

# Brokerage Research Digest

February 11, 2013

www.Zacks.com

www.ZacksPro.com

<b>F5 Networks Inc.</b>	<b>(FFIV – NASDAQ)</b>	<b>\$103.52</b>
-------------------------	------------------------	-----------------

**Note:** More details to come; changes are highlighted. Except where highlighted, no other sections of this report have been updated.

**Reason for Report:** Flash Update: F5 Networks Buys LineRate Systems

**Prev. Ed.:** January 24, 2013; Flash Update: 1Q13 Earnings Update

**Note:** November 20, 2012; 4Q12 Earnings Update (brokers' material are as of October 31)

## Flash News Update

On **Feb 11, 2013**, F5 Networks Inc. announced the acquisition of a privately-held networking services provider, LineRate Systems, for an undisclosed amount. The acquisition will further strengthen F5's exposure to the networking market. The networking giant does not expect the acquisition to have a material impact on its operating results.

Colorado-based LineRate Systems specializes in providing software solutions that help scale network services for better web-traffic management. The company is a key player in the Software-defined Networking (SDN) market and is expected to pave the way for F5's penetration within the segment.

Software-defined networking is an approach to networking in which control moves from hardware to a software application called a controller. A network administrator uses these controllers to direct and regulate network traffic from a centralized hub. This minimizes the use of different and expensive switches for controlling web-trafficking and helps in uninterrupted traffic flow. Another important factor for choosing SDN technology is that it is applicable for both private and public cloud infrastructures.

The SDN approach to networking is gaining popularity among key networking players such as Cisco Systems Inc. (CSCO), Juniper Networks Inc. (JNPR), Brocade (BRCD) and many more.

F5 already leads the Application Delivery Controller (ADC) space. LineRate greatly increases F5's chances of overshadowing its peers in the SDN space.

**MORE DETAILS WILL COME IN LATER, IMMINENT EDITIONS OF ZACKS RD REPORTS ON FFIV.**

## Portfolio Manager Executive Summary [NOTE: Only highlighted material has been changed]

Headquartered in Seattle, Washington, F5 Networks Inc. (FFIV) provides products that optimize and secure application traffic on Internet Protocol (IP) based networks. Founded in 1996, F5 Networks shares began trading in June 1999, with follow-on offerings in October 1999 and November 2003. The company also received an investment from Nokia Finance International B.V. in 2001. In July 2003, the company acquired the assets of privately-held SSL specialist uRoam. In June 2004, FFIV acquired MagniFire WebSystems for its application layer traffic filtering (applications firewall). In October 2005, the company added WAN optimization and application acceleration technology with the acquisition of Swan Labs Corporation. In September 2007, FFIV acquired Acopia, which provides storage virtualization products.

Key factors for evaluating an investment strategy for FFIV are as follows:

- The company continues to lead the application switching market, but faces challenges in expanding into complementary markets.
- F5 Networks has several new product cycles (VIPRION, WANJet, and anticipated refresh on the low-end of the BIG-IP portfolio) that could lead to substantial upside in the long term.
- Diversification efforts for Acopia appear to be paying off with traction in verticals, such as manufacturing and technology.

**Competitive Position:** F5 Networks possesses a competitive leadership position over ARX, BIG-IP, and VIPRION. However, Cisco Systems Inc. (CSCO) represents the greatest competitive threat to FFIV, given dominance of the former in the overall networking market. Cisco has tremendous engineering and marketing resources at the company's disposal. Although Cisco has failed to catch up with FFIV's technology lead for many years, it could potentially become more competitive if it decides to invest more aggressively in the technology. In addition, Citrix Inc. (CTXS) also has a strong technology platform that could pose a more significant competitive threat, if it improves execution.

Analysts' sentiments are mixed in nature with roughly 51.7% of the analysts in the Digest group being positive, 48.3% being neutral, and none being negative on the stock. The target prices, as per the Digest model, range from a low of \$83.00 to a high of \$130.00, with the average being \$104.07. The analysts expect FFIV to yield an average return of 26.0% in future.

**Bullish Stance (Buy or equivalent ratings) – 15 analysts or 51.7%:** The analysts believe that the company is uniquely positioned to benefit from application networking market growth prospects as enterprises cope with the rapidly increasing capacity and security demands of next-generation applications and architectures. The analysts expect a huge opportunity in the application traffic switching market along with robust technology and broad brand name recognition. They believe that new products and better execution could drive upside growth over the longer term. Given the strong competitive positioning and growth potential, the analysts remain positive.

**Neutral Stance (Neutral or equivalent ratings) – 14 analysts or 48.3%:** Although the analysts with a neutral stance are optimistic on FFIV, they remain cautious for the near term. The analysts believe FFIV has an entrenched position in the data center, as the advanced features of the BIG-IP application delivery controller create high switching costs and high barriers to entry. But, the analysts do not find the valuation compelling as growth is limited in the near term. Weak product growth led to lower visibility, which is pinning investor concern.

**General Long-Term Outlook on FFIV:** The analysts believe F5 to be a strong player in the fast growing Application Delivery Controller (ADC) market. The macro uncertainty and stringent budget cuts are rationalizing F5's fundamentals. But the analysts remain confident that the company is well positioned to benefit from positive secular themes when the business climate improves. The analysts expect increases at 3-year compound annual growth rates (CAGRs) of ('12-'15) of 15.6% in total revenue, of 15.4% in pro forma net income, of 17.2% in GAAP net income and of 13.8% in cash flow from operations.

## Overview [NOTE: Only highlighted material has been changed]

Key investment considerations as identified by the analysts are as follows:

Key Positive Arguments	Key Negative Arguments
<ul style="list-style-type: none"> <li>Balance sheet continues to be strong.</li> <li>The company has a solid product roadmap and the analysts expect continuous growth and market share gains in the long term.</li> <li>Competitive advantages resulting from years of investment in FFIV's architecture and interfaces that enable software companies to directly interact with F5's equipment provide the company with a unique advantage in the market.</li> </ul>	<ul style="list-style-type: none"> <li>F5 Networks participates in a competitive market against Cisco, Nortel, Juniper, Foundry, Citrix, Checkpoint, Avenail, Nokia, and Symantec. These companies have superior resources that could translate into better products.</li> <li>Lack of operating leverage could pose weakness for the company as compared to its peers.</li> <li>The company's long-term growth is predicted on its ability to gain traction with its SSL VPN products. This is largely a nascent market, the long-term growth of which remains relatively uncertain.</li> </ul>

Seattle WA-based **F5 Networks Inc. (FFIV)** provides products and services to manage Internet traffic worldwide. Its application, delivery, networking products improve performance, availability, and security of applications running on networks that use the Internet Protocol (IP). The company offers **BIG-IP** products to manage IP traffic between network servers, clients, and other devices. The company's **FirePass** systems provide SSL VPN access to remote users of IP networks, and any applications connected to those networks from any standard Web browser on any device. It also offers **TrafficShield**, a Web application firewall that provides an application-layer protection against generalized and targeted attacks; **WANJet** devices to combine wide area network optimization and traffic shaping in a single device to accelerate file transfers, email, data replication, and other applications over IP networks; and **WebAccelerator** that speeds up Web transactions, enhances Web application performance from any location, speeds up interactive performance, and improves download time. F5 Networks serves telecommunications, financial services, technology, manufacturing, and transportation enterprise customers, as well as the government. More information about the company is available at [www.f5.com](http://www.f5.com).

Note: FFIV's fiscal year ends on September 30.

## Long-Term Growth [NOTE: Only highlighted material has been changed]

F5 Networks is considered as one of the best growth stories in the sector, with a stable operating model and excellent cash flow. The company enjoys a strong market position in the Layer 4-7 content switching market. Management is also positive on FFIV's increasing push into the security market as it expects this to help increase its addressable market and revenue growth prospects.

While competitors are outlining application networking strategies, the analysts continue to believe that FFIV will likely maintain and grow its market share due to its lucrative position in the data center space while maintaining proximity with data applications. However, it is unclear at this point whether competing routers and switches can truly offer comparable levels of application intelligence and deep packet inspection since these devices are physically located further towards the edge of the corporate network.

The company announced the extension of its carrier-class hardware with the release of a BIG-IP 11050 platform and VIPRION Performance Blade 200. The BIG-IP 11050 scales up to over 6M L7 requests per second and allows the heaviest traffic loads at both L4 and L7. The VIPRION Performance Blade 200 is an ancillary product to the VIPRION chassis and represents an overall upgrade of power and performance from an increase in memory, traffic throughput, and network interfacing ports.

According to the analysts, FFIV remains a well-operated company with a growing core market. The company is well positioned from a competitive perspective, has several different drivers that would improve sales growth, an efficient management team that has a history of execution, and a sound product roadmap that will focus on improving product performance, going forward.

## Target Price/Valuation [NOTE: Only highlighted material has been changed]

Provided below is a summary of valuations and ratings as compiled by Zacks Digest:

Rating Distribution	
Positive	51.7%↓
Neutral	48.3%↑
Negative	0.0%
Digest High	\$130.00↓
Digest Low	\$83.00↓
Avg. Target Price	\$104.07↓
Analysts with Target Price/Total	22/29

General risks to the target price, according to the analysts, include competition in the application traffic management space, and the capital spending trends of enterprises and service providers. Moreover, a broad-based slowdown in either market (enterprise or service) could offset the company's growth initiatives.

## Recent Events [NOTE: Only highlighted material has been changed]

On Jan 23, 2013, F5 Networks Inc. announced first quarter 2013 result.

### Revenues

F5 Networks reported revenues of \$365.5 million in the reported quarter, up 13.4% from \$322.4 million in the year-ago period. Revenue was at the lower end of the company's guidance of \$363.0–\$370.0 million. Higher Services revenue was partially offset by lower Product revenue.

Geographically, on a year-over-year basis, Americas grew 12.0% and represented 58.0% of revenues. Europe, the Middle East and Africa (EMEA) grew 22.0%, accounting for 23.0% of total revenue. Asia-Pacific grew 16.0%, representing 14.0% of total revenue, while Japan declined 11.0% and represented 5.0% of revenues.

By vertical, Telco was the strongest, accounting for 23.0% of total revenue. Financial accounted for 20.0% of revenues, followed by Technology, which represented about 13%. Government accounted for 11% of total revenue (including 5% from U.S. federal).

## Operating Results

Gross profit in the reported quarter surged 14.2% from the year-ago quarter to \$304.6 million. Gross margin escalated 50 basis points (bps) year over year to 83.3%.

F5 Networks' operating expenses increased 4.0% year over year, mainly due to a 30.6% rise in research and development expenses and 33.5% rise in sales and marketing expenses. Expenses increased due to continuous hiring. Operating income came in at \$109.1 million, up 9.3% from \$99.8 million reported in the year-ago quarter. Operating margin in the quarter was 29.8%, down from 31.0% in the year-ago quarter.

Reported net income was \$69.5 million or \$0.88 per share compared with \$66.5 million or \$0.83 a year ago. Excluding amortization of intangibles and acquisition-related expenses, but including stock-based compensation and related tax adjustments, non-GAAP EPS was \$0.88, compared with \$0.82 in the year-ago quarter.

## Balance Sheet & Cash Flow

Cash, cash equivalents and short-term investments totaled approximately \$517.8 million in the first quarter, up from \$532.2 million in the prior quarter. Receivables were \$209.1 million versus \$185.2 million in the prior quarter. Inventories were \$18.7 million, up from \$17.4 million in the prior quarter.

F5 Networks' balance sheet does not comprise any long-term debt. Cash flow from operations was \$144.8 million, down from \$148.6 million in the prior quarter. Capital expenditure was \$7.8 million versus \$11.3 million in the prior quarter. F5 Networks repurchased 555,000 million outstanding shares for \$50.0 million during the quarter.

## Guidance

For the second quarter of fiscal 2013, F5 Networks expects revenues of \$370.0 million to \$380.0 million, up 2.3% sequentially. On a GAAP basis, earnings per share are expected in the range of \$0.93–\$0.96. Excluding stock-based compensation expense, amortization of purchased intangible assets and related tax effects, the company estimates non-GAAP earnings per share between \$1.21 and \$1.24.

On **Oct 24, 2012**, F5 Networks announced its 4Q12 results. Highlights are as follows:

- **Revenue** increased 15.2% y/y to \$362.6 million from \$314.6 million in 4Q11.
- **Reported net income** was \$0.85 per diluted share compared with \$0.84 per share in 4Q11. **Non-GAAP EPS** was \$1.12 versus \$1.06 in the year-ago quarter.
- **Cash, cash equivalents and short-term investments** totaled approximately \$532.2 million, up from \$519.7 million in the prior quarter. **Cash flow from operations** was \$148.6 million, up from \$113.4 million in the prior quarter.

- F5 Networks **repurchased** \$50.0 million worth of its outstanding shares.

## Revenue [NOTE: Only highlighted material has been changed]

As per the press release, F5 Networks reported revenues of \$362.6 million in the reported quarter, up 15.2% from \$314.6 million in the year-ago period. Revenue was at the lower end of the company's guidance of \$360.0–\$370.0 million. Higher Services revenue was partially offset by slowing Product revenue. Also, strong growth in Europe, the Middle East and Africa (EMEA) and Asia-Pacific regions was somewhat muted by weak contribution from Americas. In FY12, total revenue increased 20.0% year over year to \$1.38 billion.

Book-to-bill ratio was equal to 1 in 4Q12, compared with less than 1 in the prior quarter. There were two 10.0% distributors in the quarter. Avnet Technology Solutions accounted for 16.8% of total revenue and Ingram Micro Inc. represented 12.8% of total revenue.

Geographically, on a year-over-year basis, Americas grew 8.0% and represented 56.0% of revenues. EMEA grew 29.0%, accounting for 22.0% of revenues. Asia-Pacific and Japan grew a respective 31.0% and 13.0%, representing 15.0% and 7.0% of revenue.

By vertical, Financial was the strongest, accounting for 20.0% of the total revenue. Telco accounted for 19.0% of revenues, followed by Technology, which represented about 17%. Government accounted for 17% (including 10% from U.S. federal).

Management was positive on the strength of its security products and believes it to be the key driver for growth, going forward. Management confirmed that software attach rates and European contribution were solid for its security products.

During the quarter, F5 noticed strong demand for its VIPRION chassis-based products, with year-over-year growth of 107%, driven by strong adoption of the mid-range VIPRION 2400 system as well as sales of the high-end VIPRION systems into the service provider markets.

Provided below is a summary of revenue as compiled by Zacks Digest:

Revenue (\$ M)	4Q11A	3Q12A	4Q12A	1Q13E	2011A	2012A	2013E	2014E
Zacks Consensus				\$368.0			\$1,568.0	\$1,808.0
Total Revenue	\$314.6	\$352.6	\$362.6	\$366.7↓	\$1,151.8	\$1,377.1	\$1,567.9↓	\$1,810.7↓
Digest High	\$314.6	\$352.6	\$362.6	\$368.6↓	\$1,152.0	\$1,377.3	\$1,612.6↓	\$1,937.5↑
Digest Low	\$314.6	\$352.6	\$362.6	\$364.0↑	\$1,151.8	\$1,374.8	\$1,540.4↑	\$1,732.7↓
Y-o-Y Growth	23.7%	21.3%	15.2%	13.8%	30.6%	19.6%	13.8%	15.5%
Q-o-Q Growth	8.2%	3.8%	2.8%	1.1%				
Management Guidance				\$363.0-\$370.0				

## Revenue by Segment

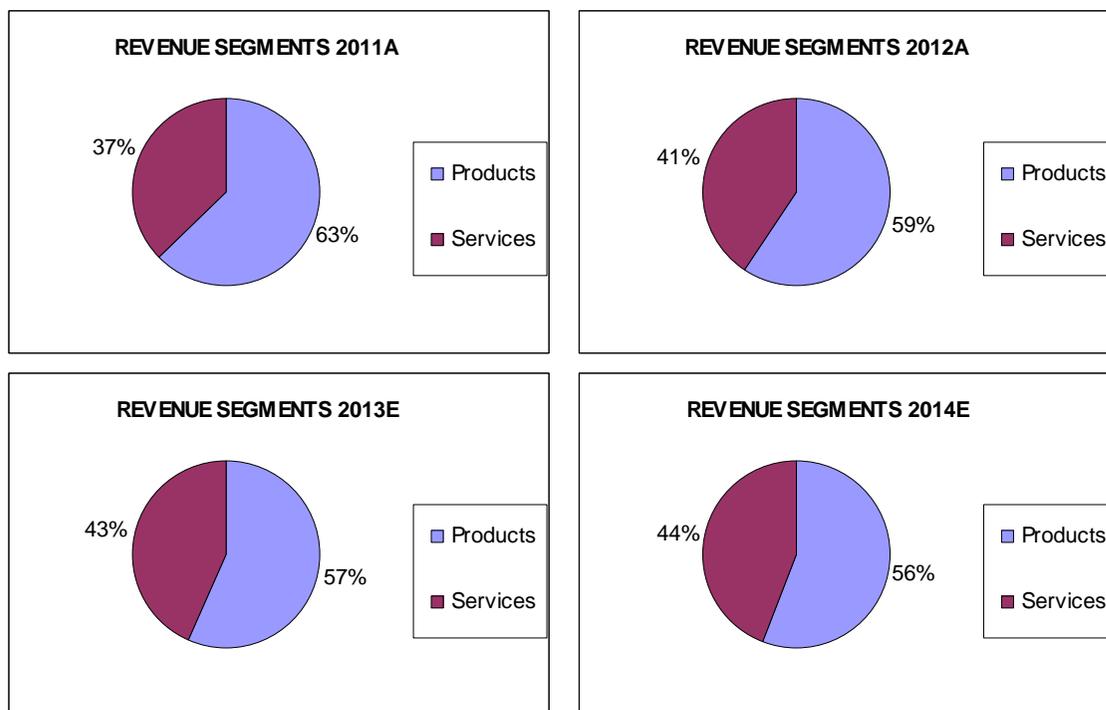
As per the press release, Product revenues were \$209.7 million (57.8% of 4Q12 total revenue) and Services revenues were \$152.8 million (42.2% of 4Q12 total revenue). Continuous enhancement of product suites and strong demand for its VIPRION, BIG-IP suites during the quarter led to a year-over-year growth of 6.2% in the Product segment. But this was partially offset by smaller deal sizes,

particularly among large U.S. enterprise and telecommunications customers. Revenues from the Services segment climbed 30.4% year over year, fueled by growth in new and renewed service maintenance contracts booked during the quarter.

Provided below is a summary of sources of revenue as compiled by Zacks Digest:

Revenue (\$ M)	4Q11A	3Q12A	4Q12A	1Q13E	2011A	2012A	2013E	2014E
Products	\$197.4	\$207.1	\$209.7	\$208.6↓	\$722.0	\$818.6	\$890.0↓	\$1,012.8↓
Services	\$117.2	\$145.5	\$152.8	\$158.2↑	\$429.9	\$558.7	\$678.7↑	\$798.4↑
Total Revenue	\$314.6	\$352.6	\$362.6	\$366.7↓	\$1,151.8	\$1,377.1	\$1,567.9↓	\$1,810.7↓

Provided below is a graphical analysis of sources of revenue:



## Outlook

Management stated that F5 will be introducing a range of products, which will drive solid revenue growth, going forward. But, at the same time, management expressed its concern about the macro uncertainties that could affect the near-term fundamentals. Management also remained concerned about an expected budget cut from telecom customers.

For 1Q13, F5 Networks expects revenues of \$363.0 million to \$370.0 million representing a flat sequential comparison.

Looking ahead to FY13, F5's goal is to reaccelerate product revenue growth through Big-IP appliance refresh and the introduction of new products such as Application Delivery Firewall (layer 3-7), DPI, and the next version of TMOS. Management expects to see sequential revenue growth throughout the year.

F5 also expects Traffix (acquired on February 2012) to start contributing materially toward revenues in 2014 as F5 sees good traction from customers for its diameter routing technology.

Though F5 seems to face the challenges of macro uncertainties (i.e. lower technology spending), analysts are positive on the basis of impending product refreshes, growing traction in the security market and share gains from archrival Cisco.

The analysts believe that F5 holds a major position in the ADC market as its products are important components for data center consolidation, virtualization and cloud services. Also, the decision of Cisco to shift its focus from the core ADC market will help F5 to capture market share.

The analysts also believe that the enterprise IT spending environment is improving along with data center spending. They believe FFIV to be the prime beneficiary of data center upgrades related to virtualization, SaaS, and cloud computing, which could drive above-average revenue growth as IT spending recovery continues.

Please refer to the Zacks Research Digest spreadsheet on FFIV for detailed revenue estimates.

## Margins [NOTE: Only highlighted material has been changed]

As per the company press release, **gross profit** in 4Q12 surged 15.9% from the year-ago quarter to \$299.9 million. Gross margin escalated 50 basis points year over year to 82.7%.

Total **operating expense** was \$188.0 million in 4Q12, up 18.0% y/y. Expenses shot up due to continuous hirings. **Selling and marketing (S&M) expense** surged 15.2% year over year to \$116.3 million in 4Q12. **Research and development (R&D) expense** was \$47.7 million in 4Q12, up 30.6% y/y. **General and administrative (G&A) expense** was \$24.0 million in 4Q12, up from \$21.9 million in 4Q11.

**Operating income** was \$111.8 million in 4Q12, up 12.6% from \$99.3 million in 4Q11. **Operating margin** was 30.8%, down from 31.6% in the year-ago quarter.

**Interest and other income** was \$0.9 million compared with \$4.1 million in the year-ago quarter. **Pre-tax income** was \$112.7 million in 4Q12, up 9.0% year over year. **Pre-tax margin** was 31.1% versus 32.9% in 4Q11. The **effective tax rate** was 39.9% versus 34.6% in 4Q11. This resulted from a higher than expected impact of foreign permanent tax differences and a higher blended effective state tax rate. **Net margin** was 18.7% versus 21.5% in 4Q11.

Provided below is a summary of margins as compiled by Zacks Research Digest:

Margins	4Q11A	3Q12A	4Q12A	1Q13E	2011A	2012A	2013E	2014E
<b>Gross</b>	83.0%	84.2%	84.0%	84.0%↑	82.8%	84.0%	83.9%↑	83.7%↑
<b>Operating</b>	38.6%	38.4%	38.6%	37.6%↓	38.2%	38.3%	38.3%↓	38.8%↓
<b>Pre-Tax</b>	39.9%	38.8%	38.8%	38.0%↓	39.1%	38.7%	38.7%↓	39.2%↓
<b>Net</b>	27.1%	25.7%	24.5%	24.9%↓	26.8%	25.3%	25.3%↓	25.7%↓

Note: Figures in the table are non-GAAP.

## Outlook

For 1Q13, management expects GAAP gross margin to be roughly 83.0%, including approximately \$3.0 million of stock-based compensation expense and \$1.0 million in amortization of purchased intangible assets. Management expects GAAP operating expenses in the range of \$193.5 million to \$198.5 million, including approximately \$25.5 million of stock-based compensation expense. The GAAP effective tax rate is expected to be 37.0% and non-GAAP effective tax rate is projected at 34.5%.

With the planned expansion of addressable market in areas like security and service providers, F5 intends to continue to invest aggressively in sales resources, services business, and development facilities. Hence, the company is planning to add more than 100 employees to its headcount in 1Q13.

Looking ahead, the company also expects GAAP gross margin of 83.0% for each quarter. It targets non-GAAP operating margins for FY13 to be roughly 38.0%, with some seasonal fluctuation. Consistent with 1Q13, FY13 effective tax rate will be 37% on a GAAP basis, and 34.5% on a non-GAAP basis throughout the year.

Please refer to the Zacks Research Digest spreadsheet on FFIV for detailed margin estimates.

## Earnings per Share [NOTE: Only highlighted material has been changed]

As per the press release, reported net income was \$0.85 per share in 4Q12, up from \$0.84 per share in 4Q11. The company's earnings missed its own guided range of \$0.90–\$0.93. The miss could be attributed to slowing Product revenue growth, higher expenses and tax rate.

Excluding the effect of stock-based compensation, amortization of intangibles and acquisition-related expenses, non-GAAP EPS was \$1.12 versus \$1.06 in the prior-year quarter. The non-GAAP EPS came below the company's guidance range of \$1.16–\$1.19.

In FY12, GAAP EPS was \$3.48, up 16.4%, while non-GAAP EPS increased 15.6% to \$4.37.

Provided below is a summary of EPS as compiled by Zacks Research Digest:

EPS	4Q11A	3Q12A	4Q12A	1Q13E	2011A	2012A	2013E	2014E
Zacks Consensus				\$0.88			\$3.95	\$4.77
Digest High	\$1.06	\$1.14	\$1.18	\$1.16↓	\$3.79	\$4.41	\$5.26↓	\$6.36↓
Digest Low	\$1.06	\$1.14	\$1.11	\$1.14	\$3.78	\$4.37	\$4.78↓	\$5.40↓
Digest Average	\$1.06	\$1.14	\$1.12	\$1.15↓	\$3.79	\$4.38	\$4.98↓	\$5.81↓
Y-o-Y Growth	34.5%	17.4%	5.9%	11.6%	50.6%	15.6%	13.7%	16.6%
Q-o-Q Growth	9.1%	4.5%	-1.6%	2.4%				
Non-GAAP Guidance				\$1.14-\$1.16				
GAAP Guidance				\$0.86 - \$0.88				

Note: Figures in the table are non-GAAP.

Following the earnings release, the majority of analysts decreased their FY13 and FY14 EPS estimates to reflect lower revenues, conservatism on Europe, US federal spending, a tightening of budget in financial services and large hiring plans.

## Outlook

For 1Q13, F5 Networks expects GAAP earnings per share in the range of \$0.86–\$0.88. Excluding stock-based compensation expense, amortization of purchased intangible assets and related tax effects, the company estimates non-GAAP earnings per share between \$1.14 and \$1.16.

The Digest model forecasts non-GAAP EPS to increase at a 3-year CAGR (2012–2015) of 15.4%, GAAP EPS at a CAGR of 16.9%, and shares outstanding at a CAGR of 0.0%.

Please refer to the Zacks Research Digest spreadsheet on FFIV for detailed EPS estimates.

---

## **StockResearchWiki.com – The Online Stock Research Community**

Discover what other investors are saying about F5 Networks Inc. (FFIV) at:

[FFIV profile on StockResearchWiki.com](#)

### DISCLOSURE

This material is being provided for informational purposes only and nothing herein constitutes investment, legal, accounting or tax advice, or a recommendation to buy, sell or hold a security. No recommendation or advice is being given as to whether any investment or strategy is suitable for a particular investor. It should not be assumed that any investments in securities, companies, sectors or markets identified and described were or will be profitable. All information is current as of the date of herein and is subject to change without notice. Any views or opinions expressed may not reflect those of the firm as a whole.