Zacks Equity Research

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Commtouch Software (CTCH-NASDAQ)

CTCH: Zacks Company Report - Outperform

Current Recommendation	**Outperform**
Prior Recommendation	N/A
Date of Last Change	09/13/2009
Current Price (02/16/10)	$3.98
Six- Month 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	**$4.30**
52-Week Low	**$1.57**
One-Year Return (%)	**115.14**
Beta	**1.04**
Average Daily Volume (sh)	**35,811**
Shares Outstanding (mil)	**24**
Market Capitalization ($mil)	**$96**
Short Interest Ratio (days)	**0.36**
Institutional Ownership (%)	**7**
Insider Ownership (%)	**N/A**
Annual Cash Dividend	**$0.00**
Dividend Yield (%)	**0.00**
5-Yr. Historical Growth Rates	
Sales (%)	**50.2**
Earnings Per Share (%)	**54.7**
Dividend (%)	**N/A**
P/E using TTM EPS	**18.1**
P/E using 2009 Estimate	**19.0**
P/E using 2010 Estimate	**N/A**
Zacks Rank	**3**

Risk Level	**Average,**
Type of Stock	**Small-Growth**
Industry	**Internet-Servcs**
Zacks Rank in Industry	**N/A**

ZACKS ESTIMATES

Revenue
(in millions of $)

	Q1 (Mar)	Q2 (Jun)	Q3 (Sep)	Q4 (Dec)	Year (Dec)
2007	2 A	3 A	3 A	3 A	11 A
2008	3 A	4 A	4 A	4 A	14 A
2009	4 A	4 A	4 E	4 E	16 E
2010	4 E	4 E	5 E	5 E	18 E

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

	Q1 (Mar)	Q2 (Jun)	Q3 (Sep)	Q4 (Dec)	Year (Dec)
2007	$0.00 A	$0.03 A	$0.03 A	$0.03 A	$0.08 A
2008	$0.03 A	$0.04 A	$0.04 A	$0.03 A	$0.14 A
2009	$0.03 A	$0.04 A	$0.05 A	$0.05 E	$0.17 E
2010	$0.05 E	$0.05 E	$0.05 E	$0.06 E	$0.21 E

Zacks Projected EPS Growth Rate - Next 5 Years % **15**

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KEY POINTS

- Hackers and Spammers are now motivated by profit rather than notoriety.
- Commtouch's in the cloud technology is superior to the competition's static solutions.
- The move into URL filtering is a tremendous opportunity for growth in our opinion as the internet remains under penetrated in most parts of the world.
- The OEM model employed by CTCH has inherent advantages.
- The firm's balance sheet is a source of strength. CTCH has no long-term debt and increased its cash to $16 million.

OVERVIEW

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.

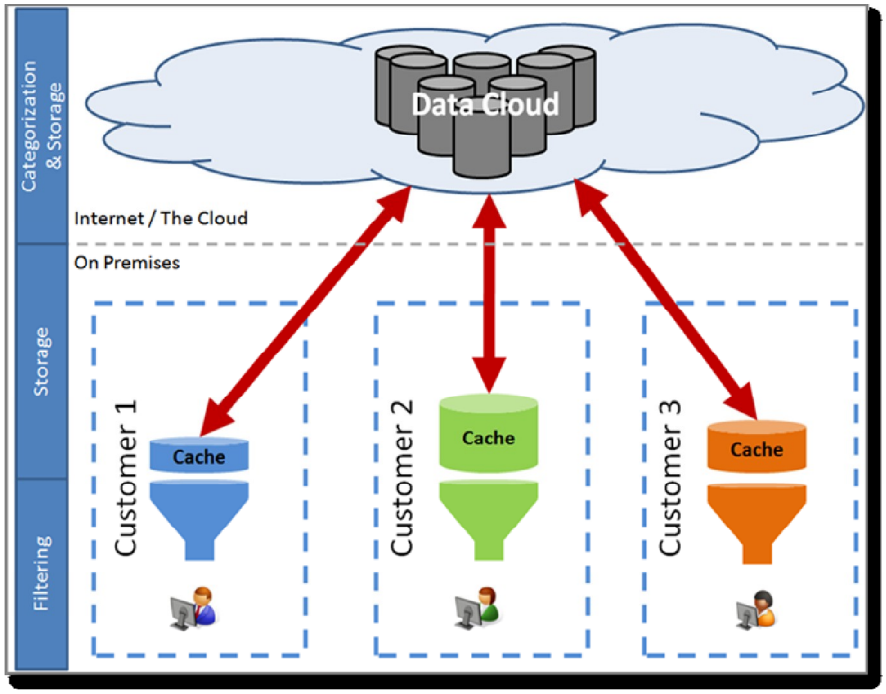
• Compliance with government regulations, such as SOX, continue to play a significant role in security spending decisions. Investment is often justified because the downside of breaches and failure is so great.

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

The Company signed agreements with eight new OEM partners during the second quarter, resulting in a total of 125 OEM partners using Commtouch messaging and/or Web security technologies. In the first quarter of 2009 the company signed 5 new companies.

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.

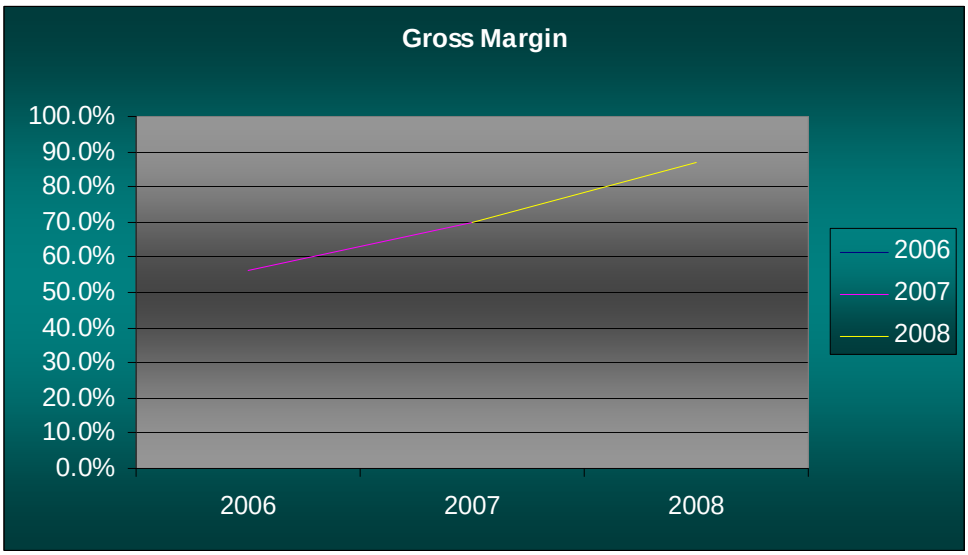
WORLD INTERNET USAGE AND POPULATION STATISTICS						
World Regions	Population (2009 Est.)	Internet Users Dec. 31, 2000	Internet Users Latest Data	Penetration (% Population)	Growth 2000-2009	Users % of Table
Africa	991,002,342	4,514,400	65,903,900	6.70%	1359.90%	3.90%
Asia	3,808,070,503	114,304,000	704,213,930	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.

Balance Sheet

The firm's balance sheet is a source of strength with no debt and 16 million in cash. The share buyback program has been expanded and should provide higher EPS numbers in the future. Company made a $477 thousand follow-on investment in Mirapoint, a secure messaging and archiving vendor and an OEM licensee. This is the Company's second investment in Mirapoint, bringing the total to date that the Company has invested to $1.2 million.



INDUSTRY OUTLOOK

INDUSTRY OUTLOOK - NEUTRAL

The outlook for the software industry is Neutral. The last few quarters have shown signs of demand stabilization and cost cutting initiatives. While areas like enterprise resource planning systems, supply chain management software, and customer relationship management software have been hit hard by weak IT spending, other niches have held up relatively well. These include gaming, video editing and security software. Government spending also has been supportive to the software industry.

With several important software categories reaching maturity, top-line growth for the industry is likely to remain below historical levels, even after the industry recovers. Nevertheless, long-term growth prospects are still modestly above average. In addition, several of the group's top companies possess stellar fundamentals, including high profit margins, pristine balance sheets and cash flow well in excess of capital requirements.

INDUSTRY POSITION

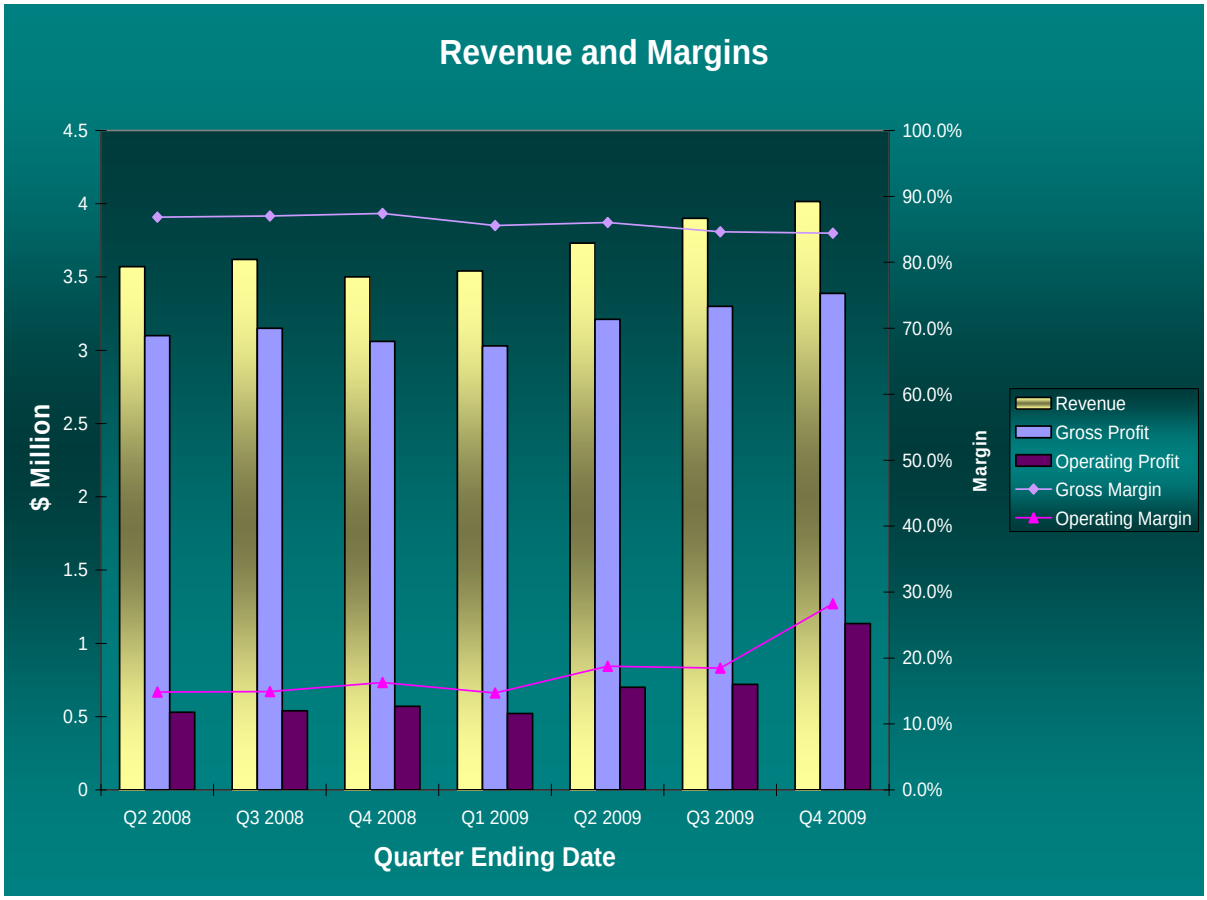
Email defense providers offering solutions on an OEM basis similar to Commtouch's business model, include Cloudmark, Mailshell and Mail-Filters. As this market continues to develop, it is likely that companies with greater resources than CTCH will attempt to either enter or increase their presence in this market by acquiring or forming strategic alliances with competitors or business partners. Some examples of this are the acquisitions of IronPort by Cisco, Secure Computing by McAfee, CipherTrust by Secure Computing, Brightmail by Symantec Corp. and Microsoft of both Frontbridge Technologies and Sybari Software.

Web security defense providers offering forms of software (gateway), multi-functional appliances and managed service solutions and which may be viewed as both competitors and potential customers to Commtouch include McAfee (Secure Computing), WebSense, IBM (ISS) and Cisco (Fastdata). Web defense providers offering solutions on an OEM basis similar to Commtouch's business model, include BrightCloud, RuleSpace and Puresight.

RECENT NEWS

On February 10th 2010 CTCH announced results for the fourth quarter of fiscal year 2010 ending December 2009. The top and bottom-line exceeded the consensus estimates. Revenue for the period was $4.01 million rising 3.19% sequentially from $3.89 million and up 14.7% year over year.

The Company signed agreements with twenty nine new OEM partners during the fourth quarter, resulting in a total of 135 OEM partners using Commtouch messaging and/or Web security technologies. In the third quarter of 2009 the company signed ten new companies.



Pro-forma gross margin for the quarter was 84.4% declining sequentially from the 84.9% level a quarter ago and down 290 basis points (bps) from 87.3% in the year ago quarter. Operating expenses were $2.25 million versus $2.26 million a quarter ago and $2.21 million in the fourth quarter of last year.

CTCH net income (GAAP) was $3.18 million or 79.2% of sales versus $0.85 million or 21.8% last quarter and $0.64 million or 18.4% in the year ago quarter. Earnings per share (EPS) was $0.13 in the December quarter compared to $0.03 in the September quarter and $0.03 a year ago. On a pro-forma basis the earnings per share were $0.05 versus $0.05 in the September quarter and $0.03 in the fourth quarter a year ago. The pro-forma adjusted numbers exclude Stock-based compensation.

Turning to the balance sheet the firm ended the quarter with $17.3 million in cash and cash equivalents compared to $16.4 million a quarter ago. The change is primarily the result of the positive operating cash flow offset by the buy-back program. As of December 31, 2009, the company had exhausted $4.9 million of the total $5 million allocated to the program; resulting in a total of 2,164 thousand shares being repurchased at an average price of $2.25 per share. The company intends to continue to implement the buy-back program under the guidance of its Board of Directors.

Management chose not to give specific quarterly guidance, but does reiterate it expects to meet its annual guidance with expected annual revenues in the range of $17 to $18 million and non-GAAP net income around $5 million.

On December 14, 2009 Commtouch announced that it has obtained approval to list its shares on the Tel Aviv Stock Exchange in addition to its current listing on NASDAQ. Trading in Tel Aviv will commence on December 16, 2009.

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 no 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 16.9x 2010 Adjusted EPS.

We value the company based on the average of our P/E multiple (19.5x 2010 estimated EPS) and our two stage intrinsic model. The group average 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 12.0% (average forecast) and a discount rate of 10%.
- A continuing period assumed to go on forever, with earnings growing at 6% and a discount rate of 12%.

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

Industry Comparables

	Pr Chg YTD	P/E CurrFY	EPS Gr 5Yr Est	Price/ Book	Price/ Sales	Price/ CF
COMMTOUCH SOFTW	9.6	19.0	15.0	5.1	6.3	37.8
Industry Mean	11.3	23.6	19.6	3.2	26.5	18.8
Industry Median	-0.3	21.5	18.7	2.0	1.7	10.0
S&P 500	-1.8	14.4		3.6	2.3	12.3
DELTATHREE.COM	-24.3				1.0	
ZIX CORP	27.5	22.9	20.0		4.7	
PRECISION AUTO	8.0				0.6	13.8
BANKS.COM INC	12.8			0.6	0.7	

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.

INSIDER TRADING AND OWNERSHIP

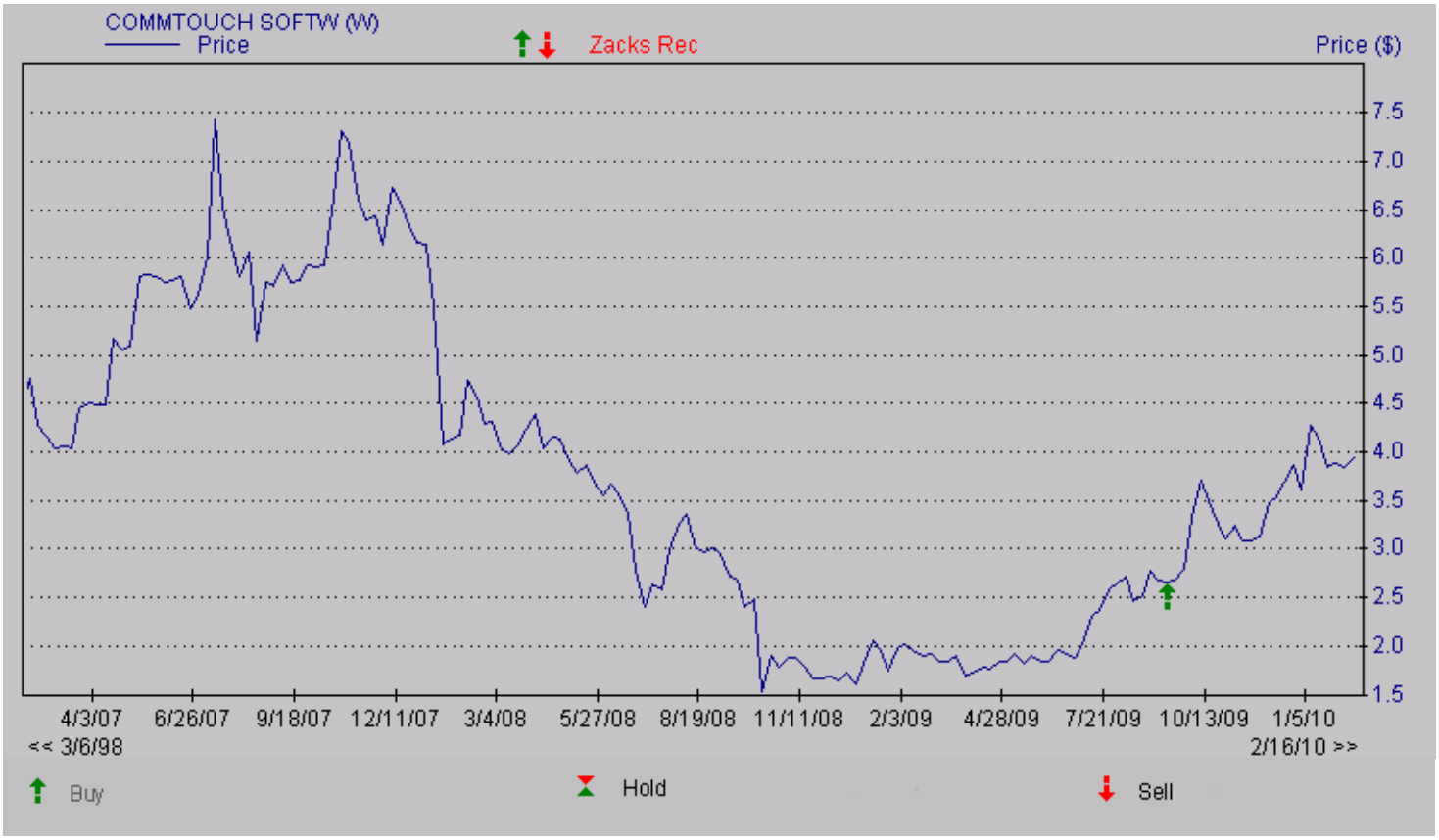
Institutional and mutual fund holders own around 2% of the company's outstanding shares. The top five institutional holders are Renaissance Technologies (with 1.7% of the total shares outstanding), Goldman Sachs Group (0.3%), Invesco (0.3%), Ingalls & Snyder (0.03%) and UBS Ag (0.2%). Three of the top five holders added shares in the last quarter, while two stayed the same.

PROJECTED INCOME STATEMENT & BALANCE SHEET

INCOME STATEMENT ($ Millions)	Dec-08 Q408	Mar-09 Q109	Jun-09 Q209	Sep-09 Q309	Dec-09 Q409	Mar-10 Q110E	FY 2006	FY 2007	FY 2008	FY 2009	FY 2010 E	FY 2011 E
REVENUE												
Net Revenue	**3.5**	**3.5**	**3.7**	**3.9**	**4.0**	**4.2**	**7.2**	**11.3**	**14.1**	**15.2**	**18.5**	**20.0**
Sequential Growth		*1%*	*5%*	*5%*	*3%*	*5%*						
OPERATING EXPENSES												
Cost of Revenues	0.44	0.51	0.50	0.59	0.63	0.62	0.9	1.4	1.8	2.2	2.3	2.4
% of Revenue	*12.6%*	*14.4%*	*13.4%*	*15.1%*	*15.6%*	*14.8%*						
Gross Profit -	**3.1**	**3.0**	**3.2**	**3.3**	**3.4**	**3.6**	**6.3**	**9.8**	**12.3**	**13.0**	**16.2**	**17.6**
Proforma Gross Margin	*87.4%*	*85.6%*	*86.6%*	*84.9%*	*84.4%*	*85.2%*	*87.6%*	*87.5%*	*87.1%*	*85.4%*	*87.4%*	*88.0%*
R&D + Engg	0.73	0.72	0.69	0.80	0.53	0.54	1.5	1.9	2.8	2.7	3.6	3.9
% of Revenue	*20.9%*	*20.2%*	*18.5%*	*20.5%*	*13.1%*	*12.9%*	*20.7%*	*16.9%*	*19.9%*	*17.4%*	*19.5%*	*19.5%*
SG&A	1.49	1.48	1.52	1.79	1.73	1.77	4.4	5.3	6.0	6.3	8	8
% of Revenue	*42.6%*	*41.8%*	*40.8%*	*45.9%*	*43.1%*	*42.1%*	*60.9%*	*47.1%*	*42.6%*	*41.3%*	*40.5%*	*41.0%*
GW Amort, Restructuring, other	-	-	-	-				-	-	-		
% of Revenue												
Total Operating Expenses	2.22	2.20	2.21	2.59	2.25	2.31	5.9	7.2	8.8	8.9	11	12
% of Revenue	*63.4%*	*62.0%*	*59.2%*	*66.4%*	*56.2%*	*55.0%*	*81.6%*	*64.0%*	*62.5%*	*58.7%*	*60%*	*61%*
Operating Income -	**0.84**	**0.84**	**1.02**	**0.72**	**1.13**	**1.3**	**0.4**	**2.6**	**3.5**	**4.0**	**5**	**6**
Operating Margin	*24.0%*	*23.6%*	*27.3%*	*18.5%*	*28.3%*	*30.2%*	*6%*	*23%*	*25%*	*27%*	*27%*	*28%*
NON-OPERATING ITEMS												
Non operating Income/Expense	0.1	-0.1	0.0	0.1	0.0	0	0.2	0.5	0.3	0.1	0	0
% of Revenue	*1.43%*	*-1.98%*	*0.27%*	*3.59%*	*-0.57%*	*-0.24%*	*3.04%*	*4.62%*	*2.41%*	*0.40%*	*0.00%*	*0.00%*
Tax Provision	0.0	0.0	0.0	0.0	0.0	0.0	0.00	0.02	0.01	0.0	0	0
Effective Tax Rate												
Net Income -	**0.89**	**0.77**	**1.03**	**0.86**	**1.11**	**1.26**	**0.65**	**3.14**	**3.80**	**4.10**	**5.0**	**5.5**
Net Income Margin	*25.4%*	*21.6%*	*27.6%*	*22.1%*	*27.7%*	*30.0%*	*9.0%*	*27.9%*	*27.0%*	*27.0%*	*27%*	*27%*
Stock Based Comp	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**0**
EARNINGS PER SHARE												
EPS - Basic	$0.03	$0.03	$0.04	$0.05	$0.05	$0.05	$0.00	$0.13	$0.15	$0.17	$0.20	$0.22
EPS - Diluted	$0.03	$0.03	$0.04	$0.05	$0.04	$0.04	$0.00	$0.11	$0.14	$0.16	$0.19	$0.21
EPS - (GAAP)	$0.02	$0.02	$0.03	$0.03	$0.13	$0.05	-$0.01	$0.08	$0.08	$0.21	$0.19	$0.21

Ken Nagy, CFA Zacks Investment Research 2/17/2010

HISTORICAL ZACKS RECOMMENDATIONS



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