TCO and is partner focused.

The Company's messaging security includes anti-spam protection, zero hour virus outbreak protection, GlobalView™ mail reputation and outbound spam protection. The anti-spam technology allows real-time blocking of spam, phishing and email-malware in any language or format with almost no false positives.

Based on its patented Recurrent Pattern Detection™ (RPD™) technology, Commtouch's anti-spam solution blocks spam based on its most fundamental characteristic - its mass distribution and repeating patterns.

Furthermore, the Company's GlobalView™ and patented Recurrent Pattern Detection™ (RPD™) technologies make threat data immediately available to millions of endpoints, providing up-to-date spam classifications, URL categorization, and malware detection services.

The Company's zero hour virus outbreak protection blocks email-borne malware outbreaks in real time by allowing the resellers customers to download an enterprise gateway while the GlobalView™ mail reputation blocks unwanted email at the network perimeter before it enters the network.

The outbound spam protection enables service providers to block emails being sent from their system that contain spam, phishing, or malware by blocking and identifying outbound spam and spammers.

The Company's web security includes GlobalView™ URL filtering which offers comprehensive coverage, accuracy and real-time security.

Finally, the AV (Anti-virus) technology, based off of Commtouch's proprietary detection and remediation technology, includes command antivirus which is designed to proactively combat modern malware threats and provides maximum performance (high scanning speeds, low resource requirements) and superior detection based on multiple scanning layers including heuristics, emulation, and smart signatures.

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.

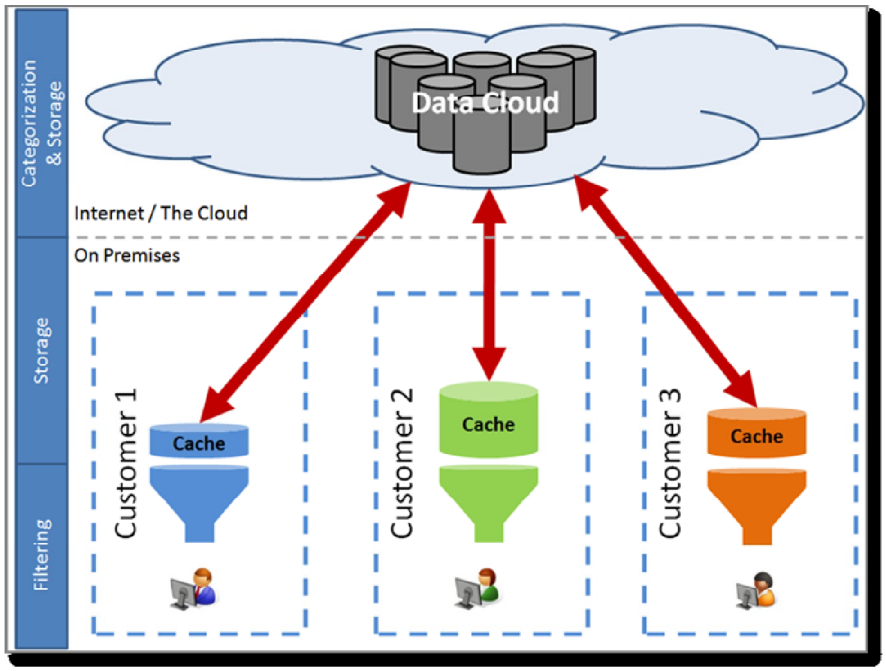
Long-term drivers:
• The need to have security tools in place to protect against malicious attacks and unintentional security incidents, such as leakage of sensitive corporate information, will remain. New risks in mobile and remote workplaces.

• 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 12.8x 2013 estimated EPS versus an industry average of 14.9x.

We value the company based on the average of our P/E multiple (14.8x 2013 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-11 Q3 11	Dec-11 Q4 11	Mar-12 Q1 12	Jun-12 Q2 12	Sep-12 Q3 12	Dec-12 Q4 12 E	FY 2007	FY 2008	FY 2009	FY 2010	FY 2011	FY 2012 E	FY 2013 E
REVENUE													
Net Revenue	**5.9**	**6.0**	**5.9**	**5.7**	**5.6**	**5.9**	**11.3**	**14.1**	**15.2**	**18.2**	**23.0**	**23.0**	**27.0**
Sequential Growth		*2%*	*-1%*	*-4%*	*-2%*	*6%*							
OPERATING EXPENSES													
Cost of Revenues	0.96	1.07	1.00	0.96	0.86	1.10	1.4	1.8	2.2	2.8	3.9	3.9	4.5
% of Revenue	*16.4%*	*18.0%*	*16.9%*	*16.9%*	*15.5%*	*18.6%*							
Gross Profit -	**4.90**	**4.88**	**4.90**	**4.71**	**4.70**	**4.80**	**9.8**	**12.3**	**13.0**	**15.4**	**19.1**	**19.1**	**22.5**
Proforma Gross Margin	*83.6%*	*82.0%*	*83.1%*	*83.1%*	*84.5%*	*81.4%*	*87.5%*	*87.1%*	*85.4%*	*84.6%*	*83.2%*	*83.0%*	*83.3%*
R&D + Engg	1.27	1.29	1.20	1.29	1.38	1.45	1.9	2.8	2.7	3.1	5.0	5.3	6.0
% of Revenue	*21.7%*	*21.6%*	*20.4%*	*22.8%*	*24.8%*	*24.6%*	*16.9%*	*19.9%*	*17.4%*	*17.0%*	*21.9%*	*23.1%*	*22.2%*
SG&A	1.89	1.93	2.13	2.19	2.55	2.35	5.3	6.0	6.3	6.8	7.8	9.2	9.8
% of Revenue	*32.3%*	*32.5%*	*36.2%*	*38.7%*	*45.8%*	*39.8%*	*47.1%*	*42.6%*	*41.3%*	*37.6%*	*33.8%*	*40.1%*	*36.3%*
GW Amort, Restructuring, other								-	-	-			
% of Revenue													
Total Operating Expenses	3.16	3.22	3.34	3.49	3.93	3.80	7.2	8.8	8.9	9.9	13	15	15
% of Revenue	*54.0%*	*54.1%*	*56.6%*	*61.5%*	*70.6%*	*64.4%*	*64.0%*	*62.5%*	*58.7%*	*54.6%*	*56%*	*63%*	*56%*
Operating Income -	**1.7**	**1.7**	**1.6**	**1.2**	**0.77**	**1.0**	**2.64**	**3.47**	**4.05**	**5.46**	**6.33**	**4.57**	**7.50**
Operating Margin	*29.6%*	*28.0%*	*26.6%*	*21.6%*	*13.9%*	*16.9%*	*23%*	*25%*	*27%*	*30%*	*28%*	*20%*	*28%*
NON-OPERATING ITEMS													
Non operating Income/Expense	-0.09	0.02	0.05	0.06	0.06	0.00	0.52	0.34	0.06	-0.06	-0.05	0.18	0.20
% of Revenue	*-1.54%*	*0.29%*	*0.86%*	*1.13%*	*1.13%*	*0.00%*	*4.62%*	*2.41%*	*0.40%*	*-0.30%*	*-0.22%*	*0.77%*	*0.74%*
Tax Provision	0.000	0.028	0.031	-0.018	0.091	0.200	0.020	0.010	0.010	0.000	0.028	0.304	0.400
Effective Tax Rate													
Net Income -	**1.64**	**1.65**	**1.59**	**1.31**	**0.74**	**0.80**	**3.14**	**3.80**	**4.10**	**5.41**	**6.25**	**4.44**	**7.30**
Net Income Margin	*28.1%*	*27.8%*	*26.9%*	*23.1%*	*13.4%*	*13.6%*	*27.9%*	*27.0%*	*27.0%*	*29.8%*	*27%*	*19%*	*27%*
EARNINGS PER SHARE													
EPS - Basic	$0.07	$0.07	$0.07	$0.06	$0.03	$0.03	$0.13	$0.15	$0.17	$0.24	$0.26	$0.18	$0.30
EPS - Diluted	$0.07	$0.07	$0.06	$0.05	$0.03	$0.03	$0.11	$0.14	$0.17	$0.21	$0.26	$0.18	$0.29

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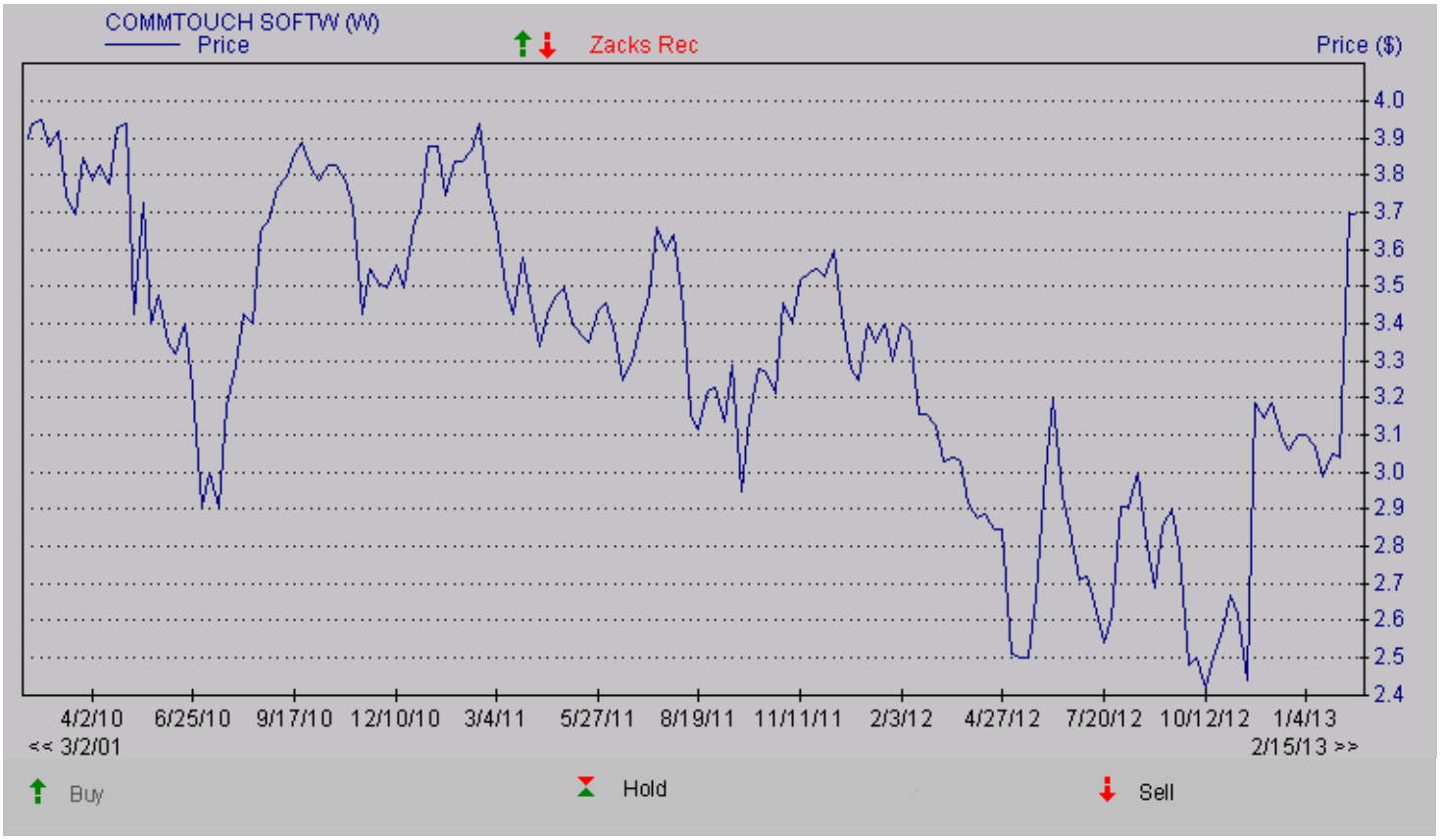
HISTORICAL ZACKS RECOMMENDATIONS



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