Jan 28, 2020

## Palo Alto Networks (PANW)

**$237.85** (As of 01/27/20)

Price Target (6-12 Months): **$201.00**

| | | |
|---|---|---|
| Long Term: 6-12 Months | **Zacks Recommendation:** (Since: 01/24/20) Prior Recommendation: Neutral | **Underperform** |
| Short Term: 1-3 Months | **Zacks Rank:** (1-5) | **3-Hold** |
| | Zacks Style Scores: | VGM:F |
| | Value: F \| Growth: C \| Momentum: D | |

## Summary

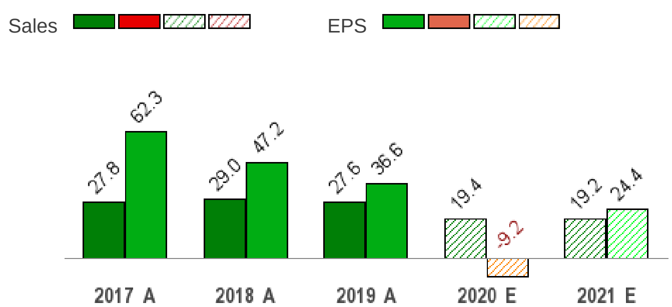
Palo Alto is hurting from stiff competition from the likes of Fortinet and Cisco. Moreover, continued acquisitions and heavy investments to boost sales and marketing are hurting the company's operating margin. Furthermore, U.S. tariff on Chinese goods is expected to negatively impact the bottom line. Volatile spending environment is also a negative. Shares of the company have underperformed the industry in the past year. However, Palo Alto is gaining from strong demand for its cloud security products. Several deal wins and growing adoption of its next-generation security platforms are positives. Palo Alto's recent acquisition synergies are also expected to boost revenues, going forward. Growing traction in Prisma and Cortex offerings is another tailwind. Estimates have been stable ahead of the company's Q2 earnings release.

## Price, Consensus & Surprise


## Data Overview

| | |
|---|---|
| 52 Week High-Low | $260.63 - $192.17 |
| 20 Day Average Volume (sh) | 795,745 |
| Market Cap | $23.3 B |
| YTD Price Change | 2.9% |
| Beta | 0.94 |
| Dividend / Div Yld | $0.00 / 0.0% |
| Industry | Security |
| Zacks Industry Rank | Bottom 25% (191 out of 255) |
| Last EPS Surprise | 1.9% |
| Last Sales Surprise | 0.6% |
| EPS F1 Est- 4 week change | 0.0% |
| Expected Report Date | 02/25/2020 |
| Earnings ESP | 1.2% |
| P/E TTM | 44.5 |
| P/E F1 | 48.1 |
| PEG F1 | 2.1 |
| P/S TTM | 7.7 |

## Sales and EPS Growth Rates (Y/Y %)




## Sales Estimates (millions of $)

| | Q1 | Q2 | Q3 | Q4 | Annual* |
|---|---|---|---|---|---|
| 2021 | 924 E | 1,002 E | 1,040 E | 1,144 E | 4,129 E |
| 2020 | 772 A | 844 E | 874 E | 972 E | 3,463 E |
| 2019 | 656 A | 711 A | 727 A | 806 A | 2,900 A |

## EPS Estimates

| | Q1 | Q2 | Q3 | Q4 | Annual* |
|---|---|---|---|---|---|
| 2021 | $1.30 E | $1.47 E | $1.56 E | $1.82 E | $6.16 E |
| 2020 | $1.05 A | $1.12 E | $1.27 E | $1.50 E | $4.95 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 01/27/2020. The reports text is as of 01/28/2020.

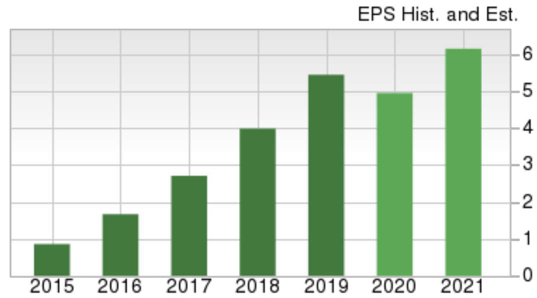
## Overview

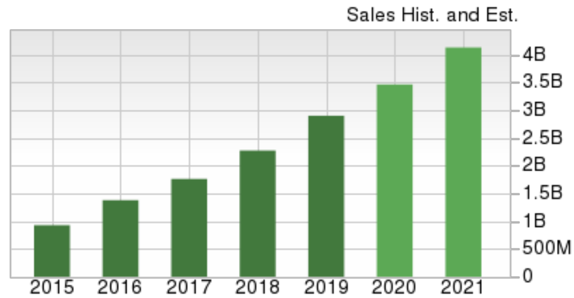
Santa Clara, CA-based Palo Alto Networks, Inc. offers network security solutions to enterprises, service providers and government entities worldwide.

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 Sell:

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

- We note that Palo Alto currently has a trailing 12-month Price/Book Value (P/B) ratio of 15.37. This level compares unfavorably with what the industry witnessed in the last year. Hence, valuation looks slightly stretched from a P/B perspective.

- 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.

## Risks

- 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 buyouts 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 latest buyout of Demisto is expected to help Palo Alto incorporate AI and machine learning 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.

- 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.

## Last Earnings Report

**Palo Alto Q1 Earnings Surpass Estimates**

| Quarter Ending | 10/2019 |
|---|---|
| Report Date | Nov 25, 2019 |
| Sales Surprise | 0.59% |
| EPS Surprise | 1.94% |
| Quarterly EPS | 1.05 |
| Annual EPS (TTM) | 5.34 |

Palo Alto reported first-quarter fiscal 2020 non-GAAP earnings of $1.05 per share, which surpassed the Zacks Consensus Estimate of $1.03. However, the figure declined 10.3% year over year. The expansion of tariffs in the United States had an adverse impact on the bottom line.

However, the company's revenues of $771.9 million increased 18% year over year, outpacing the consensus estimate of $771 million.

The top line was mainly driven by several deal wins and the increasing adoption of the company's next-generation security platforms. Growing traction in newer Prisma and Cortex offerings was another tailwind.

Moreover, the company's continued efforts to bring automation across its product portfolio by using AI and ML bolstered its position in the cloud security market.

In a parallel announcement, Palo Alto clarified its intent to acquire machine identity-based micro-segmentation company Aporeto for $150 million to bring micro-segmentation capabilities in Prisma Cloud.

**Quarterly Details**

Product revenues declined approximately 4% to $231.2 million.

However, the company witnessed a 30% jump in subscription and support revenues to $540.7 million, driven by a 38% increase in SaaS-based subscription revenues and 21% rise in support revenues. This segment of Palo Alto's business constituted 70% of total revenues in the fiscal first quarter.

Further, billings improved 18% year over year to $897.4 million. Deferred revenues rose 26% to $3 billion.

During the quarter, Palo Alto continued to acquire new customers as well as increase wallet share with existing customers.

Region wise, revenues from the Americas climbed 18% while that from Europe, the Middle East and Africa, and Asia Pacific jumped 16% and 21%, respectively.

**Margins**

Additionally, Palo Alto's non-GAAP gross margin contracted 10 basis points (bps) on a year-over-year basis to 76.6%.

Non-GAAP operating margin contracted 500 bps to 15.8% due to a headwind of about $7 million in net expenses related to the recent acquisition.

**Balance Sheet**

Palo Alto exited the fiscal first quarter with cash, cash equivalents and short-term investments of approximately $3.3 billion compared with $2.8 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 $225.2 million compared with $231.5 million in the previous quarter. Free cash flow came in at $178 million.

**Guidance**

For the second quarter of fiscal 2020, Palo Alto anticipates revenue growth of 18-19% year over year between $838 million and $848 million. Billings growth is anticipated between 16% and 17%. Non-GAAP earnings per share are estimated in the range of $1.11-$1.13, which includes expenses related to the proposed acquisition of Aporeto.

For fiscal 2020, the company estimates billings to grow in the range of 18-19% 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 to grow 19-20% year over year. Non-GAAP earnings per share are estimated in the band of $4.9-$5, down from $5-$5.1 predicted earlier to accommodate net expenses related to the Aporeto buyout.

Moreover, management projects a 23% CAGR for total billings and total revenues over the next three years in the firewall as a platform category. The company hopes to achieve $6 billion in total billings and $5 billion in total revenues by fiscal 2022.

*Note: The EPS data mentioned in the text of this section differs from the rest of report due to the difference in calculation or consideration of one-time items.*

## Recent News

On Nov 13, 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, 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).

On Sep 20, Palo Alto completed the acquisition of Zingbox.

On Sep 5, Palo Alto announced a definitive agreement to acquire the IoT security start-up Zingbox for $75 million. The impending buyout is expected to close during the company's first quarter of fiscal 2020, ending October 2019.

## Valuation

Palo Alto's shares have gained 5.4% in the past six months and 15.1% over the trailing 12 months. Stocks in the Zacks sub-industry and the Zacks Technology sector are up 9% and 11.2% in the past six months, respectively. Over the past year, the Zacks sub-industry gained 19.9%, and the sector rallied 31.4%, respectively.

The S&P 500 Index has jumped 7.9% in the past six months, and 22.2% in the past year.

The stock is currently trading at 6.15X forward 12-month sales, which compares to 7.89X for the Zacks sub-industry, 3.63X for the Zacks sector and 3.46X for the S&P 500 index.

Over the past five years, the stock has traded as high as 17.69X and as low as 4.9X, with a 5-year median of 6.74X. Our Underperform recommendation indicates that the stock will perform worse than the market. Our $201 price target reflects 5.23X 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 | 6.15 | 7.89 | 3.63 | 3.46 |
| | 5-Year High | 17.69 | 8.96 | 3.63 | 3.46 |
| | 5-Year Low | 4.9 | 5.32 | 2.3 | 2.54 |
| | 5-Year Median | 6.74 | 6.76 | 3.01 | 3 |
| EV/FCF TTM | Current | 23.53 | 24.31 | 22.73 | 33.52 |
| | 5-Year High | 98.3 | 32.78 | 23.37 | 34.48 |
| | 5-Year Low | 12.55 | 14.8 | 12.62 | 14.01 |
| | 5-Year Median | 19.59 | 19.86 | 19.35 | 20.24 |
| EV/Sales TTM | Current | 6.9 | 8.15 | 4.3 | 3.25 |
| | 5-Year High | 19.05 | 10.68 | 4.3 | 3.3 |
| | 5-Year Low | 5.07 | 5.26 | 2.56 | 2.16 |
| | 5-Year Median | 7.62 | 6.9 | 3.46 | 2.8 |

As of 01/27/2020

## Industry Analysis **Zacks Industry Rank:** Bottom 25% (191 out of 255)


## Top Peers

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

## Industry Comparison Industry: Security

| | PANW Underperform | X Industry | S&P 500 | CHKP Neutral | FEYE Neutral | FTNT Neutral |
|---|---|---|---|---|---|---|
| **VGM Score** | F | - | - | D | C | B |
| Market Cap | 23.30 B | 3.38 B | 23.86 B | 17.41 B | 3.38 B | 19.57 B |
| # of Analysts | 17 | 11.5 | 13 | 16 | 13 | 13 |
| Dividend Yield | 0.00% | 0.00% | 1.81% | 0.00% | 0.00% | 0.00% |
| **Value Score** | F | - | - | C | F | F |
| Cash/Price | 0.12 | 0.10 | 0.04 | 0.10 | 0.29 | 0.10 |
| EV/EBITDA | 50.63 | 38.29 | 13.94 | 15.52 | -35.31 | 44.42 |
| PEG Ratio | 2.05 | 2.36 | 2.00 | 2.09 | 10.03 | 3.02 |
| Price/Book (P/B) | 15.36 | 9.15 | 3.25 | 4.86 | 4.81 | 16.30 |
| Price/Cash Flow (P/CF) | 47.06 | 47.06 | 13.46 | 20.51 | NA | 57.02 |
| P/E (F1) | 48.05 | 42.21 | 18.67 | 17.78 | 110.29 | 42.21 |
| Price/Sales (P/S) | 7.73 | 8.53 | 2.62 | 8.81 | 3.88 | 9.55 |
| Earnings Yield | 2.08% | 2.22% | 5.35% | 5.62% | 0.90% | 2.37% |
| Debt/Equity | 1.20 | 0.00 | 0.72 | 0.00 | 1.36 | 0.00 |
| Cash Flow ($/share) | 5.05 | 1.08 | 6.92 | 5.57 | -0.26 | 2.01 |
| **Growth Score** | C | - | - | D | A | A |
| Hist. EPS Growth (3-5 yrs) | NA% | 14.71% | 10.68% | 10.73% | NA | 91.94% |
| Proj. EPS Growth (F1/F0) | -9.09% | 11.30% | 7.51% | 5.24% | 513.34% | 12.52% |
| Curr. Cash Flow Growth | 119.25% | 59.09% | 13.40% | 1.83% | -43.87% | 128.85% |
| Hist. Cash Flow Growth (3-5 yrs) | 69.30% | 23.40% | 8.78% | 5.13% | 10.10% | 36.70% |
| Current Ratio | 1.78 | 1.78 | 1.22 | 1.63 | 1.53 | 1.84 |
| Debt/Capital | 54.51% | 0.00% | 42.92% | 0.00% | 57.63% | 0.00% |
| Net Margin | -3.42% | 9.33% | 11.39% | 40.05% | -29.44% | 19.23% |
| Return on Equity | 2.43% | 7.41% | 17.19% | 21.86% | -20.06% | 25.46% |
| Sales/Assets | 0.48 | 0.50 | 0.54 | 0.34 | 0.31 | 0.62 |
| Proj. Sales Growth (F1/F0) | 19.43% | 14.56% | 4.09% | 3.79% | 7.56% | 14.82% |
| **Momentum Score** | D | - | - | D | B | A |
| Daily Price Chg | -2.08% | -1.95% | -1.40% | -1.00% | -2.74% | -3.02% |
| 1 Week Price Chg | 0.34% | 0.34% | -1.09% | 1.52% | -6.30% | 0.43% |
| 4 Week Price Chg | 2.77% | 2.77% | -0.25% | 2.37% | -5.85% | 6.99% |
| 12 Week Price Chg | 1.64% | 11.87% | 3.64% | 2.49% | -3.34% | 24.53% |
| 52 Week Price Chg | 14.57% | 11.09% | 18.08% | 4.28% | -10.39% | 55.22% |
| 20 Day Average Volume | 795,745 | 635,594 | 1,615,215 | 860,398 | 3,266,655 | 936,031 |
| (F1) EPS Est 1 week change | 0.00% | 0.00% | 0.00% | 0.00% | 0.00% | 0.00% |
| (F1) EPS Est 4 week change | 0.00% | 0.00% | 0.00% | -0.28% | 0.00% | 0.34% |
| (F1) EPS Est 12 week change | -146.67% | 1.89% | -0.17% | 0.20% | 10.41% | 15.09% |
| (Q1) EPS Est Mthly Chg | 0.00% | 0.00% | 0.00% | -0.74% | 0.00% | 0.00% |

## Zacks Stock Rating System

We offer two rating systems that take into account investors' holding horizons: Zacks Rank and Zacks Recommendation. Each provides valuable insights into the future profitability of the stock and can be used separately or in combination with each other depending on your investment style.

## Zacks Recommendation

The Zacks Recommendation aims to predict performance over the next 6 to 12 months. The foundation for the quantitatively determined Zacks Recommendation is trends in the company's estimate revisions and earnings outlook. The Zacks Recommendation is broken down into 3 Levels; Outperform, Neutral and Underperform. Unlike many Wall Street firms, we have an excellent balance between the number of Outperform and Neutral recommendations. Our team of 70 analysts are fully versed in the benefits of earnings estimate revisions and how that is harnessed through the Zacks quantitative rating system. But we have given our analysts the ability to override the Zacks Recommendation for the 1200 stocks that they follow. The reason for the analyst over-rides is that there are often factors such as valuation, industry conditions and management effectiveness that a trained investment professional can spot better than a quantitative model.

## Zacks Rank

The Zacks Rank is our short-term rating system that is most effective over the one- to three-month holding horizon. The underlying driver for the quantitatively-determined Zacks Rank is the same as the Zacks Recommendation, and reflects trends in earnings estimate revisions.

## 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 | F |
| Growth Score | D |
| Momentum Score | C |
| 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.

## Disclosures

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