

Fortinet

How long will it take demand to recover? Diving deeper into key investor debates

Maintain Rating: BUY | PO: 65.00 USD | Price: 57.85 USD

Firewall cycle not likely to extend beyond historical norms

Recent investor debates have centered on the firewall market's anticipated time to recovery, and the impact to Fortinet. Despite Fortinet's history of navigating four firewall cycles in the last decade, each lasting roughly 4-6 quarters, one-off factors such as supply constraints, price increases and market share gains have sparked hesitancy across the Street that the road to recovery might take longer this time through. In this note we analyze the historical demand for Firewalls, excluding the contribution of non-Fortigate and SD WAN solutions, price increases and share gains and believe the excess historical demand is almost fully absorbed by 1Q2024, which suggests to us recovery could start soon after. Our analysis suggests that there is only 1-3 months' worth of excess firewall deployment unlike the common wisdom. Fortinet's market share has remained relatively stable over the last 4 years, supporting easier comps as growth recovers. We believe Fortinet could see a major price recovery in 2024 and select it as a top pick for 2024.

Excess market absorption manageable through CY24

Starting with the 2020 revenue as a base, stripping out SD WAN and Non-Fortigate contribution and adjusting for the 10% price increase, we then growing revenues by a steady 10% annual rate till the end of 2023, we calculate the normalized Firewall revenue for YE23, assuming no unique external factors. We then compare it to the reported (expected) revenues for 2023 to suggest that there is only \$71mn of excess revenues that still needs to be absorbed in early 2024, which represents less than one month of shipments. This variance is so minute that even different assumptions would suggest that by 2H24, demand growth should accelerate and the company should start showing better billings growth rate. We note that we expect 4Q23 and 1Q23 billings growth to remain challenged, at about 5-6% decline YoY in each one of these quarters but expect the billings growth to accelerate to +10% by Year End.

Share gain contribution is a myth

Investors also believe that Fortinet gained significant market share over the last 3 years, suggesting risks to growth in a more stable market share dynamics. However, our market share data (see page 3 for details) suggests to us that Fortinet's market share has held stable at around 20% since 2019, leading us to conclude that the past years growth is more of a factor of SD WAN bundling, non-Fortigate growth, which we think should all recover and also be helped by new contribution from the new SASE platform.

Growth from new products should boost recovery

While firewall remains the key component to Fortinet's strategy, we believe new products like SASE coupled with its SD-WAN offering and other services like Secure Operations should help the company diversify revenues and escape the cyclicity of the firewall market. While early, SASE should begin impacting revenues by YE24/1H25, and we forecast non-firewall billings to account for 35% of total billings by 1H25, up from 30% as of 3Q23.

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Stock Data

Price	57.85 USD
Price Objective	65.00 USD
Date Established	3-Nov-2023
Investment Opinion	B-1-9
52-Week Range	44.12 USD - 81.24 USD
Mrkt Val (mn) / Shares Out (mn)	48,499 USD / 838.4
Free Float	82.5%
Average Daily Value (mn)	362.25 USD
BofA Ticker / Exchange	FTNT / NAS
Bloomberg / Reuters	FTNT US / FTNT.OQ
ROE (2023E)	2,206.9%
Net Dbt to Eqty (Dec-2022A)	NA
ESGMeter™	High

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SD WAN: software defined wide area networking

SASE: Secure Access Service Edge

Firewall Market Share Data

Exhibit 1: Firewall market share data 2019-2022

Fortinet's market share has remained stable around 20% of the total firewall market

	2019	2020	2021	2022
NGFW	\$6,126.7	\$6,356.7	\$7,109.9	\$8,078.6
% of Total	72.4%	74.3%	76.0%	76.6%
YoY Chg (%)	8.8%	3.8%	11.8%	13.6%
Market Share (%)				
Palo Alto Networks	26.3%	29.3%	33.6%	37.4%
Fortinet	15.7%	18.1%	18.5%	17.8%
Cisco	18.8%	16.5%	13.4%	13.9%
Check Point	16.6%	15.7%	14.4%	13.6%
SonicWALL	5.3%	5.7%	6.3%	6.0%
Juniper	3.8%	3.2%	3.3%	3.0%
WatchGuard	2.3%	2.1%	1.9%	1.7%
Other	11.1%	9.3%	8.7%	6.7%
UTM	\$1,838.3	\$1,750.0	\$1,824.1	\$1,999.6
% of Total	21.7%	20.4%	19.5%	19.0%
YoY Chg (%)	14.8%	-4.8%	4.2%	9.6%
Market Share (%)				
Fortinet	21.0%	24.8%	27.5%	27.3%
Cisco	25.1%	25.4%	23.1%	25.1%
SonicWALL	4.3%	4.9%	5.8%	6.0%
WatchGuard	6.0%	6.0%	5.4%	5.1%
Check Point	3.3%	3.3%	3.4%	3.3%
Juniper	1.1%	0.9%	1.0%	0.9%
Other	39.1%	34.7%	33.8%	32.3%
Traditional Firewall	\$493.2	\$452.2	\$419.7	\$473.5
% of Total	5.8%	5.3%	4.5%	4.5%
YoY Chg (%)	3.9%	-8.3%	-7.2%	12.8%
Market Share (%)				
Fortinet	17.1%	21.7%	23.3%	23.7%
Check Point	18.6%	20.1%	21.0%	19.9%
Cisco	10.2%	7.3%	5.6%	5.9%
Juniper	2.1%	2.0%	2.4%	2.2%
WatchGuard	1.8%	1.9%	1.9%	1.8%
Other	50.0%	46.9%	45.7%	46.5%
Total Firewall	\$8,458.1	\$8,558.9	\$9,353.7	\$10,551.7
YoY Chg (%)	9.7%	1.2%	9.3%	12.8%
Market Share (%)				
Palo Alto Networks	19.1%	21.8%	25.5%	28.6%
Fortinet	17.0%	19.6%	20.5%	19.9%
Cisco	19.7%	17.9%	14.9%	15.6%
Check Point	13.8%	13.4%	12.6%	11.9%
SonicWALL	4.8%	5.2%	5.9%	5.7%
Juniper	3.1%	2.7%	2.8%	2.6%
WatchGuard	3.1%	2.9%	2.6%	2.3%
Other	19.4%	16.5%	15.3%	13.3%
YoY Chg (%)				
Palo Alto Networks	22.5%	15.4%	28.1%	26.5%
Fortinet	17.7%	17.0%	13.9%	9.7%
Cisco	2.1%	-8.2%	-8.9%	18.4%
Check Point	5.2%	-1.8%	2.5%	7.1%
SonicWALL	1.8%	11.3%	23.3%	9.2%
Juniper	-3.1%	-13.4%	14.3%	3.1%
WatchGuard	4.3%	-4.5%	-3.1%	2.7%
Other	9.0%	-14.1%	1.1%	-1.7%

Source: Omdia

BofA GLOBAL RESEARCH

Price objective basis & risk

Fortinet (FTNT)

Our \$65 PO is based on roughly 23x 2024E EV/FCF. Our multiple is slightly below the hardware peer group average multiple of 25-35x and a discount to software peers as well. We believe the slightly below multiple to the hardware peer group is appropriate at this stage given the current business environment despite some recent share gains, shift to more recurring software, and expansion into adjacent security markets. New market tailwinds, such as software defined wide area networking (SD-WAN) should drive further market share gains.

Upside risks to our price objective are growth of non-FortiGate products, which could support high growth and acceleration from current levels and could result in more SaaS-like multiples and drive up the valuation.

Downside risks to our price objective are 1) product convergence leading to a shrinking market with larger competitors, 2) exposure to public spending and EMEA, 3) reputation risk if major threats missed and 4) early ordering that occurred during CY21/CY22 creates tough comps heading in CY23

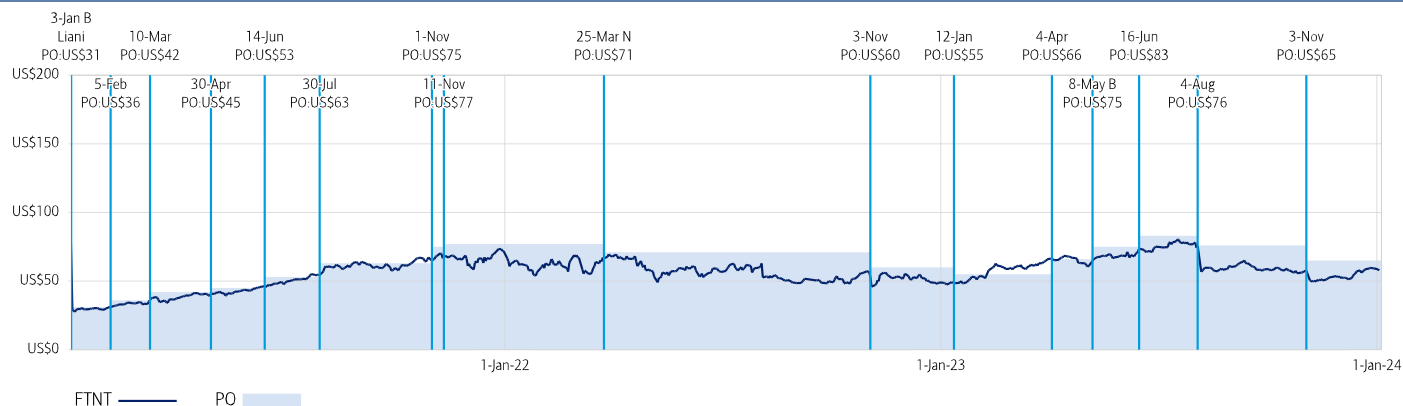
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Fortinet (FTNT) Price Chart



B: Buy, N: Neutral, U: Underperform, PO: Price Objective, NA: No longer valid, NR: No Rating

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Coverage Universe	Count	Percent	Inv. Banking Relationships ^{R1}	Count	Percent
Buy	57	51.82%	Buy	43	75.44%
Hold	27	24.55%	Hold	17	62.96%
Sell	26	23.64%	Sell	12	46.15%

Equity Investment Rating Distribution: Global Group (as of 31 Dec 2023)

Coverage Universe	Count	Percent	Inv. Banking Relationships ^{R1}	Count	Percent
Buy	1895	53.62%	Buy	1083	57.15%
Hold	832	23.54%	Hold	454	54.57%
Sell	807	22.84%	Sell	383	47.46%

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