

Fortinet

(NASDAQ:FTNT)

Recommendation

BUY

Current Price

\$52.49

Target Price

\$61.80 (17.7%)

Executive Summary

1. Company Overview

- I. Business Description
- II. Financial Statement Analysis
- III. Annotated Stock Price

2. Industry Overview

- I. Cybersecurity Industry
- II. Dominance in Security Appliance
- III. Exciting Growth in SASE

3. Economic Moat

- I. Palo Alto Network
- II. Crowdstrike
- III. Zscaler

4. Cybersecurity Threats

- I. Increasing Cyber Attacks and Demand
- II. Positioned to Capitalize Demands

5. Valuation Framework

- I. Peer Group Selection
- II. Discounted Cash Flow Analysis
- III. Football Field

6. Risks

- I. Share Buybacks
- II. Cloud Transformation
- III. Competitive Landscape

Investment Theses

Dominant Position in Security Appliance

- 117B TAM and Security Appliance Industry has grown 7% YoY
- 40% of global quarterly security appliance spend goes to Fortinet

Future Growth in SASE Market

- Increased SASE development aims to capture significant industry growth
- Industry CAGR of 25% during 2023 - 2028

All Inclusive Product Offerings

- High customizability and scalability fuel greater revenue growth

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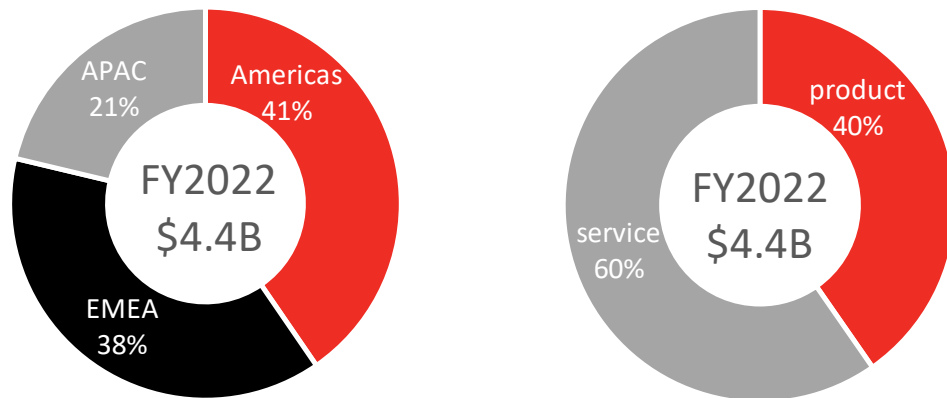
Company Overview

Business Description

Business Description

- **Founded:** 2000
- **Headquarter:** Sunnyvale, CA
- **Employees:** 12, 000+ in over 40 countries
- **Description:** FTNT provides automated security operations to protect against security threats and simplify IT infrastructure. They have 705,000 customers with 50 enterprise-grade products.
- **Key Executives:** Ken Xie (CEO) and Michael Xie (CTO)

Revenue Breakdown



Business Segments

Security Appliance

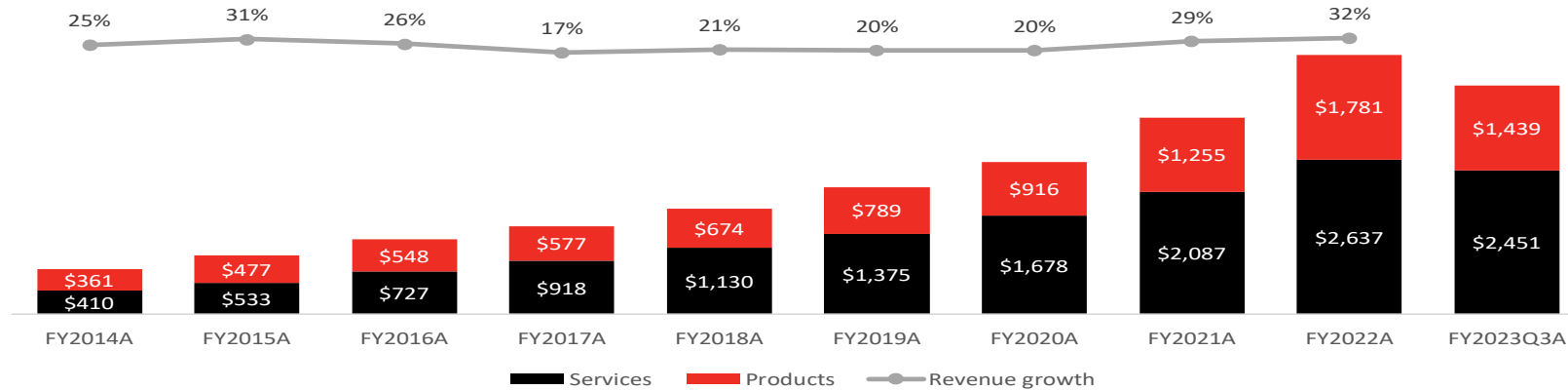
- **Core Platform & Enhanced Platform Technology Products**
 - Hardware, software, and virtual capacities spanning a wide range of network security functions with the same operating system

Subscription Services

- **FortiGuard Security Services**
 - Global research team identifies and develops security solutions leveraging AI and automation to protect applications, content, web traffic, devices, and users located anywhere
- **FortiCare Technical Support Services**
 - 24/7/365 global Support and Maintenance Team
 - 4-hour Expedited Hardware Replacement Availability

Financial Statement Analysis

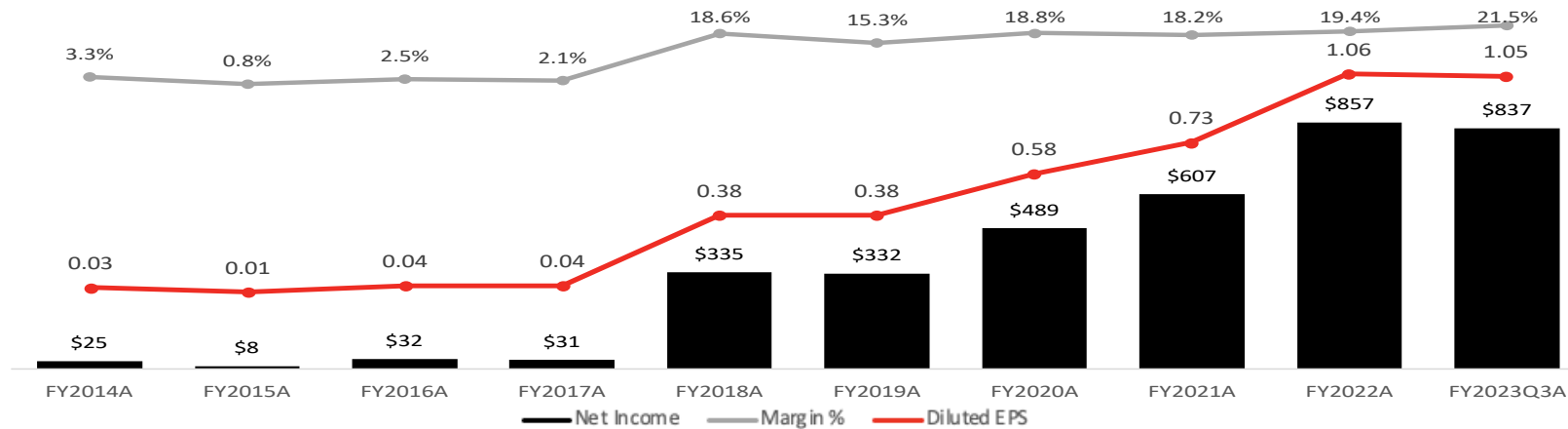
Historical Revenue & Growth



Commentary

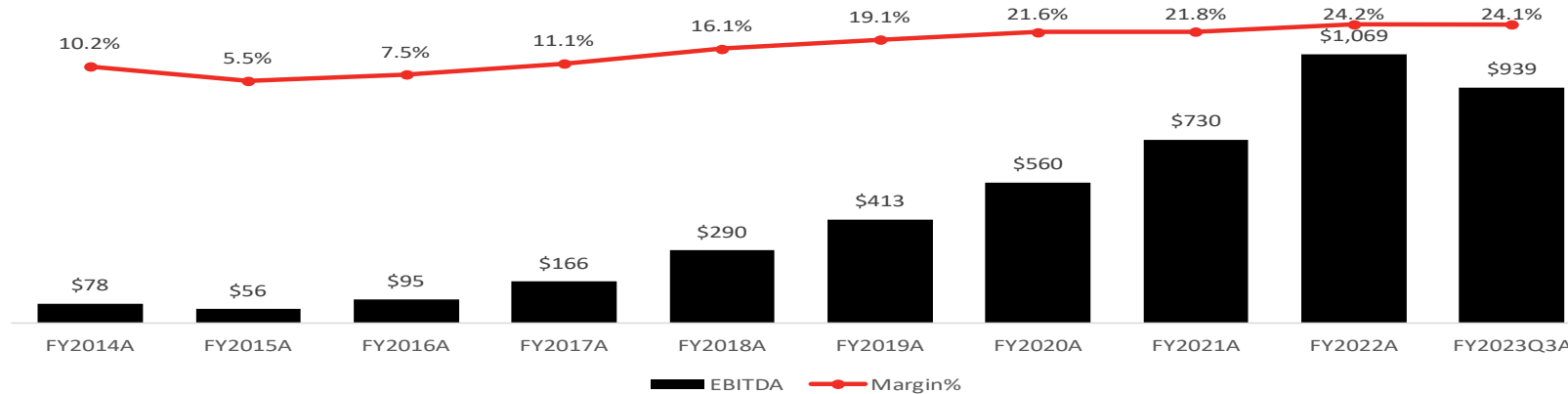
- In FY 2022, Service revenue substantially increased 41.9% and product revenue increased 26.3%.
- Diluted EPS has increased in alignment with net income due to share buybacks and growing profitability.

Net Income, Margin & EPS

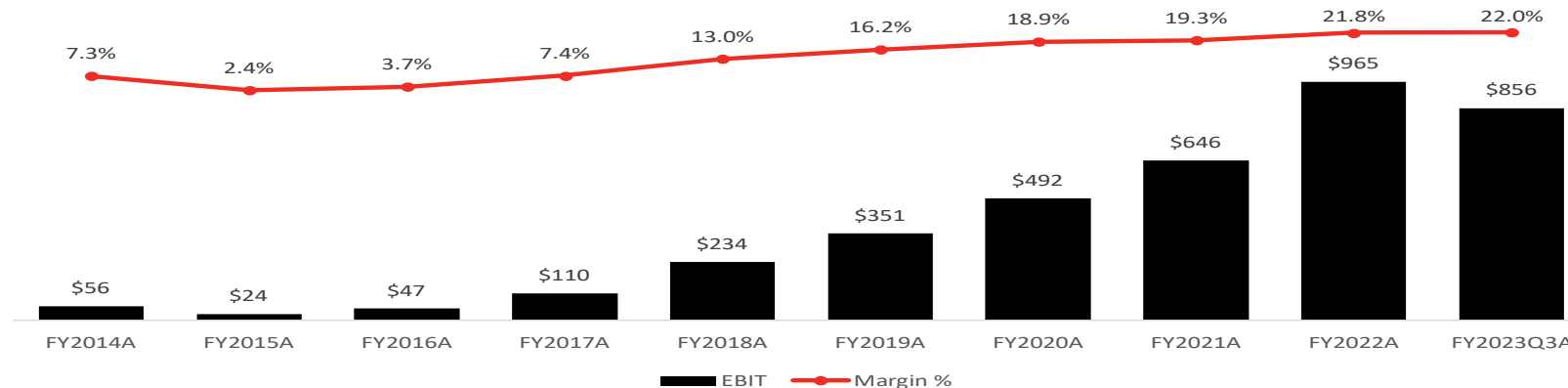


Financial Statement Analysis

Historical Adj. EBITDA & Margin



Historical Operating Income & Margin



Key Matrix (FY2022)

Profitability

Gross Profit Margin	75.4%
EBIDTA Margin	24.2%
Operating Profit Margin	21.8%

Liquidity

Current Ratio	1.2x
Quick Ratio	1.0x

Activity

Accounts receivable Days Outstanding	85.5
Accounts Payable Days Outstanding	16.2

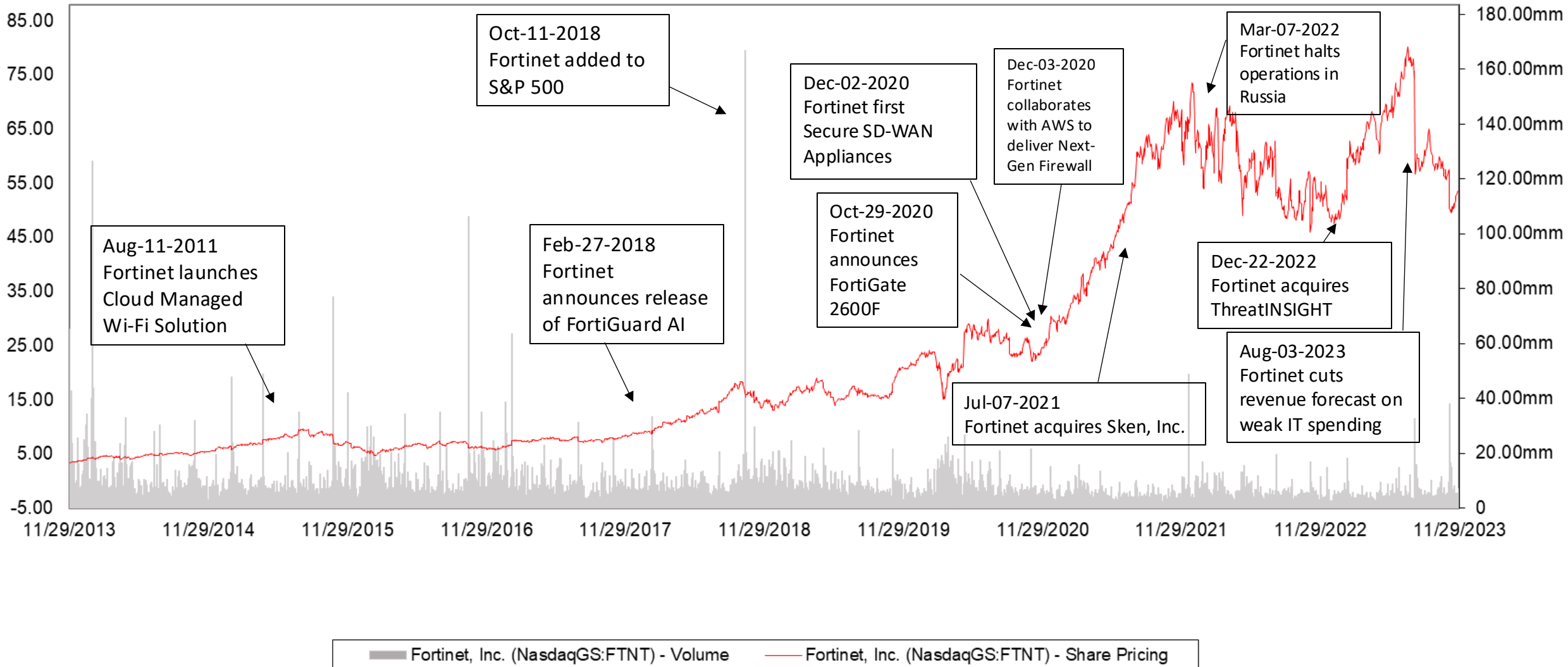
Leverage

Debt to Capital	1.4x
Debt / EBITDA	0.9x

Coverage

EBITDA / Interest	59.7x
(EBITDA – CapEx) / Interest	44.0x

Annotated Stock Price – Last 10 Years



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Industry Overview

Cybersecurity Industry

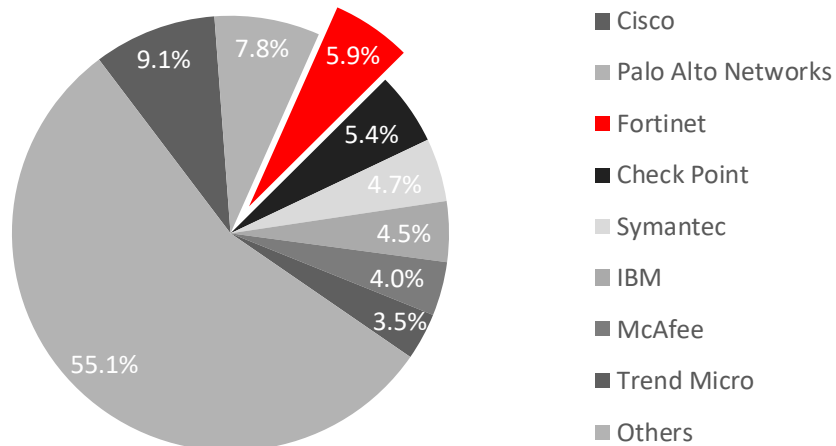
Industry Overview

- **TAM:** \$172.3B (2023)
- **Industry CAGR:** 13.8% from 2023 – 2030
- **Verticals:** Network Security, Cloud Application Security, End-point Security, Secure Web Gateway, Application Security, etc.
- **Drivers:** Implementation of new technologies (IoT, Machine Learning, Cloud, and SASE solutions), Government and e-commerce demand

Key Insights

- 8% increase in global IT spending to **\$5.1 trillion** in 2024
- "...80% of CIOs reported that they plan to increase spending on cyber/information security in 2024, the **top technology category for increased investment**" (Gartner, Inc.)

Market Share



Poised for Growth

- **One stop shop for security solutions**
 - Provide both hardware and software solutions
 - Offer a customizable set of tools: Network Security, Security Operations, Threat Intel & Response, User and Device Security, Application Security, Network Operations, and Enterprise Networking
 - Positioned to capitalize on current AI and Cloud trends
- **Customer satisfaction**
 - easy integration with any aspect of company's network

Security Appliance

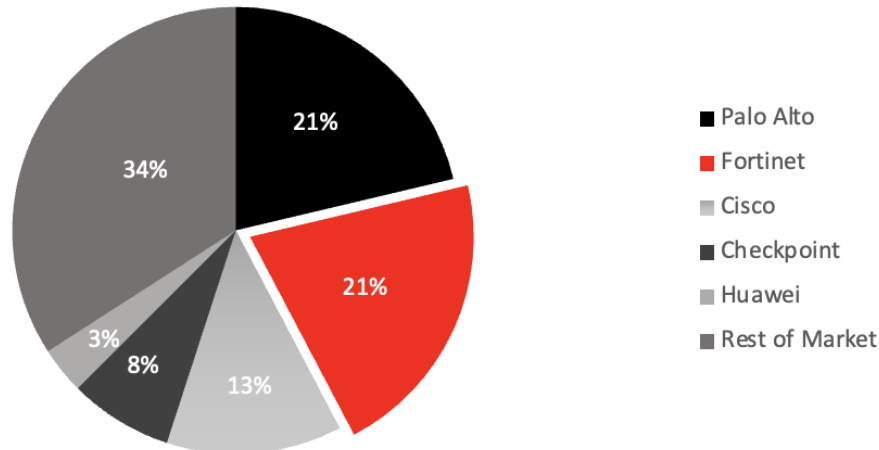
Industry Overview

- **TAM:** \$116.8B (2023)
- **Industry CAGR:** 10.6% from 2023 to 2030
- **Current Growth:** 7.6% YoY growth. Security appliance shipments surged by 22.0% YoY during the Q2 2023

Key Catalysts

- **Demand from commercial and government**
 - Sectors have started adopting security appliances to overcome the concerns regarding the safety and security of the public and enterprises
 - Supply chain constraints that have impacted the hardware-based markets continue to improve

Market Share



Fortinet's Position

- **Market Dominance**
 - Fortinet ships approximately 40% of security appliances purchased globally each quarter
- **Excellence Customer Service**
 - Fortinet delivers performance is 5-20x faster than the industry average

SASE

Industry Overview

- **TAM:** \$6.7B as of 2023
- **Industry CAGR:** 25% from 2023 to 2028
- **Description:** delivers converged network and security as a service capabilities, including SD-WAN, SWG, CASB, NGFW and zero trust network access (ZTNA)

Key Players



Growing Demands and Fortinet's position

- **Growing Client Interest**
 - Growth can be attributed to growing demand for remote work – 80 % of companies will adopt SASE
- **Single Vendor SASE Offerings**
 - 45% of the SASE market
 - Fortinet is a top 3 vendor by revenue in this market along with Cisco and Palo Alto
- **Positioned to Capitalize on SASE growth tailwinds**
 - Already have a portfolio build, integrating will not be challenging.

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Product Comparison

Security Appliance Market

	Fortinet	Palo Alto Networks
Market Share	21%	21%
Product Overview	<ul style="list-style-type: none"> Fortinet ranks #1 in the most security appliances shipped worldwide with over 600,000 customers Machine Learning firewall that adapts and provides real-time protection for zero-day threats FortiGate NGFWs often incorporate unified threat management features, including firewall, antivirus, intrusion prevention, VPN, and application control, into a single platform for simplified security management 	<ul style="list-style-type: none"> Machine Learning firewall that adapts and provides real-time protection for zero-day threats Offers Next-Generation Firewalls (NGFW) with advanced application visibility and control Granular control over applications and users, allowing policies based on specific applications and user groups
Differentiation: Speed	<ul style="list-style-type: none"> FortiGate Firewall speed of 140 Gbps Threat protection runs at 10.5 Gbps connections per second: 500 thousand 	<ul style="list-style-type: none"> Palo Alto Network PA – 3420 firewall speed of 20.8 Gbps Threat protection runs at 7.6 Gbps Connections per second is 205 thousand
Challenge	<ul style="list-style-type: none"> Fortinet is difficult to implement for more complicated companies 	<ul style="list-style-type: none"> Palo Alto has latency issues which leads to buffering
Stage of Development	<ul style="list-style-type: none"> All security appliances are fully developed and implemented 	<ul style="list-style-type: none"> All security appliances are fully developed and implemented

Cloud Security Market

	Fortinet	CrowdStrike
Market Share	-	-
Product Overview	<ul style="list-style-type: none"> • Cloud-based solutions: FortiSASE, FortiGuard CASB Service (for SaaS applications), FortiLAN Cloud, and overall cloud security infrastructure • Integration with extensive other solutions 	<ul style="list-style-type: none"> • SaaS Subscription Model: provides cloud-delivered protection of endpoints, cloud workloads, identity and data • Falcon Platform: leverages a single lightweight-agent architecture with integrated cloud modules spanning multiple security market
Differentiation: Single Cloud	<ul style="list-style-type: none"> • Single security platform - offers an integrated range of services that are customizable for a broad range of customers – includes Cloud capabilities • 50+ enterprise-grade products 	<ul style="list-style-type: none"> • Specialization towards cloud-based solutions --> less customizability for customers • 23 cloud modules through Falcon program
Challenge: Cyber Attacks	<ul style="list-style-type: none"> • Attacks on Cloud infrastructure which reduces confidence 	<ul style="list-style-type: none"> • Attacks on Cloud infrastructure which reduces confidence
Stage of Development	<ul style="list-style-type: none"> • Beginning stages of partnership with Google Cloud to gain access to and provide more cloud-based security solutions 	<ul style="list-style-type: none"> • Security solutions already utilize cloud delivery

Zero Trust Network Access

	Fortinet	Zscaler
Market Share	6.88%	12.36%
Product Overview	<ul style="list-style-type: none"> • Customizable and scalable compared to other products and multiple switchable connections • One solution for web access filtering, consolidating corporate policies, remote access with MFA, endpoint security, and visibility including vulnerabilities 	<ul style="list-style-type: none"> • Seamless deployment which does not impact production environment • 2023 Gartner Magic Quadrant ZTNA Leader • Light weight data center connectors • Compatible with other Zscaler products
Differentiation: Price	<ul style="list-style-type: none"> • One of the best inexpensive solutions • ZTNA Subscription 1 Year FortiClient: \$27 (50-499 users) • ZTNA Subscription 1 Year FortiClient: \$14 (10,000+ users) 	<ul style="list-style-type: none"> • One of the more expensive solutions on the market • Zscaler Internet Access 1 Year: \$36 (minimum 500 users)
Challenge	<ul style="list-style-type: none"> • Requires high bandwidth stable network • Compatibility issue between Forticlient and Fortigate versions 	<ul style="list-style-type: none"> • Less customizable on deployment compared with competitors • No centralized portal
Stage of Development	<ul style="list-style-type: none"> • Early stage, first ZTNA capable product released in March 2021 • Acquired OPAQ in 2020 to broaden and integrate suite of cloud security solutions 	<ul style="list-style-type: none"> • Developed stage, first ZTNA capable product released in 2020

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Cybersecurity Threats

Cybersecurity Threats

Trend

- Q3 2023 global ransomware attack frequency up 11% over Q2 and **95% YoY**
- **Adoption of cloud** amplifies the magnitude of risk due to the increasingly distributed nature of work
- More sophisticated phishing attacks due to the **utilization of AI**

Relevant News

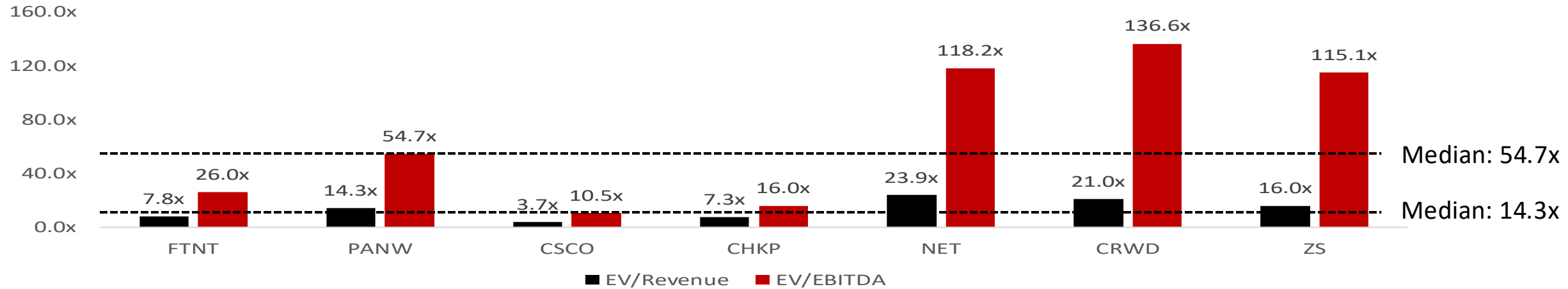
- **Clorox's share price** dropped 8.1% after the announcement of cyber attack and overall **23% drop** along with product shortage
- **ICBC attack** caused overall decline in share price
 - Negative effects on **market liquidity**
- **MGM's share price dropped 20%** and incurred **\$100M loss**
 - Customer data breached

How Fortinet can capture the rising demand

- **Hybrid product offering**
 - One stop shop for both on-premise and cloud-based security solutions – dual integration
- **FortiAI Ops**
 - Utilizes machine learning which adopts hackers' perspective to create solutions to unforeseen attack methods
- **Google Cloud partnership**
 - Will increase development and effectiveness of cloud-based solutions that can be integrated with their current system and SASE offerings

Valuation

Selected Public Companies Analysis



Name	Last Twelve Months			CY2023E			CY2024E			PEG ratio
	EV / Revenue	EV / EBITDA	P/E	EV / Revenue	EV / EBITDA	P/E	EV / Revenue	EV / EBITDA	P/E	
Fortinet	7.8x	30.6x	36.5x	7.7x	26.0x	33.7x	6.8x	23.4x	31.1x	1.9x
Palo Alto	13.5x	NM	NM	14.1x	51.5x	69.3x	11.9x	40.5x	53.8x	2.4x
Cisco	3.4x	11.3x	14.6x	3.5x	9.6x	12.7x	3.6x	9.8x	12.5x	2.7x
Checkpoint	7.2x	18.1x	20.4x	7.2x	15.8x	17.6x	6.8x	15.4x	16.2x	3.4x
CloudFlare	22.4x	NM	NM	21.1x	NM	NM	16.4x	NM	NM	3.4x
CrowdStrike	20.0x	NM	NM	25.5x	NM	NM	18.7x	73.8x	79.5x	1.5x
Zscaler	14.9x	NM	NM	18.8x	NM	NM	14.3x	69.9x	NM	1.9x

Discounted Cash Flow Analysis

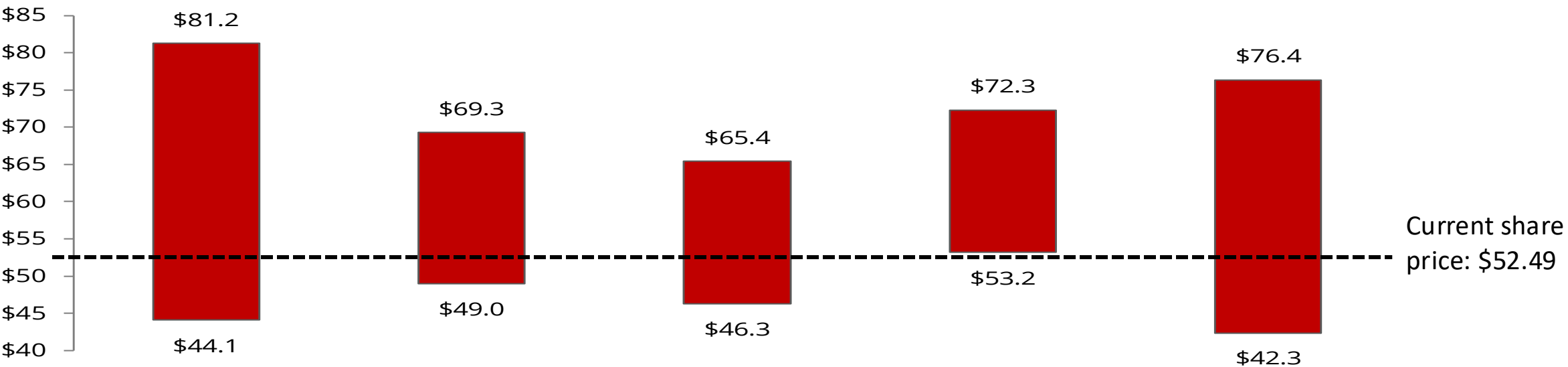
Fortinet Standalone Unlevered Free Cash Flow	Q3	Fiscal Year Ended December 31				Terminal
(\$ in millions)	2023A	2023E	2024E	2025E	2026E	Period
Revenue	3890	5301	5989	6984	8612	9925
% Growth		20.0%	13.0%	16.6%	23.3%	15.3%
EBITDA	939	1558	1733	2122	2616	3015
% margin	24.1%	29.4%	28.9%	30.4%	30.4%	30.4%
Less: Depreciation & Amortization	(83)	(115)	(147)	(155)	(169)	(194)
EBIT	856	1444	1586	1967	2447	2821
% margin	22.0%	27.2%	26.5%	28.2%	28.4%	28.4%
Less: Taxes	(49)	(250)	(277)	(344)	(427)	(493)
NOPAT	807	1193	1309	1623	2019	2328
Add: D&A	83	115	147	155	169	194
Less: Capital Expenditures	(177)	(230)	(320)	(341)	(360)	(410)
% Revenue	(4.6%)	(4.3%)	(5.3%)	(4.9%)	(4.2%)	(4.1%)
Less: Increase in Net Working Capital	(688.6)	(675.3)	(677.1)	(557.5)	(738.2)	(840.5)
Unlevered Free Cash Flow		403	459	879	1090	1272

Discount Rate	Enterprise Value (\$bn)			Implied Growth Rate			Equity Value Per Share(\$)		
	Exit Multiple			Exit Multiple			Exit Multiple		
	20.8x	21.3x	21.8x	20.8x	21.3x	21.8x	20.8x	21.3x	21.8x
10.9%	44.2	45.2	46.2	10.9%	10.9%	10.9%	57.4	58.6	59.9
12.9%	41.3	42.2	43.1	12.9%	12.9%	12.9%	53.7	54.9	56.0
14.9%	38.6	39.5	40.3	14.9%	14.9%	14.9%	50.4	51.5	52.5

Highlights

- The revenue growth will slow down in 2024 based on the Fortinet's management projection on product revenue.
- The revenue growth will accelerate in 2025 and 26 because of the product pivot into SASE.
- Increase in NWC because of the deferred revenue from subscriptions.
- Comparing with the street case, we utilized the same projections. But they have higher free cash flow because of the deferred revenue calculations.

Football Field



52 - Week Low - High	Analyst Price Targets As of 12/03/2023	Discounted Cash Flow Base Case			Discounted Cash Flow Street Case			Public Comparables EV / Revenue		
High	High	WACC			WACC			FY 2022A Revenue		
81.2	69.3	12.9%			12.9%			\$4,417.40		
Low	Low	Exit Multiple EV/EBITDA			Multiple Range			Multiple Range		
44.1	49.0	20.3x	-	22.3x	20.3x	-	22.3x	7.3x	-	13.4x

Risks

Risks

Firm Risk: Share Repurchase

- With the Share Repurchase Program, company spending could have been used in R&D or through an acquisition to expand the business during a period of high volatility

Industry Risk: Cloud Transformation

- Security appliances industry headwinds due to increasing demand for Cloud based services by many customers

Market Risk: Competitive Landscape

- With Palo Alto's head start in the SASE market, this could hinder Fortinet's growth
- Rapidly developing industry, with start ups that can specialize in particular verticals

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Appendix

Discounted Cash Flow Analysis (Street Case)

Fortinet Standalone Unlevered Free Cash Flow (\$ in millions)	Q3	Fiscal Year Ended December 31				Terminal
	2023A	2023E	2024E	2025E	2026E	Period
Revenue	3890	5301	5989	6984	8612	9925
% Growth		20.0%	13.0%	16.6%	23.3%	15.3%
EBITDA	939	1558	1733	2122	2616	3015
% margin	24.1%	29.4%	28.9%	30.4%	30.4%	30.4%
Less: Depreciation & Amortization	(83)	(115)	(147)	(155)	(169)	(194)
EBIT	856	1444	1586	1967	2447	2821
% margin	22.0%	27.2%	26.5%	28.2%	28.4%	28.4%
Less: Taxes	(49)	(250)	(277)	(344)	(427)	(493)
NOPAT	807	1193	1309	1623	2019	2328
Add: D&A	83	115	147	155	169	194
Less: Capital Expenditures	(177)	(230)	(320)	(341)	(360)	(410)
% Revenue	(4.6%)	(4.3%)	(5.3%)	(4.9%)	(4.2%)	(4.1%)
Less: Increase in Net Working Capital	(688.6)	675.3	677.1	557.5	738.2	840.5
Unlevered Free Cash Flow		1754	1813	1994	2567	2953

Discount Rate	Enterprise Value (\$bn)			Implied Growth Rate			Equity Value Per Share(\$)		
	Exit Multiple			Exit Multiple			Exit Multiple		
	20.8x	21.3x	21.8x	20.8x	21.3x	21.8x	20.8x	21.3x	21.8x
10.9%	49.6	50.6	51.6	10.9%	10.9%	10.9%	64.2	65.5	66.7
12.9%	46.7	47.6	48.6	12.9%	12.9%	12.9%	60.6	61.8	62.9
14.9%	44.1	44.9	45.8	14.9%	14.9%	14.9%	57.2	58.3	59.4

WACC

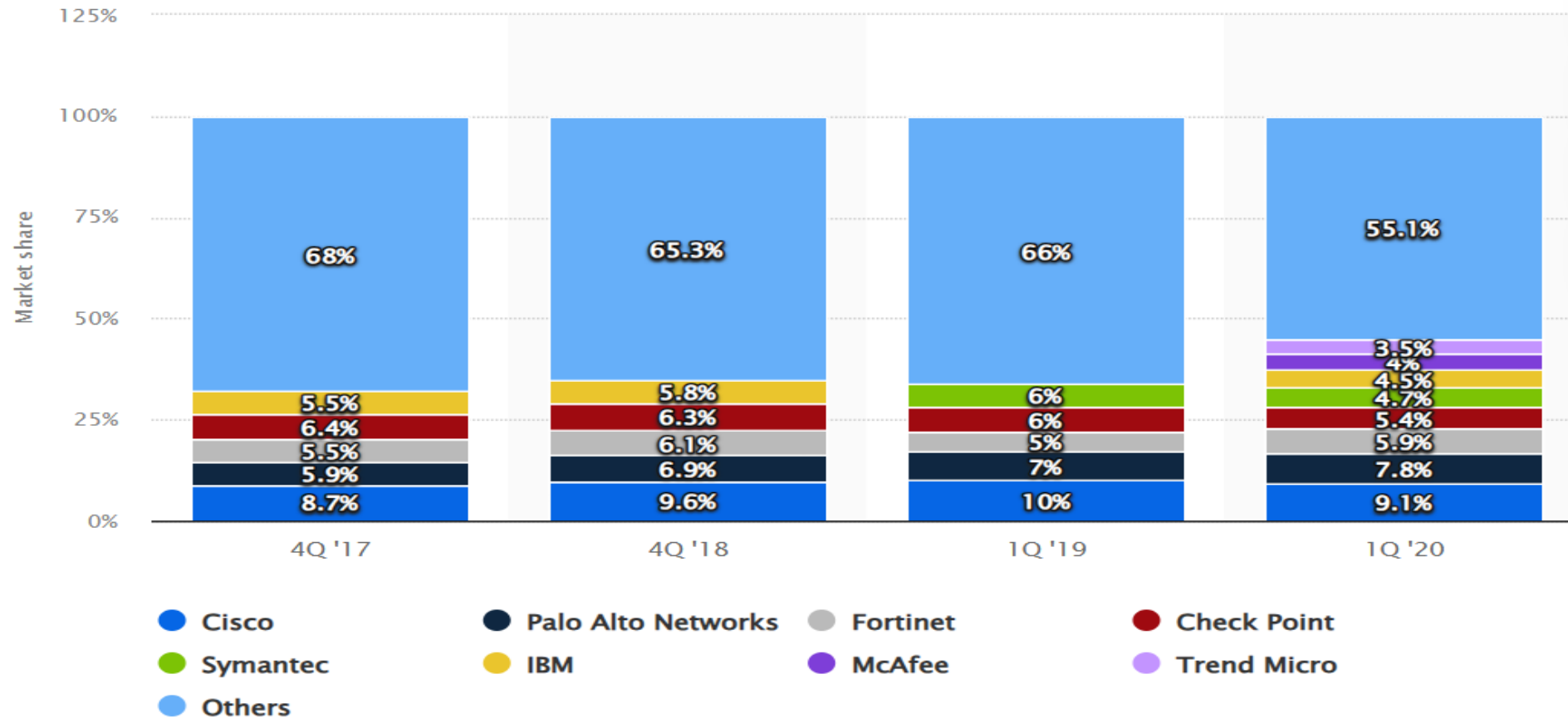
Weighted Average Cost of Capital

Risk free rate (R_f)		4.42%
Equity Beta		1.27
Equity risk premium ($R_m - R_f$)		6.89%
Cost of Equity (K_e)		13.15%
Cost of debt		1.80%
Tax rate		21.50%
After-tax Cost of Debt (K_{dt})		1.41%
Percentage of Capital		
Debt	990.4	2.3%
Equity	41530.1	97.7%
Total capital	42520.5	100.0%
Weighted Average Cost of Capital		12.9%

Exit Multiple Methodology

WACC	12.9%
EV/Revenue multiple	21.3x
NPV of UFCF 2023 - Terminal	2989.6
Terminal year EBITDA	3015.0
Terminal value in year 5	64310.0
PV of terminal value	39264.4
Enterprise Value	42254.0
Add: cash	1682.9
Less: debt	(990.4)
Add: Held-to-Maturity Assets	528.1
Equity Value	43474.6
Diluted shares outstanding	791.2
Equity Value Per Share	54.9
Current share price	\$52.49
Implied upside	4.7%
Implied growth rate	12.9%

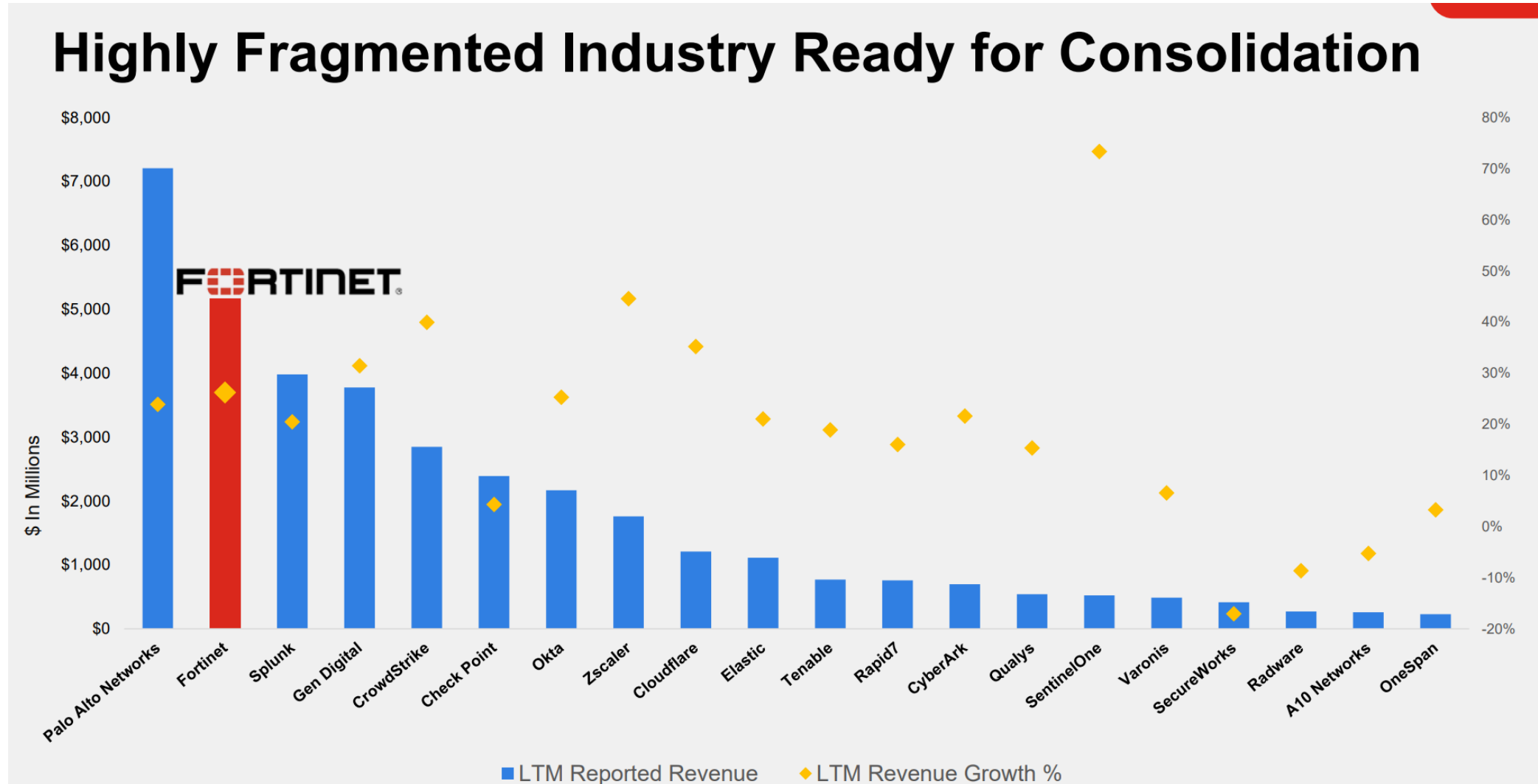
Cybersecurity Market Share



Details: Worldwide; 2017 to 2020

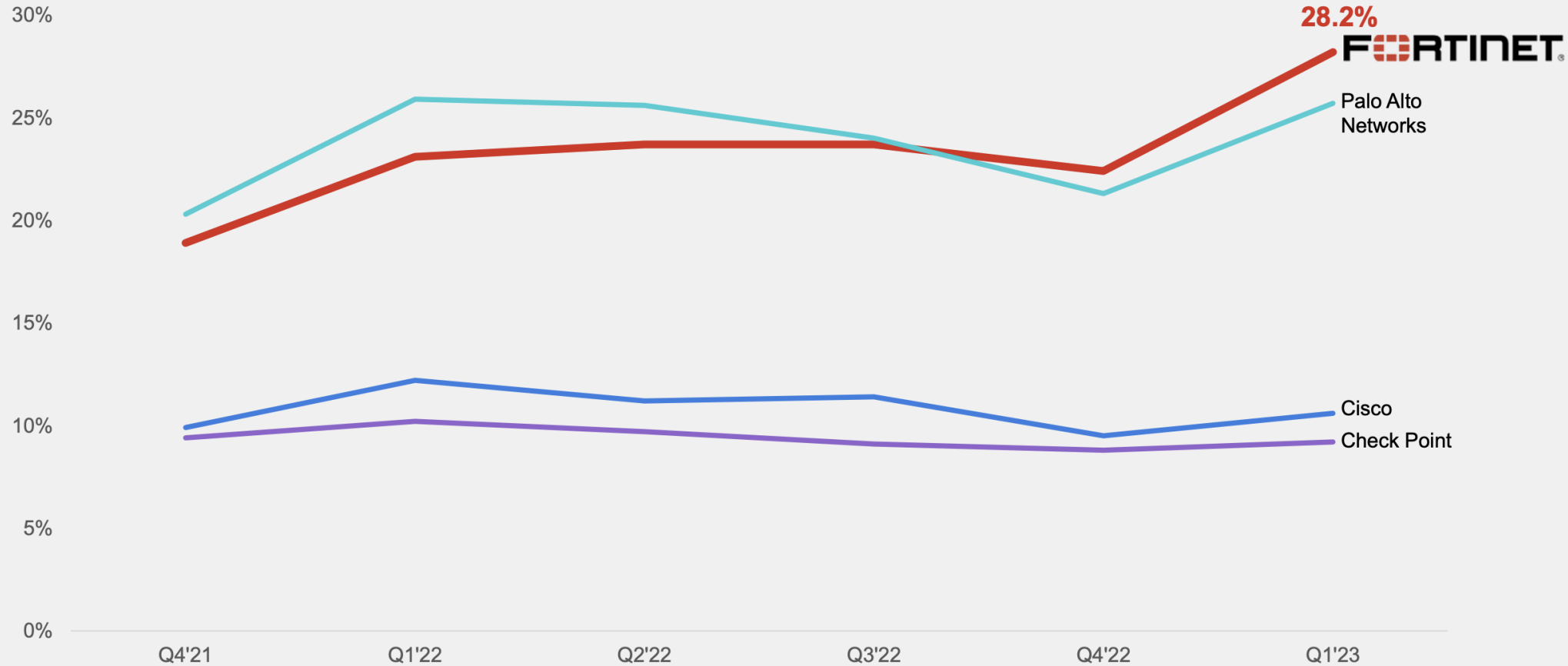
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Cybersecurity Market Share



Revenue Market Share

Fortinet is #1 in Revenue Market Share



Customers

