Zacks Small-Cap Research

February 21, 2013
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Commtouch Software (CTCH-NASDAQ)

CTCH: Expect 42-46% Top-Line Growth in 2013- OUTPERFORM

Current Recommendation	**Outperform**
Prior Recommendation	N/A
Date of Last Change	09/13/2009
Current Price (02/20/13)	$3.59
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 and Antivirus has the potential to be a significant growth driver. We see value in the shares.

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	**22.4**
P/E using 2013 Estimate	**21.1**
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	6.8 A	24.0 A
2013	7.5 E	8.0 E	8.5 E	10.5 E	34.5 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	$0.01 A	$0.16 A
2013	$0.03 E	$0.03 E	$0.05 E	$0.06 E	$0.17 E

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WHATS NEW

On February 20, 2013, Commtouch Software Ltd, reported financial results for its fourth quarter and full year ended December 31, 2012.

Commtouch reported solid progress with new booking sales for the fourth quarter and full year fiscal 2012 more than doubling year over year, while acquisition related transaction and integration expenses, combined with increased investments in global sales and marketing infrastructure, contributed to lower bottom-line profitability.

Furthermore, the new client wins during the fourth quarter reflect the increased global reach of the Company's recently extended sales and marketing efforts including key new accounts from North America, India and China among the other global regions.

Fourth quarter 2012 revenues grew by 14 percent or $835,000 year over year to $6.785 million compared to $5.950 million for the comparable quarter of 2011.

Still, the Company reported a GAAP net loss of $547,000 for the quarter, down from net income of $1.275 million during the three months ended December 31, 2011.

The drop was primarily due to the impact of acquisition related costs expenses as well as lower gross margins.

It should be noted that during the fourth quarter, Commtouch closed the previously announced acquisitions of FRISK Software International's antivirus business as of October 1, 2012 and Eleven GmbH as of November 16, 2012.

The acquisition of Eleven accelerated the delivery of the Company's "Security-as-a-Service' quality and broadened it, enabling Commtouch to provide more OEM services and private labeled application as well as expanded its European footprint to head offices closer to many of their customers.

During the fourth quarter and full year, the Company recognized expenses totaling approximately $0.4 million and $0.8 million in the respective periods related to acquisition related costs.

Gross margin during the quarter fell year over year to 79.9 percent from 81.1 percent for the three months ended December 31, 2011.

Gross margin declined primarily related to the acquisition of Eleven which has gross margins of roughly 75 percent and below the gross margin percentages generated by the Commtouch business historically.

Still, as the Company moves through the integration and streamlining process, management anticipates that it will begin to see a gradual improvement in the gross margin overtime as business efficiencies are realized.

Based on a weighted average number of diluted common shares of 25.598 million, GAAP diluted net loss per share resulted in $0.02 loss per share for the fourth quarter fiscal 2012. This compares to diluted net income per share of $0.05 on a weighted average number of diluted shares of 24.828 million during the three months ended December 31, 2011.

Non-GAAP net income for the fourth quarter of 2012 fell year over year by $1.384 million to net income of $269,000 while non-GAAP earnings per diluted share for the fourth quarter of 2011 fell to $0.01 compared to $0.07 for the three months ended December 31, 2011.

For the full year ended December 31, 2012, revenues were in line with the upper end of management's guidance expectation, growing year over year by $894,000 to $23.910 million from $23.016 million for the twelve months ended December 31, 2011.

GAAP net income for the twelve months fell year over year to $1.485 million for the full year ended December 31, 2012. This compares to net income of $4.598 million for the comparable twelve months ended December 31, 2011.

The drop in net income was due to the impact of acquisition related costs as well as the 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 launch as well as lower gross margins.

Gross margin for the year fell to 81.8 percent compared to 82.2 percent for fiscal 2011.

Based on a weighted average number of diluted shares of 25.140 million shares, diluted net income per share resulted in net income of $0.06 per diluted share during the full year fiscal 2012. This compared to a diluted net income per share of $0.19 on a weighted average number of diluted shares of 24.654 million shares during the twelve months ended December 31, 2011.

On a non-GAAP basis, net income for fiscal 2012 dropped year over year by $2.475 million to $3.908 million and non-GAAP earnings per diluted share for the twelve months of 2012 was $0.16 compared to $0.26 for the full year ended December 31, 2011.

Although cash and equivalents dropped to $5.137 million for the period ended December 31, 2012, cash usage during the quarter included the net purchase price payments of $10.2 million, as well as payments for transaction and integration costs associated with the two acquisitions completed during the quarter.

Similarly, cash used for operating cash activities during the quarter was $1.6 million, which included payments for professional service fees and other acquisition related costs associated with the two acquisitions that closed during the quarter.

Still, the Company ended 2012 with renewed revenue growth and tremendous progress on its recent transformation into a provider of comprehensive SecaaS offerings, which was accelerated by its strategic acquisitions and the formal launch of its new cloud-based email Security-as-a-Service offering in early 2013, highlighting the Company's execution on its strategic roadmap and its foundation for future growth.

Commtouch's new Email Security-as-a-Service solution marks a major launch of the Company's latest cloud-based offerings and is complemented by new solutions focused on Email Security On-Premise for Service Providers and Mobile Security Services for Android.

Commtouch's e-mail "security-as-a-service" combines permanent protection against e-mail based threats such as spam, phishing and malware with maximum post efficiency and minimum time to market while its new mobile security service for android is the first ever OEM solution that offers cloud assist antivirus and web security services delivered through a single easy to integrate client as the gate for the popular mobile operating system.

Similarly, the new On Premise e-mail security services for service providers delivers additional simplified messaging security and optimization functionality enabling Commtouch to better address the requirements of any service provider that offers e-mail services to end users. The new solution leverages e-mail security technology asset which Commtouch acquired as part of its purchase of Eleven GmbH.

The three recently launched solutions have generated pronounced initial customer interest setting the stage for strong revenue growth in 2013.

Management is undertaking a range of initiatives designed to optimize the integration, synergies and

streamlining of its recent acquisition with a focused commitment to bottom line profitability. The Company also remains committed to investing in its enhanced sales and marketing platform to fully leverage the value for innovative new “securities-as-a-service” offering among customers and partners worldwide.

Additionally, the Company’s focus remains on increasing its market share in the fast growing market for cloud based e-mails, web and anti-virus solutions including a significant launch of its new upcoming cloud based web security solution which is currently on-track for release during the first quarter of 2013.

Likewise, management anticipates that organic new bookings growth, combined with the synergies of its recent strategic acquisitions, helps puts Commtouch on track to realize double digit year over year full year 2013 revenue growth.

Along the same lines, management anticipates revenues for the full year 2013 revenue to be in the range of $34.0 million and $35.0 million, which would be a year over year increase of approximately 42 percent to 46 percent when compared with fiscal 2012.

Similarly, full year 2013 GAAP net income is expected to be greater than $2.0 million while non-GAAP net income is anticipated to be greater than $3.5 million.

Both GAAP and non-GAAP net income guidance includes a higher level of sales and marketing expense versus 2012 to support a strengthened global sales platform.

Likewise, management plans to continue to strategically invest in the build-out of its global sales and marketing efforts.

It should be noted that during the first half of 2013, the company also expects to recognize extraordinary expenses related to its previously announced acquisitions, as well as related integration and streamlining expenses, totaling approximately $0.8 million, the majority of which will be recognized in the first quarter of 2013. The impact of these charges is reflected in the aforementioned full year 2013 GAAP net income guidance. The company expects the impact of integration and streamlining activities to positively impact the financial performance of the business during the second half of 2013.

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 December 31, 2012, the Company had repurchased 105,000 shares at an aggregate cost of approximately $279,000.

Likewise, as of December 31, 2012, approximately 767,000 shares have been repurchased through the program at an aggregate cost of approximately $1.7 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

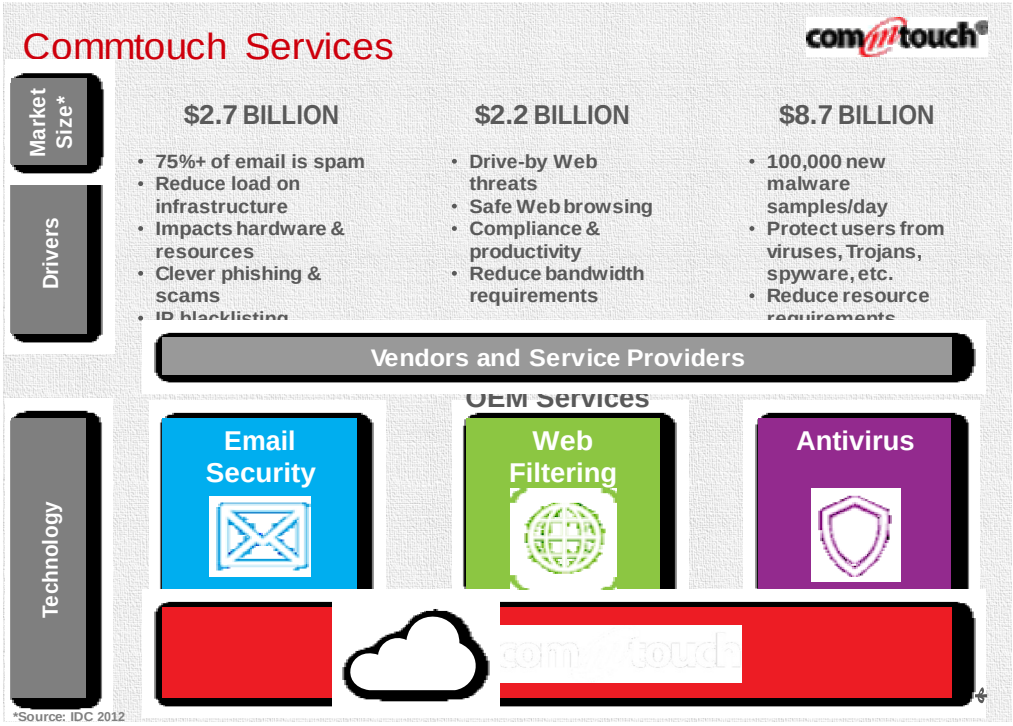
security platform and expanding into the mobile space.

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.

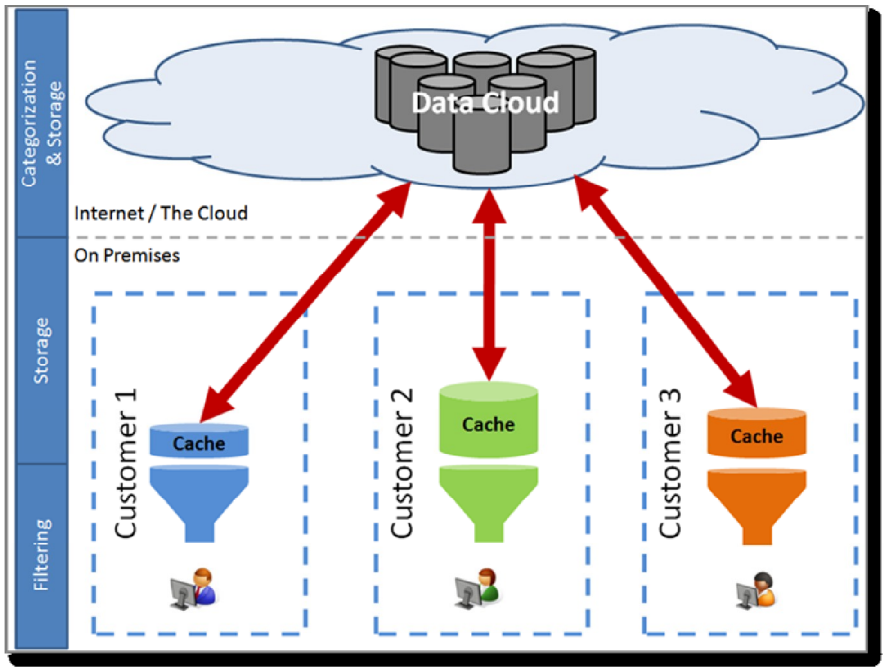
Long-term drivers:
• The need to have security tools in place to protect against malicious attacks and unintentional security incidents, such as leakage of sensitive corporate information, will remain. New risks in mobile and remote workplaces.

• 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.

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.

We value the company based on the average of our P/E multiple (22.0x 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

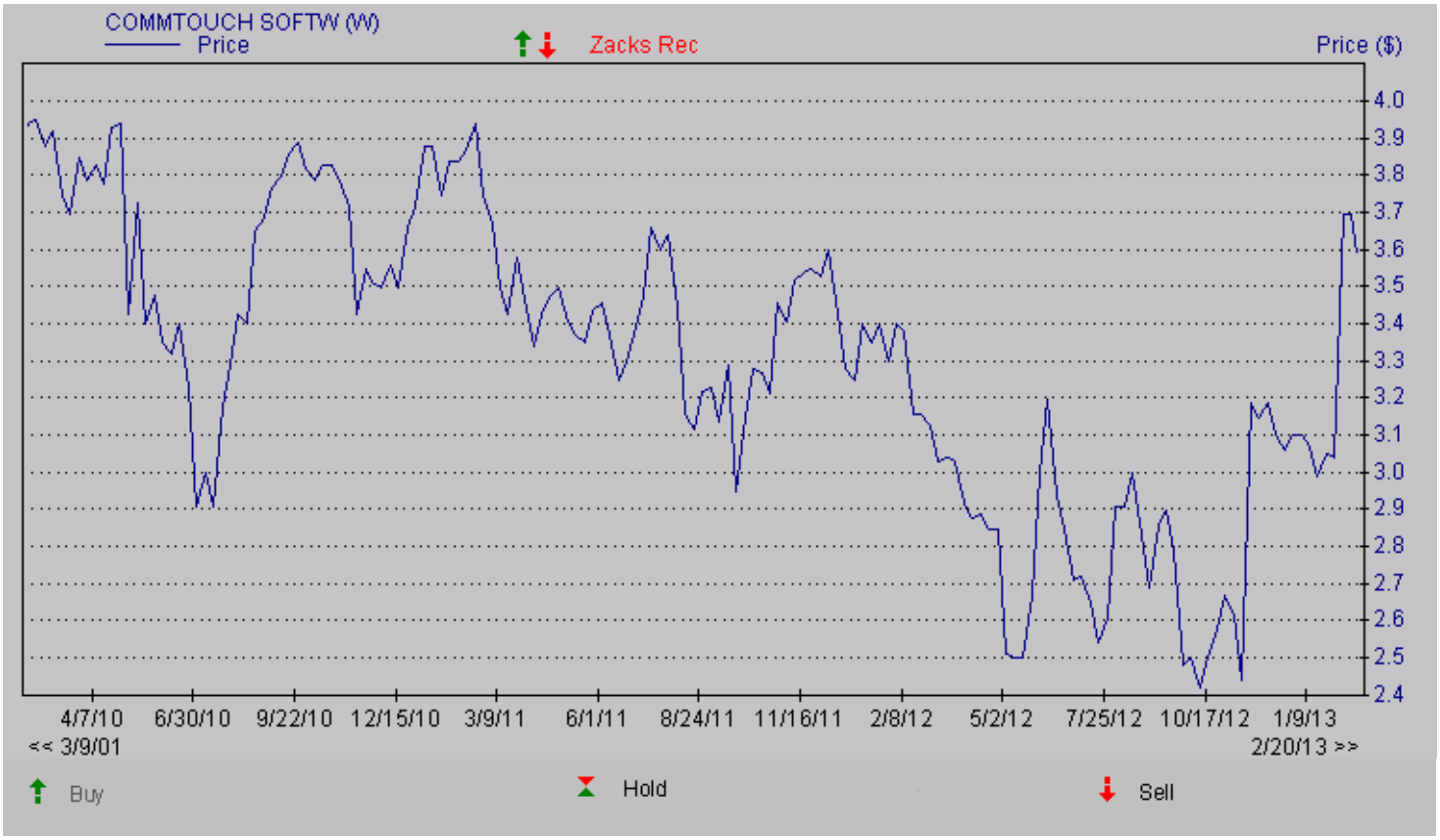
- The company is headquartered in Israel and faces political risk.
- Future growth depends on the adoption rate of technology and a delay could result in revenues and earnings dropping below expectations.
- The Nature of the business forces the firm to stay ahead of hackers and spammers. While these 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)	Dec-11 Q4 11	Mar-12 Q1 12	Jun-12 Q2 12	Sep-12 Q3 12	Dec-12 Q4 12	Mar-13 Q1 13 E	FY 2008	FY 2009	FY 2010	FY 2011	FY 2012	FY 2013 E
REVENUE												
Net Revenue	**6.0**	**5.9**	**5.7**	**5.6**	**6.8**	**7.5**	**14.1**	**15.2**	**18.2**	**23.0**	**24.0**	**34.5**
Sequential Growth		*-1%*	*-4%*	*-1%*	*21%*	*11%*						
OPERATING EXPENSES												
Cost of Revenues	1.07	1.00	0.96	0.86	1.21	1.30	1.8	2.2	2.8	3.9	4.0	7.5
% of Revenue	*18.0%*	*16.9%*	*16.9%*	*15.4%*	*17.9%*	*17.3%*						
Gross Profit -	**4.88**	**4.90**	**4.71**	**4.70**	**5.57**	**6.20**	**12.3**	**13.0**	**15.4**	**19.1**	**19.9**	**27.0**
Proforma Gross Margin	*82.0%*	*83.1%*	*83.1%*	*83.9%*	*82.1%*	*82.7%*	*87.1%*	*85.4%*	*84.6%*	*83.2%*	*83.2%*	*78.3%*
R&D + Engg	1.29	1.20	1.29	1.38	2.18	2.20	2.8	2.7	3.1	5.0	6.1	7.8
% of Revenue	*21.6%*	*20.4%*	*22.8%*	*24.6%*	*32.1%*	*29.3%*	*19.9%*	*17.4%*	*17.0%*	*21.9%*	*25.3%*	*22.5%*
SG&A	1.93	2.13	2.19	2.55	3.59	3.50	6.0	6.3	6.8	7.8	10.5	14.0
% of Revenue	*32.5%*	*36.2%*	*38.7%*	*45.5%*	*52.9%*	*46.7%*	*42.6%*	*41.3%*	*37.6%*	*33.8%*	*43.7%*	*40.6%*
GW Amort, Restructuring, other							-	-	-			
% of Revenue												
Total Operating Expenses	3.22	3.34	3.49	3.93	5.76	5.70	8.8	8.9	9.9	13	17	22
% of Revenue	*54.1%*	*56.6%*	*61.5%*	*70.2%*	*85.0%*	*76.0%*	*62.5%*	*58.7%*	*54.6%*	*56%*	*69%*	*63%*
Operating Income -	**1.7**	**1.6**	**1.2**	**0.77**	**-0.2**	**0.5**	**3.47**	**4.05**	**5.46**	**6.33**	**3.41**	**5.25**
Operating Margin	*28.0%*	*26.6%*	*21.6%*	*13.8%*	*-2.8%*	*6.7%*	*25%*	*27%*	*30%*	*28%*	*14%*	*15%*
NON-OPERATING ITEMS												
Non operating Income/Expense	0.02	0.05	0.06	0.06	0.15	0.15	0.34	0.06	-0.06	-0.05	0.33	-0.50
% of Revenue	*0.29%*	*0.86%*	*1.13%*	*1.07%*	*2.25%*	*2.00%*	*2.41%*	*0.40%*	*-0.30%*	*-0.22%*	*1.37%*	*-1.45%*
Tax Provision	0.028	0.031	-0.018	0.091	-0.077	0.020	0.010	0.010	0.000	0.028	0.027	0.500
Effective Tax Rate												
Net Income -	**1.65**	**1.59**	**1.31**	**0.74**	**0.27**	**0.63**	**3.80**	**4.10**	**5.41**	**6.25**	**3.94**	**4.25**
Net Income Margin	*27.8%*	*26.9%*	*23.1%*	*13.2%*	*3.9%*	*8.4%*	*27.0%*	*27.0%*	*29.8%*	*27%*	*16%*	*12%*
EARNINGS PER SHARE												
EPS - Basic	$0.07	$0.07	$0.06	$0.03	$0.01	$0.03	$0.15	$0.17	$0.24	$0.26	$0.16	$0.18
EPS - Diluted	$0.07	$0.06	$0.05	$0.03	$0.01	$0.03	$0.14	$0.17	$0.21	$0.26	$0.16	$0.17

Ken Nagy, CFA Zacks Investment Research 2/20/2012

HISTORICAL ZACKS RECOMMENDATIONS



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