

Proofpoint (NASDAQ: PFPT) - BUY

Philip Song
(617) 777 4384
philipssong@gmail.com

Recommendation:

I recommend a long position on Proofpoint (PFPT) with a 1-year price target of \$150/share, offering 30% upside from a current price of \$115/share. I believe that Proofpoint has 1) product leadership in a growing market with high switching costs and proven cross-selling opportunities, 2) a strong cash position and industry leading recurring revenue growth, and 3) an attractive buy-in opportunity due to excessive market pessimism.

Business Description:

Proofpoint is a cloud-based IT security company that generates revenue from subscriptions to its SAAS platform, where the company hosts its suite of cybersecurity solutions in email security, threat protection, incident response, regulatory compliance, and other secure communication capabilities. The company also derives revenue from hardware, training, and professional services fees.

Capitalization		Key Stats	
Share Price	\$115	52 Week High	\$133.58
Shares Outstanding	57.3M	52 Week Low	\$83.81
Market Cap	\$6.6B	FY20 EV/Revenue	5.5x
Cash & Equivalents	\$0.95B	FY20 P/E	71.2x
Total Debt	\$0.82B	1 Year Target Price	\$150
EV	\$6.76B	IRR	30%

Investment Thesis:

1. Product leadership in a growing market with high switching costs yields cross-selling opportunities

Proofpoint enjoys dominant market share in email security solutions, capturing 22% of the addressable market last year. Email security is a growing market in IT, forecasted to grow at a 9% CAGR through 2025. Proofpoint has a proven ability to cross-sell within its customer base, with roughly half of its enterprise customers using 3 or more of Proofpoint's products. I believe Proofpoint is well-positioned to leverage its leadership in email security and diverse product portfolio to penetrate adjacent markets across Proofpoint's other product lines. Proofpoint also offers high customer retention (averaging ~90% since 2015) due to high switching costs in on-premise servicing/deployment.

2. Strong cash position and growth in recurring revenue provides favorable outlook

Proofpoint started the year off strong by reporting Q1 earnings that were above both guidance and consensus, growing 23% compared to the year-ago period. Proofpoint also enjoys a strong cash position, with close to \$1B of cash and equivalents on its balance sheet, also having increased from last year. 98% of revenue was through recurring subscriptions, a high proportion relative to other SaaS companies (average is ~70%).

3. Excessive market pessimism allows for a cheap buy-in supported by potential tailwinds

In response to COVID, management lowered its 2020 revenue guidance by ~5%, causing the stock to trade down ~15%. Currently, the stock trades at a significant discount to its peers at a forward EV/revenue multiple of 6.5x, with the average multiple in its peer group trading at ~10x. I believe the street is over-penalizing the stock on account of lowered guidance and COVID disruptions, which in my view, do not sufficiently justify the present discount. Alternatively, I believe management has provided a somewhat conservative outlook, considering that the email security market stands to benefit from tailwinds related to increasing WFH trends. Although COVID-related disruptions are possible in the short-term, I believe demand will quickly rebound revenue growth back to around ~20%.

Valuation:

I am valuing the company assuming a one year holding period. In a base case, I assume the forward EV/Revenue multiple will re-rate to 8.5x, the median in Proofpoint's peer group, and drive TTM revenue of \$996.5M. In a bull case, I assume the forward EV/Revenue multiple will re-rate to 10x, the average premium in Proofpoint's peer group, and drive revenue of \$1.1B. In a bear case, I assume the multiple will not re-rate and remain at its current level of 6.4x, driving revenue of \$991.3M. In the base case, I arrived at a 1-year price target of \$150/share, implying 30% upside. As a sanity check, a DCF analysis assuming 12.5% cost of capital and 5% perpetual growth yields a price range similar to that of a multiples-based approach.

Risks

- **COVID disruptions:** Layoffs at enterprise customers will reduce on-seat pricing. Additionally, WFH will delay on-prem integration and servicing.
- **Counterargument:** Short-term COVID pressures should not affect the fundamental value proposition of Proofpoint's products.

Catalysts:

- As remote work is increasingly standardized, hackers will have more opportunities to target company emails; high likelihood of triggering events to cause IT security to become more of a public concern in the near-future.
- 2020 revenue guidance seems conservative— in my view there is a good chance of beating guidance/expectations in the coming quarters.

	Base	Bull	Bear
FY21 Revenue (\$M)	\$996.5	\$1,113	\$993.3
EV/2021E Rev Multiple	8.5X	10x	6.5x
Implied share price	\$150	\$196	\$115
IRR	30%	70%	0%
DCF implied price	\$111	\$147	\$97