IT Security Note: Intrusion Prevention and NET's IntruVert/Entercept Deals

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Updata Capital, Inc.

www.updata.com

New Jersey Office:

125 Half Mile Road
Suite 201
Red Bank, NJ 07701
(732) 945-1000

****

Virginia Office:

2100 Reston Parkway
Suite 430
Reston, VA 20191
(703) 736-0020

For more security Information contact:
Don More
Senior Vice President
dmore@updata.com

Network Associates Jumps into the Intrusion Prevention Fray

In early April Network Associates announced it would buy IntruVert Networks and Entercept Security, two San Jose-based intrusion detection & prevention (IDP) firms, for $100 million and $120 million respectively, in cash.

IntruVert sells a high-speed network IDP appliance launched last September that combines denial-of-service protection with signature and anomaly-based attack prevention. Entercept's leading host-based IDP software uses behavioral rules and signature analysis to harden applications and operating systems.

Seven private IDP firms have been acquired in recent months by NET, Cisco, Netscreen, Symantec and ISS, all at high valuations (see chart 1). There have also been at least 15 venture investments exceeding $174 million in the segment over the past 12 months (see chart 2 on next page).

As NET has observed, prices paid for IntruVert and Entercept – which we estimate to be 20x and 12x run-rate revenues respectively – are broadly in line with recent similar deals.

More near-term acquisitions are plausible. Likely acquirors include CA, Check Point, ISS, Microsoft and NetIQ.

Are the M&A Valuations Merited?

Today's IDP systems attempt to close the security gap left by firewalls that miss attacks disguised as legitimate traffic, and by traditional intrusion detection (ID) systems that merely observe breaches rather than prevent them.

Intruvert, Entercept and other IDP vendors utilize sophisticated attack signature and protocol/packet anomaly and traffic pattern analyses to more accurately detect breaches or unauthorized actions, and stop them in real time. Appliance-based designs with hardware acceleration enable high throughput.

Industry analysts predict IDP spending will grow faster than the overall security market, at an annual rate of somewhere between 19% (Infonetics Research) and 46% (IDC), with demand exceeding $1 billion in 2006. Prevention demand will grow faster than detection (although increasingly vendors combine both).

The consensus is that IDP will become core to the security infrastructure, as firewalls have become. If this occurs, NET's IDP investments could drive large market valuation gains.

Interest in IDP is not new. Five years ago, security vendors rushed to buy promising ID players after analysts forecasted 50%+ annual spending growth in the space. In February 1998, Cisco acquired WheelGroup for its NetRanger product. Days later, Network Associates bought firewall vendor (and Updata client) Trusted Information Systems partly for its Stalker ID line. TIS in turn acquired Haystack several months before for its ID technology. In March,

CHART 1: Recent Intrusion Detection/Prevention Acquisitions

Ann't Date	Seller	Buyer	Deal Value ($ MM)	LTM Rev ($ MM)*	Mult of LTM Rev	Description
Apr-03	Entercept Security	Network Associates	$120	$8	15.0 x	*Host-based intrusion prevention*
Apr-03	Intruvert	Network Associates	$100	$2	50.0 x	*Network intrusion prevention*
Jan-03	Okena	Cisco Systems	$154	$5	30.8 x	*Host-based intrusion prevention*
Oct-02	Psionic	Cisco Systems	$12	NA	NA	*Behavioral IDP technology*
Aug-02	OneSecure	NetScreen Technologies	$40	$2	23.0 x	*Network intrusion prevention*
Aug-02	vCIS	Internet Security	$20	NA	NA	*Behavioral inspection based IDS*
Jul-02	Recourse Technologies	Symantec	$135	$10	13.5 x	*Network intrusion prevention*

*Estimated.

RSA (then Security Dynamics) jumped in, buying Intrusion Detection (an Updata client). 48 hours earlier, ISS went public, its stock price doubling the first trading day. Shortly thereafter, buyers snapped up other attractive ID firms of the day like Centrax, AbirNet and Netect.

CHART 2: Venture Investment in Intrusion Detection & Prevention

Invest Date	Company	Sector	Amount Raised ($MM)	Round
Apr-03	NetContinuum	Web Application Security Appliance	$20.0	C
Mar-03	Lancope	Intrusion Detection and Prevention	$5.0	B
Feb-03	Sourcefire	Intrusion Detection Software	$11.0	B
Dec-02	eEye Digital Security	Intrusion Prevention, Vulnerability Assessment	$9.0	C
Oct-02	nCircle	Vulnerability Assessment, Management	$20.0	C
Oct-02	Intruvert	Intrusion Prevention Appliance	$15.5	C
Oct-02	Tipping Point	Firewall/VPN/Intrusion Detection Appliance	$10.0	PP
Sep-02	Finjan Software	Behavioral Content Inspection and Antivirus	$8.5	E
Aug-02	Arbor Networks	DDoS and Anomaly Detection and Prevention	$22.0	B
Jul-02	Company51	Intrusion Prevention	$10.0	A
Jun-02	Sourcefire	Intrusion Detection	$5.5	A
Jun-02	Mazu Networks	DDoS Detection and Prevention	$12.0	B
May-02	Riverhead Networks	DDoS Detection and Prevention	$9.0	B
May-02	Recourse Technologies	Intrusion Detection; Vulnerability Assessment	$11.0	D
Apr-02	Lancope	Intrusion Detection and Prevention	$5.5	A
		TOTAL Raised LTM	**$174.0**	

Overall, these acquisitions (see Chart 3 below) failed to meet expectations because customer demand did not materialize as planned, and ID technology proved unable to help administrators wade through large volumes of event data. Today, NET and its competitors believe that both the market and technology are ready. If they are correct, the high M&A valuations will have been easily justified.

Acquisitions Push NET's Transformation Forward

For over a year, management has been transforming NET by divesting or discontinuing lagging businesses, and entering high-growth security markets wih no entrenched leadership. Last year NET sold the PGP desktop encryption and Gauntlet firewall/VPN lines, and wound down CyberCop intrusion detection and vulnerability assessment with a view to integrating their functionality into Sniffer. In August, the Company added surveillance capabilities to Sniffer by buying Traxess. In September, NET acquired the 25% of McAfee.com it did not own to build on its consumer business. In January 2003, NET entered the anti-spam market by acquiring Deersoft.

The latest IDP acquisitions complement NET's antivirus business while reducing dependency on it, furthering management's goal of building a Sniffer-based security platform and instantly make the company a leading IDP vendor. IntruVert will be integrated with NET's architecturally compatible Sniffer network management tool next year. Entercept's software will be incorporated with McAfee software as both work on analogous underlying policy engines and attack signature databases.

CHART 3: Older Intrusion Detection/Prevention Acquisitions

Ann't Date	Seller	Buyer	Deal Value ($ MM)	LTM Rev ($ MM)*	Mult of LTM Rev	Description
Dec-01	Centrax Technology	NFR Security	NA	NA	NA	*Host-based IDS*
May-01	Network ICE	Internet Security	$196	$14	14.0 x	*Host resident intrusion detection*
Feb-99	Netect	BindView	$35	$0	116.7 x	*Intrusion prevention management*
Jan-99	Internet Tools	Axent Technologies	$27	$0	106.0 x	*Intrusion detection software*
May-98	AbirNet	Memco	$28	$3	9.2 x	*Security management, monitoring*
Mar-98	Intrusion Detection	RSA	$33	$5	7.3 x	*Network security monitoring*
Feb-98	WheelGroup Securities	Cisco Systems	$128	$9	15.1 x	*Intrusion detection*
Feb-98	Trusted Information Systems	Network Associates	$300	$42	7.1 x	*Firewall and IDS software*
Oct-97	Haystack Laboratories	Trusted Information Systems	$24	$2	13.6 x	*IDS software*

Perhaps ironically, NET's recent spate of deals bring to mind former CEO Bill Larsen's ultimately unsuccessful string of acquisitions that aimed to create suites of related security offerings. That effort failed due to difficulties integrating the acquired products, and unspectacular customer service. NET's present day M&A strategy has been more targeted and carefully executed.

Conditions permitting, we anticipate one or more additional acquisitions by NET this year to reinforce its IDP foray.

Right Deals at the Right Time but Uncertainty Remains

NET paid premium prices for premium quality companies in a potentially large, leaderless market segment. IntruVert and Entercept each have won key industry awards and have bested larger competitors in bake-offs. Both also have growing customer bases that will generate revenues while the businesses are being integrated. Further, the $220 million spent does not present undue financial risk given NET's strong cash flow and balance sheet. NET also understands that inaction presents risks. Symantec and Sophos are gaining market share in the enterprise antivirus market, and quarterly results announced last week suggest weakness in corporate sales.

All that said, time will tell when NET's new IDP business begins to contribute to the bottom line. Integration and ongoing development (e.g. creating lower-priced IDP products for the middle market) will require further investment. Intrusion prevention is still a small space, and the market's appetite is not fully known. For example, customers primarily use IntruVert's appliance for intrusion detection rather than prevention out of concern that legitimate traffic may be blocked by mistake. It is unclear how readily users will switch to the new prevention paradigm. (Continuing desire for intrusion detection points to the ongoing importance of Security Event Management (SEM) vendors to NET and other IDP players.)

Even if the IDP market grows as planned, NET faces competition. A dozen vendors at this year's RSA Conference are announcing or already offer products overlapping with IntruVert or Entercept. Cisco's Okena is on par with Entercept (which itself was formerly a Cisco partner). ISS, which until April 2 partnered with NET to co-market a bundled Sniffer/IDP solution, is perhaps a few quarters behind IntruVert's technology and remains the ID market leader. ISS also plans to launch a Linux-based security appliance later this year. Symantec offers IDP host and network products, and will be teaming with Sun to introduce an IDP appliance. However, Symantec's slower-than-desired integration of Recourse buys NET some time.

NET also lacks an enterprise firewall offering, which could disadvantage it vis-a-vis companies like Netscreen and TippingPoint that bundle firewall and IDP features. Along those lines, look for Check Point to become a big IDP player, partly out of concern that IDP technology may eventually supplant firewalls.

Further Consolidation Ahead

We expect more acquisitions in and around IDP this year. Promising IDP candidates include Lancope, Sana Security and public appliance vendor Tipping Point. Arbor Networks, which has focused on fighting distributed denial-of-service attacks, will soon launch an appliance more competitive with IntruVert. ISS remains a target as well. In Web Application Intrusion Prevention, which we consider to be an element of IDP, Sanctum and KaVaDo hold leadership positions and would be a good fit for NET, Symantec or Cisco.

An area of particular importance to IDP is Security Event Management (SEM), which enhances intrusion detection by centrally managing, integrating and correlating security event data from multiple devices, improving system accuracy and responsiveness. Promising firms include eSecurity, likely the largest SEM vendor, and ArcSight, which already partners with IntruVert. Symantec acquired SEM company MountainWave last July simultaneous with its Recourse deal. Cisco has chosen, for now, to partner with NetForensics to gain SEM capabilities but may also acquire a company in this space. An SEM acquisition by NET this year would not be surprising.

Vulnerability Assessment and Remediation – helping customers find and seal vulnerabilities before intrusions occur – is another logical partner to an IDP offering. Products from eEye and Qualys are among the top ranked here.

The crowded security market is inexorably consolidating toward a field dominated by a few large vendors like Network Associates that will offer an array of solutions. What has occurred in the IDP sector is happening in practically every security segment, perhaps more slowly and with less fanfare. Security firms that do not plan to become consolidators have an opportunity to achieve strong valuations in a sale, provided that they are a leader in a growing segment.

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www.updata.com

New Jersey Office:

125 Half Mile Road
Suite 201
Red Bank, NJ 07701
(732) 945-1000

Contact
Barry Goldsmith: bgoldsmith@updata.com
Ira Cohen: icohen@updata.com
John MacDonald: jmacdonald@updata.com

Virginia Office:

2100 Reston Parkway
Suite 430
Reston, VA 20191
(703) 736-0020

Contact
John Burton: jburton@updata.com
Joel Kallett: jkallett@updata.com

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