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Zacks Small-Cap Research

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CYREN (CYRN-NASDAQ)

CYRN: First New Cloud Product Rolled Out to Customers

CYREN (formerly Commtouch Software) is an email and web security software and SaaS vendor. Until recently it has sold its technology to OEMs as an engine to eliminate spam, phishing etc. in products such as Gmail and Checkpoint appliances, but it has just launched a new inexpensive, simple to deploy cloud-based service to be sold via resellers to small and medium businesses. Near term expect losses, but once cloud products ramp, growth will accelerate and the valuation should expand closer to its much more highly valued peers.

OUTPERFORM

Current Recommendation	**Outperform**
Prior Recommendation	N/A
Date of Last Change	09/13/2009
Current Price (3/4/14)	$3.76
Target Price	**$5.00**

OUTLOOK

SUMMARY DATA

52-Week High	**$4.09**
52-Week Low	**$2.31**
One-Year Return (%)	**9.16**
Beta	**0.34**
Average Daily Volume (sh)	**163,414**
Shares Outstanding (mil)	**26**
Market Capitalization ($mil)	**$99**
Short Interest Ratio (days)	**0.65**
Institutional Ownership (%)	**0**
Insider Ownership (%)	**N/A**
Annual Cash Dividend	**$0.00**
Dividend Yield (%)	**0.00**
5-Yr. Historical Growth Rates	
Sales (%)	**18.8**
Earnings Per Share (%)	**-4.2**
Dividend (%)	**N/A**
P/E using TTM EPS	**N/M**
P/E using 2014 Estimate	**N/M**
P/E using 2015 Estimate	**50X**
Zacks Rank	**3**

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

ZACKS ESTIMATES

Revenue
(in millions of $)

	Q1 (Mar)	Q2 (Jun)	Q3 (Sep)	Q4 (Dec)	Year (Dec)
2012	5.9 A	5.7 A	5.6 A	6.8 A	24.1 A
2013	7.9 A	8.1 A	8.0 A	8.4 A	32.8 A
2014	8.3 E	8.6 E	9.1 E	9.6E	35.7 E
2015					40.0 E

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

	Q1 (Mar)	Q2 (Jun)	Q3 (Sep)	Q4 (Dec)	Year (Dec)
2012	$0.05 A	$0.04 A	$0.01 A	$0.01 A	$0.11 A
2013	-$0.01 A	-$0.01 A	$0.00 A	-$0.07 A	-$0.05 A
2014	-$0.02 E	-$0.01 E	$0.00 E	$0.01 E	-$0.01 E
2015					$0.07 E

Zacks Projected EPS Growth Rate - Next 5 Years 10% **N/A**

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WHAT'S NEW

Year-End Earnings Announced and New Products Launch

With 2013 behind us, CYREN has started the new year with the long awaited launch of its first cloud-based platform product "CYREN WebSecurity." Until the acquisition of eleven, CYREN had only been selling a technology engine for email filtering to its OEM customers. This product was then built upon by the OEM and sold to end users as a complete product. These customers, who then build a solution into a storage device, router or email service, have been beset by competition from private companies such as Zscaler and Websense which are offering alternative cloud-based solutions at lower end-user prices external to a device. In response, CYREN has now taken its core engine and built its own cloud-based complete solution to compete against Zscaler and Websense. Its product, targeting small and medium businesses (SMBs), is even easier to use than those cloud services currently on the market.

CYREN WebSecurity achieved commercial availability January 30, 2014 and its first distributor CertSys, was signed February 24, 2014. CYREN showed its new product to resellers and distributors last week at the RSA Conference in San Francisco. This product protects employees away from the office from web-based threats just as they are protected in the office via firewalls. The web browsing traffic passes from a device through Wi-Fi or the cell network via CYREN's servers where it is filtered before and after the web. This not only protects the device, but also allows companies to avoid contamination once an employee returns to work. It can also allow establishments who provide Wi-Fi the ability to filter web access to protect customers.

CYREN Reports the December Quarter

On February 24, 2014, CYREN Ltd. (formerly Commtouch Software Ltd.), the provider of email 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, reported financial results for its fourth quarter and year ended December 31, 2013.

CYREN reported that fourth quarter 2013 Non-GAAP revenues grew by 19% percent to $8.4 million from $7.0 million for the year ago quarter missing our estimates slightly. Much of the growth in the quarter was due to the acquisitions of FRISK Software International's (based in Iceland) antivirus business as of October 1, 2012 and eleven GmbH (based in Germany) as of November 16, 2012.

Gross margin during the quarter on a non-GAAP basis declined once again to 78.8% versus 85.5% a year ago. We believe this has been caused by continuing pricing pressure due to increased competition in the sector, as well as by combining with eleven, a lower gross margin business. As a result, gross profits were up 10.2%, less than the growth in sales.

Ex-one time charges, non-GAAP operating expenses for the fourth quarter were $8.4 million compared to $5.6 million in the fourth quarter of 2012, up 23%. This ramp was due primarily to increased R&D (up 17%) and S&M (52%) as the company pushed to get out new products and increase the sales presence to OEMs and resellers as the new SaaS products roll out.

The company reported a non-GAAP net loss of $1.9 million for the fourth quarter, a decrease from a profit of $0.3 million last year. This equated to ($0.07) EPS in 2013.

Q4 one-time charges include:

- An acquisition related earn-out adjustment of $3.3 million.

- An increase in bad debt reserve of approximately $350,000.
- The write-off of the investment in a customer that was sold at a lower price than the company had paid of 1.3 million.
- The reduction of tax loss carry-forwards by $5.8 million. These were set to expire before the company expected to be able to use them.

Cash and equivalents decreased to $3.8 million compared to $5.1 million for the period ended December 31, 2012. The company has drawn $3.2 million from its new credit facility. The company's current and quick ratio now stands at 0.75X and DSOs on an annual run rate basis is 57 days.

Full Year Results

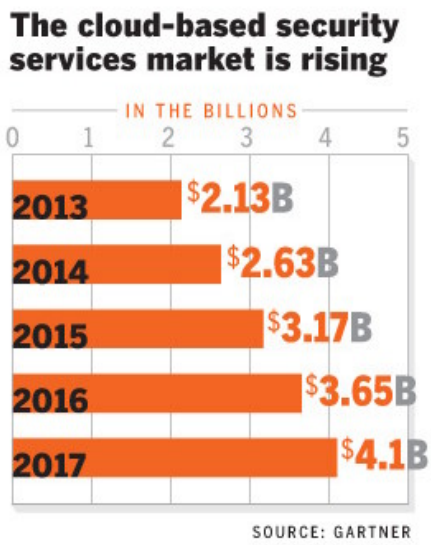
For the year, the company reported non-GAAP revenues of $32.8 million versus $24.1 million, up 19%. Growth was almost entirely from the acquisition of eleven in Germany that added an email SaaS solution and had $8 million in revenues. Its customers include Siemens, BMW and Porsche.

Gross margin declined to 80.5% from 82.4% a year ago largely due to the integration with eleven, which operates at lower gross margins as well as continuing ASP declines in the industry. ASP for the company's core business will remain under pressure as customers are threatened by the lower prices offered by the industry's cloud-based solutions which are undercutting traditional vendors.

Operating expenses increased considerably from $19.7 to $27.8 million (excluding one-time items) up 41%. The biggest increase was in sales and marketing (up 80%). G&A was up 11% and R&D 48%.

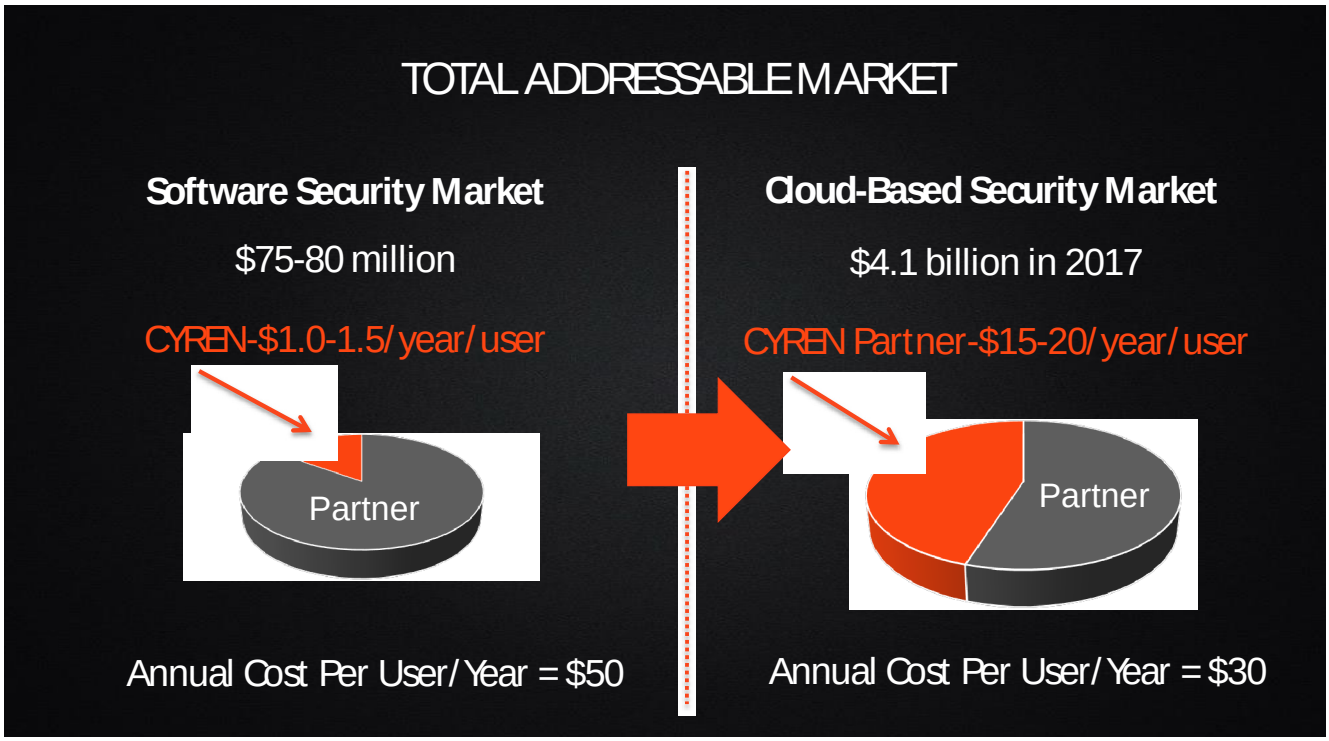
The operating loss for the year before one-time items was $1.6 million yielding an EBITDA of $3.2 million versus $6.2 million in 2012.

CYREN is Transitioning to a Higher Revenues and Margin Business



After years of being a small component of email and web security, CYREN is embarking on a new path. It is in the process of build out a full cloud-based product line that can be sold white label to vendors such as telcos and storage providers to protect their customers. Cloud-based security is on the rise according to Gartner who predicts that what was a $2.1B industry in 2013 will grow to $4.1B in 2017 as shown on the chart. This is an annual compound growth rate of 18.2%. If CYREN can capture even a small portion of this market, it can accelerate its organic growth.

In addition, rather than selling a component engine to an OEM for just $1.00 per year who in turn sells its product to the user for $50 per year, CYREN is now selling a complete product to a partner that will pay CYREN approximately $15 dollars and resell it to an end user for about $30 per year. This will increase the potential revenue to CYREN exponentially for the same number of end users, as shown in the following graph. In addition the target market for this product is much larger.



The company's first product, "WebSecurity," is used for protecting users from threats on the web. It will protect users from viruses and malware as well as allow users to block unwanted sites. The blocking feature will be particularly helpful in schools, restaurants and libraries that may want to block inappropriate sites from use in their locations where they provide Wi-Fi access to the public, or companies that want to block non work related access. Other products addressing other security requirements will be rolling out throughout the next two years. Since all traffic will have to go through CYREN's cloud servers, the company is setting up 20 more satellite locations in addition to the 13 data centers they have around the world to minimize latency. The most competitive feature that CYREN has against its competitors is that setting up a new user is as simple as sending him and email. A simple "click this link" gets protection instantly and is very important to smaller businesses that have little or no in-house IT support.

Looking Forward

The next product to expect from CYREN will be a cloud-based email service. It is in the process of porting over the current SaaS offering from the acquisition of eleven to its new cloud platform. This email product will protect against spam, phishing, viruses and other threats that come in from the email Internet application.

Next up will be products that protect from Advanced Persistent Threats (APTs) what will undercut high priced solutions from vendors like FireEye and a Data Loss Prevention (DLP) solution that protect against information leaking out of a system.

These products will all be funded by the cash flow that the core business provides.

COMPETITION

CYREN sells its security engine to virtually every cyber security and anti-virus company out there as shown on the chart below. They comprise over 180 partners serving 550 million users worldwide.



While we believe the core business will not see new entrants, the company's new product, WebSecurity, and other products not yet introduced will compete mainly with Websense and Zscaler.

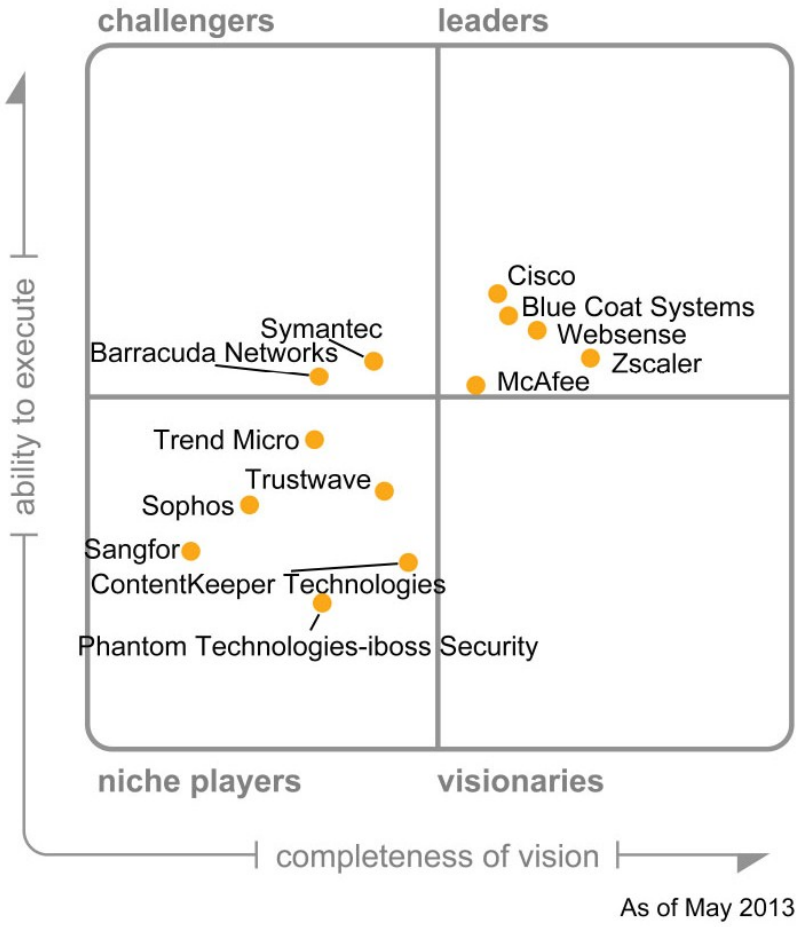
Websense

Websense, located in San Diego was founded in 1994 and was a public company up until last year when it was acquired by private equity at a $908 million valuation. In 2012, it generated $361 million in sales and was profitable. The company employees 1,300 people worldwide. According to its website it is "a global leader in protecting organizations from the latest cyber attacks and data theft. Websense TRITON comprehensive security solutions unify web security, email security, mobile security and data loss prevention (DLP). More than 11,000 enterprises use Websense TRITON security intelligence to stop advanced persistent threats (ATP), targeted attacks and evolving malware. Websense prevents data breaches, intellectual property theft and enforces security compliance and best practices.

Zscaler

Zscaler is a smaller private start-up located in San Jose and India with 280 employees. It has received $38 million in funding with the last and only round in 2012 from Lightspeed. It describes itself as selling an integrated, cloud-delivered security services include Web Security, Mobile Security, Email Security and DLP. The Zscaler Direct-to-Cloud Network processes daily more than 12 billion transactions from more than 12 million users in 180 countries across 100 global data centers with near-zero latency. It claims to have 4,500 global enterprise customers.

Gartner Magic Quadrant for Secure Web Gateway



INVESTMENT THESIS

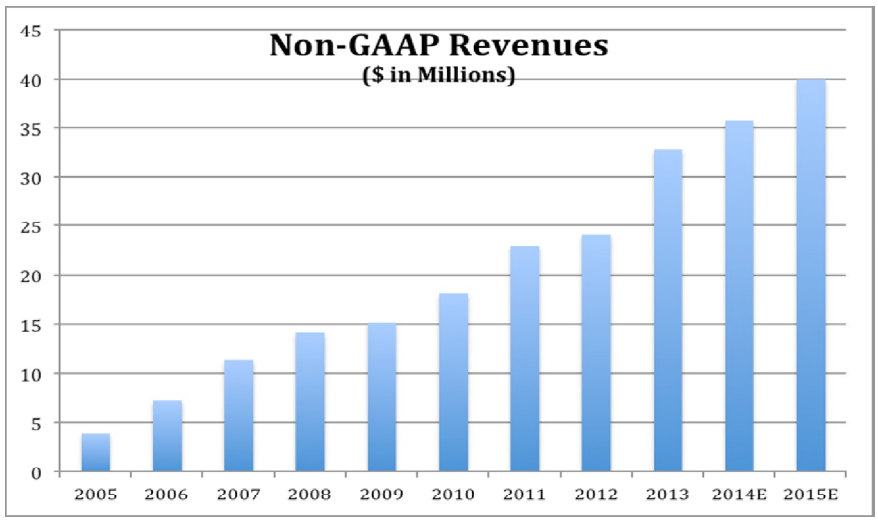
- CYREN is rolling out new higher growth products that should accelerate revenues and earnings in 2015 and beyond which should translate to a higher valuation and higher multiples more in line with its public peers.
- Versus public comparable companies in the Internet security business CYREN is considerably undervalued. This sector is experiencing increased investor attention due to the increasing occurrences of cyber attacks and security breeches in the news. It is believed that companies will commit higher spending to avoid these breeches in the future and the market will grow faster than previously thought.
- A number of high profile cyber security vendors such as Zscaler and Rapid7 are expect to go public near term. This is in addition to recent IPOs FireEye and Barracuda Networks. These companies are much more highly valued than CYREN and as a comparable its stock could rise.

VALUATION

CYREN currently trades at a price of $3.76 that gives it a market cap of $100 million, and an enterprise value of $99 million. EV to sales is at a 3xs its trailing 12-month revenues versus its peers that trade from a range of 50x for FireEye to for 8.5x Checkpoint. The difference is primarily that FEYE is expected to grow revenues 150% this year while Checkpoint is estimated to grow only 6%.

On an acquisition basis we can look to the acquisition of Websense in May 2013 for $906 million or 2.5x times 2012's $361 million in sales or almost 50 times earnings.

We believe that CYRN is undervalued relative to public comparable. While it is losing money near term, we believe that by 2016, when it has returned to more normalized margins, it could trade at least in line with Checkpoint if not higher. Even assuming a modest 6% growth for the next two years and using Checkpoint's 8.5 times multiple, CYREN could trade at a price of $14 by the end of 2015. At a rapid uptake of the new cloud-based products that price could be higher.



RISKS

- The company operates in a highly competitive industry. There are larger well-funded players with greater traction that could be difficult to take market share from.

- Customers may find the new products to be uncompetitive versus other more established offerings.

- The company may have difficulty penetrating new markets and reaching a new group of customers through the reseller channel.

- The company may need cash and using equity financing could be dilutive.

PROJECTED INCOME STATEMENT

In the last earnings report, the company provided guidance only to the extent that it believes that growth for the core detection business would be in the low single digits for revenues in the 2014 year. Sales for the new product WebSecurity, and other products not yet introduced, would be incremental to that but it gave no guidance as to when the product would ramp or what sales it might achieve. This is down considerably from the 19% growth reported for the 2013 year, though most of that growth was from acquisition.

It also indicated that in addition to a one-time increase in the bad debt reserve in the G&A line, the expenses seen in the fourth quarter for R&D and S&M would decline. In Q4 CYREN put on a big push in R&D to finish off the product as well as had extraordinary hiring expenses for new talent. With similar sales, we expect less of a loss in the Q1, but do not expect significant sales growth unless there is rapid uptake of the new WebSecurity product. Until we see traction in that product, we are estimating modest to flat sales.

Forecast for the March 31, 2014 Quarter

The March quarter is the first quarter that will anniversary a full quarter of the CYREN with the acquisitions made in 2012. As a result there will be no benefit from the acquisition and all growth will be organic. In the first quarter there little seasonality and we expect non-GAAP revenues to be slightly higher than the December quarter at $8.4 million versus $7.9 million last year (up 6.3%) and expenses to be lower. This could lead to near breakeven on an operating basis, but to a net income loss of $0.5 million after interest expense is paid, or a non-GAAP EPS loss of ($0.02).

Forecast for 2014

Given that the company's new products require a different sales force to sell to resellers and end users, we believe that it may take time to ramp revenues. It may take until the September quarter to see any acceleration in growth and any traction in the uptake of the product line. As such we believe that 2014 will be a wait and see year with the real growth coming in 2015. The new WebSecurity product is currently for sale with only one customer and there has not been enough information to accurately predict revenues at this point in time. Cautiously we are predicting that most of the company's growth will come in the later half of the year resulting in non-GAAP revenue growth of only 9% to $35.7 million. At this stage we are hesitant to build in high growth to our numbers, but they may be raised as the year progresses and the there is greater insight into the prospects and timing of the new products.

2014 will be a year of building and could result in earnings at breakeven as the company invests in marketing and R&D with the corresponding lags in sales. Investors may see the fruits of this effort in 2015 when the company truly hits its stride.

	Non-GAAP Dec Q4 12	Non-GAAP Dec Q4 13	Non-GAAP March Q1 14	Non-GAAP June Q2 14	Non-GAAP Sept Q3 14	Non-GAAP Dec Q4 14	Non-GAAP 2012	Non-GAAP 2013	Non-GAAP 2014
REVENUE									
Non-GAAP Rev	$7.01	$8.12	$8.37	$8.62	$9.12	$9.62	$24.14	$32.8	$35.71
GAAP Revenue	$6.8	$8.0	$8.2	$8.5	$9.0	$9.5	$23.9	$32.2	$35.25
Yr-to-yr Gr.								35%	9%
OPERATING EXPENSES									
Cost of goods sold	1.2	1.7	1.8	1.8	1.9	2.2	4.0	6.4	$7.78
Gross Margin	5.8	6.4	6.6	6.8	7.2	7.4	19.9	26.4	27.9
% of Sales	85.5%	78.8%	78.5%	78.6%	78.7%	77.1%	82.4%	80.5%	78.2%
R&D	2.2	2.6	2.4	2.4	2.4	2.4	6.0	8.9	$9.60
S&M	1.8	2.7	2.3	2.3	2.3	2.3	5.3	9.6	$9.20
G&A	3.1	3.4	2.0	2.0	2.0	2.0	8.3	9.2	$8.00
Adjustment of Earnout								0.0	$0.00
Tot Operating Exp.	7.0	8.7	6.7	6.7	6.7	6.7	19.7	27.8	26.8
Operating Income	(1.2)	(2.3)	(0.1)	0.1	0.5	0.7	0.2	(1.4)	1.1
Yr-to-yr Gr.									
Net Interest	(0.1)	(0.4)	(0.4)	(0.4)	(0.4)	(0.4)	0.1	(1.3)	(1.3)
Impairment of Investment								0.0	0.0
Pretax Income	(1.3)	(2.7)	(0.5)	(0.3)	0.1	0.3	0.3	(2.6)	(0.1)
Taxes	(0.5)	0.0	0.0	0.0	0.0	0.0	(0.6)	0.0	0.0
Tax Rate	40.2%	0.0%	0.0%	0.0%	0.0%	0.0%	-217.0%	0.0%	0.0%
Net Income	(0.8)	(2.7)	(0.5)	(0.3)	0.1	0.3	0.9	(2.6)	(0.1)
EPS-Basic	($0.03)	(0.10)	(0.02)	(0.01)	0.00	0.01	0.04	(0.10)	(0.00)
EPS-Fully dil.	($0.03)	(0.10)	(0.02)	(0.01)	0.00	0.01	0.04	(0.10)	(0.00)
Yr-to-yr Gr.									
Non-GAAP EPS	$0.01	($0.07)	($0.02)	($0.01)	$0.00	$0.01	$0.04	($0.10)	($0.00)
Share Out	25.6	26.5	26.7	26.9	27.1	27.3	24.6	26.2	26.2
Fully diluted shares	25.6	26.5	26.7	26.9	27.1	27.3	25.1	26.2	26.2

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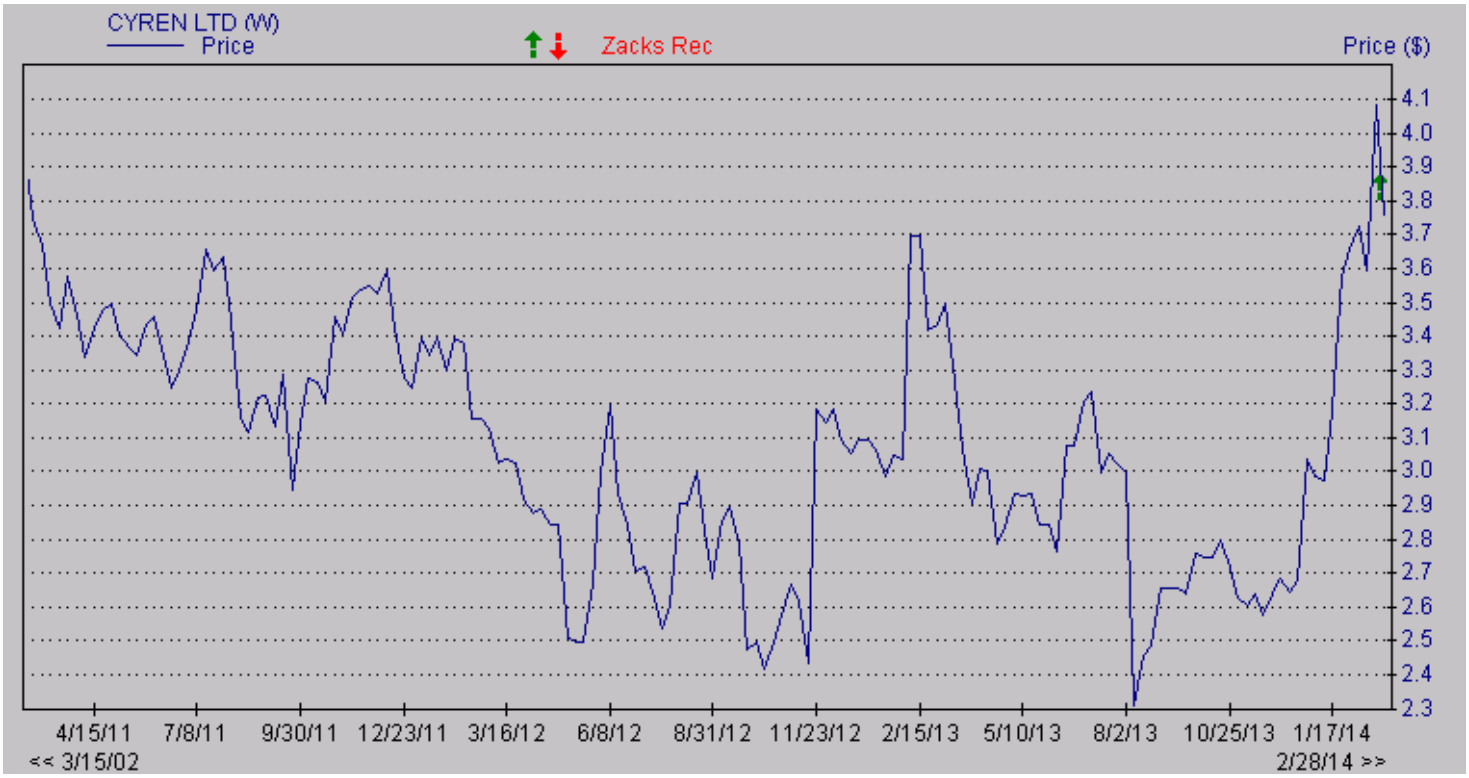

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