3D ADVISORS

This 3DAdvisors Report Covers:
✓ **Insider Trading**: Insider Trading Behavior
✓ **Accounting**: Quality of Earnings Issues
✓ **Governance:** Corporate Governance Issues
✓ **Fundamentals:** Analysis of fundamentals
Deception: Deception detection analysis

As Growth Fades, Insiders Sell In Familiar Fashion
F5 Networks Inc. (NASDAQ:FFIV)

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Contact: Bob Gabele (954) 779-3974 or bgabele@3DAdvisors.com

Business Description

F5 Networks Inc. engages in marketing, selling, and servicing products that optimize the delivery of network-based applications, and availability of servers, data storage devices, and other network resources. In addition, the Company offers a range of services, such as consulting, training, installation, maintenance, and other technical support services. It primarily serves technology, telecommunications, financial services, transportation, and manufacturing industries, as well as government customers. The Company markets its products and services through distributors, value-added resellers, and systems integrators. It has operations in the Americas, Europe, the Middle East, Africa, Japan, and the Asia Pacific. F5 Networks was founded in 1996 and is headquartered in Seattle.

Key Statistics

Sector:	Last Close:	Market Cap:	Avg Vol (3m):
Technology	**$35.93**	**$2.82B**	**2,107,030**
Industry:	**52 Wk Range:**	**Trailing P/E:**	**Shrs Out:**
Internet Software & Services	**$17.75-$38.80**	**34.78**	**78.51M**
F/T Employees:	**FYE:**	**Forward P/E:**	**Short % of Float:**
1,694	**30-Sep**	**20.53**	**7.0%**

Summary of 3DAdvisors Findings for FFIV

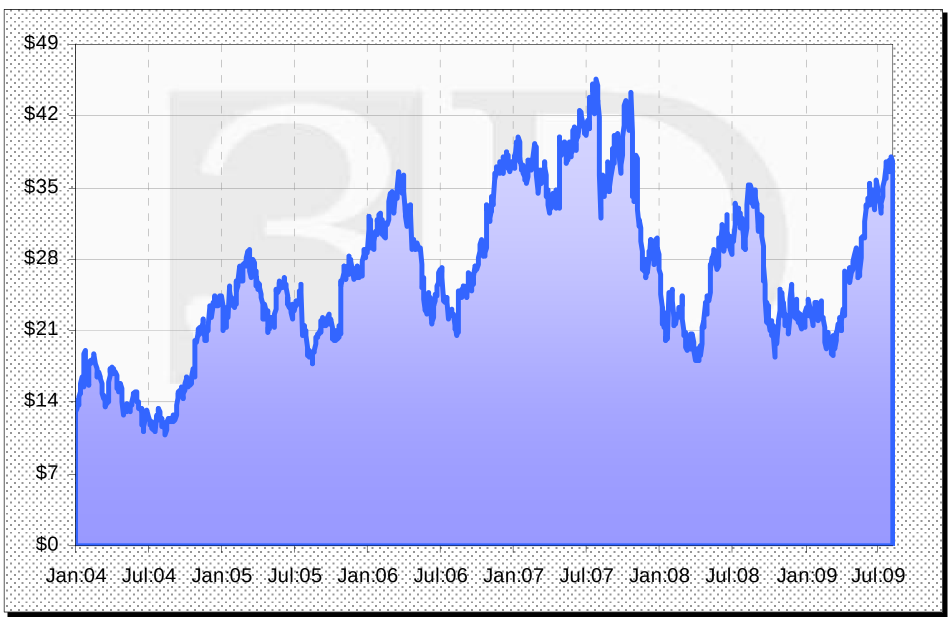
- **Insider Trading:** Trading and accounting behavior on the watch of CEO McAdam
- **Insider Trading:** Recent trading behavior similar to 2005/2006 sell-off by insiders
- **Fundamentals:** FFIV appears to have over-paid for struggling Acopia
- **Governance:** Incentive comp targets change as revenue growth lags
- **Accounting:** Revenue recognition changes and related disclosures are red flags
- **Fundamentals:** Decline in product revenues persists, implications significant

Discussion of 3DAdvisors Findings for FFIV

There are plenty of good things that can be said about a company that generates lots of cash, has no long-term debt and maintains a healthy stash of deferred revenues. This description clearly fits F5 Networks Inc. (NASDAQ:FFIV). But when overlooked or under appreciated contrary behavioral and fundamental issues begin to appear at these same seemingly strong companies, they can also become vulnerable to abrupt volatility and negative stock price action. Recent executive behavior and fundamental risks at F5 Networks also fit this description, and it is not the first time a mixed picture has emerged to put the Company on our radar.

There has been plenty to keep us interested in FFIV, which we first began following back in 2005/2006, well before its now-infamous option backdating scandal. At that time, we had spotted aggressive 10b5 trading plan activity by the majority of the management team. Further analysis revealed a host of trading, governance and earnings quality risks including, to name a few, unusual options grant practices, revenue recognition changes and interesting movement in allowances. In fact, the persistence of the above behaviors at the time led FFIV to become one of our more closely followed names of the period. Between April 2005 and July 2006 we posted six separate reports covering our findings on FFIV.

Figure 1. FFIV Daily Closing Price, 01/03/04 through 08/07/09. Source: Reuters.



Given a clear management proclivity towards self serving behavior, we were hardly surprised when both the SEC and DOJ opened investigations into the Company's option granting practices in May of 2006, making it one of the first companies ensnared in the options backdating scandal. For its part, the Company set up a Special Committee to perform its own internal review of its equity grant process which led to a restatement of five years of financials, and while the internal inquiry was ongoing we would have expected FFIV to impose a trading black out pending its outcome, as would have been the case at almost any other company, *but not FFIV*. Insiders continued selling without interruption under their ongoing 10b5-1 plans, settling for prices as low as $22 after the issue had traded at $36 just a few months earlier. At the time, we also noted that it was not the first time that CEO **John McAdam** benefited from suspiciously timed option grants; while President and COO of Sequent Computer Systems, he received several option grants on favorable dates that also drew scrutiny (more on this below). Remarkably, after more than three years, the SEC and DOJ investigation of FFIV option grant practices is still not complete.

Now, nearly three years after our last update report on FFIV, we find ourselves again drawn to the Company due to a recent and familiar surge in executive selling under 10b5-1 trading plans which is perhaps not all that surprising given the fact that the shares have recently traded right around $38, about twice what they fetched back in early March. But rather than uncovering any signs that the Company might soon resume its upward trajectory in revenue and earnings growth which might justify the recent upward momentum in the stock, our investigation has revealed a marked slow down in net revenue growth, most notably caused by sagging product sales, a surge in inventories, and the failure of a recent and expensive acquisition to make any meaningful contribution to the top or bottom line. Management responses to probing by analysts on these points, as is usually the case in such circumstances, leave us less than satisfied. Adding some spice to the above predicament are some curious and frequent changes in the wording in various filings regarding revenue recognition policy for an undisclosed number of customers that receive extended payment terms.

But the FFIV story has been and continues to be first and foremost about noteworthy executive behavior that clearly contradicts positive comments and guidance provided by management and sometimes industry fundamentals. We begin this report with an overview of the past behavior of the Company's chief executive, which is as colorful as it is central to our thesis in this particular instance.

<u>Insider Trading: Trading and accounting behavior on the watch of CEO McAdam</u>

Were it not for the acquisition of Sequent Computer Systems by IBM in July of 1999, John McAdam may have attained the dubious distinction of being the only executive to have been tangled up in option backdating scandals at two separate companies. It is quite apparent looking back at some of his related filings at Sequent Computer where he was President and COO that there were some interesting "out of phase" grants that benefitted both McAdam and former Sequent CEO, **Karl Powell**. These grants, occurring in 1997 and 1998, caught our attention because in the three prior years options had been granted by Sequent in July and February/March, whereas the grants in question occurred in January and December.

The January 1997 options, granted on 01/02/07 at a strike price of $17.44 per share, occurred earlier than in the two prior years and before a big run-up in Sequent shares, which would take them to as high as $30.63 by 3Q07. As the shares rallied higher through 2Q07 the July grant (the regular date the prior three years) did not take place but instead was replaced with a December 16th grant when the shares had backed down to $22.39. Similar activity took place the following year when McAdam and Powell each received options for 100,000 shares, exercisable at $9.13, this time on October 28th with the shares trading at a 52-week low. An interesting side-bar to the 1998 activity is that other Section 16 insiders received their July grants that year, with a strike price of

$13. The postponement of the McAdam and Powell grants allowed both executives to net an extra $387,000 in profits on subsequent trades.

There were also some revenue recognition issues raised at Sequent while McAdam was in the executive suite, just as there are now at FFIV. In a weekly news publication in Portland, OR called the Willamette Week, it was reported in August of 1999[1] that on the last day of the quarter ended 03/31/99, Sequent had shipped a large order of computer gear which filled two 48-foot semi trucks and was valued between $15 and $20 million. The problem was that the customer, whose name appeared on the order, never received the goods, nor (according to the customer, Federal Data Corp. of Maryland) had it even purchased them. Instead of arriving at Federal Data facilities, the order showed up at a warehouse in Portland (operated by a company named Jet Delivery Service) and was subsequently returned to Sequent on April 20th, a couple of weeks later and well into the second quarter. Sequent insisted that it had never booked the revenues related to the shipment. This all allegedly occurred just prior to the Company's acquisition by IBM and on the heels of a rough stretch of disappointing earnings and other problems at Sequent. McAdam was President at the time.

A more recent example of questionable McAdam behavior involves his trading decisions. On 05/21/09, the Supreme Court for the State of Washington ruled against FFIV when it refused to throw out a derivative action (related to the options backdating scandal) based on the fact that the plaintiffs failed to make a demand on the directors prior to filing suit. It was on that very day (05/2109) that McAdam sold 180,000 shares, his largest trade in at least three years, which was also after he made a conference speech that caused the shares to rally 7 % (more details below). To this, we note that federal actions had been stayed pending the resolution of the Washington court matter. FFIV chose not to issue a press release or SEC Form 8-K concerning this decision, but instead chose to bury the disclosure in the 3Q09 SEC Form 10-Q filed on 08/07/09. Not that the derivative action, in itself, is highly material but it is his decision to sell such a large number of shares while in possession of the news, and apparently prior to its broader dissemination, that catches our eye.

As they say, "Leopards don't change their spots", and when it comes to certain types of behavior that interest us, the cliché certainly seems to apply to Mr. McAdam.

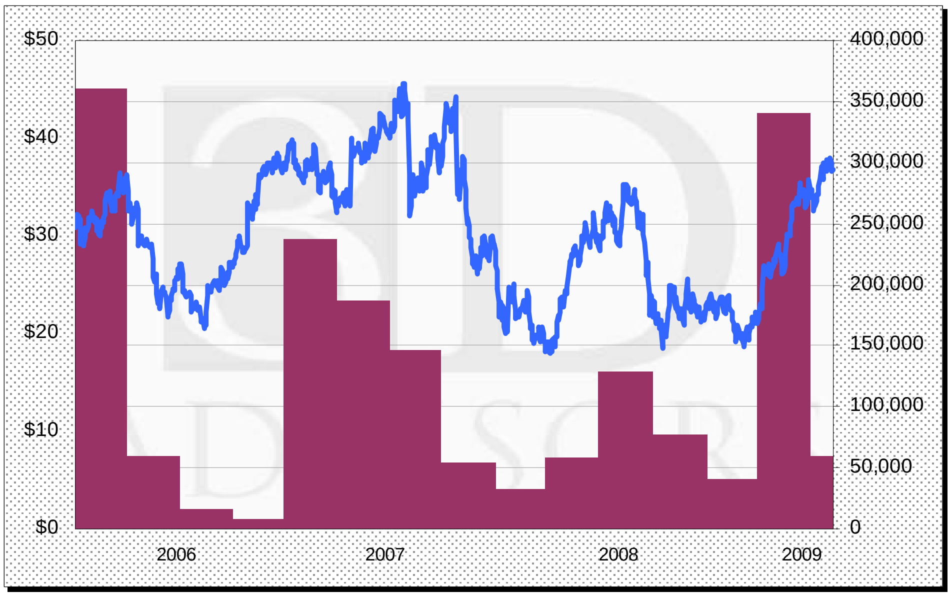
<u>Insider Trading: Recent behavior similar to 2005/2006 sell-off by insiders</u>

We would offer that the task of sizing up the trading behavior of FFIV insiders has changed in recent years since the Company began granting time-vested restricted stock (and later performance stock) rather than stock options in 2005; a move that occurred before the Company even received notice from the SEC and DOJ of their options investigations. Granted, there is a difference between the monthly vesting of previously-granted options and the current quarterly schedule of the more recent restricted share grants. Interestingly, such adjustments have not altered the executives' selling patterns as they continue to monetize restricted stock immediately upon vesting, which now occurs nearly every two months due to the variable grant dates. And despite holding considerably fewer shares than they did before draining their sizeable ownership

[1] Jaquiss, Nigel, "Return to Sender", Willamette Week, August 18, 1999. http://wweek.com/html/business081899.html

positions back in 2005 and 2006, there were three high-ranking officers who executed their largest sales on record during the second quarter. In total, all eight of the Company's Section 16 executives and one board member collectively sold 400,000 shares, mostly through 10b5-1 plans between May 1st and August 3rd at increasing prices from $27 to $37.

Figure 2. FFIV Daily Closing Price, 01/03/06 through 08/07/09 (Blue Line and Left Scale) and Quarterly Sales by Insiders, 1Q06 through 3Q09. Source: Reuters and FFIV SEC Filings.



The spike in last quarter's volume of insider sales is the fundamental reason we are now highlighting the FFIV trading profile; this driven by the fact that certain key insiders are selling at unprecedented levels. The first large sale came from President, CEO John McAdam, who dropped half of his holdings (180,000 shares) on May 21st, the day after the shares rallied 7% on his keynote speech given at the annual Interlop IT conference in Las Vegas. Our experience has shown that there are few insider behaviors as significant as the one where a key executive sells into a rally sparked by his own optimistic statements. Adding fuel to this fire, six additional executives moved to cash in shares on this management-induced rally as well. Since the conference did not fall on or near a date their restricted stock vested, it left us wondering how so many individuals managed to pull off simultaneous trades through their separate pre-arranged sales plans on this particular rally.

The next notable trade came from Chief Accounting Officer **John Rodriquez**, whose title is somewhat misleading as his scope of responsibility seems more like that of the typical CFO. It includes worldwide accounting operations, financial, accounting and SEC reporting and the overseeing of the Company's human resources department and corporate facilities. It is Rodriguez, not CFO **Andy Reinland**, who signs off on the Company's certifications of financials with CEO McAdam and is considered to be the 'principal financial officer'. Rodriguez sold in each of the last four quarters either immediately upon the vesting of restricted shares or shortly after, typically disposing fewer shares than he acquired. The consistent pattern came to an end when he traded out of sequence on June 1st, cashing in 30,319 shares. He would then resurface on August 3rd, immediately upon the vesting of more shares, and sold not only the 4,000 newly-actionable shares but another 7,000 from his common holdings, depleting his holdings by 73%. His June sale was his largest (by a wide margin) since becoming a registered seller four years earlier.

Another seller of interest is **Mark Anderson**, Senior V.P. of Worldwide Sales, who in similar fashion to Rodriguez's behavior, stepped outside of his normal 10b5-1 selling pattern to unload 60,000 shares on June 11th. Not only did he monetize the last of his stock options, which otherwise would not have expired for another five years, but he also cleared out all of his common stock except the few shares purchased through the Employee Stock Purchase Plan (ESPP) two months earlier. This lone trade covered more shares than all ten of his prior dispositions combined, wiping out 98% of his ownership. Lastly, V.P. of Business Operations **Edward Eames** no longer has any exposure to FFIV stock after clearing out shares that became unrestricted on May 1st, 'flipping' the shares he purchased through the ESPP on the previous day, and finally cashing in the 4,000 shares that vested on August 1st. It is quite an impressive feat that Eames has monetized every share and option awarded to him during his nine year career, not to mention the 15,000 shares he has purchased through the ESPP.

Here are the details on the noteworthy recent trading behavior:

- **John McAdam (57)*** – President, Chief Executive Officer, Director. McAdam sold 180,000 of his directly held common shares through an undisclosed sales plan on 05/21/09. This was his largest trade in terms of volume in more than three years and the lowest prices at which he has sold ($30) since November 2005. McAdam has an interesting trading history. He has exclusively traded through 10b5-1 plans since 2002 but the Company has never provided any details on his plans and the trades themselves have been lumpy and sporadic in their recurrence. Yet, they have typically come after earnings surprises or significant price increases and routinely preceded momentum reversals. A trend we are seeing now is that after owning more than 1 million options and shares as recently as 2004, he continues to sell down his ownership each year and currently has just 177,000 shares. This is no insignificant amount, but well below the levels we are accustomed to seeing him hold. **His May sale erased 50% of his ownership** and with just 13,000 new shares vesting per quarter due to the Company's declining revenues, it will take more than one year, barring any further sales, for him to replace the shares recently sold.

- **John Rodriguez (48)*** – Senior V.P., Chief Accounting Officer. Rodriguez has traded solely with 10b5-1 plans since becoming a registered Section 16 filer in October 2005. We know little about the adoption and expiration dates of his plans, but Rodriguez has typically sold once per quarter upon the vesting of his restricted stock awards. Nearly each quarter Rodriguez has sold fewer shares than he had vest, which contributed to his holdings growing tenfold between 2008 and 2009. The trend changed when he executed his largest sale on record, selling 30,319 shares on 06/01/09 at $33. This sale covered more stock than he vested in over the last six months. He would go on to sell another 11,000 shares on August 3rd, **which altogether erased 75% of his actionable holdings**. Since none of Rodriguez's past 10b5-1 activity ever covered as many shares as he sold in the lone June trade, we suspect he may have opened a new plan before the Company released FY 2Q earnings.

- **Mark Anderson (46)** – Senior V.P. of Worldwide Sales. Anderson registered as a Section 16 filer in October 2007 and first began trading under a 10b5-1 plan in May 2008, selling each quarter since then upon the vesting of his restricted stock awards. In the past year he slowly increased his direct stock holdings having vested in 38,000 shares and selling just 29,000. As we have seen with a number of his peers, Anderson's behavior changed course in the second quarter when he monetized all 43,751 of his remaining stock options (October 2014 expiration) on 06/01/09 and also sold 16,000 shares of his common. He would later clear out the 7,100 shares that vested on August 1st (August 3rd sale date). **The sales covered 98% of his actionable ownership, by far his most impressive moves to date.** With just 7,000 shares becoming actionable each quarter, it will take years for him to replace the equity just diversified.

- **Edward Eames (50)*** – Senior V.P. of Business Operations. Eames has a different trading and ownership profile than his counterparts, having sold down his holdings to nearly zero in late 2007 and consistently selling all shares that become actionable on a quarterly basis. Not only has he disposed of newly-vested stock, but Eames also 'flips' shares purchased through the Company's Employee Stock Purchase Plan (ESPP). For example, he bought 350 shares through the ESPP on 04/30/09 and then vested in 3,938 shares on 05/01/09. That same day he sold all 4,288 shares at $27, **trading in every single actionable share at his disposal**; Eames has now maintained a zero ownership balance for the last five months, which continued in August when he immediately cashed out the 4,000 shares he vested in on August 1st.

- **Jeffrey Christianson (51)** – Senior V.P., General Counsel. Christianson executed a total of three sales covering 11,000 shares between December 2006, when he became a Section 16 filer, and February 2009. From 05/01/09 to 06/11/09 he sold 25,000 shares with five different transactions at increasing prices from $27 to $35. All trades appear to have come through the same predetermined sales plan. **The sales covered roughly 40% of his actionable ownership**, which still remains at historically high levels, but more important is the noticeable pickup in his trade frequency. Christianson is one of a number of F5 execs who have uncharacteristically executed multiple transactions since the release of FY 2Q earnings.

  * Indicates that the individual is a Named Executive in the Company's most recent Proxy.

<u>Fundamentals: FFIV appears to have over-paid for struggling Acopia</u>

The September 2007 acquisition of Acopia Networks is not living up to expectations. FFIV paid $210 million to acquire this provider of storage virtualization technology and although The Street sold down FFIV shares on news of the deal, management has steadfastly maintained its confidence in the acquisition. The truth of the matter, however, may lie in the fact that the Company seems to have been late to the party, paying too much to get into a market that competitor Cisco had already entered, paid less then cut loose:

Cisco's acquisition of NeoPath was announced in 2006 and closed March/April of 2007. However, on 03/30/07 Cisco sent a letter to the users of NeoPath products informing them that the file virtualization products of NeoPath "are being taken off the market immediately." The document reads, "In connection with Cisco Systems acquisition of NeoPath Networks, we are announcing the immediate end-of-sale (EOS) of NeoPath File Director and Fileyzer product families, support contracts and professional services…No new service contracts will be sold and existing service contracts will not be renewed or extended beyond their current expiration dates."

An article from a year earlier[2] seems to suggest that analysts originally believed that CSCO eventually would incorporate the NeoPath technology into one of its chassis and that it wouldn't be sold as a stand alone product. At the time of the acquisition, NeoPath was said to have 40 to 50 customers. In the same article from 2006, we also find a good brief comparative description of NeoPath and Acopia Networks. "NeoPath's closest competitor, Acopia Networks Inc., provides more functionality than most file virtualization products, such as snapshots and replication, taking away this capability from the underlying filers. NeoPath meanwhile, is more like a router, directing packets, analysts said." Given this basic description of NeoPath and the small number of acquired customers, one can certainly understand the logic behind the letter sent to customers. In fact, perhaps CSCO was ahead of the game. Acopia had 100 customers at the time of its deal with FFIV, the majority of them concentrated in the financial sector.

Another article from September of 2008[3] suggests that the long-term market for file virtualization is just not there. In fact, the article says, "According to the analysts, the market for file virtualization hasn't lived up to its original promise, despite the high-profile acquisitions of file virtualization technology by EMC, Cisco, Brocade and F5 Networks in recent years."

In the end it appears FFIV may have felt pressured to get into the file virtualization market lest it be left behind by its bigger competitors and so it jumped in with the acquisition of Acopia. But one could also argue that FFIV overpaid for Acopia. The two largest players in the file virtualization market were Acopia and NeoPath and CSCO paid only $40 to $42 million for NeoPath while NuView was acquired by Brocade Communications Systems in March of 2006 for $60 million. According to the article from 2008, EMC, CSCO and Brocade have all moved forward and have refocused their file virtualization products.

Given the recent revenue figures posted by Acopia, FFIV clearly has not forced any such refocus: When the Company originally acquired Acopia, guidance indicated that $25 to $30 million of revenue should result in 2008. Indeed, amidst the early fanfare and heavy analyst interest CFO Reinland indicated, on both the 1Q08 and 2Q08 conference calls that he would be "disappointed" if Acopia revenue did not exceed that range in 2008. From the 1Q08 conference call:

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[2] Maitland, Jo, "Cisco to invest in NeoPath for file virtualization", SearchStorage.com, April 17, 2006. http://searchstorage.techtarget.com/news/article/0,289142,sid5_gci1180479,00.html#
[3] Pariseau, Beth, "File virtualization shops going strong, but market uncertain", SearchStorage.com, September 8, 2008. http://searchstorage.techtarget.com/news/article/0,289142,sid5_gci1328867,00.html#

> **Analyst:** With regards to Acopia, very nice job on the top line. Also fair to assume that the return, your accretion or back to break even in that business are also ahead of schedule?
>
> **Andy Reinland, CFO:** Yes, I think that's fair to say. As long as we are moving forward. As John said, we expected that we'd be disappointed if we didn't exceed the $30 million. We're investing in Acopia but continue to manage it closely and realize that we're managing an entire business here and will do so as we go forward, but that would accelerate the break even there.

When asked again about Acopia exceeding $30 million on the subsequent (2Q08) conference call, Reinland reiterated his confidence. However, with 65% of its customer base in the financial sector and the large majority of that being Wall Street related (Acopia counted Bear Stearns as one if its 100 customers at the time of the acquisition), things did not work out the way FFIV had hoped. Acopia wrapped up the year at $25.6 million in revenues and the trend looks to be a disappointment again this year: Through 3Q09, Acopia revenue growth seems stunted at only $13.2 million ($3.7, $4.5 and $5 million in each of the first three quarters, respectively). McAdam now is pushing back his guidance on when the Acopia acquisition will pan out, referring to its market as “nascent” and requiring “a lot of evangelizing” (2Q09 conference call). It is hard to determine how much of the under performance is a result of the misery in the financial sector, but one has to wonder if CSCO read the tea leaves right and excited the market after realizing it wouldn’t pan out the way many had thought. In any case, FFIV now appears saddled with an expensive, underperforming asset for the foreseeable future.

The Acopia baggage could hurt a bit on the balance sheet as well. FFIV allocated $150 million of the purchase price to Goodwill raising the specter of impairment should current trends continue. Granted, with a strong balance sheet an impairment write-off would likely not provide much of a catalyst. That jab, however, combined with the right hook of the revenue shortfall thus far seen from Acopia, has the ability to cause a knockdown, especially given the fact that FFIV shares have essentially doubled since March.

<u>Governance: Incentive comp targets change as revenue growth lags</u>

In the post-backdating era, FFIV management has found new ways to ensure that its equity compensation picture remains lucrative for those involved. As mentioned earlier, the Company began issuing restricted shares in lieu of options in 2005. Subsequently, in 2006, performance stock was introduced into the mix. The performance-based awards made in December 2006 and August 2007 were to vest on a quarterly basis only if sales during the quarter exceeded the same quarter a year before by 20%. These targets were not set very high as sales in 2006 and 2007 jumped 40% and 33%, respectively. But the Company lowered the bar for the next awards issued in August 2008 when sales growth in the first three fiscal quarters of 2008 each slipped below 20%; a very subtle indication they had concerns the trend would continue with sales likely deteriorating at an even faster pace. Below are the revenue and payout targets for the 2008 performance stock awards [bolding is ours]:

The executive officers earn 125% of the 2008 Performance Award if the revenue increase is 20%, 100% of the 2008 Performance Award if the revenue increase is 11%, and 75% of the 2008 Performance Award if the revenue increase is 6%. No portion of the 2008 Performance Award is earned if the revenue increase is less than 6%.

Interestingly, even the new lower standards did not result in delivery of the performance shares through the first nine months of F/Y 2009 (ended 09/30/08). Executives were not issued the last 25% of their total 2007 performance awards since revenue in 3Q08 and 4Q08 came in below 20%. Consequently, through the first three measurement periods (quarters) for the fiscal 2008 awards, only 25% of the total possible shares had been granted since the 6% threshold had not been achieved in the last two quarters.

Taking into account the forecasted decline for fiscal 4Q08 sales, it seemed that receiving further performance shares would certainly be out of reach. But we were hardly surprised when the new awards made on August 3rd added EBITDA targets to the revenue growth goals. Although we will not know what the exact targets are until the next Proxy is released, this is now the second amendment to the vesting provisions of the performance shares in two years. This latest self-serving change not only raises our antennae because of the Company's recent revenue difficulties, which management, by lowering the bar, may have been reacting to in order to preserve their payouts, but also in light of the Company's original justification for tying the shares to revenue in the first place [bolding is ours]:

The Compensation Committee believes that revenue growth is currently the most appropriate measure for the performance-based equity awards as the Company's ability to consistently grow revenue is an important element in maintaining and growing shareholder value and furthers the shared interests of the Company's executive officers and shareholders.

Just to underscore the importance of these compensation changes, we note that in 2008 stock-based compensation expense was almost as large as its net income.

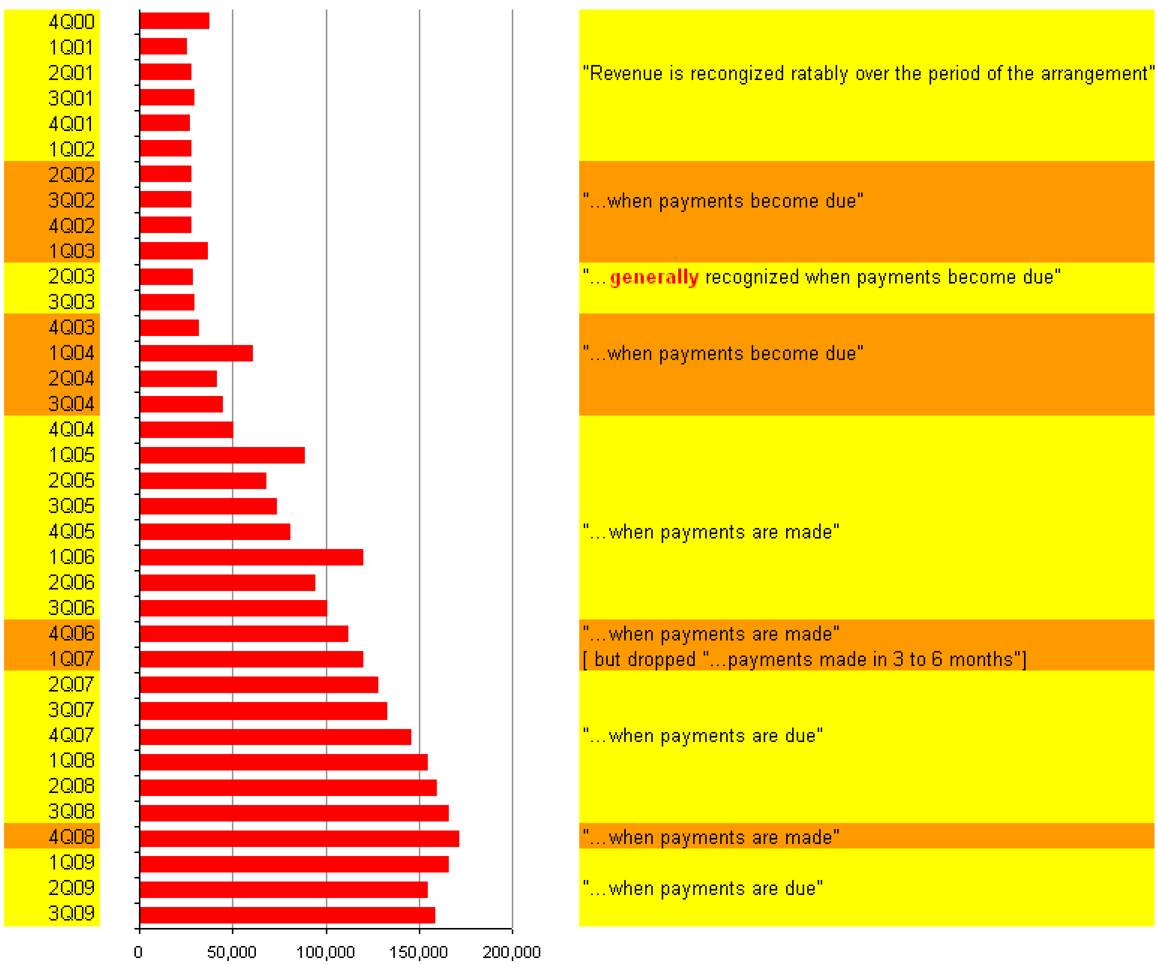
<u>Accounting: Revenue recognition changes and related disclosures are red flags</u>

There is a disturbing inconsistency and a lack of disclosure in one of the Company's revenue recognition practices. The Company offers extended payment terms to *certain customers* and has been doing so since at least 2000. The amount of revenue, however, which is subject to such extended terms, has never been disclosed. In these cases, revenue is not recognized at the time shipments are made to the customers to whom extended terms have been offered, but rather, recognition of such revenue is deferred until a later date.

Initially, this revenue recognition for these customers had occurred "ratably over the term of the arrangement." Things changed in 2Q02, however, when the Company disclosed that it had begun recognizing revenue from "extended term" customers to "…when payment is due". This practice remained in place until 4Q04 when FFIV again changed its revenue recognition date for these customers to "…when payments are received". In subsequent quarters, FFIV would move its revenue recognition for these customers back and fourth no less than four additional times. Clearly, any lapse between due dates and payment dates could obviously give rise to opportunities for the Company to manage the timing of revenue. The fact that the Company has moved back and forth between the practices, together with a failure to disclose what portion of revenue is subject to “extended terms”, we would think would be a significant red flag to investors, especially at a time when revenue growth (or lack thereof) is of such a concern.

Figure 3 below shows the timeline of these changes in revenue recognition for customers receiving “extended payment terms” and total net revenues for each quarterly period beginning 4Q00. Note that, for six quarters prior to 4Q08, FFIV recognized these revenues on the date “…when payments are due”. Then in 4Q08, the Company switched, just for one period, recognition back to “…when payments are made” only to flip back to “…when payment are due” for the next three quarters. One can easily imagine the earnings management potential attendant to such behavior, and whether or not 4Q08 revenues were enhanced by early payment by some customers.

Figure 3. FFIV Revenue Recognition Changes for Extended Payment Customers and Total Net Revenues ($000), 4Q00 through 3Q09. Source: FFIV SEC Filings.



No explanation has ever been given as to why such revenues are not recognized at the time of shipment, or why the Company switches between the two practices. However, the practice does raise certain questions. First, the Company appears to have a valid, legally collectible receivable when shipment is made, which would seem to require recognition of revenue at the time of shipment. Although, in the case of these “certain customers” who receive extended terms, the Company makes no such statement. To this, one might assume that the accounts receivable from those certain customers are less than reasonably assured, thereby justifying deferral of the revenue.

That, then, calls into question the quality of the accounts receivable from those customers. Secondly, since the cost of goods sold must also be deferred until revenue is recognized, this might be accomplished by keeping the appropriate cost in inventory. This raises the related question as to how realistic inventory values on the balance sheet may be.

To this, we note that, from the inception of this flip-flopping recognition process, the Company had consistently disclosed the extended terms of such arrangements to be between 30 and 90 days. This designation, however, was dropped in 1Q07. Since, the Company has made no mention as to the range length of “extended terms”. This certainly leads one to believe that, since the 1Q07, the “extended terms” offered by FFIV, though undisclosed, have been extended further than the original 30 to 90 days as had been the practice earlier.

The lack of disclosure of the amounts involved, no reasons given for the revenue deferral and possible inventory and receivables valuation questions, all cause one to question certain aspects of both the balance sheet and the income statement.

Fundamentals: Decline in product revenues persists, implications significant

FFIV has enjoyed several years of robust net revenue growth (see Figure 3 above), but there has been a significant change in that trend over the last couple of quarters. In fact, upon closer inspection it seems that despite a few acquisitions, organic growth, and in particular product growth, has been slowing for quite some time. FFIV has attempted to enter “complimentary” markets through acquisitions, introduced a new “flagship” product in 2007 called VIPRION and has completed a product refresh in 2008; however, these strategies seem to be overshadowed by the current recessionary environment. Revenues are falling, margins are under pressure and reserves are being made to inventory that has ballooned.

Sequential Revenue Growth* (%)	2007	1Q08	2Q08	3Q08	4Q08	2008	1Q09	2Q09	3Q09
Products	28.9	3.0	1.8	2.4	0.9	15.3	-6.8	-12.8	1.3
Services	48.9	13.9	6.9	8.1	9.2	48.6	4.0	4.1	4.3
Total	33.4	5.9	3.2	4.0	3.4	23.7	-3.3	-6.9	2.6

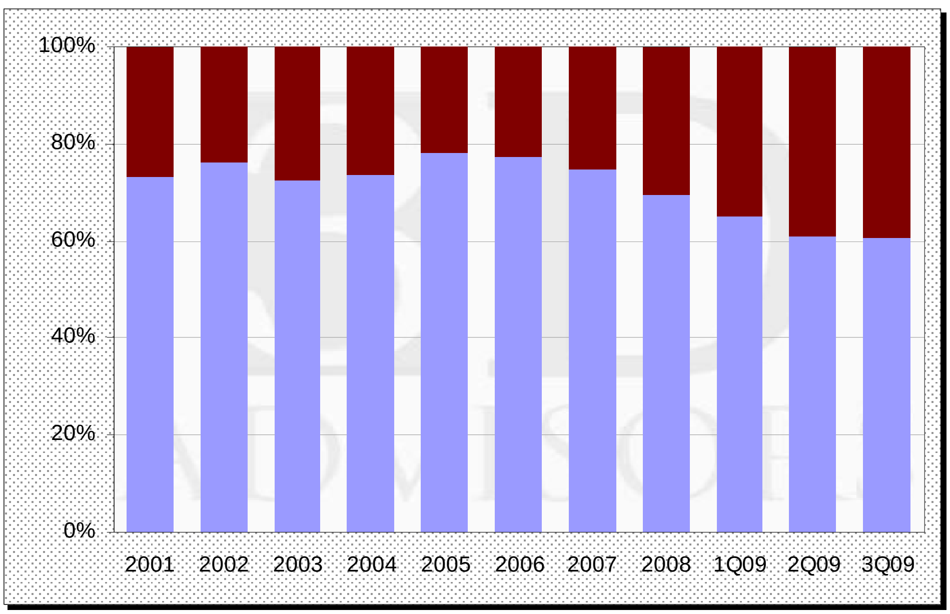
*Fiscal year end is September 30.

Y/Y Revenue Growth* (%)	2007	1Q08	2Q08	3Q08	4Q08	2008	1Q09	2Q09	3Q09
Products	28.9	19.7	16.7	17.4	8.2	15.3	-2.1	-16.1	-16.6
Services	48.9	57.2	49.3	46.5	43.6	48.6	31.1	27.7	23.2
Total	33.4	28.5	24.7	25.0	17.6	23.7	7.4	-3.1	-4.4

* Fiscal year end is September 30.

Between 2001 and 2007, product revenue regularly ranged between 73% and 78% of FFIV revenues each year, the balance being service revenue which is typically derived from customers to whom products were sold in earlier periods. The proportion of product revenue, which peaked in 2005 and 2006 at about 78%, has been trending downward sequentially ever since and is now at 61% (3Q09).

Figure 4. Percentage of Net Revenue Derived from Product Sales (Blue Bars) and Service Sales (Red Bars). Source: FFIV SEC Filings.



The fact that service revenue has been sustaining FFIV revenue has not been lost on analysts, generating several related analyst questions on the 1Q09 and 2Q09 conference calls. CFO Reinland had no wiggle room on the rather diplomatically asked question during the Q2 call:

> **Analyst:** Andy, with regards to the service revenue, which again, continues to grow very nicely, just by taking the midpoint of your guidance and your comment that you expect service revenue to grow again quarter over quarter implies that at the very least you're expecting a decline possibly in product revenue again in the June quarter. When is it that you think service revenues get hurt if product

doesn't reverse its course? How would you say is your level of visibility 12 months forward into that growth pattern of services right now versus where it was two quarters ago?

Andy Reinland, CFO: The visibility I would say is still similar, but we just can't ignore the reality of what we've seen with the product growth, and obviously that's going to affect the service growth over time. So given the assumption the product revenue doesn't start to grow, we'll see service revenue keep slowing. I think for the next two quarters, definitely, it should still be fairly strong. Not as strong as we saw last year but fairly strong.

The Q209 conference call was peppered with questions concerning the continued fall off in product revenue and what effect it would eventually have on service revenue, which had managed to keep at least some modest revenue growth going. Perhaps the most interesting exchange was this one from the call:

Analyst: My question is about services. Obviously the past several quarters service growth has been positive while the product revenues gone the other way. Could you talk about, please, some of the drivers behind that and to what extent we would expect that to continue in the future? I worry there will be a fall off in the service revenue commensurate, or at least in the same general direction as product revenue.

Edward Eames, SVP of Business Operations: Yes, there are four constituents. The first is consulting and training, which is the smallest piece of it, so that has probably fallen off the furthest already because that's the first discretionary spend most companies cut, so I don't think that's going to fall any further than it has. [And this is always] a direct correlation with the product sales, so that will follow along with that. And renewal has continued at a very strong rate. Add to that, during this year, we have stopped the support of Version 4 and have reduced some of those contracts, so I can see the growth of renewal continuing for some time.

Analyst: So even though the product revenue is now below the run rate that it's been for the past year or so we should still expect service revenues for several more quarters, or do you think that there's a large base of service opportunities to sell into for the next several quarters?

Edward Eames: I think definitely for a couple more quarters. It's not a case of looking for a base that's not contracted, because our attach rates are still very high, and have continued at that rate. But it's making sure we convert every initial contract into renewal as the time period goes on, and we've been successful at doing that over the last five years or so.

To the above, we remind the reader that Edward Eames this year has been routinely selling out all actionable holdings as soon as they vest and holds no vested stake in F5 equity.

And finally, in addition to sagging product revenue growth, FFIV appears to be at a disadvantage vis-à-vis its main competitors as it is paying more for its dwindling sales growth. In the latest quarter (3Q09, ended 06/30/09) sales and marketing expense ate up 35% of revenues, up from 33.7% in 2Q09. Cisco, on the other hand, saw percentages of just 24% and 23.7% for the same periods, respectively. For this fiscal year 2008 (ended 09/30/08), the 36.5% of net revenue that FFIV spent on sales and marketing far surpassed Cisco's 21.2%. So, it is no surprise to us that the percentage of each sales dollar brought to the bottom line has eroded in each of the past five years. In 2008 it was about half of what it was in 2004. In 2008, sales and marketing expense increased 35% in pursuit of 24% top line growth. Clearly, revenue growth with a disproportionately smaller percentage of the sales dollar coming to the bottom line is hardly a formula for long-term success.