

Sourcefire, Inc. (FIRE)

FIRE: Short-Lived Upsell Opportunity has Concealed Decelerating Growth, Slowing Customer Adds, and the Market's Shift Away from IPS

At the current price of \$51, we believe that shares of Sourcefire ([FIRE](#)) are highly overvalued. Following a 55% rally since the start of 2012, FIRE shares now imply a 5.4x 2013E revenue multiple and a 204x 2013E GAAP P/E. With valuation multiples as rich as these, it might sound strange to hear that Sourcefire added only 452 new customers in 2012, the exact same amount they added in 2011. Yet FIRE's revenue growth expanded from 27% to 35% in 2012, masking the slowing momentum in new customer adds. We can attribute this mismatch to the introduction of two new software products, a next-generation firewall and an anti-malware tool, in Q4 2011 and Q1 2012, respectively. These upsell tools allow FIRE to achieve a combined pricing uplift of 30%, providing a one-time growth boost for new and existing customers. Comments from management indicate that this was a defensive measure taken to protect Sourcefire's core Intrusion Prevention System ("IPS") business from obsolescence as recently introduced next-generation firewalls now incorporate many features of standalone IPS. Gartner [believes](#) these NGFW systems could subsume 50% of new IPS deployments by 2015. While a bullish Wall Street continues to brush aside these issues, our research indicates that FIRE's upsell opportunity is becoming saturated, new product introductions will increase competitive pressure, and FIRE's GAAP earnings are actually shrinking on a year-over-year basis (2012 [10-K](#), [10-Q3](#)).

<u>Capitalization</u>			<u>Multiples</u>		
<i>\$mm; FY End Dec 31st</i>	<i>4/27/2013</i>		<i>\$mm</i>	<i>#</i>	<i>Multiple</i>
Current Share Price	\$51.04		2012A Revenue	\$223.1	6.8x
Outstanding Shares	30.7		2013E Revenue	279.2	5.4x
RSUs	1.6		2014E Revenue	336.4	4.5x
Dilutive Effect of Options	1.1				
Market Capitalization	\$1,699.7		2012A GAAP EPS	\$0.16	319.0x
Less: Cash	(184.1)		2012A Non-GAAP EPS	0.84	60.8x
Add: Debt	–		2013A GAAP EPS (1)	\$0.25	204.2x
Enterprise Value	\$1,515.5		2013E Non-GAAP EPS	0.98	51.8x
		#	2014A GAAP EPS (1)	\$0.39	129.3x
Options Outstanding	1.7	Strike	2014E Non-GAAP EPS	1.20	42.4x
Warrants	–	–			
Dilutive Effect of Options	1.1				

Sources: FIRE 2012 10-K, CapitalIQ

(1) Assumes \$30m of SBC in 2013/2014, or non-GAAP addback of \$0.59/share (after 35% tax)

Sourcefire, a 12-year old network security business, is a leading provider of Intrusion Prevention Systems ("IPS"). Modern IPS tools use rule-based systems to identify suspicious packet traffic, alert

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the IT administrator, shut down attempted malware attacks, and block host, service, or application access as needed. Every network is different, but a firewall is typically used on the perimeter of the network as a first-line defense, where line speeds are the greatest, while IPS sits inside the firewall to provide a second layer of protection. According to [Gartner](#), the \$4.9bn firewall market is believed to be four times larger than the \$1.2bn IPS market. Some of the largest end-markets for IPS are security-sensitive industries with large information flows, such as governments, financial institutions, and telecommunications networks.

Prior to the introduction of next-generation firewall (“NGFW”), the firewall and IPS systems were purchased separately, creating the need to manage two different security platforms. But Gartner and other industry [experts](#) now believe the firewall market is shifting towards NGFW adoption, allowing users to integrate firewall and IPS features into a single tool. Very worryingly for Sourcefire, research from Gartner indicates these NGFW systems could subsume 50% of new IPS deployments by 2015. Sourcefire has reacted to this threat by introducing its own NGFW software, which it now offers alongside its IPS for a 10% pricing increase. While this can help FIRE retain some customers over the near-term, we believe Sourcefire will find it challenging to maneuver from an “IPS-first” business to one primarily known for its firewall. Sourcefire’s founder and CTO, Marty Roesch, has stated that, “we typically lead with Intrusion Prevention Systems” and “we don’t really see greenfield opportunities very often in a space like [Next-Generation Firewall]” (Q4 2012 [Call](#)). Mr. Roesch has also acknowledged that Sourcefire’s move to NGFW was mostly defensive in [nature](#): “If you look at some of the market predictions, a fair amount of the IPS market will be delivered on NGFW markets and we don’t want to cede market [share].”

The next-generation firewall sector is extremely crowded with highly-regarded pure-play participants like Fortinet, Palo Alto Networks, and Check Point alongside networking giants like Cisco and Juniper. Given the momentum behind NGFW adoption, Gartner believes that end-market growth in the IPS market will begin to slow in 2013 before inverting to negative year-over-year growth in 2015.

Even in the midst of this market shift, Wall Street analysts have bent over backwards to justify FIRE’s current price. Some of the outlandish valuation metrics proposed by the Street include an 8% terminal growth rate (Wells Fargo, 11/16/12), a 6.7x 2013E revenue multiple (Stephens, 5/1/12), and assigning a 50% probability to FIRE getting acquired “in the next few years” (FBN Securities, 1/12/12). Morgan Stanley (2/22 report) uses a 21x “adjusted” 2014E free cash flow multiple, which would sound more reasonable if it didn’t exclude stock-based compensation expense without adjusting for the corresponding shareholder dilution. Management has done little to temper this reckless enthusiasm going into the new year. On the Q4 2012 call, Marty Roesch stated that FIRE continues “to see the opportunity to double the top line every 3 years,” a goal we believe is unrealistic given the transitory benefit of upsells, the market’s shift towards NGFW, and FIRE’s heavy reliance on federal spending (20% of 2012 sales). Moreover, our management-case discounted cash flow model, where FIRE’s operating margins reach management’s long-term goals, implies a fair value range of \$17 - \$26. This equates to a discount of 50% – 65% below Sourcefire’s current share price. With such a large disconnect between FIRE’s share price and intrinsic value, it should be concerning that FIRE’s GAAP earnings actually shrunk by 24% in 2012 due to skyrocketing equity-based compensation and buckling gross margins.

Recent commentary from Fortinet ([FTNT](#)) and Check Point ([CHKP](#)), two leading network security vendors, could foreshadow industry-wide weakness in the first quarter results. On a special investor call on April 10th, Fortinet was forced to lower its Q1 2012 revenue guidance from \$138m – \$141m to \$134m – \$136m, sending FTNT shares down 13% for the day. Fortinet attributed the weakness to

slowing European spending and delayed capex at the large telecom customers. Sourcefire is meaningfully exposed to both end-markets. Check Point reported its Q1 2012 report on April 23rd, 2013 with a revenue print of \$322.7m, at the low-end of management's guidance (\$320 - 332m) and below analyst expectations (\$328m). Due to industry-wide weakness, CHKP doesn't expect a resumption of growth until the second half of the year. This pair of read-throughs could be particularly dangerous for Sourcefire following the victory lap it took on its Q4 call, which reset growth expectations higher than the Street expected. At a 5.4x 2013E revenue multiple and 204x GAAP P/E, FIRE will have little margin for error on its April 30th earnings announcement.

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I. Summary of Red Flags

We believe that Sourcefire is substantially overvalued for the following reasons:

- **Next-Generation Firewalls Could Replace 50% of IPS Deployments by 2015.** As the creator of the open-source *Snort* software, Sourcefire is deservedly praised for creating one of the industry's most influential IPS products. But when it comes to mindshare in the firewall market, Sourcefire fails to even earn a [mention](#) in Gartner's Enterprise Firewall Magic Quadrant. This should be concerning to FIRE investors because industry pundits believe that next-generation firewall technology, which combines the features of both traditional firewalls and IPS systems, will subsume 50% of IPS deployments by 2015. Admittedly, some customers may continue to prefer a multi-layer approach as opposed to all-in-one NGFWs, but the threat to standalone IPS will only grow in time. Even after launching its own version of an NGFW in Q4 2011, Sourcefire's founder, Marty Roesch, admits that FIRE still approaches customers with an IPS-first mindset, "*I think the way people are approaching is that we typically interact with, you see them starting up with IPS deployments and then turning on license keys to bring the additional functionality to bear where necessary*" (FIRE Q3 2012 [Call](#)). While this strategy plays to FIRE's strengths, and allows them to avoid head-to-head competition with Palo Alto ([PANW](#)), Check Point, Fortinet, and other NGFW leaders, it could be a losing strategy over the long term.
- **Slowing New Customer Adds and Saturation of the Upsell Opportunity will make Growth More Challenging in 2013.** Sourcefire has attempted to mitigate the threat from competitive NGFW systems by launching two new products, a Sourcefire-branded NGFW and the *FireAMP* Anti-Malware tool. After paying the upfront hardware, subscription, and maintenance costs associated with a Sourcefire IPS, customers can add NGFW and Anti-Malware software for a combined 30% price increase. The [addition](#) of these [tools](#) to FIRE's portfolio in late 2011/early 2012 allowed Sourcefire to grow quarterly revenue by an impressive 51% (year-over-year) in Q1 2012. Since then, however, upsell opportunities appear increasingly sparse, as YoY revenue growth slowed to 27% in Q4 2012. Many have overlooked this slowing quarterly growth, instead citing FIRE's 35% revenue growth in 2012. Yet recent data in FIRE's 10-K reveals that Sourcefire only added 452 new customers in 2012, which is precisely the same amount of customers adds as in 2011. This may indicate that 2012's growth reacceleration was the result of one-off upsell opportunities, not increased customer wins.
- **A Management-case DCF Model Yields a Fair Value of FIRE of \$17 - \$26, a 60% Decrease from the Current Share Price.** Since GAAP profitability continues to shrink, Sourcefire utilized a February 25th Investor [Presentation](#) to remind shareholders of its long-term margin goals. FIRE argues that, as the business expands, it can materially decrease R&D, selling & marketing, and G&A expense as a percentage of revenue. This

long-term plan would theoretically add around 1000bps to FIRE's 2012 operating margin. While these long-term goals are praiseworthy, in practice they could be difficult to achieve. Given the more than dozen competitors in both IPS and Firewall, FIRE must perpetually invest in new research just to stay competitive. As for the selling & marketing expense, Sourcefire's shift towards adding channel partners should pressure margins during the transition period, as shown by the 200bps increase in S&M expense between 2010 and 2012. But even if we overlook these challenges and assume that FIRE's EBIT margins consistently expand, reaching management's long-term goals by 2017, a discounted cash flow analysis yields a fair value of only \$20/share. This analysis uses a 10% cost of capital and a 3% long-term growth rate, both reasonable assumptions given FIRE's share price volatility and the growing threat from NGFW. Further sensitizing this range to a 9% – 11% WACC and a 2% – 4% long-term growth rate produces a fair value range of \$17 - \$26/share, or about 60% below FIRE's current share price of \$51.04.

- **Recent CEO Appointment and Industry Precedent Suggest that Sourcefire is not a Near-Term Acquisition Target.** When traditional valuation metrics fail, analysts have turned to valuing Sourcefire as a buyout target. For example, last year's initiating coverage report from FBN Securities (1/12/12) assigns a 50% probability to FIRE getting acquired "in the next few years" as part of its valuation analysis. Assumptions like this are reckless. To begin with, the April 10th appointment of John Becker at CEO, replacing Marty Roesch who served in an interim role, reduced the odds of a near-term takeover. If FIRE had been in back door negotiations for a sale of the company, it wouldn't be necessary to grant Mr. Becker a 400,000 share restricted stock and option [package](#) that would partially accelerate on a change of control. Secondly, a survey through precedent network security deals reveals that many have already passed over Sourcefire in favor of other platform acquisitions. IBM ([IBM](#)) [acquired](#) Internet Security Systems in August 2006, HP ([HPQ](#)) [acquired](#) TippingPoint via the 3Com deal in November 2009, Intel ([INTC](#)) [bought](#) McAfee in April 2010, and Dell ([DELL](#)) paid \$1.2bn [for](#) SonicWall in March 2012. The two firms most cited as acquirers, Cisco ([CSCO](#)) and Juniper ([JNPR](#)), already market in-house, highly-ranked next-generation firewall systems. Finally, the Israeli-based Check Point agreed to [acquire](#) FIRE in 2005 only to have the deal [blocked](#) by the U.S. government on security grounds. At 21% of 2012 revenue, the federal government is by far Sourcefire's largest customer and has its IPS systems installed throughout its official networks. The government is extremely interested in ensuring FIRE remains domestically controlled. Because of this, the possibility of an acquisition by a foreign buyer is effectively nil while national security risks would complicate a transaction with a U.S. buyer, especially one that has interests abroad. These reasons, in addition to Sourcefire's high 6.8x LTM revenue multiple, make us believe that a near-term takeout is unlikely at the current share price.
- **Wall Street Research is Drastically Overstating Sourcefire's Addressable Market Opportunity.** By combining the firewall with the IPS, next-generation firewalls can consolidate hardware and software tools into one platform, eliminating the need to purchase separate IPS and firewall hardware. Since upfront product expenses are

typically the lion's share of a vendor's income, the cost savings to customers are meaningful. But when viewed from the perspective of the vendors, such as Sourcefire, this innovation might lower the revenue opportunity. This can be demonstrated by Sourcefire's new sales model, where customers need only pay 30% more to add NGFW and Anti-Malware software to FIRE's traditional IPS system. And because FIRE is an IPS-first business, we believe Sourcefire's ability to upsell NGFW and Anti-Malware is primarily limited to existing IPS users. If this is the case, we can calculate FIRE's addressable market by multiplying the size of the IPS market (\$1.2bn) by the incremental upsell opportunity (130%), yielding a TAM of \$1.5bn. Since Gartner's market size data only tracks product revenue, and not service revenue, it makes sense to gross this figure up to \$2.5bn (product revenue is 60% of FIRE's total). Lastly, if we then apply Gartner's prediction that 50% of standalone IPS will convert to NGFW, then FIRE's addressable market would be just \$1.25bn, or about 25% less than FIRE's current market capitalization. Comparatively, many analysts mistakenly believe that FIRE's TAM is between \$5 -10bn (Topeka, FBN, Wells Fargo, and others). Without this enormous addressable market opportunity, many of the valuation arguments made to justify FIRE's 2013 GAAP P/E of 200x+ quickly fall apart.

- **FIRE's Valuation Disconnect can be Partially Attributed to Non-GAAP Earnings, which Overstate GAAP Earnings by 400%.** Any investor that takes the time to scrutinize Sourcefire's 10-K would quickly conclude that not only is FIRE's business barely profitable but its GAAP earnings actually fell in 2012. Diluted earnings per share shrunk from \$0.21/share in 2011 to just \$0.16/share in 2012. But this is of little concern to Wall Street research analysts, who instead value Sourcefire using "adjusted" earnings. Driven by the exclusion of stock-based compensation, Sourcefire's adjusted earnings per share grew from \$0.57 in 2011 to \$0.81 in 2012. Realizing that SBC expense seems to be considered free in the research community, Sourcefire's management appears to be actively shifting cash salaries into equity-linked compensation. Even as revenue grows, SBC as a percentage of revenue has doubled since 2008, growing from 6% in 2008 to 12% in 2012. These adjustments have allowed FIRE to show steady year-over-year adjusted earnings growth when underlying earnings have actually decreased since 2010. This tactic has buttressed FIRE shares over the short-term, but we believe the continued degradation of FIRE's quality of earnings should be a clear red flag to any potential investor.

II. Company Overview

Sourcefire is a network security business that markets a portfolio of cybersecurity products to both commercial and federal clients. In a typical cybersecurity system, hardware and software tools work together to help manage the always-present risk of viruses, malware, worms, known vulnerabilities, and other unwanted network breaches. Sourcefire is best known for its “Snort” Intrusion Prevention System, an open-source software tool that can detect, track, and block malicious packet traffic from invading the enterprise. In the traditional network security model, IPS hardware was placed alongside a separate firewall platform and the two products worked in tandem to provide an added layer of security protection. A non-industry practitioner can think of firewall as the guard at the door while IPS is the agent that frisks data packets as they pass through the system. Sourcefire is one of about a dozen major vendors of IPS; it has the fifth largest market share behind Cisco, McAfee (Intel), HP, and IBM. Because many customers operate with a firewall-based system alone, the firewall market is about four times as large as the IPS market. The added protection of IPS security is more widely used in advanced networks, such as those employed by banks, telecom companies and the federal government.

Since firewall offers the larger market opportunity, most other network security providers naturally lead sales discussions with their firewall platform. Sourcefire, however, is a decidedly IPS-first business. The Sourcefire story begins with its founder, Marty Roesch, writing code for an open-source packet analyzer, or a “sniffer,” in his spare time at home. This program, eventually named Snort, was released in 1999 and quickly spread amongst security programmers who manipulated the Snort program to fit their own needs. In 2001, Roesch left his job at a start-up to create a business around Snort. Roesch grew the business from four people at the end of 2001 to a business with 400 employees today. Despite that fact that the Snort brand is generally well-regarded amongst professionals, Sourcefire has consistently wrestled with the challenge of collecting revenue for an open-source program that is mostly given away for free. Sourcefire has settled [on](#) a “value-add model with an open-source core” where it sells computing hardware, technical service, and software to large commercial and federal clients. Though the open-source model has its advantages to battle ever-changing cybersecurity threats, it also means that anyone can download a basic version of Snort for [free](#).

Like many companies beholden to a single core product, FIRE has attempted to diversify its business away from IPS. Sourcefire first began to earnestly expand its product suite in 2007 when it [bought](#) IP rights to ClamAV, an open-source anti-malware (“AMW”) program. Sourcefire then acquired another AMW offering in January 2011 through the \$21m acquisition of Immunit, a cloud-based AMW [provider](#). Recognizing the competitive threat imposed by next-generation firewall, FIRE then launched a NGFW product of its own in [late](#) 2011. The market welcomed the introduction of these upsell-oriented products by driving FIRE shares from \$30 in H2 2011 to over \$50/share today. But recent comments from FIRE management indicate that these upsell markets are smaller than some believe. On the Q4 2012 conference call, FIRE’s CFO indicated that, *“So from a pricing standpoint, to go from IPS to a Next-Generation Firewall when you buy from Sourcefire, that’s about a 10% uplift in price.”* On the same call, FIRE also stated that anti-malware provides a 20% uplift, which gives FIRE a combined upsell opportunity of 30%. As enticing as this pricing uplift is to potential investors, net customers adds were flat in 2012. Sourcefire only added 452 new customers in 2012, the exact same amount they added in 2011.

	Year Ended December 31,		
	2012	2011	2010
Supplemental operating data:			
Number of deals in excess of \$500,000	76	68	36
Number of deals in excess of \$100,000	406	333	240
Number of new customers	452	452	376
Percentage of channel-influenced deals	46%	51%	39%
Total channel partners	738	576	339
Number of full-time employees at end of period	599	451	351

Source: Page 36, Sourcefire 2012 10-K

Even as it increased operating expenses, pushing down GAAP earnings from \$0.21 in 2011 to \$0.16 in 2012, FIRE was unable to increase customer adds in 2012. As the NGFW was released in December 2011 and Anti-Malware (*FireAMP*) in Q1 2012, we can attempt to tease out the impact of these upsell tools on quarterly results. Viewing the chart below, we can see that 2012 was a particularly strong year for FIRE, as revenue grew 35% year-over-year versus just 27% and 26% in 2011 and 2010. However, what should be concerning to investors is that quarterly year-over-year comparisons have slowed since Q1 2012. This could be the impact of Sourcefire slowly exhausting its pool of upsell candidates and having to compete for new client accounts, a much more formidable task.

Year-over-year Revenue Growth is Decreasing

\$m	Q1 2011	Q2 2011	Q3 2011	Q4 2011	Q1 2012	Q2 2012	Q3 2012	Q4 2012
Commercial	\$16.2	\$21.1	\$18.8	\$32.4	\$20.8	\$27.6	\$24.7	\$30.9
% YoY Growth	32.8%	36.1%	24.5%	45.9%	28.4%	30.8%	31.4%	(4.6%)
International	8.4	9.5	10.5	13.7	15.7	14.7	17.7	26.3
% YoY Growth	12.0%	31.9%	41.9%	28.0%	86.9%	54.7%	68.6%	92.0%
Federal	6.1	5.8	15.9	7.1	9.8	8.3	16.4	10.2
% YoY Growth	1.0%	(26.6%)	16.1%	40.0%	60.7%	43.1%	3.1%	42.9%
Total Revenue	\$30.7	\$36.4	\$45.2	\$53.2	\$46.3	\$50.6	\$58.8	\$67.4
% YoY Growth	18.8%	18.9%	25.0%	40.2%	50.8%	39.0%	30.1%	26.6%

FIRE releases NGFW and FireAmp

Sources: Sourcefire 2012 10-K and Press Releases

Even in the face of these worrying trends, Sourcefire has not been shy about Q1 expectations, telling investors that it expects \$56m-\$58m of revenue in Q1 2013. FIRE's growth-oriented investors, who now have their expectations set very high, will expect FIRE to meet the high end of the range. Looking further out, management has told investors it can continue to "double the top line every 3 years" (Q4 2012 Call), quite an optimistic comment given the industry headwinds recently mentioned by [Fortinet](#) and [Check Point](#) on their Q1 2013 calls. Management also guided that "less than 30%" of FIRE's installed base had bought the entire FirePOWER platform (IPS+NGFW+AMW). Given the amount of competition in NGFW and IPS, and the tendency of customers to switch vendors every five years or so, we don't believe this penetration number gets much higher. Moreover, a mere 10% or 30% one-time pricing uplift is not enough to meet the management plan of doubling revenue every 3 years. And if predictions

that next-generation firewall will subsume the IPS market come true, growth figures like those seen in 2012 will fade from memory like a long-ago dream.

\$m	2008	2009	2010	2011	2012
<i>IPS Market Share(1)</i>					
Cisco	\$249.0	\$235.0	\$267.0	\$261.0	\$266.7
McAfee (Intel)	152.0	198.0	210.0	212.2	229.8
HP	151.0	161.0	193.2	207.0	186.0
IBM	96.4	115.6	125.0	172.8	183.9
Sourcefire	33.0	49.0	62.0	81.7	112.3
Others	217.6	180.1	201.9	174.4	183.2
IPS Market Size	\$899.0	\$938.7	\$1,059.1	\$1,109.2	\$1,161.9
% YoY Growth	11.7%	4.4%	12.8%	4.7%	4.8%

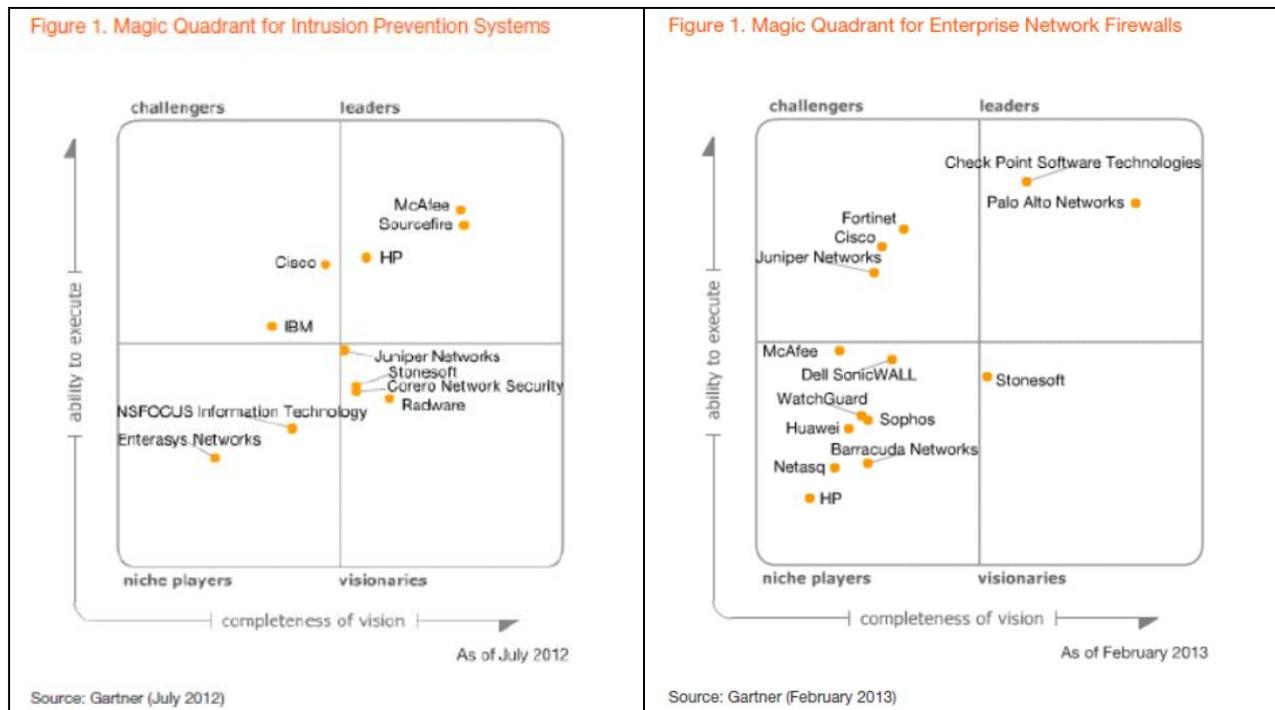
Source: Gartner

(1) Figures only include product revenue

Vendors wage a constant battle to differentiate themselves in the extremely crowded IPS market. There are about a dozen IPS vendors that jostle for position, the fifth largest of which is Sourcefire. Cisco, the market leader, is a one-stop provider of networking and security products for many Fortune 500 clients. Cisco has the strongest sales channel, great international support, and a top-tier ranking in Gartner's Magic Quadrant. The business experienced a hiccup in 2011, but it has since recovered following an internal realignment in late 2011. New SVP of Security Chris Young made his mark in September 2012 by releasing a completely updated [suite](#) of IPS and next-generation firewall products that could help it gain share in 2013. The second largest IPS vendor is McAfee, the pure-play security business [acquired](#) by Intel in late 2010. Gartner's Magic Quadrant ranks McAfee's IPS as a best-in-class tool, stating that "*McAfee is highly visible on Gartner client IPS shortlists, especially in government markets*". While Sourcefire frequently mentions its close ties to federal customers, McAfee's Network Security [Platform](#) was the first IPS product to make the U.S. Department of Defense's Approved Products List. McAfee [reached](#) this milestone in November 2011, a year [before](#) Sourcefire.

HP, the third largest vendor, obtained their *TippingPoint* IPS system in the 2009 acquisition of 3Com. While some customers have historically sworn by TippingPoint for its [simplicity](#), HP has repeatedly shown an inability to execute. This led to substantial market share loss in 2012. HP responded in September 2012 with a [refresh](#) of its networking security platforms, giving it both NGFW and next-generation IPS capabilities. Looking at the market share figures above, it's likely that much of FIRE's growth came at HP's expense. We'll see whether HP can do a better job of protecting share in 2012 after launching a new product suite. Rounding out the lead vendors is IBM, which is using its mindshare in overall IT to become a leader in network security. IBM has been a major IPS vendor since its 2006 [acquisition](#) of Internet Security Systems. IBM [released](#) a next-generation IPS in July 2012, the XGS 5000. The XGS 5000 builds on its legacy IPS by incorporating filtering capabilities, application-level controls, and social [media](#) monitoring, amongst other features.

These recent product refreshes by Sourcefire's well-capitalized competition will ensure that the struggle for market share continues into 2013. The fierce competition amongst the vendors can be further demonstrated by FIRE's need to spend between 35 – 45% of its total revenue on selling & marketing expense in each of the past five years. A product that can sell itself does not require such a well-compensated sales force.



As shown in the chart above, Gartner does not believe Sourcefire’s new firewall product even deserves a [ranking](#) in their Firewall Magic Quadrant. This is because Sourcefire’s NGFW is merely sold as an add-on feature for existing Snort IPS customers. FIRE is not a ‘firewall-first’ business. Sourcefire’s founder, Marty Roesch, admitted this on the Q3 2012 conference call:

<Jonathan Ruykhaver, Stephens>

“When you look at the pipeline activity around the FirePOWER platform relative to NGIPS and next-gen firewall, should we expect a growing portion of sales activities as we enter next year to be driven by next-gen firewall or will the majority of the pipeline activity remain centered around your IPS in the next-gen IPS?”

<Martin F. Roesch, Founder, Chief Technology Officer and Director>

“Well, I’d say that it is going to be largely, for us, centered around IPS for starters. I think the way people are approaching it is that we typically interact with, you see them starting up with IPS deployments and then turning on license keys to bring the additional functionality to bear where necessary and we are of course very comfortable with this approach to getting access to the market because it plays to our strength” (FIRE Q3 2012 Call).

Given the nonexistent ranking from Gartner, we believe that investors should view Sourcefire’s NGFW as a 10% upsell feature. We don’t think that NGFW represents the \$5bn+ market opportunity for Sourcefire that analysts believe it is.

III. Next-Generation Firewalls Could Replace IPS in Many Applications

Over the past few years, the network security industry has been in the early stages of a major technological shift. In the past, the firewall was kept separate from the IPS. By having a second security tool on the network, IPS allowed network engineers to analyze traffic flows in different parts of the network and enabled more granular packet inspection. IPS also allowed engineers to set up different rule systems at distinct endpoints. For example, a dual IPS/firewall would be placed over the server with customer names but a less complex firewall can be employed elsewhere. Following the introduction of NGFW, advances in firewall functionality now allow security engineers to get the benefit of two devices in one. Next-generation firewall allows complex rule setting, enables packet analysis from multiple points within the network, and duplicates many of the traffic 'sniffing' and blocking tools of traditional IPS.

Gartner, the technology research firm, is a big believer in this shift towards NGFW, as explained in their recent February 2013 report:

*"The firewall market has evolved from simple stateful firewalls to NGFWs, incorporating full-stack inspection to support intrusion prevention, application-level inspection and granular policy control. **Such NGFWs will eventually subsume mainstream deployments of stand-alone network intrusion prevention system (IPS) appliance technology at the enterprise edge** [emphasis added]. Gartner already sees this shift in the form of reduced IPS buying activity and a flattening of IPS market growth, but Gartner believes the security-conscious segment of the market will continue to use separate IPSs."*

– February 2013 Gartner [report](#)

Gartner predicts that "by 2015... more than 50% of IPS deployments will be part of an NGFW." The NGFW vendors with the most industry buzz are Palo Alto Network, Fortinet, and Check Point. Cisco, Juniper, and McAfee round out the top 6 next-generation firewall vendors by market share. Other notable NGFW vendors include Barracuda Networks (private) and Dell (*Sonicwall*). Palo Alto Networks, who is admittedly biased towards NGFW, further explained the technological shifts on their last conference call:

"So from a pure security perspective what you'd like to have is the technology in different boxes to actually be integrated in a creative way, because that's the best possible way to detect and then really prevent that malware, and that is what we have in the markets. So I think in just a general architectural matter, that's the way the world's going." – PANW Feb 28th, 2012 [Call](#)

Assigning any sort of significant terminal value to FIRE is questionable if the market is moving away from them. And if that is the case, FIRE should not be trading at over 200x 2013 earnings and 5x 2013 revenue.

Decelerating IPS Market Growth Could Impair Growth Aspirations

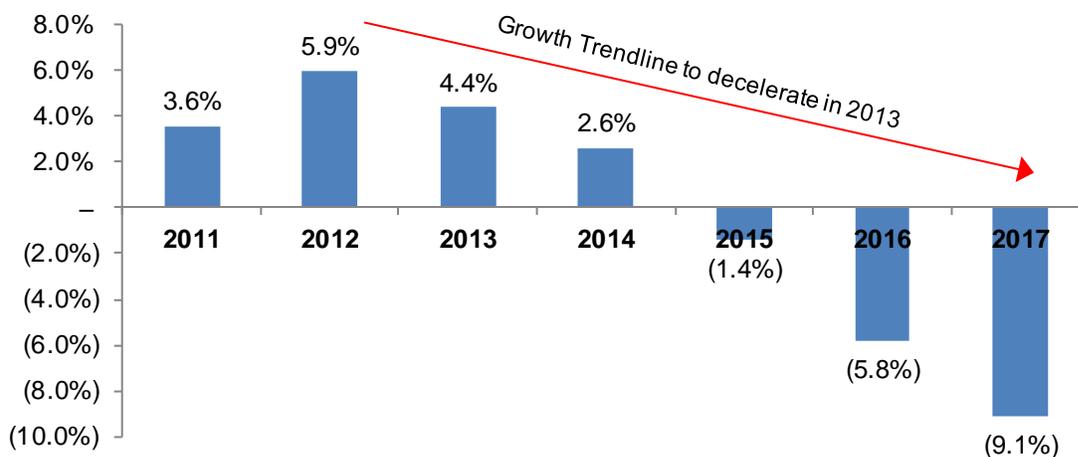
While some customers may continue to prefer a redundant IPS solution, we believe that many enterprise customers will replace existing IPS systems with next-generation firewalls. Since

product refresh cycles occur typically every 5 years or so, this transition won't happen overnight. But new data from Gartner indicates the 2013 could be the year when IPS growth hooks downward. Gartner's updated Enterprise Network Equipment numbers, released March 26th, 2013, [predict](#) that worldwide IPS market growth will decelerate from 5.9% in 2012 to 4.4% in 2013 before declining to 2.6% growth in 2014. Predicted growth is actually negative in 2015 and beyond.

Gartner's Q1 2013 Enterprise Network Equipment Forecasts

WW Vendor Revenue	2011	2012	2013	2014	2015	2016	2017
IPS Market Size	1,097	1,162	1,213	1,244	1,226	1,155	1,051
% YoY Growth	3.6%	5.9%	4.4%	2.6%	(1.4%)	(5.8%)	(9.1%)

IPS Market Year-over-Year Growth



Source: April 9th, 2012 Gartner report

With a decelerating IPS market as the backdrop, Sourcefire must continue to take share from Cisco, McAfee, HP, and IBM to have any chance of meeting analyst expectations in 2013. And even if FIRE can mitigate end-market declines with share gains, this trend should have dire implications for analysts' long-term growth assumptions. For example, Wells Fargo utilizes an 8% terminal growth rate in their DCF to justify a price target of \$54 – \$58. This assumption appears completely incongruent with the chart above.

IV. FIRE's Valuation has Become Disconnected from Reality

A Management-Case DCF suggests a \$17 - \$26/share Fair Value

When it comes to pricing FIRE stock, analysts and investors have brushed aside traditional metrics of valuation in favor of wishful thinking. Much of the misunderstanding can be ascribed to an increasingly large mismatch between GAAP and non-GAAP earnings. In their defense, FIRE's management does acknowledge that non-GAAP figures should be used for *relative* valuation, by disclosing that "non-GAAP financial measures may be useful to investors in comparing our performance to the performance of other companies" (2012 10-K), rather than

absolute valuation. And when an entire sector becomes overhyped and overvalued, comparable multiples become meaningless. We have relied on a discounted cash flow model to estimate FIRE's intrinsic valuation. Our DCF assumptions include consensus revenue estimates for 2013 and 2014, management's long-term margin targets, and our own estimates based on historical trends. Notably, we do not add back stock-based compensation to the model. In lieu of excluding the SBC add-back, we could have instead increased FIRE's share count over time, which would achieve the same fair value target. This would have added to FIRE's cash inflows but it would have led to FIRE's share count approximately doubling in the next 20 years (assume \$30m of SBC in 2013 growing at 10%/year).

(\$ in Millions)	Historical		Illustrative "Mgmt-Case" Projections					Term Value
	2011A	2012A	2013E	2014E	2015E	2016E	2017E	2018E
Free Cash Flow Build Up								
Revenue	\$165.6	\$223.1	\$279.2	\$336.4	\$386.8	\$425.5	\$468.1	
% YoY Growth	26.9%	34.7%	25.2%	20.5%	15.0%	10.0%	10.0%	
Gross Margin	128.4	171.1	212.2	255.6	297.9	327.6	365.1	
% of Revenue	77.5%	76.7%	76.0%	76.0%	77.0%	77.0%	78.0%	
Less: R&D	(33.1)	(41.6)	(47.5)	(57.2)	(61.9)	(68.1)	(74.9)	
% of Revenue	20.0%	18.6%	17.0%	17.0%	16.0%	16.0%	16.0%	
Less: S&M	(64.6)	(86.8)	(103.3)	(124.5)	(135.4)	(148.9)	(159.1)	
% of Revenue	39.0%	38.9%	37.0%	37.0%	35.0%	35.0%	34.0%	
Less: G&A	(19.7)	(28.2)	(30.7)	(37.0)	(38.7)	(42.6)	(46.8)	
% of Revenue	11.9%	12.6%	11.0%	11.0%	10.0%	10.0%	10.0%	
Less: D&A	(7.4)	(9.0)	(9.5)	(10.5)	(11.0)	(11.5)	(12.0)	
% of Revenue	4.5%	4.0%	3.4%	3.1%	2.8%	2.7%	2.6%	
EBIT	\$3.6	\$5.5	\$21.2	\$26.5	\$50.9	\$56.6	\$72.2	
Less: Taxes (\$46.4m NOLs; 35% Rate)	(0.5)	(4.4)	0.0	(0.5)	(17.8)	(19.8)	(25.3)	
Net Operating Profit After Tax	\$3.1	\$1.2	\$21.2	\$26.0	\$33.1	\$36.8	\$47.0	
Add: Total Depreciation & Amortization	\$7.4	\$9.0	\$9.5	\$10.5	\$11.0	\$11.5	\$12.0	
Less: Capital Expenditures (excl M&A)	(6.5)	(8.9)	(10.0)	(10.0)	(10.0)	(12.0)	(12.0)	
Less (Add): Changes in Working Cap	(6.2)	8.1	(5.0)	(5.0)	(5.0)	(5.0)	(5.0)	
Free Cash Flow (Incl. SBC Expense)	(\$2.2)	\$9.3	\$15.7	\$21.5	\$29.1	\$31.3	\$42.0	\$43.2
Discount Factor			0.95	0.87	0.79	0.72	0.65	0.59
Forecast Period - Discounted Cash Flows			\$15.0	\$18.7	\$22.9	\$22.4	\$27.3	
Total Forecast Period Discounted Cash Flows							\$106.3	

2018E Free Cash Flow (A)	\$43.2
Weighted Average Cost of Capital (B)	10.0%
Long-Term Growth Rate (C)	3.0%
Terminal Value - Gross (A)/(B-C)	\$617.4
Discounted Terminal Value	\$365.5
Add: Forecast Period FCFs	106.3
Add: Existing Balance Sheet Cash	184.1
Discounted Cash Flow Valuation	\$656.0
/ Diluted Shares Outstanding	32.2
Fair Value per Share	\$20.35
Discount to Current Price (\$51.04)	(60.1%)

		Fair Value Sensitivity Analysis				
		Weighted Average Cost of Capital				
		12.0%	11.0%	10.0%	9.0%	8.0%
Long-term Growth Rate	1.0%	\$15.26	\$16.33	\$17.66	\$19.32	\$21.48
	2.0%	15.97	17.24	18.83	20.90	23.67
	3.0%	16.83	18.37	20.35	23.00	26.74
	4.0%	17.92	19.82	22.36	25.95	31.34
	5.0%	19.32	21.76	25.19	30.36	39.01

Using the assumptions above, we believe that FIRE has a fair value of \$17 - \$26, approximately 60% lower than FIRE's current share price. The middle of this range employs a 10% discount rate, which we believe is generous given the high-multiple, volatile nature of the stock, and a long-term free cash flow growth rate of 3%, well above Gartner's estimate of long-term IPS market growth. Cash flows have been discounted using a mid-year timescale and a 35% tax-rate, after applying FIRE's \$46.4m federal NOL balance. By our terminal value year of 2017, our model's gross margin, R&D margin, and S&M margins all reach a range within management's

long-term goals. We consider this to be a best-case scenario for the business, and yet the implied valuation target is still only \$20/share.

	2010A	2011A	2012A	Long-Term
Net Revenue	100%	100%	100%	100%
Gross Margin	79%	78%	77%	77% - 79%
R&D	14%	20%	19%	15% - 16%
Sales & Mktg	37%	39%	39%	33% - 34%
G&A + Depr	17%	14%	12%	9% - 10%
Adj Op Margin	18%	16%	17%	25% - 28%

Source: Sourcefire's February 25th, 2013 Corporate Presentation

To further ensure that our model is fair, we reconciled our EBIT figures to management's estimate of "adjusted operating margin," a figure that excludes SBC expense. Assuming that SBC costs management about 11% of their revenue, as is the recent norm, our Adjusted EBIT margin reaches 26% in 2017; again, this is in-line with the long-term management forecasts.

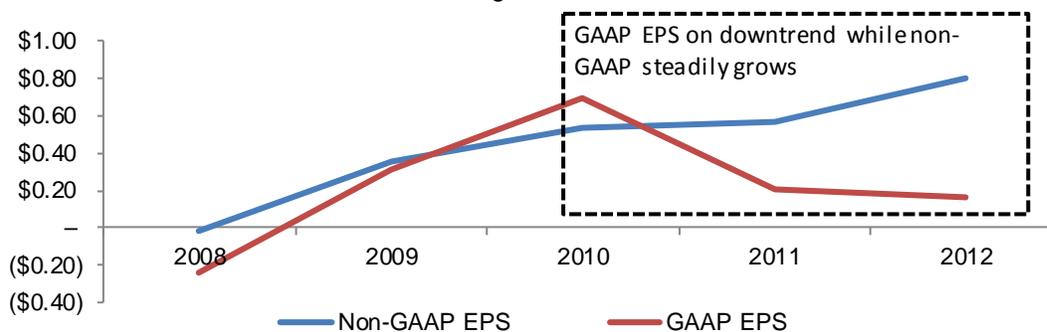
<i>EBIT Reconciliation</i>	2011A	2012A	2013E	2014E	2015E	2016E	2017E
EBIT	\$3.6	\$5.5	\$21.2	\$26.5	\$50.9	\$56.6	\$72.2
Add: SBC	14.9	26.2	30.7	37.0	42.6	46.8	51.5
<i>% of Revenue</i>	<i>9.0%</i>	<i>11.7%</i>	<i>11.0%</i>	<i>11.0%</i>	<i>11.0%</i>	<i>11.0%</i>	<i>11.0%</i>
Adjusted EBIT	\$18.5	\$31.7	\$51.9	\$63.5	\$93.4	\$103.4	\$123.7
<i>% Adjusted Margin</i>	<i>11.2%</i>	<i>14.2%</i>	<i>18.6%</i>	<i>18.9%</i>	<i>24.2%</i>	<i>24.3%</i>	26.4%

Non-GAAP Earnings Adjustments Mask Falling Profitability

Sourcefire's management quotes an adjusted EPS figure in their press releases. This is quite convenient because stock based compensation is one of Sourcefire's largest expenses items, and it grows every year. Since 2010, the divergence between Sourcefire's non-GAAP reporting and GAAP has grown progressively extreme. Sourcefire appears to be paying its employees with more and more stock and options.

EPS Reconciliation	2008	2009	2010	2011	2012
Net Income	(\$6.1)	\$8.9	\$20.0	\$6.2	\$5.0
Add: SBC	4.5	6.2	9.3	14.9	26.2
Add: CEO Transition Costs	0.7	—	—	—	—
Add: Amortization of Intangibles	—	—	—	1.0	1.4
Add: Other Acquisition-Related	—	—	0.2	3.2	1.4
Less: Tax Credit for R&D	—	—	—	(2.0)	—
Less: Release of Valuation Allowance	—	—	(7.6)	—	—
Less: 35% Tax-Effect	0.5	(5.1)	(6.5)	(6.5)	(9.1)
Adjusted Net Income	(\$0.3)	\$10.0	\$15.4	\$16.8	\$24.9
Weighted Avg Diluted Shares	25.38	27.98	28.90	29.53	30.93
Non-GAAP EPS	(\$0.01)	\$0.36	\$0.53	\$0.57	\$0.81
GAAP EPS	(\$0.24)	\$0.32	\$0.69	\$0.21	\$0.16
Divergence	(94.4%)	12.6%	(22.8%)	171.6%	395.9%

Source: Sourcefire 2012 and 2010 10-K filings



The divergence between non-GAAP and GAAP EPS grew to 172% in 2011, which seems high enough. But that figure more than doubled in 2012 as SBC increased to \$24.2m, or almost 12% of revenue. This is important because Wall Street's forward EPS projections, and the resulting valuation multiples, are in non-GAAP figures (\$0.99/share in 2013 and \$1.21/share in 2013). While this is certainly causing some of the confusion in FIRE's valuation, we also believe that many investors own FIRE stock solely on the hopes that a larger competitor will step in and acquire it. However, we don't believe a deal is likely over the near-term.

At the Current Price, Sourcefire is Not a Viable Acquisition Target

When traditional valuation tools fail to justify FIRE's valuation, it's comforting to put down the pen and say, "well, it could be an acquisition target." This seems to be the *modus operandi* for initiating coverage reports from analysts, none of which contain sensible DCF analyses. Retail-oriented trading sites stoke the fire by encouraging traders to [buy](#) FIRE calls on the hopes that Cisco or another large competitor overpays for a deal. We believe that there are a few problems with this narrative.

To begin with, many of the major networking companies have already made their platform acquisitions in IPS. IBM bought Internet Security Systems in August 2006, HP acquired TippingPoint via the 3Com deal in November 2009, Intel purchased McAfee in April 2010, and Dell paid \$1.2bn for SonicWall in March 2012. The remaining networking businesses, Cisco and Juniper, already market next-generation firewall systems. It would be unrealistic for them to pay 7x+ revenue for a company that cannibalizes their existing security businesses. Cisco owns the

5500-X NGFW [Series](#) while Juniper sells the SRX NGFW [Series](#). With next-generation firewall products already in place, Cisco and Juniper have no need to move against the market's evolution by acquiring an IPS vendor.

Even if one of these vendors decided to pay \$2bn+ for a business with an addressable market of about half that, FIRE's ties to the U.S. government add execution risk to any deal. In 2005, the Israel-based Check Point agreed to acquire Sourcefire for \$225m. But the deal came under scrutiny as government officials and the U.S. Department of Defense objected to foreign ownership of Sourcefire. Following an investigation by the Committee on Foreign Investment, the deal was officially called [off](#) in March. This happened in spite of Check Point's vigorous lobbying efforts. Seeing this precedent before them, even a U.S. executive could be wary of investing time and money into a deal that might be blocked by the government.

Finally, we believe that the [appointment](#) of John Becker at CEO on April 8th, 2013 indicates that a sale process is not currently underway. If buyout negotiations were in their final stages, it wouldn't be necessary to switch CEOs at the eleventh hour.

V. Multiple Risks to Expected Growth

Weak Results for Two Close Competitors Forebodes a Weak First Quarter

Fortinet (FTNT), a well-regarded NGFW and Endpoint Protection business, issued a results [warning](#) on April 10th, three weeks before its scheduled announcement of Q1 2013 results. Revenue expectations for the quarter were reduced from \$138 – \$141m to \$134 – \$136m. The market reacted by selling off FTNT by 13% on the day. Investors have favored these stocks because of the supposedly recurring subscription revenue and large deferred revenue balances, which is why FTNT's minor revision caused such a panic. Fortinet's CEO explained that, *"we saw more customers, especially within the enterprise sector, buying only what they needed and hold off on very large projects"* (Fortinet April 10th, 2012 [call](#)). FTNT also highlighted delayed capital spending by the large telecommunications companies: *"I think we see some behavior changing [at] the service provider in Q1. In the past...[they were] in a CapEx mode...Now they try to move towards the OpEx kind of model, try to conserve some cash."*

Check Point Software (CHKP), another network security leader, released its own [disappointing](#) Q1 2012 report on April 23rd, 2013. Revenue of \$322.7m was in the lower end of management's guidance (\$320 - \$332m) and below analyst expectations (\$328m). Given the current uncertainty in the marketplace, CHKP was forced to give a very wide range for Q2 2012 revenue, \$320 - \$350m. CHKP doesn't expect to see growth return until the second half of the year, *"I think that we are looking for a resumption of growth...and I think it's expected more towards the second half of the year"* (CHKP Q1 2013 [call](#)). CHKP went on to comment, *"I think we see it constantly for a long time, there's great pressure on customers' budgets...And I would just add that, in general, I do think that any new market is immune to macroeconomic, including the security [industry]."*

The read-through for Sourcefire's first quarter is not encouraging. International revenue was a major growth driver in Q4 2012, rising by a whopping 92% while the U.S. Commercial segment actually fell by 5% YoY. Because much of FIRE's recent success can be attributed to Europe,

as can be seen by management comments of “we had a great year, International, obviously, and there are a number of reasons for it...Europe was particularly strong” (FIRE Q4 2012 Call), investors should be worried about FIRE’s lofty expectations in Q1 2013. Telecom was another bright spot for Sourcefire in Q4: “We’ve had success in the telco space in particular, we’ve done very well there” (Q4 2012 Call).

Wall Street Overstates Sourcefire’s Addressable Market Opportunity

For 2012, Gartner estimates the size of the IPS market at \$1.2bn, Firewall at \$4.9bn, and Anti-Malware (Endpoint Protection) at about \$2.8bn. Most Wall Street analysts estimate Sourcefire’s addressable market by merely adding these three groups together, leading to a mammoth \$9bn figure. Below is a chart from a January 2012 FBN Securities report that uses somewhat dated Gartner figures to arrive at a similar conclusion. Many other research analysts make similar assumptions when discussing Sourcefire’s revenue opportunity.

Below is Sourcefire’s TAM According to a January 2012 Initiating Coverage report from FBN Securities:

Figure 1: FIRE Is Dramatically Increasing Its TAM

(\$ Billion)	2009	2014
IPS	\$ 1.2	\$ 2.1
Next-Generation Firewall		\$ 4.8
Endpoint Protection		\$ 3.3
Total FIRE TAM	\$ 1.2	\$ 10.2

Source: Company reports (using Gartner) and FBN Securities estimates

We believe the method employed by FBN and others grossly overstates Sourcefire’s addressable market opportunity. Assuming that Sourcefire’s upsell opportunity will be limited to existing IPS users, pricing data disclosed by Sourcefire on their last conference call allows us to make a more accurate measurement. Since we know that NGFW software adds a 10% pricing uplift and AMW a 20% uplift, it makes more sense to simply multiply these percentages by the existing IPS market size. Compare our chart below to the FBN figures and one quickly sees that the divergence is enormous.

\$m	2008	2009	2010	2011	2012
IPS Market Share					
Cisco	\$249.0	\$235.0	\$267.0	\$261.0	\$266.7
McAfee (Intel)	152.0	198.0	210.0	212.2	229.8
HP	151.0	161.0	193.2	207.0	186.0
IBM	96.4	115.6	125.0	172.8	183.9
Sourcefire	33.0	49.0	62.0	81.7	112.3
Others	217.6	180.1	201.9	174.4	183.2
IPS Market Size	\$899.0	\$938.7	\$1,059.1	\$1,109.2	\$1,161.9
% YoY Growth	11.7%	4.4%	12.8%	4.7%	4.8%
IPS * 10% (Firewall)	\$89.9	\$93.9	\$105.9	\$110.9	\$116.2
IPS * 20% (Antimalware)	179.8	187.7	211.8	221.8	232.4
Total Addressable Market	\$1,168.7	\$1,220.3	\$1,376.9	\$1,441.9	\$1,510.5

Sources: Gartner, Management Q4 2012 comments

Gartner's revenue figures only include product revenue, not services/maintenance revenue. Since FIRE earned about 40% of its 2012 revenue from the services line, we would gross up Sourcefire's revenue TAM from \$1.5bn to about \$2.5bn (\$1.5bn/60%). If Gartner is correct in their prediction that 50% of standalone IPS will convert to NGFW by 2015, then FIRE's addressable market halves to \$1.25bn. This figure is less than one-fifth the TAM used by FBN Securities.

FIRE's Reliance on Federal Revenue is Concerning

With U.S. budgetary concerns firmly on the mind of elected officials, the last customer any private company wants is the U.S. government. Yet the federal sector is by far FIRE's largest customer, contributing 20% of FIRE's total revenue in 2012. The government's last major cybersecurity initiative, the Comprehensive National Cybersecurity Initiative ("[CNCI](#)"), was launched in January 2008. This Security Council [order](#) required the deployment of "an intrusion detection system of sensors across the Federal enterprise." Naturally, the order helped Sourcefire's Federal revenue grow by 158% in 2008 and 91% in 2009, the first two years after the Initiative (*FIRE 2010 10-K*). Congress has not approved a major new initiative since. Compared to the tremendous growth in 2008 and 2009, FIRE has only managed to grow Federal revenue by 9%, 7%, and 28% over the past three years (*2012 10-K*).

\$m	2008	2009	2010	2011	2012
Sourcefire Revenue					
Commercial	\$41.8	\$49.5	\$65.0	\$88.5	\$104.0
International	18.1	23.7	32.8	42.1	74.4
Federal	15.8	30.2	32.8	35.0	44.7
% Growth	154.8%	91.1%	8.6%	6.7%	27.7%
% of Total Revenue					
Commercial	55.2%	47.8%	49.8%	53.4%	46.6%
International	23.9%	22.9%	25.1%	25.4%	33.3%
Federal	20.9%	29.2%	25.1%	21.1%	20.0%

Source: Sourcefire SEC filings (10-K)

The current administration recently attempted to update the 2008 CNCI initiative by introducing the Cybersecurity Act of 2012. Unfortunately for Sourcefire, the Senate voted the Act [down](#) in August 2012. Business groups and privacy advocates feared the legislation would be both costly and overreaching. The administration responded to the Senate's action by bypassing Congress and issuing an Executive [Order](#) instead. Industry commenter John Wood considers the Order to be largely [toothless](#), as the orders are both voluntary and narrow in scope.

Finally, the government isn't always the most business-friendly customer. Beyond widely understood Federal budget constraints, Sourcefire itemizes several other problems with its biggest customer in its 2012 10-K: "*Contracting with public sector customers is highly competitive and can be expensive and time-consuming...Public sector customers often have contractual or other legal rights to terminate current contracts for convenience...[and] Many government agencies already have installed network security products of our competitors.*" With a still [unresolved](#) U.S. Budget Sequestration continuing to wreak havoc on Defense budgeting, we don't believe the government will be a particularly receptive customer in 2013.

VI. Conclusion

Stories of foreign hackers infiltrating government databases, insiders stealing trade secrets, and recent twitter [hacks](#) are a constant reminder of the ever-evolving cybersecurity threat. But enthusiasm for the network security industry shouldn't blind investors to sober valuation analysis when picking stock investments. Since the start of 2012, investors have piled into FIRE on the presumption that FIRE growth was reaccelerating. While this was true on a dollar basis, FIRE's net new customer adds were flat YoY in 2012. Sourcefire was only able to drive revenue growth from 27% in 2011 to 35% through the introduction of two new upsell products, the NGFW and Anti-Malware tools. But as slowing quarterly growth since Q1 2012 shows, this upselling opportunity may be ephemeral. As customers swap their legacy IPS systems to next-generation firewall, many of Sourcefire's existing customers could decide to shop around for competing NGFW products. This shifts the discussion away from IPS, Sourcefire's strength, towards NGFW, where pure-play companies like Palo Alto Networks, Fortinet, and Check Point have greater brand cachet. To stay competitive, Sourcefire will be forced to invest more heavily in R&D, share margin with an ever increasing roster of selling partners, and increase salaries to attract talented sales reps. This will ensure that FIRE continues to barely squeak out a profit, as demonstrated by the fall in GAAP earnings from \$0.21/share in 2011 to \$0.16 in 2012.

Management concluded their Q4 2012 opening remarks by assuring investors it could "double the top line every 3 years." While this helped induce a short-term rally and a fresh round of bullish reports from the Street, we believe that management overreached. Sourcefire's expectations are now set too high and they've failed to acknowledge the growing competitive risks to their core IPS business. The first order of business for Sourcefire's new CEO, John Becker, may be to reset growth expectations to a more sustainable level.

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