

IT Security Sector Report

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UPDATA CAPITAL

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Recently Announced Update Capital Deal



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Prevention is Key to Security's Future

In April, we reported that damage caused by computer viruses reached an all-time high in the first quarter. Since then, evidence of pervasive IT security vulnerabilities continues making news. For example, a May Deloitte survey found that 83% of global financial services firms suffered successful network attacks in the past year, up from 39% in 2002. In June, the Anti-Phishing Working Group reported 75% monthly growth in data theft based on spoofed e-mails and fraudulent websites.

While Bill Gates rightly suggested at the recent Gartner IT Symposium that security threats will diminish due to improving technologies, it will take awhile. Today's largely reactive approach to securing IT ensures that enterprises are always a step behind the constantly changing threat environment. The key to turning the tide in IT security lies with prevention.

Prevention signifies several things. First, it means building software less vulnerable to attack. To that end, software vendors are stepping-up efforts to embed security in development, testing and deployment. In April, the Cyber Security Partnership, a group of leading vendors, issued a draft report describing the need to address security through the complete product lifecycle. Advanced application vulnerability discovery and testing tools are greatly needed in pre-production.

Following deployment, automated patch and configuration management solutions are required to confront the rapidly closing time window from vulnerability discovery to exploit, which vulnerability management firm Foundstone estimates is 10 days today, down from 288 days in 1999, and likely to approach zero days soon. Objective certification of software security-worthiness, such as through Common Criteria, is also increasingly needed.

Prevention also means discouraging malfeasance by punishing wrongdoers. In May, Microsoft's Anti-virus Reward Program led to the capture of the Sasser worm culprit. To support more

aggressive law enforcement efforts, monitoring and forensic tools are available and under development to help find, track and prosecute offenders. Complementing this effort, intelligence solutions are increasingly relied on to discover threats and their sources earlier.

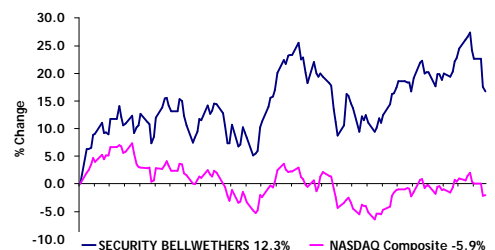
Finally, prevention means deploying proactive network and host based devices that adapt to the dynamic threat landscape. Though significant investments have been made in anomaly and behavior-based technologies that discover intrusion attempts, hybrid attacks and worms in the wild, security solutions remain predominantly "reactive", as signature-based content applications attest.

While proactive technology is still nascent, many security vendors are launching solutions that will soon change the security industry's posture from cure to prevention.

Security Outperforms NASDAQ

IT security declined with the broader technology market in July, but continues to handily outperform NASDAQ thus far in 2004. An unweighted price index of the 12 largest U.S.-traded security companies in terms of market capitalization (92% of the universe) rose 12% year-to-date through mid-July, compared to NASDAQ's 6% decline (Chart 1 below). Update's basket of 29 security companies trade at mean and median Enterprise Value/2004e Revenue multiples of 3.4x and 2.3x, and 2004 mean and median P/E's of 32.7x and 30.4x. Through mid-July, 11 companies announced quarterly results; seven exceeded Street revenue and EPS estimates.

Chart 1: YTD Share Price Performance



M&A, Venture Investment Show Strength

At least six IT security M&A transactions were announced in Q2 2004, plus two more through mid-July. Deals include: Symantec's acquisition of anti-spam vendor Brightmail, which had filed to go public; a letter-of-intent from Steelcloud to acquire V-One, a public VPN technology company; and an unsolicited (and thus far rejected) offer by CyberGuard to acquire Secure Computing. Announced deal volume for Q2 totaled \$449 million. Excluding Q1's Juniper Networks-Netscreen \$3.6 billion merger, the largest security acquisition ever, Q2 deal volume rose 47% over Q1 and 12% over prior-year Q2. (Table 2 lists recent M&A deals below.)

Update records 28 private equity investments in IT security since the beginning of April totaling \$236 million (Table 1, right). First half-year investment volume for the industry was \$586 million, a 58% increase over the prior-year first half, and a 22% rise over the second half of 2003. Recently popular investment areas include internal access control, identity security, vulnerability management and wireless security.

Table 1: Q2 2004 Security Venture Investment

Invest. Date	Company	Description	Amount (\$MM)	Round
Jul-04	Janus Technologies	Security configuration management	\$3.3	A
Jul-04	Vernier	Wireless security	\$10.0	D
Jul-04	BNX	Secure identity management	\$9.0	F
Jul-04	Application Security	Database security	\$7.0	C
Jul-04	Vsecure Technologies	Network intrusion prevention	\$2.0	C
Jul-04	Netasq	Firewall appliance	\$3.7	C
Jul-04	Authentec	Biometric fingerprint sensors	\$7.6	D
Jun-04	Q1 Labs	Network monitoring, IDS	\$11.0	C
Jun-04	Guardium	Database security	\$5.0	B
Jun-04	Finjan	Behavioral anti-virus	\$10.0	B
Jun-04	Determina	Intrusion prevention	\$16.0	B
Jun-04	eEye Digital	Vulnerability assessment	\$15.0	D
Jun-04	Infracore	File security	\$7.5	B
Jun-04	Bluefire	Wireless device security	\$10.0	C
May-04	e-Security	Security event management	\$5.0	C
May-04	Secure Software	Application security	\$5.3	A
May-04	TrustWave	Financial transaction security	\$10.0	A
May-04	Nevis Networks	Network security - stealth mode	\$10.0	B
May-04	Sensory Networks	Network security accelerator	\$6.0	B
May-04	Lockdown Networks	Vulnerability, patch management	\$4.0	na
Apr-04	WholeSecurity	Endpoint, identity security	\$10.0	B
Apr-04	Intrusic	Internal security, anti-espionage	\$2.1	B
Apr-04	Columbitech	Wireless LAN security	\$1.5	E
Apr-04	Senforce	Mobile computer security management	\$12.4	B
Apr-04	Vormetric	Stored data security	\$15.0	C
Apr-04	Lancope	IDS, vulnerability assessment	\$12.5	C
Apr-04	Trusted Network Technol.	Internal network firewall, access control	\$12.0	B
Apr-04	DigitalPersona	Fingerprint biometrics	\$13.0	C
			\$235.9	

Table 2: Recent Security M&A Activity

(\$ in millions)

Ann't Date	Seller	Buyer	Deal Value	LTM Rev	Mult of LTM		Description
					Rev	Rev	
Jul-04	Cerberian	Blue Coat	\$18	NA	NA		Web filtering software
Jul-04	SecureComputing [rejected bid]	CyberGuard [unsolitec]	\$247	\$81	3.0 x		Firewall, web-filtering, access mgmt
Jun-04	Trio Security	Symbol Technologies	NA	NA	NA		Mobile data security
May-04	AmikaNow!	Entrust	NA	NA	NA		Anti-spam; content scanning IP
May-04	V-One	Steelcloud	\$9	\$4	2.4 x		VPN software
May-04	Brightmail	Symantec	\$370	\$26	14.2 x		Anti-spam
May-04	Magnifire	F5	\$29	NA	NA		Web application security
Apr-04	Webwasher	CyberGuard	\$41	\$9	4.8 x		Content security platform
Mar-04	Riverhead	Cisco	\$39	NA	NA		DDoS; Intrusion Prevention
Mar-04	SSP	Saflink	\$50	\$13	3.7 x		Identity management
Mar-04	Corvigo	Tumbleweed	\$39	NA	NA		Anti-spam software
Mar-04	Twingo	Cisco	\$5	NA	NA		SSL VPN technology
Mar-04	DeLean	Identix	\$3	NA	NA		Skin biometric technology
Mar-04	Fortress Solutions	BeTrusted	NA	NA	NA		Security consulting
Feb-04	Ubizen	BeTrusted	\$4 €	43 €	2.0 x		MSSP; application security
Feb-04	TransDigital Technologies	Viisage	\$50	NA	NA		Identity management (passports)
Feb-04	NetScreen	Juniper Networks	\$3,621	\$310	11.7 x		ASIC Firewall/VPN appliance
Jan-04	Asgard Holdings	SteelCloud	\$3	NA	NA		Network security services
Jan-04	Cobion AG	Internet Security	\$33	\$5	6.6 x		Content filtering; anti-spam
Dec-03	Guardent	VeriSign	\$140	\$24	5.8 x		MSSP
Dec-03	Business Layers	Netegrity	\$43	\$10	4.3 x		Identity provisioning
Dec-03	Zone Labs	Check Point	\$205	\$28	7.3 x		Desktop firewall
Dec-03	SnapGear	CyberGuard	\$16	NA	NA		Linux security; firewall/VPN appliances
Nov-03	Waveset	Sun	\$150	\$15	10.0 x		Identity provisioning
Oct-03	Digital Silicon (Sentauros)	Demarc Security	NA	NA	NA		Intrusion detection software
Oct-03	Ositis	Blue Coat	\$7	NA	NA		E-mail and Web antivirus appliacne
Oct-03	ITM ThreatSmart	Perimeter	NA	NA	NA		MSSP player
Oct-03	Rainbow (merger)	Safenet	\$457	\$136	3.4 x		Tokens, anti-piracy, SSL acceleration
Oct-03	SafeWeb	Symantec	\$26	\$3	10.4 x		SSL VPN appliances
Oct-03	SSH Communs. (oem business)	Safenet	\$14	NA	NA		VPN, content inspection software
Oct-03	Mormar Technology	DynTek	NA	NA	NA		Security Consulting
Oct-03	Neoteris	Netscreen	\$265	\$32	8.3 x		Virtual VPNs

Table 3: Public Company Trading Data

Company	Market Value				Enterprise Value/ Revenues		P/E CY2004	5-yr EPS Growth Rate %	PEG Ratio CY2004
	Price 7/21/04	% of 52 Week Hi	Market Cap	Enterprise Value (1)	LTM	CY2004			
ActivCard Corp	\$6.66	67.3%	\$281	\$59	1.8x	1.8x	NA	35.0%	NA
Aladdin Knowledge Systems Ltd	17.44	60.7%	224	201	3.4x	2.9x	27.7x	50.0%	0.6x
BindView Development Corp	2.65	51.1%	125	86	1.2x	1.1x	113.7x	30.0%	3.8x
Check Point Software Technologies	21.46	79.0%	5,576	4,533	10.2x	8.8x	21.0x	12.7%	1.7x
CyberGuard Corp	6.35	51.8%	151	131	3.1x	2.2x	28.6x	25.3%	1.2x
Digimarc Corp	11.75	67.2%	242	171	2.0x	1.8x	45.6x	21.3%	2.1x
Entrust Technologies Inc	2.71	47.5%	178	86	1.0x	1.0x	NA	18.3%	NA
Gemplus International SA	3.84	66.2%	2,391	2,387	2.4x	3.0x	NA	NA	NA
Hi/fn Inc	9.34	49.5%	120	66	2.3x	1.4x	NA	26.7%	NA
Identix Inc	5.47	61.1%	474	429	5.4x	5.6x	NA	27.1%	NA
Internet Security Systems Inc	13.05	61.5%	654	443	1.8x	1.6x	21.5x	17.2%	1.3x
Intrusion Inc	1.24	22.4%	6	4	0.6x	NA	NA	NA	NA
Macrovision Corp	21.38	79.4%	1,073	898	6.5x	5.8x	24.8x	21.7%	1.1x
Netegrity Inc	7.08	49.9%	289	226	2.7x	2.3x	38.0x	23.8%	1.6x
NetIQ Corp	10.31	64.0%	588	266	1.0x	1.0x	114.9x	13.9%	16.6x
McAfee	16.75	84.8%	3,125	2,477	2.7x	3.1x	35.8x	16.1%	2.2x
RSA Security Inc	18.13	85.0%	1,188	969	3.6x	3.2x	38.5x	17.7%	2.2x
Safenet Inc	24.10	54.2%	366	192	2.5x	0.9x	18.8x	22.1%	0.8x
Secure Computing Corp	6.39	32.0%	243	214	2.6x	2.3x	20.8x	21.8%	1.0x
SonicWALL Inc	7.84	76.9%	549	294	2.8x	2.2x	57.6x	16.7%	3.5x
Symantec Corp	43.05	84.6%	15,769	13,359	7.1x	6.0x	30.4x	16.6%	1.7x
TipplingPoint Technologies Inc	19.12	56.2%	135	103	17.8x	NA	NA	25.0%	NA
Trend Micro Inc	38.50	84.6%	5,091	4,624	10.5x	8.7x	48.5x	NA	NA
Tumbleweed Communications Corp	2.86	32.4%	124	101	2.9x	2.1x	110.0x	35.3%	3.1x
Vasco Data Security International	2.30	68.0%	73	73	3.1x	NA	NA	NA	NA
Viisage Technology Inc	6.80	47.6%	213	235	5.7x	3.8x	NA	33.3%	NA
Watchguard Technologies Inc	5.85	66.5%	195	117	1.5x	1.3x	NA	26.0%	NA
Websense Inc	30.40	80.1%	720	520	5.9x	5.0x	33.5x	23.9%	1.4x
Zix Corp	6.03	32.5%	182	158	19.6x	9.1x	NA	NA	NA
Mean		60.8%			3.6x	3.4x	32.7x	24.1%	2.7x
Median		61.5%			2.7x	2.3x	30.4x	23.0%	1.7x

(1) Enterprise value is equal to market capitalization plus debt and pfd stock minus cash and cash equivalents

(2) Outliers, as indicated by a box, are excluded from mean and median calculations

Selected Public Company News

- 7/21 – ISS approves new shares repurchase program.
- 7/13 – Cyber Security Industry Alliance extends membership to firms with less than \$10 million revenue.
- 7/13 – Microsoft's delayed major security upgrade to Windows XP will be released in August.
- 7/9 – Zix is granted patents for its secure email transmission and forwarding technologies.
- 7/1 – WatchGuard names Edward Borey CEO, and Jim Richman CFO on 5/15.
- 6/30 – Network Associates changes name to McAfee.
- 6/29 – Safenet names Ken Muller CFO; promotes former CFO to President.
- 6/14 – Identix names Elissa Lindsoe CFO.
- 6/7 - Cisco Systems and Trend Micro partner to deliver worm and virus prevention services.
- 6/2 – Digimarc Awarded 150th U.S. Patent.
- 6/1 – ActivCard appoints Ben Barnes CEO.

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