Palo Alto Networks (PANW)

$171.34 (As of 04/06/20)

Price Target (6-12 Months): **$180.00**

Long Term: 6-12 Months	**Zacks Recommendation:** (Since: 02/24/20) Prior Recommendation: Underperform	**Neutral**
Short Term: 1-3 Months	**Zacks Rank:** (1-5)	**3-Hold**
	Zacks Style Scores:	VGM:F
	Value: D | Growth: D | Momentum: F	

Summary

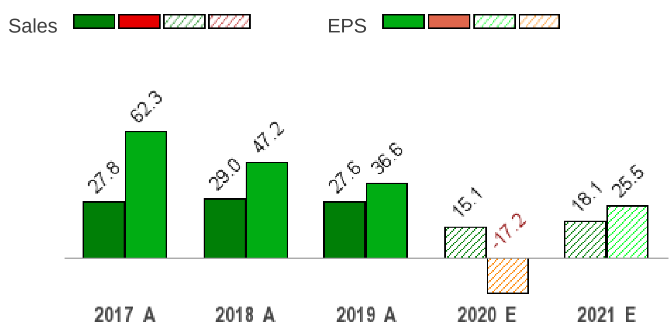
Palo Alto Networks is benefiting from continuous deal wins and strong demand for its next-generation security platforms. Its recent acquisition synergies are expected to drive revenues, going forward. Growing traction in Prisma and Cortex offerings is another tailwind. Growing customer base remains a positive. However, continued impact of sales incentives was an overhang. Continued acquisitions are also hurting the company's profitability. Furthermore, U.S. tariff on Chinese goods is expected to affect the bottom line. Volatile spending environment is also a negative. Moreover, competition from the likes of Fortinet and Cisco are perpetual woes. Shares of the company have underperformed the industry in the past year.

Price, Consensus & Surprise

Data Overview

52 Week High-Low	$251.11 - $125.47
20 Day Average Volume (sh)	1,944,179
Market Cap	$17.1 B
YTD Price Change	-25.9%
Beta	1.07
Dividend / Div Yld	$0.00 / 0.0%
Industry	Security
Zacks Industry Rank	Bottom 40% (152 out of 253)
Last EPS Surprise	6.3%
Last Sales Surprise	-3.1%
EPS F1 Est- 4 week change	-5.4%
Expected Report Date	06/03/2020
Earnings ESP	-3.9%
P/E TTM	34.1
P/E F1	38.0
PEG F1	1.6
P/S TTM	5.5

Sales and EPS Growth Rates (Y/Y %)



Sales Estimates (millions of $)

	Q1	Q2	Q3	Q4	Annual*
2021	900 E	955 E	986 E	1,077 E	3,943 E
2020	772 A	817 A	832 E	924 E	3,338 E
2019	656 A	711 A	727 A	806 A	2,900 A

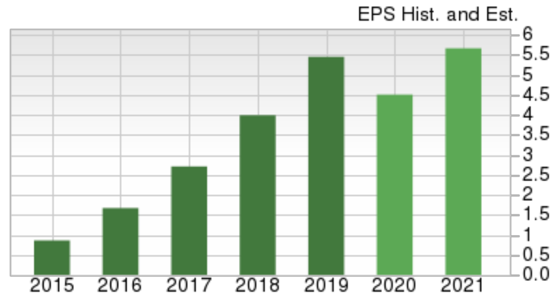
EPS Estimates

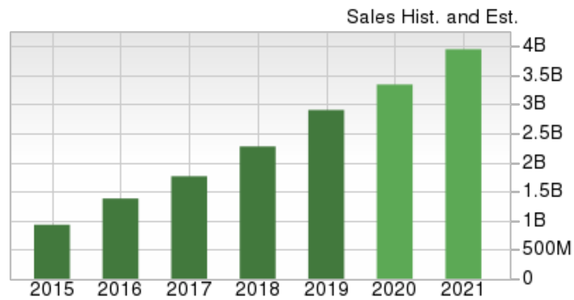
	Q1	Q2	Q3	Q4	Annual*
2021	$1.21 E	$1.42 E	$1.37 E	$1.74 E	$5.66 E
2020	$1.05 A	$1.19 A	$0.94 E	$1.35 E	$4.51 E
2019	$1.17 A	$1.51 A	$1.31 A	$1.47 A	$5.45 A

*Quarterly figures may not add up to annual.

The data in the charts and tables, including the Zacks Consensus EPS and Sales estimates, is as of 04/06/2020. The reports text is as of 04/07/2020.

Overview





Santa Clara, CA-based Palo Alto Networks, Inc. offers network security solutions to enterprises, service providers and government entities worldwide.

The company's next generation firewall products deliver natively integrated application, user, and content visibility and control through its operating system, hardware and software architecture. It serves the enterprise network security market, which includes Firewall, Unified Threat Management (UTM), Web Gateway, Intrusion Detection and Prevention, and Virtual Private Network technologies.

Through its products and subscription services, Palo Alto provides integrated protection against dynamic security threats while simplifying the IT security infrastructure. Its solutions incorporate application-specific integrated circuits, hardware architecture, operating system, and associated security and networking functions.

The company's network security gateways protect customer data, reduce security complexities and lower total cost of ownership. Customers can implement their security policies on traffic between internal networks and the Internet, as well as between internal and private networks shared with partners.

The company has a single operating segment. However, the company announces its revenues from products and services separately. For fiscal 2019, the company reported total revenues of $2.9 billion, which grew 28% year over year.

Palo Alto's fiscal 2019 revenues from its products rose 25% year over year to $1,096.2 million. Revenues from subscriptions and support increased 29% to $1,803.4 million.

Further, Palo Alto operates across different geographic regions, including the Americas, Europe, the Middle East, and Africa (EMEA) and the Asia-Pacific and Japan (APAC).

The company faces competition from large companies like Cisco and Juniper, independent security vendors such as Symantec, Check Point, Fortinet, FireEye and several other small companies.

Reasons To Buy:

> Product ramp ups, deal wins, continuous growth of the network security market and expected benefits from the ongoing investments are the positives.

- Cyber security has become a mission-critical, high-profile requirement as financial well being, brands and reputation of enterprises are exposed to sophisticated cyber threats. Palo Alto is growing rapidly in this space on the back of its innovative next-generation security platforms. The company's security platforms have innovative traffic classification engine that helps it in identifying network traffic by application, user and content. As a result, organizations have in-depth visibility into all traffic and applications which help them to control usage, content, risks and cyber threats at the user level. Therefore, Palo Alto's security platforms simplify security infrastructure for organizations by eliminating the need for multiple, stand-alone security appliances and software products. This reduces the total cost of ownership thereby giving the organization a competitive edge.

- Palo Alto has made strategic acquisitions to boost growth. The buyout of LightCyber expanded the company's Next-Generation Security Platform. Over the last few years, it also completed several important acquisitions to broaden its portfolio and global reach. Buyouts of Morta Security and Cyvera expanded its product portfolio and the customer base. Another acquired company, CirroSecure's resources and expertise has helped Palo Alto in boosting the functionality of its enterprise security platform and guard the SaaS collaboration products of Salesforce.com, Google Drive, Box and Dropbox better. Moreover, the company expanded its endpoint detection and response (EDR) capabilities with the acquisition of Secdo. Moreover, the RedLock buyout extended its leadership in cloud security. Its buyout of Demisto is helping Palo Alto incorporate AI and ML to enhance the automation of its customers' security operations. Container security company Twistlock, and serverless security firm PureSec, are expected to help Palo Alto better protect customers' journey to the cloud. Its impending acquisition of machine identity-based micro-segmentation company Aporeto will bring micro-segmentation capabilities in Prisma Cloud, further fortifying it.

- Palo Alto has made strategic partnerships to expedite growth. The company formed the NextWave Technology Partner Program under which an organization can join as strategic or integration partner. Over the last one year, it has expanded its strategic partnership with VMware to address cloud and mobile security needs of organizations. Apart from this, Palo Alto has made strategic alliance with Aruba Networks to offer security solutions tailored for mobile users. Furthermore, with another partnership with Splunk, Palo Alto is offering solutions to effectively coordinate detection, incident investigation, and response for advanced threats. Moreover, by integrating its solutions with Citrix, the company offers security solutions to cloud networking platforms. These strategic partnerships bring in customers for Palo Alto thereby boosting the top line.

- The exponential growth in the amount of data, complexity of data formats and the need to scale resources at regular intervals has led to a tremendous surge in demand for cloud computing software and applications. This trend, on the other hand, has made it necessary for companies to enforce stricter data security measures. Therefore, looking at the industry's trends, Palo Alto is currently focusing on cloud-based protection services. The company currently offers a subscription-based cloud protection service — WildFire — which helps end-customers in identifying malware on any network and takes preventive measures automatically. Moreover, Palo Alto has launched several new subscription-based services in the last few months – AutoFocus, Aperture, GlobalProtect cloud service and Logging Service – which have expanded its cloud protection capabilities.

- Palo Alto is currently focusing on selling more subscription-based services. This unique business model is helping it to generate stable revenues while expanding margins. Subscription-based service is a high gross-margin business (approximately 80%) compared with the hardware-centric model. We believe that the strategy will continue to improve the company's top line and bottom line. Palo Alto has been witnessing tremendous customer growth for its subscription-based services like WildFire and Trap. Further, the company's subscription-based services – AutoFocus, Aperture, Traps and Virtual continue to witness solid growth. We believe that continued focus on subscription-based products and services and product upgrades will boost the company's top line.

Reasons To Sell:

- We note that Palo Alto currently has a trailing 12-month Price/Book Value (P/B) ratio of 10.6. This level compares unfavorably with what the industry witnessed in the last year. Hence, valuation looks slightly stretched from a P/B perspective.

Intensifying competition, an uncertain economic environment and currency headwinds remain concerns.

- Near-term prospects for Palo Alto are not promising as customer changing behavior has recently hit several other players in this space. For the past few months, various competitors in the cyber security space noticed that the companies have been breaking their cybersecurity investment plans into phases and implementing the same over longer periods of time, instead of making a single large investment. This makes us slightly cautious about the company's near-term performance.

- Palo Alto faces stiff competition from several big and small players in the security application market. Further, over the past few years, the demand for IT security has been on the rise driven by increasing awareness and cyber attacks, making the market more attractive for new players. Also, there are some established players in the adjacent markets like Cisco and Juniper that can cross sell security products and include security into their existing product lines, further intensifying competition in the space. Therefore, companies must deliver prompt and advanced technologies to suit customer requirements and expedite product launch to stay afloat.

- To survive in the highly competitive cyber security market, each player must continually invest in broadening its capabilities. Over the past few years, Palo Alto has invested heavily to enhance its sales and marketing capabilities, particularly by increasing the sales force. This has negatively impacted its operating margins. Furthermore, though the company foresees these investments to garner benefit over the long run, we note that there is uncertainty about the payback period.

Last Earnings Report

Palo Alto Q2 Earnings Beat Estimates, Revenues Miss

Quarter Ending	01/2020
Report Date	Feb 24, 2020
Sales Surprise	-3.14%
EPS Surprise	6.25%
Quarterly EPS	1.19
Annual EPS (TTM)	5.02

Palo Alto reported second-quarter fiscal 2020 non-GAAP earnings of $1.19 per share, which surpassed the Zacks Consensus Estimate by 6.25%. However, the bottom line declined 21.2% year over year.

The company's revenues of $816.7 million improved 15% year over year. However, the figure missed the Zacks Consensus Estimate of $843 million.

The top line was primarily driven by several deal wins and increasing adoption of the company's next-generation security platforms. Growing traction in Prisma and Cortex offerings also acted as a tailwind.

However, revenues were below the company's expectations primarily due to the negative impact of sales incentives related to Next-Generation Security products, which continued from the prior fiscal year.

Quarterly Details

Product revenues declined approximately 9.24% to $246.5 million.

However, the company's subscription and support revenues improved 29.7% to $570.2 million, driven by a 37% increase in SaaS-based subscription revenues and 20% rise in support revenues. This segment of Palo Alto's business constituted 70% of total revenues in the fiscal second quarter.

Further, billings improved 17% year over year to $998.9 million. Deferred revenues surged 27% to $3.2 billion.

During the reported quarter, Palo Alto continued to acquire new customers — adding more than 2,500 customers— and increase wallet share with existing customers.

Region wise, revenues from the Americas climbed 15% while Europe, the Middle East and Africa, and Asia Pacific revenues rose 12% and 20%, respectively.

Margins

Additionally, Palo Alto's non-GAAP gross margin expanded 10 basis points (bps) on a year-over-year basis to 76.4%.

Non-GAAP operating margin contracted 670 bps to 17.9% due to a headwind of about $79 million in net expenses related to the recent acquisition.

Balance Sheet

Palo Alto exited the fiscal second quarter with cash, cash equivalents and short-term investments of approximately $3.5 billion compared with $3.3 billion at the end of the preceding quarter.

The company's balance sheet does not have any long-term debt.

It generated cash flow from operations of $306.9 million compared with $225.2 million in the previous quarter. Free cash flow came in at $257.8 million.

Guidance

For third-quarter fiscal 2020, Palo Alto anticipates revenue growth of 15-17% year over year between $835 million and $850 million. Billings growth is anticipated between 19% and 22%, ($980 million-$1 billion).

Non-GAAP earnings per share are estimated in the range of 96-98 cents.

Capital expenditure of approximately $85-$90 million is expected in the third quarter with approximately $50 million allocated for future expansion of Palo Alto's headquarters in Santa Clara.

For fiscal 2020, the company estimates billings to grow in the range of 17-18% year over year. Moreover, it now expects billings growth of its next-generation security business (Prisma and Cortex) at 79-82%.

Revenues for the fiscal year are estimated between $3.35 billion and $3.39 billion, suggesting an improvement of 16-17% year over year.

Non-GAAP earnings per share are estimated in the band of $4.55-$4.65.

Recent News

On Feb 24, 2020, Palo Alto launched Cortex XSOAR, an extended security orchestration, automation and response platform to provide security leaders with improved capabilities against threats across their entire enterprise.

On Jan 6, 2020, Palo Alto announced that the Prisma Cloud has been deemed “In Process” for the Federal Risk and Authorization Management Program (FedRAMP). Moreover, it has been added to Palo Alto Networks Government Cloud Services.

On Dec 23, 2019, Palo Alto completed the buyout of machine identity-based microsegmentation company, Aporeto, in order to reinforce its cloud native security platform delivered by Prisma Cloud.

On Nov 13, 2019, Palo Alto expanded its Cortex portfolio with the addition of Cortex XDR 2.0. The new offering adds third-party data for analytics and investigations, while converging prevention, detection, investigation and response in one platform to enhance security and operational efficiency.

On the same day, Palo Alto announced new enhancements to the comprehensive secure access service edge platform, namely Prisma Access. These include cloud-delivered software-defined wide area network (SD-WAN) and data loss prevention capabilities. These upgrades will extend the company’s comprehensive cloud security strategy, Prisma, and enhance its capabilities to provide end-to-end protection for modern applications. This, in turn, will safeguard clients’ journey to the cloud in a much better fashion.

On Oct 5, 2019, Palo Alto announced that its Cortex XDR and Cortex Data Lake have received the "In Process" designation for the Federal Risk and Authorization Management Program (FedRAMP).

Valuation

Shares of Palo Alto have plunged 25.9% in the year so far and 28.3% over the trailing 12-month period. Stocks in the Zacks sub-industry and the Zacks Computer & Technology sector have fallen 13.3% and 18%, respectively, year-to-date (YTD). Over the past year, the Zacks sub-industry and the sector decreased 12.9% and 9.2%, respectively.

The S&P 500 Index has declined 22.7% YTD and 14.2% in the past year.

The stock is currently trading at 4.5X forward 12-month sales, which compares to 6.47X for the Zacks sub-industry, 2.89X for the Zacks sector and 2.72X for the S&P 500 index.

Over the past five years, the stock has traded as high as 17.69X and as low as 3.51X, with a 5-year median of 6.57X. Our Neutral recommendation indicates that the stock will perform in-line with the market. Our $180 price target reflects 4.73X forward 12-month sales.

The table below shows summary valuation data for PANW

Valuation Multiples - PANW

		Stock	Sub-Industry	Sector	S&P 500
P/S F12M	Current	4.50	6.47	2.89	2.72
	5-Year High	17.69	8.96	3.58	3.44
	5-Year Low	3.51	5.32	2.32	2.54
	5-Year Median	6.57	6.63	3.03	3.00
EV/FCF TTM	Current	16.07	20.45	18.07	17.76
	5-Year High	85.93	32.78	22.50	33.44
	5-Year Low	11.73	14.80	12.07	13.99
	5-Year Median	19.37	19.77	19.03	20.41
EV/Sales TTM	Current	4.58	6.50	3.31	2.47
	5-Year High	19.05	10.68	4.44	3.46
	5-Year Low	3.35	4.95	2.57	2.16
	5-Year Median	7.38	6.85	3.55	2.83

As of 04/06/2020

Industry Analysis **Zacks Industry Rank:** Bottom 40% (152 out of 253)

Top Peers

Check Point Software Technologies Ltd. **(CHKP)**	Neutral
Cisco Systems, Inc. **(CSCO)**	Neutral
FireEye, Inc. **(FEYE)**	Neutral
Fortinet, Inc. **(FTNT)**	Neutral
Juniper Networks, Inc. **(JNPR)**	Neutral
Qualys, Inc. **(QLYS)**	Neutral
CyberArk Software Ltd. **(CYBR)**	Underperform
Proofpoint, Inc. **(PFPT)**	Underperform

Industry Comparison Industry: Security

Industry Peers

	PANW Neutral	X Industry	S&P 500	CHKP Neutral	FEYE Neutral	FTNT Neutral
VGM Score	F	-	-	F	C	C
Market Cap	17.08 B	3.19 B	18.06 B	15.07 B	2.24 B	18.61 B
# of Analysts	17	12	13	16	13	14
Dividend Yield	0.00%	0.00%	2.34%	0.00%	0.00%	0.00%
Value Score	D	-	-	D	F	F
Cash/Price	0.19	0.14	0.06	0.11	0.50	0.12
EV/EBITDA	35.86	24.25	11.15	13.65	-25.02	30.49
PEG Ratio	1.68	2.58	1.87	2.25	4.79	2.91
Price/Book (P/B)	10.62	7.27	2.46	4.22	3.11	13.96
Price/Cash Flow (P/CF)	33.90	33.90	9.59	17.43	NA	37.04
P/E (F1)	39.23	38.03	15.66	16.29	52.73	40.75
Price/Sales (P/S)	5.47	6.85	1.92	7.55	2.52	8.63
Earnings Yield	2.63%	2.62%	6.30%	6.14%	1.89%	2.46%
Debt/Equity	1.13	0.61	0.70	0.00	1.37	0.00
Cash Flow ($/share)	5.05	2.13	7.01	5.94	-0.18	2.91
Growth Score	D	-	-	D	A	A
Hist. EPS Growth (3-5 yrs)	NA%	15.24%	10.92%	10.41%	NA	106.16%
Proj. EPS Growth (F1/F0)	-17.32%	0.30%	0.33%	3.71%	281.54%	7.17%
Curr. Cash Flow Growth	119.25%	45.71%	5.93%	-0.22%	-24.85%	45.71%
Hist. Cash Flow Growth (3-5 yrs)	69.30%	37.87%	8.55%	4.14%	13.41%	46.74%
Current Ratio	1.78	1.59	1.24	1.53	1.55	1.88
Debt/Capital	53.01%	40.81%	42.36%	0.00%	57.87%	0.00%
Net Margin	-5.58%	8.95%	11.64%	41.39%	-28.95%	15.14%
Return on Equity	-2.19%	7.14%	16.74%	23.10%	-19.35%	27.51%
Sales/Assets	0.46	0.46	0.54	0.35	0.32	0.62
Proj. Sales Growth (F1/F0)	15.12%	13.42%	1.00%	1.43%	3.98%	18.17%
Momentum Score	F	-	-	F	C	C
Daily Price Chg	5.34%	6.35%	7.93%	5.36%	7.94%	6.35%
1 Week Price Chg	0.07%	-2.64%	-4.40%	-0.77%	-15.35%	4.28%
4 Week Price Chg	7.91%	-2.42%	-6.89%	12.86%	-19.58%	23.80%
12 Week Price Chg	-28.88%	-18.22%	-24.81%	-8.69%	-40.54%	-7.55%
52 Week Price Chg	-28.27%	-16.84%	-17.63%	-16.84%	-40.12%	25.33%
20 Day Average Volume	1,944,179	796,038	4,147,873	2,129,348	4,462,159	3,217,910
(F1) EPS Est 1 week change	0.00%	0.00%	0.00%	-0.26%	0.00%	0.00%
(F1) EPS Est 4 week change	-5.45%	-2.65%	-4.97%	-1.52%	-5.38%	-2.50%
(F1) EPS Est 12 week change	-475.68%	-9.71%	-6.79%	-1.63%	15.45%	2.85%
(Q1) EPS Est Mthly Chg	-2.91%	-2.18%	-7.32%	-2.26%	-6.19%	-1.17%

Zacks Style Scores

The Zacks Style Score is as a complementary indicator to the Zacks rating system, giving investors a way to focus on the highest rated stocks that best fit their own stock picking preferences.

Academic research has proven that stocks with the best Value, Growth and Momentum characteristics outperform the market. The Zacks Style Scores rate stocks on each of these individual styles and assigns a rating of A, B, C, D and F. We also produce the VGM Score (V for Value, G for Growth and M for Momentum), which combines the weighted average of the individual Style Scores into one score. This is perfectly suited for those who want their stocks to have the best scores across the board.

Value Score	D
Growth Score	D
Momentum Score	F
VGM Score	F

As an investor, you want to buy stocks with the highest probability of success. That means buying stocks with a Zacks Recommendation of Outperform, which also has a Style Score of an A or a B.

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