ADVISORS

This 3DAdvisors Report Covers:
✓ **Insider Trading**: Insider Trading Behavior
✓ **Accounting**: Quality of Earnings Issues
✓ **Governance:** Corporate Governance Issues

Big Selling and Holdings Reductions at Lower Prices F5 Networks Inc. (NASDAQ:FFIV) Update

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F5 Networks, Inc. is a provider of application traffic management products. The Company develops, manufactures and sells products and services to help companies efficiently and securely manage their Internet traffic. The Company's BIG-IP application traffic management products help manage Internet protocol (IP) traffic to servers and network devices in a way that maximizes the availability, scalability and throughput of those network components and the applications that run on them. F5 Networks' complementary FirePass products provide secure user access to corporate networks and applications, enabling companies to extend secure remote access to anyone connected to the Internet by leveraging standard Web browser technology. The Company's TrafficShield application firewall product provides security for IP-based applications and data, protecting them from hackers and other malicious attacks at the application layer. On May 31, 2004, F5 Networks acquired MagniFire Websystems, Inc.

Summary of 3DAdvisors Findings for FFIV

- **Insider Trading:** Big selling and holdings reductions at lower prices
- **Governance:** Sudden shift in option granting behavior not a surprise
- **Accounting:** Employee option exercises generate bulk of cash flow
- **Accounting:** Key reserves are maintained at lowest possible level

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Discussion of 3DAdvisors Findings

After dropping to as low as $42 in the May weakness, and after our earlier reports covering the Company (in an *Insider Research Bulletin* on 03/09/05 and a full report on 04/13/05), we were surprised to see additional significant selling and holdings reductions from F5 Networks insiders into the first rebound, a bounce taking the shares back to the $50 range.

In our first two reports, we focused on the fact that, under the cover of 10b5-1 trading plans, certain key insiders at the Company had accelerated their selling to the point where they had significantly slashed their holdings far beyond what we would expect under 10b5-1 trading plans, which are supposed to be for normal “safe harbor” diversification efforts. Additionally, the holdings reductions for the related insiders occurred during a time when option grants had been on the decline at the Company. Driving our curiosity at that time was the fact the only remaining options to vest for these sellers would do so in May. **With one minor exception, none of the group of executives held any unvested options beyond those that would have vested in May of this year** (directors had a small amount under the director option program).

Needless to say, we hardly expected to see that, when those May options vested, the executives involved would move so quickly to exercise their entire amounts, selling all of the underlying shares in the process, and these were options not set to expire until 2014. **Rarely have we seen such a rush to liquidate holdings by a group of top executives as we are seeing at F5.**

Our full report (04/13/05) also revealed a subtle shift in revenue recognition whereby the Company changed the payment terms previously extended to “certain customers” from “when payments become due” to “when payments are made”. This intrigued us as it would seem that, by changing revenue recognition from a due date to an actual payment date, the opportunity for out-of-period recognition would have widened as it would be possible to ask these “certain customers” to delay payment in situations which may inure to F5’s benefit.

Evidence of manipulation of various allowances also caught our eye as the Company, in one fell swoop, reversed its entire valuation allowance for deferred tax assets attributable to its U.S operations in Q4 of 2004, and this after many periods of earnings volatility.

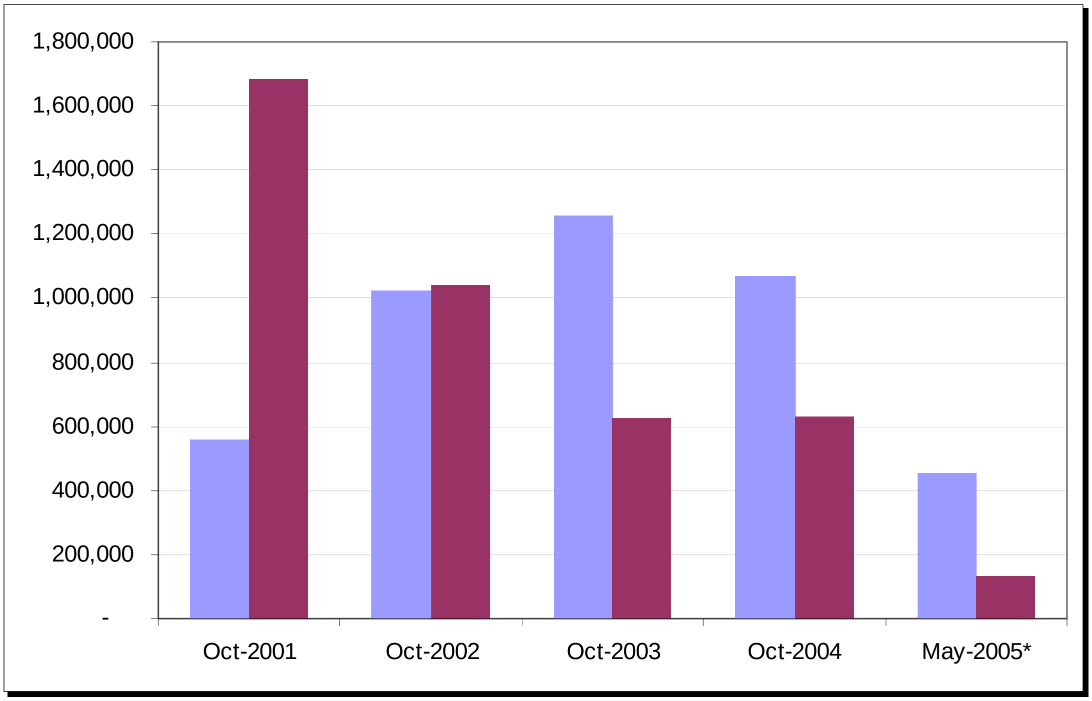
Last but not least, governance issues held our attention as well as the Company had gone through much effort to create individual option plans for each incoming senior executive in an apparent move to allow for issuance of options outside of the plans already approved by shareholders. By using this rare loophole (see our 04/13/05 report) the Company was able to circumvent the spirit of rules designed to prevent management from diluting shareholders without their approval.

Insider Trading: Big selling and holdings reductions at lower prices

Between May 2nd and May 18th, six executives sold 317,259 shares, adding to the insider trading and option behaviors at F5 that were already sending a loud signal. As was covered in our earlier reports, we have a classic situation where the number of options being granted over the last few years has fallen sharply, while insider option exercises have accelerated. The net effect on insiders’ option positions is dramatic, as shown in Figure 1. And since the underlying shares from these options are being sold and new option grants and vesting of older option grants is not keeping pace, the reductions in actionable positions (exercisable options plus common stock) is likewise extreme for the Company’s named executives, as shown in Table 1.

But there is more to this story than just unusually aggressive exercising and selling and subsequent rapid deterioration of holdings. Much more. Keep in mind that much of the aggressive selling here has taken place under the cover of “Automatic Sales”, or “Pre-arranged trading plans”, as the insider data services like to list dispositions occurring under 10b5-1 trading plans, suggesting the sales are unimportant and beyond the control of the insiders involved. In this case, however, it is very clear

Figure 1. Exercisable (Blue) and Non-Exercisable Options (Red) Held by Named Executives. Source: FFIV SEC Filings.



* The only non-exercisable options are held by Thomas Hull (131,250 options)

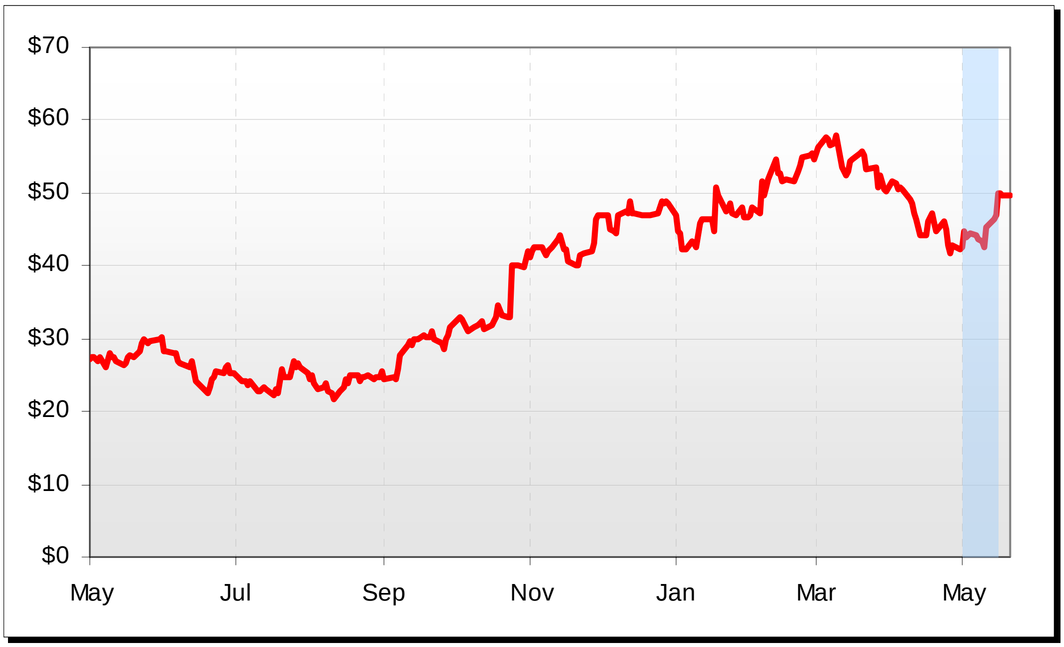
that F5 insiders have routinely abused their 10b5-1 plans by consistently increasing the shares sold under the plans to decimate their holdings. Furthermore, in this May round, the selling materialized quickly as the shares moved up off the recent lows, but still took place substantially below the level at which the previous round took place (see Figure 2 below). This type of selling behavior, where bouts of selling and big holdings reductions take place at successively lower prices, should never be ignored.

Table 1. Holdings Reductions for Named Executives. Source: FFIV SEC Filings.

Insider	Position	11/15/02	02/20/04	5/20/05	Reduction since 2002	Reduction since 2004
J. McAdam	Pres, CEO	772,776	615,610	302,209	**60.89%**	**50.91%**
S. Coburn	SVP, CFO	102,499	133,957	6,500	**93.66%**	**95.15%**
J. Pancottine	SVP, GM	228,349	187,787	1,646	**99.28%**	**99.12%**
E. Eames	SVP	171,134	234,649	125,020	**26.95%**	**46.72%**
T. Hull*	SVP	--	--	78,750	**N/A**	**N/A**
J. Reiter	VP, GC	--	110,900	10,976	**N/A**	**90.10%**

And finally, remember that the overall option granting behavior at FFIV is unusual, to say the least, which puts the Company's significant exposure to options expensing in a new light. We covered the governance issue in our 04/13/05 report having to do with the creating of plans for four specific insiders that allowed the Company to get around the requirement that the plans be shareholder approved. And in terms of options expensing, the Company estimated in its most recent Form 10-K that earnings would have been reduced by 58% (from $0.92 a share to $0.39) had options been expensed for the fiscal year ended September, 2004.

Figure 2. FFIV Daily Closing Price, May 3, 2004 through May 23, 2005. Blue shaded area is where six insiders sold 317,259 shares. Source: Reuters and FFIV SEC Filings.



- **John McAdam (53)** – President, CEO, Director. McAdam has been selling off a substantial percentage of his holdings since adopting a 10b5-1 trading plan back in November 2002. Since then, his quarterly selling has intensified, but since the Company hasn't disclosed any of its executives' trading plans parameters, it is unclear when his plans have started and are expected to expire. One thing is certain though, and that is that McAdam, after selling 120,000 shares on May 2nd at $42, now **holds 51% fewer shares** than he had in February 2004. The May activity stemmed from the exercise of two fully-vested options with plenty of time remaining before expiration (expiration dates: May 2012 and May 2013). Not only has he continued to sell, but his most recent trade was executed at 11% lower prices than his February 2005 activity. With the absence of any new option grants (or restricted stock grants), McAdam currently doesn't hold any unvested options, which makes the recent selling even more compelling (see Appendix A).

- **Steve Coburn (51)** – Senior V.P., Finance, CFO. Coburn started selling under the cover of a pre-arranged trading plan back in February 2004, but didn't display the same scheduled persistence as we've seen from McAdam. In fact, as FFIV shares have hit turbulence over the years, Coburn has manipulated his plan so that his sales have only been executed at incrementally higher prices, including his last sale of 95,000 shares in February 2005 at $47. That transaction drained a majority of his holdings, but we knew that he would have more options becoming actionable in April and May. What we didn't anticipate was that he would monetize those shares upon vesting, and for the first time, do so at lower prices than he'd taken for his shares in the past. On May 13th he exercised three series of options with expiration dates ranging between May 2011 and May 2014, and then sold the 63,500 shares at $45. With only 6,500 vested options and no common shares remaining, the sale **wiped out nearly all of what remained from his actionable holdings** which amounted to 130,000-plus shares just last year. Coburn currently doesn't have any unvested options (see Appendix A) so we don't foresee any sizeable selling in the near or long-term – he has nothing left to sell.

- **Jeffrey Pancottine (44)** – Senior V.P. and General Manager, Security Business Unit. No FFIV insider has displayed more self-serving abuses of 10b5-1 plans than Pancottine, who has been a Section 16 insider since 2000 but didn't begin diversifying his holdings until March 2003. Diversification might be the wrong term to use in this case, as Pancottine has actually distributed a majority of his ownership in the Company. Under his trading plan, Pancottine sold a total of 33,000 shares in 2003, which he followed up with 103,000 shares in 2004. Including the 49,167 shares he sold on May 9th and May 13th at $45, Pancottine has now sold 256,042 shares through the first five months of the year. **All that remains of the 187,787 shares he had access to in February 2004 are 1,646 shares of common stock (or, better put, a 99% reduction in his holdings)** as he recently monetized his last remaining vested options which weren't scheduled to expire until May 2013 and April 2014. What's more, he was willing to part with the remainder of his holdings at prices 10% lower than what he accepted for his shares back in February. Like most of his peers, Pancottine doesn't have any unvested options (see Appendix A).

- **Joann Reiter (47)** – V.P., General Counsel, Secretary. Reiter, a Company exec since 1999, has been selling quarterly since early 2003 under a pre-arranged trading plan, but it wasn't until late 2004 that she became noticeably more aggressive. After selling a total of 77,000 shares between October 2001 and September 2004, Reiter sold 89,000 shares in November 2004 as the issue established new highs. The sale accounted for a majority of her holdings, which prevented her from any material selling until new options vested. That transpired in April when her April 2014 options vested, which compelled Reiter to monetize the last of her options (expiration dates: May 2013 and April 2014) and sold the underlying 44,592 shares, **equal to 80% of her position**, between May 2nd and May 18th at prices ranging from $42 to $50. Most remarkable is that Reiter last sold 2,290 shares in March at $59, and then executed her first sale of 2,290 shares in the recent round at 29% lower prices. She then worked her way up to a 40,000-share sale just weeks later at $50, which was still 15% off her March activity. Though she doesn't have any vested or unvested options remaining, she still holds 10,976 shares of common, which oddly is the second largest common position of all FFIV execs (see Appendix A).

- **Edward Eames (46)** – Senior V.P., Business Operations. Though his selling has definitely picked up year-to-year, Eames has shown more restraint with his shares than other FFIV executives. After selling 140,000 shares in 2004 under his 10b5-1 plan, his 2005 activity, which includes sales on May 9th and May 13th totaling 40,000 shares at $45, top 101,000 shares. Not only has he **sold 47% of his holdings** since early last year, but his most recent trade was executed at an 18% discount to his last selling in March. Eames currently has 125,000 vested options, but only 20 shares of common (see Appendix A).

Governance: Sudden shift in option granting behavior not a surprise

With the past option granting behavior we have observed, combined with the recent heavy employee option exercises and selling that have dramatically depleted the holdings of senior management, we were very interested to see what the Company would do with new option grants in 2005. After all, shareholders did authorize the 2005 Equity Incentive Plan in February, which increased the number of shares that can be issued by 1.7 million, so we fully expected to see new grants in April or May, when they have been traditionally made.

In the last conference call, the issue of options came up, where the Company commented on both expensing options but also continuing to use options as an important tool to provide incentives to executives:

> **Analyst:**
>
> Okay, a slightly different subject, option issuance. The FAS rules on options obviously are still somewhat in flex. What are your plans on reporting options? If you decide to report options, will you report pro forma or will you report as is, and also will you change your option -- option issuance as a result of that -- that circumstance?
>
> **Steve Coburn, F5 Networks, Inc. - SVP of Finance, CFO**
>
> Yes. This is Steve. I'll answer the first part of the question, Alex. I think it's likely that we would report pro forma going forward at the time we adopt. We currently are evaluating the recently revised rules related to equity compensation expense, and expect to provide guidance on this matter next quarter.
>
> **John McAdam, F5 Networks, Inc. - President, CEO**
>
> And just -- just to -- to add to that, Alex, in case anybody's in any doubt, we -- we are very, very committed to continue with giving options to employees, because we think it's very critical for retention and recruitment, and our intention is to keep with it.

As of this writing, no new grants have been made to executive management. We called the Company to ask when they expected to make the grants, and a senior 3DA analyst had the following exchange with an HR representative at the Company:

> **3DA**: Could you give us an idea of when we might expect to see the next round of incentive awards to your executives? Since the shareholders approved the 2005 Incentive Plan in February we've noticed that directors have received awards but none to date for the execs.
>
> **F5**: We can't provide that information. There is a changing landscape and we are currently reviewing our options.

3DA: Well, your Company typically provides between one and three awards per year and we haven't seen any new grants in the past 52 weeks.

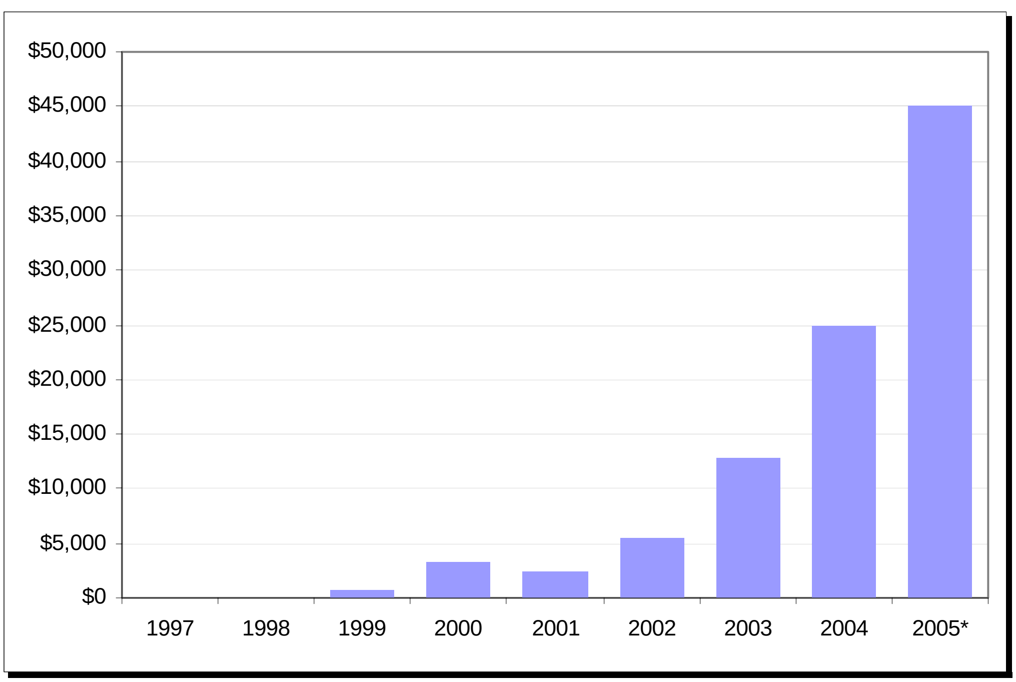
F5: Again, we're not giving out this information. The board is reviewing this matter.

Since the Company won't tell us or investors exactly what is going on, we are left to speculate on why there has been a sudden shift in granting behavior. It seems perfectly reasonable that the board may be reviewing the use of options, despite the views of Mr. McAdam, given that they don't appear to be providing long term incentives as executives have taken to exercising options as soon as they become available and selling all the shares. That and the fact that the Company will soon be required to recognize a pretty heavy options expense, have probably given the board plenty of reason for pause. Needless to say, the recent option exercises and holdings reductions have left us very interested in this shift in behavior.

Accounting: Employee option exercises generate the bulk of cash flow

Not only do we see aggressive selling by Section 16 filing insiders but also evidence that significant broad-based selling is underway at the regular employee level as well. This is revealed in the proceeds received by the Company (and the attendant tax benefit) from employee stock option exercises. As you can see in Figure 3 below, the activity is absolutely off the charts. It has been our observation, over the 24 years that we have been analyzing insider behavior, that the vast majority of the time, when rank and file employees exercise options, the underlying shares are promptly sold.

Figure 3. Cash Received From Employee Option Exercises ($000). Source: FFIV SEC Filings.



We are compelled to wonder what F5 cash flow would look like had the employees not been selling so aggressively. For the first six months of F/Y 2005, the Company generated $31 million in Cash from Operations vs. $18.6 million the corresponding period in 2004. The 2005 number, however, was aided significantly by a $24.4 million tax benefit from employee stock option exercises. Without this benefit, Cash from Operations would have been an anemic $6.7 million, far below the number generated for the same period in 2004, a period when no such tax benefit aided Cash from Operations. It is quite clear that option exercises are cash flow's *sine qua non* (the essential ingredient).

The same holds true for cash generated from these employee exercises which hit $45.1 million for the six month period ending 03/31/05. With Cash and equivalents registering just $21.7 million at the end of the period, we are left to wonder how much the absence of that extra $45 million in proceeds would have affected the business plan for the period.

Accounting: Key reserves are maintained at the lowest possible level

F5 maintains certain key reserves at the lowest possible levels. Take, for instance, the situation concerning product warranties. The Company "accrues for warranty costs as part of its cost of sales based on associated material product costs and technical support for labor costs." It is clear, from looking at the numbers, that the provisions track the actual payments and that their reserve simply covers essentially one year's worth of cost. Should anything large come up, the reserve would be hard pressed to handle the situation.

Table 2. Activity Related to Product Warranties During the Three Months and Six Months Ended March 31, 2005 and 2004 ($000). Source: FFIV 2005 Q2 Form 10-Q.

	Three months ended March 31		Six months ended March 31	
	2005	2004	2005	2004
Balance, beginning of period	$ 1,062	$ 829	$ 1,062	$ 827
Provision for warranty issued	272	116	538	214
Payments	(271)	(115)	(537)	(211)
Balance, end of period	$ 1,063	$ 830	$ 1,063	$ 830

Likewise, the A/R Allowance seems at minimum levels as well. Indeed, with Receivables up 53%, at 3/31/05, over the same six month period the prior year, F5 managed to reduce it's A/R Allowance by almost 7%.

To this, F5 uses the safe harbor that its reserve process relies on historical data. To this we would comment that although certain reserves has proven adequate based on past revenue levels, it appears that no consideration has been given to the likelihood that higher warranty and/or A/R write off expense could be expected to accompany the higher revenue numbers currently being experienced by the Company. Unless there is good reason to believe that additional business will be accompanied by a combination of much higher quality of collectibility and less warranty payments, of which no indication is given, we would expect that they are facing an increase in the related reserves come year-end upon the auditor review of the situation.

It would seem that F5 is delaying the inevitable for a few quarters.

Appendix A

Option and Restricted Stock Vesting Schedules for Selected F5 Networks Inc. Insiders

Grant Date	Equity Type	Options/ Shares	Strike Price (Options)	First Vesting Date	Expiration Date (Options)	Remaining Options/Shares in Series	Unvested Options/Shares in Series	Vesting Dates of Remaining Restricted Shares/Options
John McAdam, President, CEO, Director. Common Stock Holdings: 57,209 shares								
05/08/03	Options	160,000	$14.64	06/08/03	05/08/13	145,000	0	Fully Vested
04/30/04	Options	100,000	$25.49	04/30/05	04/30/14	100,000	0	Fully Vested
Steve Coburn, Senior V.P.-Finance, CFO. Common Stock Holdings: 0 shares								
05/29/01	Options	200,000	$12.72	05/29/02	05/29/11	4,200	0	Fully Vested
05/08/03	Options	55,000	$14.64	06/08/03	05/08/13	2,300	0	Fully Vested
Jeff Pancottine, Senior V.P., General Manager-Security Business Unit. Common Stock Holdings: 1,646 shares								
No Options Remaining								
Edward Eames, Senior V.P.-Business Operations and Global Services. Common Stock Holdings: 20 shares								
05/06/02	Options	70,000	$11.12	06/06/02	05/06/12	70,000	0	Fully Vested
05/08/03	Options	55,000	$14.64	06/08/03	05/08/13	55,000	0	Fully Vested
Thomas Hull, Senior V.P.-Worldwide Sales. Common Stock Holdings: 0 shares								
10/10/03	Options	225,000	$23.69	10/20/04	10/20/13	170,000	131,250	4,687 vest per month
04/30/04	Options	40,000	$25.49	04/30/05	04/30/14	40,000	0	Fully Vested
Joann Reiter, V.P., General Counsel, Secretary. Common Stock Holdings: 10,976 shares								
No Options Remaining								