From: Randy Eckel
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Subject: PANW FYQ416 - Marker Thoughts
Date: Thursday, September 1, 2016 5:41:28 AM

Company: PANW	**Company Bias:**	**Sector Bias:** Neutral
Quarter: 4 fy2016	**Sector:** DC Perimeter Security	
Current Qtr: In-line	***Guide Next Qtr:*** Lowered	

Summary: PANW FYQ416 - Marker Thoughts

Marker Thoughts

Palo Alto Networks rebounded in FyQ4 with consensus beats in both Revenue and Billings. Revenue growth was solid at +41% YoY. Product revenue came in a few million above consensus, and Short-term Deferred Revenue was in-line. Management guided FyQ117 a bit below consensus and guided down FY17 Product revenue growth, while guiding Services revenue up.

Management indicated they are expecting Product revenue to grow only 12-13% YoY in Fy17, while Services (Subscriptions, Support & Maintenance and Professional Services) will grow better than 50%.

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- Total Revenue for FyQ4 was up 41% YoY
- Services revenue was up 62% YoY
  - Subscription revenue was up 66% YoY; the WildFire Subscription Malware protection solution continues to ramp
  - Support and Maintenance was up 57% YoY
- Billings was up 45% YoY, driven by a 74% YoY increase in Deferred Revenue; however, the upside was helped by another large increase in Long-Term Deferred Revenue (+85% YoY).
- All three regions grew in the 41% range

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- Product revenue guidance for FY17 was below even the most pessimistic forecasters

MARKER BOTTOM LINE

As we have noted for years, PANW continues to benefit from (i) its position as the leader in NGFW, (ii) a productive Channel, and (iii) a strong Subscription and high-end appliance Product cycle. The company's Subscription "attach rates" continue to improve, as Wildfire moves from free-to-paid, and from a "nice to have" to a "must have".

We have been Neutral on the company due to (i) we are seeing a decline in 1a & 1b enterprise Data Center (DC) Perimeter Security spending, (ii) competition continues to ramp, (iii) our thesis that spending is shifting from the DC perimeter to inside the DC, and will continue to do so, (iv) while PANW has a play inside the DC, today it pales in comparison to its NGFW opportunity, and (v) the core business and its attached Subscriptions might be home runs, but its new, unattached Subscriptions (Traps, Aperture, Autofocus) are both immature and just singles ... at least in the medium-term.

Unfortunately, expectations for the company continued to be stubbornly high as if the company was immune to overall security spending trends and traditional enterprise product life cycles. But that has changed in Fy17 as management set a much more realistic bar for product revenue growth.

Despite a lower than expected contribution from new product sales, consensus for Fy17 has PANW growing total revenue more than 30% (consensus is 33%). Recurring revenue should grow greater than 50%. Free cash from operations should be in excess of $700 mm. Operating margin should be close to 20%. Fy18 revenue consensus is +29 - 30%.

PANW is clearly still a growth business ... but just not as fast as it has been growing.

Given this new guidance, these are our questions

- Given that the NGFW refresh is slowing, is 12 - 13% product revenue growth actually conservative?
- Given slowing appliance growth, when will that start to impact services growth?
- Will PANW's newer unattached subscriptions be successful? If so, when and how successful?
- Given slowing appliance sales, do they have too many salespeople? Will there be disruption in the sales ranks?
- Do investors care about Fy18 consensus today?

These are the questions that come to our mind now that we have been surprised by a lower than expected product growth guidance. We did a quick check with some of our top PANW partner contacts yesterday. Based on the information we have today:

- Given that the NGFW refresh is slowing, is 12 - 13% product revenue growth actually conservative?
    - **We did a quick survey of our top U.S. PANW contacts and came away with the sense that they would be very disappointed if their appliance sales growth was less than 15%. They forecast on average 20% growth YoY**
- Given slowing appliance growth, when will that start to impact services growth?
    - **Likely not until Fy18 as the impact from slowing appliance sales hits Support / Maintenance and attached subs. Absent improved contribution from the new subscriptions, service rev growth could slow to around 30% in Fy18**
- Will PANW's newer unattached subscriptions be successful? If so, when and just how successful?
    - **This is an open question that no partner can answer. Fortunately, PANW has a year or so to make material progress, but the jury is out**
- Given slowing appliance sales, do they have too many salespeople? Will there be disruption in the ranks?
    - **Probably. They may lose some salespeople, but it will probably be the ones they want to lose. Less productive salespeople leaving should help them improve margin**
- Do investors care about Fy18 consensus today?
    - **We are not the best judge of this, but our sense is no. If PANW can pull in better than 12 - 13% Fy17 YoY growth in Product revenue, that would be a big positive. We suspect there are investors looking to own PANW for its leadership in network security, and its services growth and cash flow**

<u>We remain positive on the company</u>

Although 30% revenue growth in Fy18 is far from a given, <u>our sense is that Fy17 guidance will soon be considered conservative</u>. **For that reason we are moving our Neutral Bias to Positive for Fy17, or until we see evidence that**:

1) Product revenues could underperform 12 - 13%
2) It is clear that the unattached subscriptions are not ready to pick up the Fy18 slack (see below)

Trading in the mid $130s, we believe that PANW is reasonably undervalued versus its peers at EV/EBITDA(17) = 25, and EV/FCF = 16x.

<u>Unattached subscriptions will have to make up the difference in Fy18 and beyond</u>

For PANW to grow 30% in Fy18, the company will need to get its unattached subscriptions to move the needle. Although management indicated that Traps was running at a "mid-eight figure run rate", and Aperture / AutoFocus combined at an eight figure rate, they both have a long way to go to make up for the eventual slowing of the attached subscriptions.

(**Marker Note** - PANW also sells its VM series of virtual appliances. We consider them a substitute for a hardware appliance in SDN deployments, so we don't lump them into the unattached category. Although management indicated that it too was on a mid-eight figure run rate, we believe they VM series needs a material re-imaging and re-pricing to really gain traction in a Hybrid Cloud world and thereby help compensate for declining growth in appliances)

According to PANW's channel, all of these unattached subscription products have much work to be done before they are successfully sold in volume. PANW has a year to turn one or more of these products into solid doubles or triples to take up the slack.

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