

TRADER EXTRA

Proofpoint Needs Profits

Stocks whose products help combat security breaches, like fast-growing Proofpoint, have skyrocketed.

By VITO J. RACANELLI

Oct. 17, 2015 12:20 a.m. ET

It seems like a week doesn't go by without another admission of a computer security breach at a major corporation or institution. Unsurprisingly, stocks whose products help combat these threats, like that of fast-growing Proofpoint (PFPT), for example, have skyrocketed.

Wall Street analysts love the stock, with 22 Buy ratings out of 24 analysts who cover it. Shares have raced from its 2012 initial public offering of \$13 to \$59.52 lately, a rise of more than 300%. Though it has retreated from a high of \$72 earlier this year, the shares still trade at a nosebleed valuation. It could drop plenty more when investors tire of Proofpoint's habit of producing year after year of net losses, even though it has been around for about a decade.

Proofpoint gets most of its sales for its e-mail software to combat viruses and spam, among other threats, through a recurring subscription model. The market buzz comes courtesy of 42% revenue growth last year, to \$195.6 million, and another 36% rise in the first half of 2015, to \$82.2 million.

Such revenue growth is nice. But sustainable earnings are the real proof, and Proofpoint doesn't have much of that. More importantly, a realistic prospect of future profits seems far off, given the expenses Proofpoint continues to incur.

Net losses, based on generally accepted accounting principles (GAAP), have widened from \$21 million in 2010 to \$64.5 million last year. Things look no better in the first half of 2015, when the red ink was \$46.7 million versus \$29.5 million in the first half of 2014.

Investors should look beyond the cyber-security hoopla. The company, with a \$2.4 billion market value and 3,400 customers globally, is afflicted with a problem many tech companies have: Expenses are outpacing sales, because the business landscape is highly competitive.

In the five years ended 2014, revenue grew an average annual 28%. Operating expenses rose even faster, at 34%. This worrisome trend accelerated in the first half of 2015, when operating costs rose 45% to \$121 million, equal to revenue for the first half.

Proofpoint bulls say the company will achieve economies of scale eventually, and cost growth will slow even as sales continue to drive higher. Yet if it hasn't turned a profit with this robust a client list, how will it do so in the future?

Rivals, such as Microsoft (MSFT), Alphabet (GOOGL), and Intel (INTC), among others, are bigger and more profitable, according to a report from [New Constructs, an independent accounting-research firm](#). They sport deeper pockets, which gives them more operating flexibility and pricing leeway. They can bundle their security software into a wider product offering, the report points out.

Proofpoint bulls say stock compensation, a noncash expense, makes up a big chunk of costs and losses. Results should be adjusted to reflect that and other noncash charges, it's argued. In the first half of 2015, for example, earnings before interest, taxes, depreciation, and amortization (Ebitda)—after adjusting for extraordinary items and noncash expenses, such as stock-based compensation—swung to \$1.7 million from a negative-\$1.3 million in the year-earlier period.

However, some of the noncash expenses aren't going away soon. [According to New Constructs, the value of the stock options outstanding listed](#) in the last annual report was nearly equal to about 10% of the company's market value. Executive stock compensation has grown while losses have worsened.

Moreover, those bullish Wall Street analysts like to estimate EPS using non-GAAP figures. But even using these more flattering numbers, the stock trades at a still-rich P/E of 152 times the consensus EPS estimate of 39 cents, two years out in 2017.

The main threat to our skeptical view is that a larger company could buy Proofpoint, but the Proofpoint bull case remains overly exposed to blue-sky thinking. We'll find out more Wednesday, when the company, which declined to comment, reports third-quarter results.

(See Trader: ["Goldilocks Scenario Helps Drive Stocks Higher"](#))