

F R O S T & S U L L I V A N  
INDEPENDENT EQUITY RESEARCH



allot

## Q1 Update Report

Jun. 10 2020



Today's forms of communication have made the world into a very small place. We can easily communicate with our families, friends, and colleagues, on the other side of the world, **via our cellular network**, to message them about the latest episode of our favorite show, streamed **via our home WiFi network**. Because these networks have become such a vital part of our lives they have become a vital asset for communication service providers (CSPs) that supply us with cellular, internet, and other services.

Allot Ltd. (NASDAQ, TASE: ALLT) is a B2B2C software company with over 20 years of experience that focuses on Network-based Security and Network Intelligence Solutions. These solutions enable entities such as telecom service providers to secure and optimize the digital experience of their users. Allot's motto is "See. Control. Secure." and it is a precise definition of the company's value proposition. The company allows its customers to see what is going on in their network, control their network to give the best experience to end users on all connected devices, and secure all of these devices against threats. It does this while providing network insights that save its customers significant capital and while creating new revenue streams for them. In essence, Allot empowers its customers to get more out of their networks.

The Company's solutions are deployed globally for network analytics, traffic control and shaping, and network-based security including mobile security, DDoS protection, IoT security, and more. Allot's multi-service platforms are deployed by over 500 mobile, fixed, and cloud service providers and over 1000 enterprises. Their network-based security as a service solution has achieved over 50% penetration with some service providers and is already used by over 23 million subscribers in Europe.

## Q1 Revenues up 16% YoY; Broadcom has chosen Allot to provide SSG solutions; Company is on track with updated growth expectations; Target price is 45.8 NIS

**Stock Exchange:** NASDAQ / TASE

**Ticker:** ALLT

**Sector:** Technology

**Sub Sector:**  
Software/Internet

**Stock target price:**  
45.8 NIS

**Data as at June 10, 2020:**

**Closing price:** 36.94 NIS

**Market cap:** 1.27 B NIS

**# of shares:** 34.3 million

**Stock performance (YTD):**  
25.26%

**Volume (3 month average):**  
2612

### Highlights

Allot announced its Q1 2020 financial results with the following highlights:

- Q1 revenues were \$29.3 million, up 16% year-over-year.
- Non-GAAP gross margin increased to 74.8% compared to 72.4% in Q1 2019 and GAAP gross margin increased to 74.0% compared to 71.2% in Q1 2019.
- Non-GAAP net loss of \$0.4 million and GAAP net loss \$1.7 million, both significantly improved from non-GAAP net loss of \$1.9 million and GAAP net loss of \$3.3 million in Q1 2019.
- Cash/investments at the end of Q1 totaled \$110.7 million compared to \$117.6 million in Q4 2019
- Company guidance for 2020 revenue is between \$135 and \$140 million, representing accelerated double-digit year-over-year growth.

Allot was chosen by Broadcom as the recommended vendor to offer a transitional path from the discontinued **PacketShaper** line of products to the Allot Secure Service Gateway (SSG). Following their Broadcom acquisition, the Symantec Enterprise Division has chosen to End of Sale the PacketShaper line of products to concentrate their investment in the Enterprise Security Software market. Consequently, they've announced that the PacketShaper products are designated as End of Life (EoL) as of 31 March, 2020. As part of the partnering agreement, Allot is offering attractive financial terms and discounts for product replacements to help customers transition from Symantec PacketShaper to equivalent Allot products.

Due to **COVID-19** some deals which were expected to close were delayed and are now expected to close during the second quarter. Allot reports that service providers have experienced increased bandwidth of 30% to 40% and that demand for their solutions has either remained constant or increased during the period of the pandemic.

In May, Allot launched **BusinessSecure**, a new solution from the Allot Secure family of services, for telcos to protect their business customers from cyberattacks. CSPs can now offer their SMB and Enterprise customers protection from emerging cybersecurity threats using a rev-share SecaaS model with Allot.

We expect Allot to show a significant increase in revenues over the next 5 years due to the high growth expected in the SecaaS sector and importantly due to the company's transition from a CAPEX to a Rev-Share business model in this sector. In essence this means that every new individual telecom subscriber that chooses to secure their mobile device will pay a portion of the monthly fee to the telecom and a portion will be allocated to Allot. With large telecoms servicing millions of subscribers the potential here is great.

For our comprehensive coverage including detailed competitive landscape, market, and Company product insights, see our [Initiation Report](#). In light of the company's revenue forecast and progress, our estimate of Allot's valuation is \$457 million / NIS 1.57 billion; target price of NIS 45.8 / \$13.3. Below are our main assumptions and forecast for 2019-2022:

000, \$	2018A	2019A	2020E	2021E	2022E
<b>Revenues</b>	95,837	110,100	133,521	164,463	215,107
<b>Gross profit</b>	67,751	76,266	93,732	116,275	152,081
<b>Operating (loss) profit</b>	-4,810	-8,978	-3,765	1,380	12,463

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## Executive Summary:

### Investment Thesis:

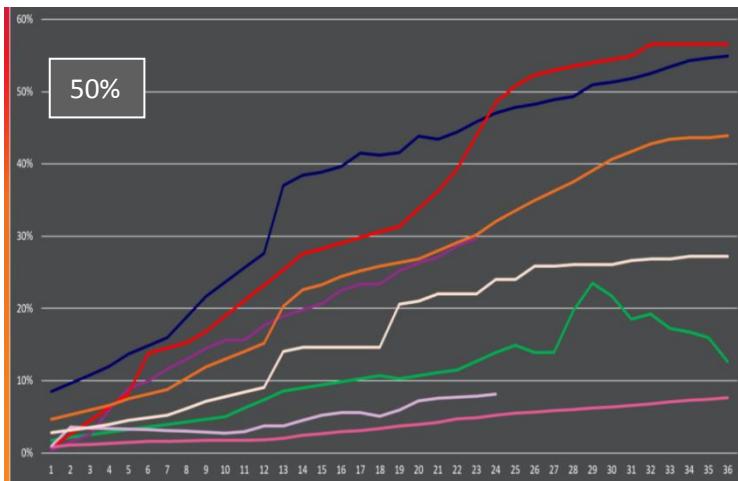
Today's forms of communication have made the world into a very small place. We can easily communicate with our families, friends, and colleagues, on the other side of the world, **via our cellular network**, to message them about the latest episode of our favorite Netflix show, streamed **via our home WiFi network**. Because these networks have become such a vital part of our lives they have become a vital asset for communication service providers (CSPs) that supply us with cellular, internet, and other services.

The problem is that as our **networks become more advanced to meet our expectations**, by supplying us with capabilities such as 8K video streaming, gaming, virtual reality, ultra-reliable low latency/low bandwidth V2X collision avoidance systems and other machine-to-machine communications on a massive scale, **we expect to pay less to use them**. That is, network costs are rising for CSPs but Average Revenue per User (ARPU) is not.

The second major problem that arises is that as more and more devices utilize our networks, there are more and more targets for cyber-attacks. Imagine a hacker infecting two million IoT devices and using them to launch a massive DDoS attack on vital city infrastructure.

These two developing problems are those that Allot has dedicated itself to solve. The Company's **Network Intelligence** Solution allows CSPs to get more out of their existing network bandwidth so that end users receive high Quality of Experience (QoE) without intensive CAPEX investment. That is, simple broadband pipes, where data flows, become smart and sophisticated allowing CSPs to see what type of data is flowing at high resolution and to adapt to congestion.

Allot attempts to turn the security problem into an opportunity for CSPs by creating an added source of revenue for them with their **Network Security** Solution. If we think about it, we quickly realize that our homes have become mini IT organizations with at least 10 connected devices that surround us and that we surrender our most intimate details to. Because Allot's solution is network based (it is located on the network) and not end-point based (they also provide end-point security where necessary) users do not have to download or install anything. They are automatically protected.



The graph to the left shows the penetration rates of Allot's security solution over weeks for different CSP subscriber populations. We can see that gradually Allot's Network Security solution is achieving penetration rates over 50% for some cellular CSPs in certain geographies. Should CSPs communicate the need for this solution clearly and awareness develop with end users, the revenue potential for Allot is significant. Vodafone's (one of the largest Tier 1 CSPs in the world) CEO Vittorio Colao: *"Our Secure Net product (provided by Allot) is already 160 million in revenue... we have been building quietly and we will leverage on."*

Over time mobile data prices have declined exponentially while data usage has increased exponentially. In theory, if data revenue continues to decrease at a rate faster than network costs then revenue per unit of data could become negative. This point is especially important considering that some CSPs are transitioning from tiered services to unlimited data services where they have no control over the revenue per unit of data used.

That is why it is critical for CSPs to find ways of reducing their CAPEX investments and to create new revenue streams. Another important trend that is driving adoption of Network Intelligence and Network Security Solutions is the regulatory landscape. Just this year the UK introduced a law requiring all visitors of adult content websites to prove that they are 18 or over. This was done to reduce the risk of children accessing or stumbling into adult content and to set a standard for international child protection online. Sites that do not comply with the law will be blocked by mobile and fixed CSPs. Further regulations such as the implementation of the Network and Information Security Directive (NISD) and the General Data Protection Regulation (GDPR) in the EU that require network operators to ensure that their network and information systems meet minimum standards of cyber security could lead to significant upside for Allot. Allot allows CSPs to adapt to the above trends such as the increase in device and data usage, increase in need for security, and increase in need for QoE while limiting CAPEX and creating new revenue streams. Within the competitive landscape Allot is well positioned and provides network awareness and security of the highest quality.

100 CSPs surveyed by Allot pinpoint network QoE as their top business objective (26%), followed by competitive pricing (25%). This means that QoE is prioritized over pricing. Congestion and DDoS are QoE killers. 48% of CSPs reported that DDoS accounts for 3-5% of their traffic and an additional 11% reported it accounts for 6-10% of their traffic, which contributes to congestion. There is high concern that growing IoT deployment will create more traffic. 66% of CSPs are very concerned that IoT will generate outbound DDoS and 51% fear that 5G is going to further increase DDoS traffic. Effective congestion management can deliver customer satisfaction while reducing costs. CSPs noted that they need to expand capacity of 20% of cells annually and at an approximate cost of \$30,000 per cell. However, according to Allot benchmarks, by optimizing congestion management, CSPs can gain back up to 20% of inefficiently utilized bandwidth. If they combine real-time QoE visibility with the ability to prioritize traffic to deliver optimal QoE at minimal bandwidth cost, they can protect their bottomline profitability without extensive capacity expansion. Allot contends that the common misconception is that spending big money on bandwidth and network equipment is the only way to go and that cost reduction can be the hidden benefit of getting QoE right.

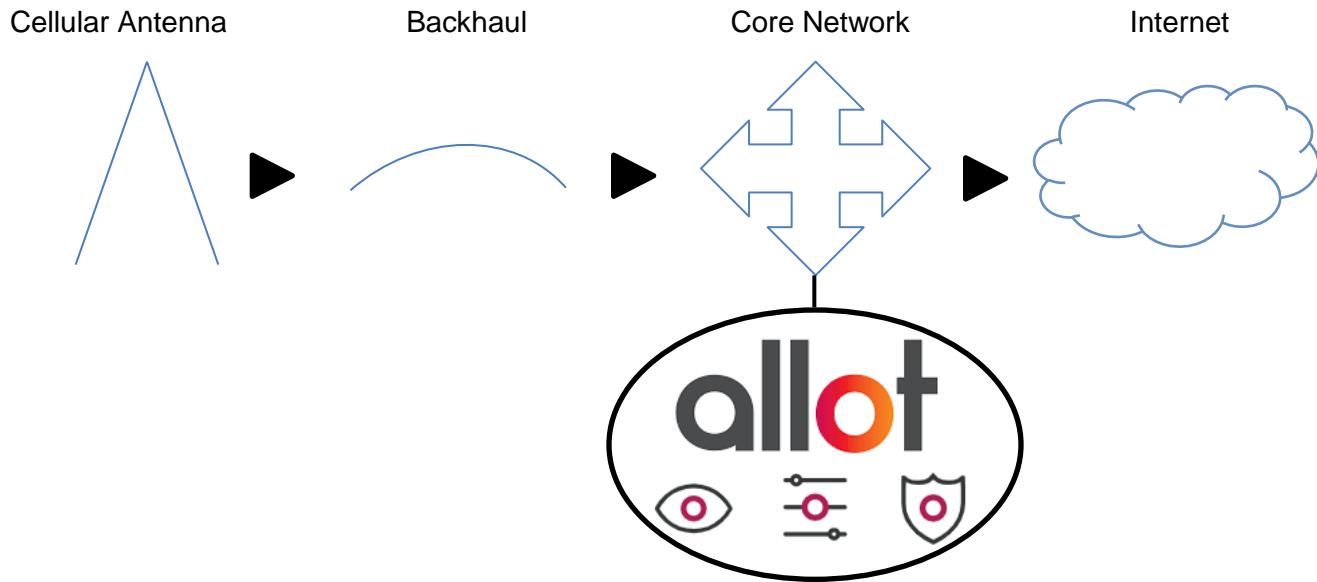
Allot has made a strategic decision to focus its marketing and sales efforts on mobile Network Security reaching out to what seems like the blue ocean of cyber security. We expect Allot to show a significant increase in revenues over the next 5 years due to the high growth expected in this sector and importantly due to the company's transition from a CAPEX to a Rev-Share business model. In essence this means that every new telecom subscriber that chooses to secure their device will pay approximately 50% of the monthly fee to the provider and 50% will be allocated to Allot. With large telecoms servicing millions of subscribers the potential here is great. The more Allot's security solution penetrates subscribers the more revenues will increase. Allot uses a term called "MAR" to describe this. MAR stands for Maximum Annual Revenue and this is an approximation of the theoretical annual revenues Allot would receive if 100% of the customer's subscribers, as estimated by Allot, signed up for SecaaS. For example if Allot were to sign on a telecom to its SecaaS service and that telecom had 10M subscribers then the MAR could be 50% (the portion of the rev-share allocated to Allot varies) of about a 1 dollar security fee payed monthly multiplied by 12 months and multiplied again by 10M

customer subscribers. This equals 50 cents X 12 months X 10M users = a \$60M MAR. Today Allot has already on-boarded a few Tier 1 telecom customers that offer Allot's security value added service to end users.

**The nature of the company can be characterized for investors by its two offerings. The Network Intelligence solution brings in a constant and steady stream of revenues which according to our evaluation will show low two digit growth in the next two years and then transition to high one digit growth. The second offering, mobile Network Security, is a relatively new and growing business which we expect to have significant high double digit CAGRs in the next five years based on Allot's reputation, deep know how on a global scale, and the high potential of the Rev-Share model. Allot's main customer segment is telecom service providers which can leverage both of Allot's solutions. Due to the synergy between these offerings (one allows customers to see and control their networks and the other to secure them) we believe in the investment potential of the company.**

## Technology Overview:

In order to understand the value proposition of Allot it is important to understand where their solution fits within the big picture. Below is a use-case meant to demonstrate this. The following diagram represents a cellular network:

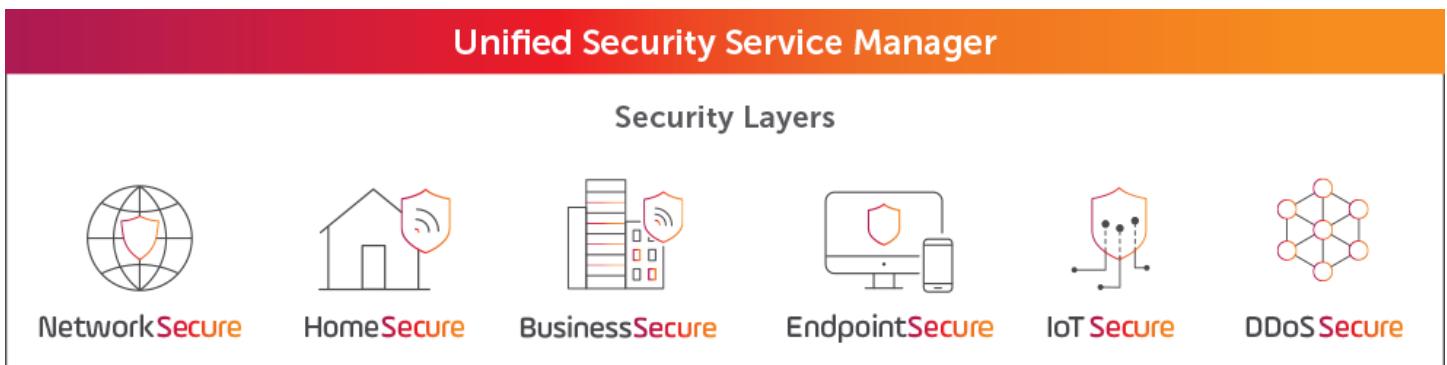


When you want to watch a YouTube video on your mobile device through your cellular provider your phone makes a request to the nearest cellular antenna. The antenna then sends this request through either physical cables or wireless methods termed “backhaul”. The backhaul carries your request to the core network which is like a highway intersection where data is directed to where it needs to go in the internet to retrieve the YouTube video you want. On the way back from the internet the video is sent back through to the core network to the backhaul to the cellular antenna and to your phone. The YouTube video, sent across the network, is sent in small data chunks termed “packets” because our networks are not designed to send data in one large chunk. Because of this, Network Intelligence Solutions such as Allot’s are also termed Deep Packet Inspection or DPI solutions. **The core network, where all of the data packets are directed, is where the Allot Network Intelligence and Network Security software sit with a very low signature that does not affect the flow of data. It is at this critical point that Allot’s solution sees, controls, and secures the data packets flowing in the network.**

Allot is network agnostic. Just as they secure and optimize mobile networks, they secure and optimize fixed, satellite, cloud and all other network types that support our connected devices such as laptops and IoT devices.

This means that their software turns broadband pipes into smart networks allowing value-added internet services to be rapidly deployed for Communication Service Providers of mobile broadband, wireless broadband, mobile satellite service, and digital subscriber line carriers. The two main platforms by which they offer their services are **Allot Secure** and **Allot Smart**.

**Allot Secure** is intended to protect any and all connected devices from cyber threats. It consists of 6 parts (detailed in the chart below) that work together to achieve a unified experience. Allot Secure enables CSPs to offer security as a service (SECaas), which is a source of added revenue for them.



**Allot Smart** is powered by deep packet inspection (DPI) technology that supervises and filters the data packets sent over the network. It allows for a cost-effective high quality experience and has the potential to lower access bandwidth costs, defer bandwidth capacity expansions, and reduce revenue leakage. Some of the ways Allot achieves this is by providing visibility and forecasting. With Allot Smart a CSP can truly understand what type of data is flowing through their pipes, enforce policies such as parental controls or data limits, and perform network planning. For example, a CSP may choose to look at the changing trend in amount of YouTube users on their network, forecast future use, and understand that they are able to defer investing in capital intensive network infrastructure for a few years. An additional example would be a CSP having a congested network that does not deliver content at speeds and quality that create user satisfaction. Allot Smart identifies the sources of congestion in a network and mitigates the congestion delivering content that ensures a quality experience (QoE) and therefore limiting churn.

## Financial Analysis

Allot generates revenues from two sources: (1) sales of Network Intelligence Solutions which show network operators what is happening on their networks at the highest resolution and (2) sales of Network Security solutions, such as security as a value added service that telecom service providers can offer to subscribers in order to protect them from cyber threats. The Company additionally provides maintenance and support services pursuant to a one- to three-year maintenance and support program, which may be purchased by customers at the time of product purchase or on a renewal basis.

### First Quarter 2020 Financial Results Summary

**Total revenues** for the first quarter of 2020 were \$29.3 million, an increase of 16% compared to \$25.3 million in the first quarter of 2019.

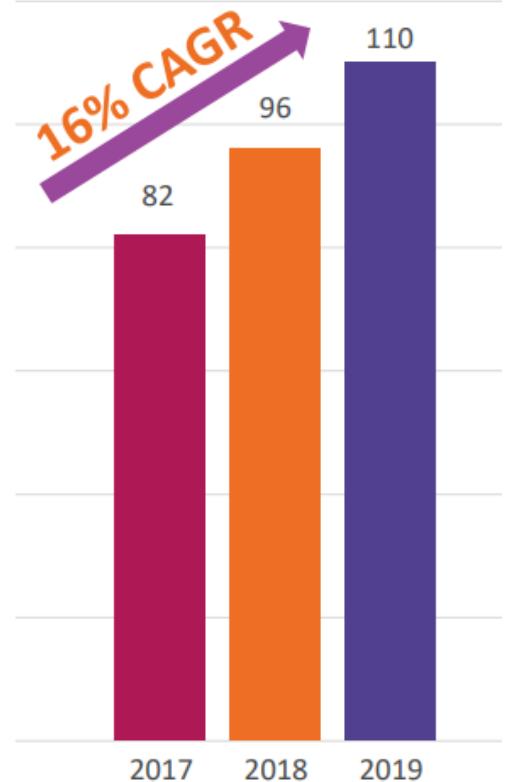
**Gross profit on a GAAP basis** for the first quarter of 2020 was \$21.7 million (gross margin of 74.0%), a 20% improvement compared with \$18.0 million (gross margin of 71.2%) in the first quarter of 2019.

**Gross profit on a non-GAAP basis** for the first quarter of 2020 was \$21.9 million (gross margin of 74.8%), a 19% improvement compared with \$18.3 million (gross margin of 72.4%) in the first quarter of 2019.

**Net loss on a GAAP basis** for the first quarter of 2020 improved to \$1.7 million, or \$0.05 per basic share, compared with a net loss of \$3.3 million, or \$0.10 per basic share, in the first quarter of 2019.

**Non-GAAP net loss** for the first quarter of 2020 improved to \$0.4 million, or \$0.01 per basic share, compared with a non-GAAP net loss of \$1.9 million, or \$0.05 per basic share, in the first quarter of 2019.

**Cash and investments** as of March 31, 2020 totaled \$110.7 million, compared with \$117.6 million, as of December 31, 2019.



## Appendices

### Appendix A - Financial Reports

**TABLE - 1**  
**ALLOT LTD.**  
**AND ITS SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF OPERATIONS**  
(U.S. dollars in thousands, except share and per share data)

	Three Months Ended	
	March 31,	
	2020 (Unaudited)	2019 (Unaudited)
Revenues	\$ 29,289	\$ 25,342
Cost of revenues	<u>7,610</u>	<u>7,293</u>
Gross profit	<u>21,679</u>	<u>18,049</u>
Operating expenses:		
Research and development costs, net	8,699	7,174
Sales and marketing	<u>11,522</u>	<u>11,477</u>
General and administrative	<u>3,041</u>	<u>2,705</u>
Total operating expenses	<u>23,262</u>	<u>21,356</u>
Operating loss	(1,583)	(3,307)
Financial and other income, net	<u>151</u>	<u>532</u>
Loss before income tax expenses	<u>(1,432)</u>	<u>(2,775)</u>
Tax expenses	<u>228</u>	<u>558</u>
Net Loss	<u>(1,660)</u>	<u>(3,333)</u>
<b>Basic net loss per share</b>	<u><b>\$ (0.05)</b></u>	<u><b>\$ (0.10)</b></u>
<b>Diluted net loss per share</b>	<u><b>\$ (0.05)</b></u>	<u><b>\$ (0.10)</b></u>
Weighted average number of shares used in computing basic net loss per share	<u>34,625,632</u>	<u>33,983,863</u>
Weighted average number of shares used in computing diluted net loss per share	<u>34,625,632</u>	<u>33,983,863</u>

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**TABLE - 3**  
**ALLOT LTD.**  
**AND ITS SUBSIDIARIES**  
**CONSOLIDATED BALANCE SHEETS**  
(U.S. dollars in thousands)

	<b>March 31, 2020</b>	<b>December 31, 2019</b>
	<b>(Unaudited)</b>	<b>(Audited)</b>
<b>ASSETS</b>		
<b>CURRENT ASSETS:</b>		
Cash and cash equivalents	\$ 29,494	\$ 16,930
Short-term bank deposits	800	5,557
Restricted deposit	32,156	23,183
Available-for-sale marketable securities	47,841	61,012
Trade receivables, net	23,140	29,008
Other receivables and prepaid expenses	7,589	6,528
Inventories	15,153	10,668
Total current assets	<u>156,173</u>	<u>152,886</u>
<b>LONG-TERM ASSETS:</b>		
Restricted deposit	440	10,913
Severance pay fund	341	387
Operating lease right-of-use assets	5,797	6,368
Deferred taxes	432	517
Other assets	766	926
Total long-term assets	<u>7,776</u>	<u>19,111</u>
PROPERTY AND EQUIPMENT, NET	<u>8,700</u>	<u>8,135</u>
GOODWILL AND INTANGIBLE ASSETS, NET	<u>34,884</u>	<u>35,037</u>
Total assets	<u><u>\$ 207,533</u></u>	<u><u>\$ 215,169</u></u>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
<b>CURRENT LIABILITIES:</b>		
Trade payables	\$ 13,944	\$ 11,676
Deferred revenues	29,921	36,360
Short-term operating lease liabilities	2,951	3,151
Other payables and accrued expenses	19,885	22,255
Total current liabilities	<u>66,701</u>	<u>73,442</u>
<b>LONG-TERM LIABILITIES:</b>		
Deferred revenues	6,075	5,262
Long-term operating lease liabilities	2,738	3,820
Accrued severance pay	749	794
Total long-term liabilities	<u>9,562</u>	<u>9,876</u>
SHAREHOLDERS' EQUITY	<u>131,270</u>	<u>131,851</u>
Total liabilities and shareholders' equity	<u><u>\$ 207,533</u></u>	<u><u>\$ 215,169</u></u>

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