



This 3DAdvisors Report Covers:

- ✓ **Insider Trading:** Insider Trading Behavior
- ✓ **Accounting:** Quality of Earnings Issues
- Governance:** Corporate Governance Issues

ELX Books One-Time Gains While Insiders Cash Out Emulex Corporation (NYSE:ELX)

July 2, 2003

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

Emulex Corporation is a designer, developer and supplier of a broad line of storage networking host bus adapters (HBAs) and application-specific computer chips (ASICs) that provide connectivity solutions for storage area networks (SANs), network-attached storage (NAS) and redundant array of independent disks (RAID) storage. HBAs are the data communication products that enable servers to connect to storage networks by offloading communication processing tasks as information is delivered and sent to the network. The Company's products are based on internally developed ASIC and embedded firmware and software technology, and offer support for a wide variety of SAN protocols, configurations, system interfaces and operating systems.

Summary of 3DAdvisors Findings for ELX

- ▶ **Accounting:** Earnings benefited from repurchase of convertible securities
- ▶ **Accounting:** Cash flow enhanced by insurance reimbursement
- ▶ **Insider Trading:** Insider behavior seems to reflect valuation concerns

Discussion of 3DAdvisors Findings

Accounting: Earnings benefited from repurchase of convertible securities

In Q1 of 2003, Emulex booked a \$28 million gain, or about \$0.35 of the reported \$0.39 EPS for the period, when the Company bought back \$136.5 million of its outstanding convertible subordinating notes, picking them up for what would seem to be bargain prices (about \$102.7 million). These notes had been issued just six months prior, to the tune of \$345 million, to buyers we must assume could not be too happy with the deal. The repurchase gains continue to represent the largest financial effect on the bottom line this year. The gain continues to represent 60% of the reported EPS through the nine-month period, ending in Q3.

In its favor, the Company did not try to hide this. In the Q1 release conference call, management discusses net income on a pro forma basis, without the effect of this

transaction. They then pat themselves on the back by saying, repeatedly, how they took advantage of market conditions to make this move that enhanced shareholder return.

Now, in the Q3 earnings release and conference call, nothing was said about any further repurchases of these notes. The related "Q" does however, and it is fairly evident that they plan to go back to this watering hole again. During the period ending 3/31/03, the Emulex Board of Directors expanded its share repurchase program to cover an additional \$190 million of these convertible subordinated notes. It's interesting to us that, since Emulex began repurchasing these notes, all conventional share repurchasing has ceased.

It remains curious how so many of the notes have come available for Emulex to so opportunistically to repurchase. The notes become due 2/7/07, so it's not as if the buyers were deep in the whole. Also, there's interesting detail of the Note Issuance that, upon a change of control, the notes could be sold back to Emulex for Par, so why not just hang in there? It is curious matter to us when something such as this offers a ready-made boost to earnings only if the counterparties to the trade allow for it to happen. The fact that it is seems about to happen again is doubly interesting.

Accounting: Cash flow enhanced by insurance reimbursement

Operating Cash flow in that Q3 period was enhanced 66% by \$27 million from insurance carriers in reimbursements for the Company's settlement of various class action suits. This injection helped Emulex report Cash From Operations at \$67 million for the nine-month period. Without the settlement reimbursements, this number would have been \$40 million, vs. \$64 million the corresponding previous nine-month period.

Insider Trading: Insider behavior seems to reflect valuation concerns

Emulex share price took a big hit with the release of the Company's Q3 results on April 24, dropping a quick 24%. Company guidance indicating slower revenue growth was not what analysts and investors wanted to hear. Several analysts downgraded the stock on the news.

Even though ELX has clawed its way back during the recent tech stock rally, we find it interesting (no, fascinating) that so many Emulex insiders have surfaced to unload shares, both before and after the Q3 release. Adding to our interest is the fact that so many of them had not sold since the shares were trading at or near the all-time 2000/2001 peak; and yet they are now converging in the same time frame. Adding to this story is the fact that Emulex shares have been in the doldrums since late last year and have lagged the performance of a number of industry peers in the recent stock market strength. Consequently, the insiders involved do not have "profit taking" to use as the excuse for their collective reactions at this time. This is the type of selling that can easily be missed, when it occurs during a veritable blizzard of overall insider selling, the likes of which we've been seeing in this recent market rally. With no real profit-taking motive to force their actions, it would seem that these insiders have found some other reason to act at this time.

The most interesting seller is Chief Technology Officer, **Ronald Quagliara (53)**. He has been with the Company since 1995, having been appointed to his current position in July of 2002. Quagliara exercised options for just over 23,000 shares in late May, and sold 51,432, many more than he had acquired upon the exercise. He got just under \$24 for the shares. He's selling more here than he did at slightly higher prices last November (20,000 at \$26 each). In fact, the sales have trimmed his holdings by about 17%. Quagliara has been a filing insider since at least 1999, yet these are his largest-ever sales. Quite interesting when you consider how high the shares were going for back in the 2000/2001 period. His only sales that came close were at end of 2001, in the \$70 to \$80 range, a few months before the shares careened to their current levels, apparently to stay. But he's not all; there are plenty of other interesting sellers:

Kirk Roller (40) - President and COO. Mr. Roller has exercised options for, and gotten out of, 74,998 shares between late April and mid May, at prices in the \$21 to \$22 range. These sales trimmed his holdings by 49%, a big drop by today's standards. These sales far-surpassed any selling done by Roller back in Emulex's peak years. In fact, with the exception of a 17,300-share sale in February of 2002, these are his first large sales since back in October/November of 2001.

Michael Smith - Executive President, Worldwide Marketing. He decided to sell 16,250 shares, in May, after exercising options for 10,000. In the past, Smith has typically sold either what he had exercised for, or far less. This is the first time he has ever sold an amount exceeding his exercises.

William Gill (45) - Executive V.P. Worldwide Sales. He sold 21,250 shares, in late May, for prices in the \$20 to \$22 range. Gill has been with the Company since early 2000 and has only sold once in the past (2,500 shares in February of 2001).

Sadie Herrera (53) - Executive V.P. Human Resources. She sold 21,700 shares, on May 30th, for prices just below \$25 each. Prior to this, she had primarily exercised options and held shares, or sold part of those exercised for. This is the first time she had ever trimmed her position in such a fashion (i.e. sold shares out of holdings, without exercising options to get them). It is also the first time she has sold a share since November of 2001.

Paul Folino (50) - Chairman and CEO. He dropped 49,000 shares between April 30th and May 30th at prices between \$20 and \$25. Unlike the others, he has been a bit more of a regular seller, having dropped shares in May of 2002 (65,000 at \$31.64), February of 2002 (92,000 at \$36.97). Interesting though, how each of his sales has occurred at lower prices than the previous.

To this group, add sales by Directors **Cornelius Ferris** (20,000 in May for \$22.22 each), and **Michael Downey** (10,000 in May for \$22.50 each).

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