

# F5 NETWORKS INC

## FORM 10-Q (Quarterly Report)

Filed 2/14/2002 For Period Ending 12/31/2001

|             |  |
|-------------|--|
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| Industry    | Computer Networks  |
| Sector      | Technology   |
| Fiscal Year | 09/30  |



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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549**

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**FORM 10-Q**

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**[X] QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES  
EXCHANGE ACT OF 1934**

For the quarterly period ended December 31, 2001

OR

**[ ] TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES  
EXCHANGE ACT OF 1934**

For the transition period from            to

Commission File Number 000-26041

**F5 NETWORKS, INC.**

(Exact name of registrant as specified in its charter)

**WASHINGTON**

(State or other jurisdiction of incorporation or organization)

**91-1714307**

(I.R.S. Employer Identification No.)

**401 Elliott Avenue West  
Seattle, Washington 98119**

(Address of principal executive offices and zip code)

**(206) 272-5555**

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days: Yes  No .

Indicate the number of shares outstanding of each of the registrant's classes of common stock as of the latest practicable date: 25,208,139 shares of common stock, no par value, as of February 1, 2002.

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F5 NETWORKS, INC.

FORM 10-Q FOR THE QUARTER ENDED DECEMBER 31, 2001

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The accompanying notes are an integral part of these condensed consolidated financial statements.

**PART I — FINANCIAL INFORMATION**

*Item 1. Financial Statements*

**F5 NETWORKS, INC.**

**CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**

(unaudited, in thousands except per share data)

|   | Three months ended<br>December 31, |                   |
|---|------------------------------------|-------------------|
|   | 2001                               | 2000              |
| Net revenues:                               |                                    |                   |
| Products                                    | \$ 20,658                          | \$ 17,733         |
| Services                                    | 6,367                              | 7,000             |
| Total net revenues                          | <u>27,025</u>                      | <u>24,733</u>     |
| Cost of net revenues:                       |                                    |                   |
| Products                                    | 5,963                              | 8,086             |
| Services                                    | 2,694                              | 3,584             |
| Total cost of net revenues                  | <u>8,657</u>                       | <u>11,670</u>     |
| Gross profit                                | <u>18,368</u>                      | <u>13,063</u>     |
| Operating expenses:                         |                                    |                   |
| Sales and marketing                         | 12,440                             | 13,451            |
| Research and development                    | 4,137                              | 4,844             |
| General and administrative                  | 4,045                              | 4,688             |
| Restructuring charge                        | —                                  | 1,071             |
| Amortization of unearned compensation       | 133                                | 576               |
| Total operating expenses                    | <u>20,755</u>                      | <u>24,630</u>     |
| Loss from operations                        | (2,387)                            | (11,567)          |
| Other income, net                           | 505                                | 199               |
| Loss before income taxes                    | (1,882)                            | (11,368)          |
| Provision (benefit) for income taxes        | 189                                | (2,437)           |
| Net loss                                    | <u>\$ (2,071)</u>                  | <u>\$ (8,931)</u> |
| Net loss per share — basic and diluted      | <u>\$ (0.08)</u>                   | <u>\$ (0.41)</u>  |
| Weighted average shares — basic and diluted | <u>24,883</u>                      | <u>21,677</u>     |

The accompanying notes are an integral part of these condensed consolidated financial statements.

## F5 NETWORKS, INC.

**CONDENSED CONSOLIDATED BALANCE SHEETS**  
(unaudited, in thousands except share data)

|   | <u>December 31,<br/>2001</u> | <u>September 30,<br/>2001</u> |
|---|------------------------------|-------------------------------|
| <b>ASSETS</b>   |                              |                               |
| Current assets:   |                              |                               |
| Cash and cash equivalents   | \$ 13,680                    | \$ 18,321                     |
| Investments   | 58,740                       | 51,462                        |
| Accounts receivable, net of allowances of \$6,380 and \$6,245   | 20,548                       | 22,628                        |
| Inventories   | 2,830                        | 2,602                         |
| Other current assets  | 5,080                        | 6,885                         |
| Total current assets  | <u>100,878</u>               | <u>101,898</u>                |
| Restricted cash   | 6,000                        | 6,000                         |
| Investments   | 1,302                        | —                             |
| Property and equipment, net   | 14,876                       | 15,496                        |
| Other assets, net   | 1,366                        | 1,269                         |
| Total assets  | <u>\$124,422</u>             | <u>\$124,663</u>              |
| <b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>   |                              |                               |
| Current liabilities:  |                              |                               |
| Accounts payable  | \$ 3,607                     | \$ 4,460                      |
| Accrued liabilities   | 12,064                       | 11,517                        |
| Deferred revenue  | 11,840                       | 11,031                        |
| Total current liabilities   | <u>27,511</u>                | <u>27,008</u>                 |
| Long-term liabilities   | 1,245                        | 1,167                         |
| Commitments and contingencies:  |                              |                               |
| Shareholders' equity:   |                              |                               |
| Preferred stock, no par value; 10,000,000 shares authorized, no shares outstanding                                | —                            | —                             |
| Common stock, no par value; 100,000,000 shares authorized 24,969,000 and 24,764,000 shares issued and outstanding | 124,643                      | 123,393                       |
| Accumulated other comprehensive income  | 439                          | 573                           |
| Unearned compensation   | (403)                        | (536)                         |
| Accumulated deficit   | (29,013)                     | (26,942)                      |
| Total shareholders' equity  | <u>95,666</u>                | <u>96,488</u>                 |
| Total liabilities and shareholders' equity  | <u>\$124,422</u>             | <u>\$124,663</u>              |

The accompanying notes are an integral part of these condensed consolidated financial statements.

## F5 NETWORKS, INC.

**CONDENSED CONSOLIDATED STATEMENT OF CASH FLOWS**  
(unaudited, in thousands)

|   | Three months ended<br>December 31, |            |
|---|------------------------------------|------------|
|   | 2001                               | 2000       |
| <b>Cash flows from operating activities:</b>  |                                    |            |
| Net loss  | \$ (2,071)                         | \$ (8,931) |
| Adjustments to reconcile net loss to net cash provided by (used in) operating activities: |                                    |            |
| Restructuring charges   | —                                  | 1,071      |
| Provisions for asset write downs  | 275                                | 178        |
| Provisions for inventory write downs  | (43)                               | —          |
| Amortization of unearned compensation   | 133                                | 576        |
| Provision for doubtful accounts and sales returns   | 2,005                              | 5,615      |
| Depreciation and amortization   | 1,435                              | 1,087      |
| Deferred income taxes   | —                                  | (2,230)    |
| Changes in operating assets and liabilities:  |                                    |            |
| Accounts receivable   | 40                                 | 4,267      |
| Other Receivables   | —                                  | (2,388)    |
| Inventories   | (180)                              | (11,400)   |
| Other assets  | 1,680                              | (1,081)    |
| Accounts payable and accrued liabilities  | (711)                              | 2,857      |
| Deferred revenue  | 782                                | (1,285)    |
| Net cash provided by (used in) operating activities                                       | 3,345                              | (11,664)   |
| <b>Cash flows from investing activities:</b>  |                                    |            |
| Purchase of investments   | (30,037)                           | (9,856)    |
| Sales of investment   | 21,508                             | 15,271     |
| Purchases of property and equipment   | (657)                              | (5,822)    |
| Net cash used in investing activities   | (9,186)                            | (407)      |
| <b>Cash flows from financing activities:</b>  |                                    |            |
| Proceeds from the exercise of stock options and warrants                                  | 1,251                              | 976        |
| Repurchase of common stock  | —                                  | (1,082)    |
| Net cash provided by (used in) financing activities                                       | 1,251                              | (106)      |
| Net increase (decrease) in cash and cash equivalents                                      | (4,590)                            | (12,177)   |
| Effect of exchange rate changes on cash and cash equivalents                              | (51)                               | (54)       |
| Cash and cash equivalents, at beginning of period   | 18,321                             | 24,662     |
| Cash and cash equivalents, at end of period   | \$ 13,680                          | \$ 12,431  |

The accompanying notes are an integral part of these condensed consolidated financial statements.



**F5 NETWORKS, INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
(unaudited)

**1. The Company and Basis of Presentation:**

F5 Networks provides integrated products and services to manage, control and optimize Internet traffic and content. The Company's five core products, the BIG-IP® IP Application Switch & Controller, 3-DNS® Controller, GLOBAL-SITE™ Controller, EDGE-FX® Cache, and the SEE-IT™ Network Manager, help manage traffic and content to servers and network devices in a way that maximizes availability and throughput. F5's unique iControl™ Architecture integrates its products and also allows its customers to integrate the company's products with other third party products. The Company's solutions address many elements required for successful Internet and Intranet business applications, including high availability, high performance, intelligent load balancing, fault tolerance, security, streamlined manageability, and global data management and content control. By enhancing Internet performance availability and content distribution, the Company's solutions enable its customers and partners to maximize the use of the Internet in their business.

The condensed consolidated financial statements included herein have been prepared by the Company, pursuant to the rules and regulations of the Securities and Exchange Commission ("SEC") for interim financial statements and are unaudited. Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States have been condensed or omitted pursuant to such rules and regulations. However, the Company believes that the disclosures are adequate to make the information presented not misleading. The condensed consolidated balance sheet as of September 30, 2001 has been derived from the audited consolidated balance sheet as of that date. These unaudited condensed consolidated financial statements should be read in conjunction with the financial statements and the notes thereto included in the Company's Annual Report on Form 10-K for the fiscal year ended September 30, 2001, filed with the SEC on December 28, 2001.

The unaudited condensed consolidated financial statements included herein reflect all adjustments, (which include only normal, recurring adjustments) which are, in the opinion of management, necessary to state fairly the results for the interim periods presented. The results of operations for the interim periods presented are not necessarily indicative of the operating results to be expected for any subsequent interim period or for the full fiscal year ending September 30, 2002.

**2. Summary of Significant Accounting Policies:**

**Principles of Consolidation**

The consolidated financial statements and accompanying notes are prepared in accordance with accounting principles generally accepted in the United States of America. The consolidated financial statements include the accounts of the Company and all majority owned subsidiaries. Significant intercompany accounts and transactions have been eliminated in consolidation.

**Reclassifications**

Certain reclassifications have been made to prior year balances to conform to the current year presentation. These reclassifications had no impact on previously reported net loss, shareholders' equity, or total assets. The Company had previously reported cash equivalents and investments on a combined basis, as they are readily convertible to cash without penalty and subject to insignificant risk of change in value. The Company has presented investments separately within current assets and long-term assets based upon maturities and managements' intent with regard to those securities.

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### Use of Estimates

The preparation of financial statements is in conformity with accounting principles generally accepted in the United States of America and requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities as of the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Estimates that are particularly susceptible to changes in the near term are the adequacy of allowances for sales returns and bad debt, inventory obsolescence, warranty costs, useful lives of assets and deferred taxes.

### Revenue Recognition

The Company recognizes revenue in accordance with the guidance provided under Statement of Financial Accounting Standards (SFAS) No. 48, "Revenue Recognition When Right of Return Exists," SEC Staff Accounting Bulletin (SAB) No. 101, "Revenue Recognition in Financial Statements," Statement of Position ("SOP") No. 97-2, "Software Revenue Recognition," and SOP No. 98-9 "Modification of SOP No. 97-2, Software Revenue Recognition, with Respect to Certain Transactions."

The Company sells products through resellers, original equipment manufacturers and other channel partners, as well as directly to end users, under similar terms. Typically a software license, hardware, installation and customer support elements are combined into a package with a single "bundled" price. A portion of the sales price is allocated to each element of the bundled package based on their respective fair values when the individual elements are sold separately. Revenues from the license of software, net of an allowance for estimated returns, are recognized when the product has been shipped and the customer is obligated to pay for the product. When rights of return are present and the Company cannot estimate returns, the Company recognizes revenue when such rights lapse. Installation revenue is recognized when the product has been installed at the customer's site. Revenues for customer support are recognized on a straight-line basis over the service contract term. Estimated sales returns are based on historical experience by product and specific identification and are recorded at the time revenues are recognized.

### Cash Equivalents and Investments

Cash equivalents and short term investments are highly liquid investments, consisting of investments in money market funds and short-term investments, which are readily convertible to cash without penalty and subject to insignificant risk of changes in value. The Company's cash equivalents and investments balance consists of the following (in thousands):

|                           | December 31,<br>2001 | September 30,<br>2001 |
|---------------------------|----------------------|-----------------------|
|                           | (in thousands)       |                       |
| Cash and cash equivalents | \$13,680             | \$18,321              |
| Short-term investments    | 58,740               | 51,462                |
| Long-term investments     | 1,302                | —                     |
|                           | <u>\$73,722</u>      | <u>\$69,783</u>       |

### Concentration of Credit Risk

The Company places its temporary cash investments with five major financial institutions.

F5 NETWORKS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
(unaudited)

The Company's customers are from diverse industries and geographic locations. The majority of net revenues from international customers are denominated in U.S. dollars. These international revenues were approximately \$8.5 million for the three months ended December 31, 2001, and \$7.6 million for the three months ended December 31, 2000. For the three months ended December 31, 2001 and 2000, one customer accounted for 8% and 11% of net revenues, respectively. One customer accounted for 9% and 5% of the Company's accounts receivable balance at December 31, 2001 and 2000, respectively.

**Inventories**

Inventories consist of hardware, software and related component parts and are recorded at the lower of cost or market (as determined by the first-in, first-out method).

Inventories are comprised of the following:

|   | December 31,<br>2001 | September 30,<br>2001 |
|---|----------------------|-----------------------|
|   | (in thousands)       |                       |
| Finished goods                          | \$ 3,028             | \$ 3,283              |
| Raw materials                           | 1,254                | 1,347                 |
| Less: Provision for excess of inventory | (1,452)              | (2,028)               |
|   | <u>\$ 2,830</u>      | <u>\$ 2,602</u>       |

The Company established an estimated reserve for excess inventory based upon the Company's forecasted sales projections. Adjustments to this reserve are reflected as a component of cost of sales.

**Investment**

In December of 2001, the Company purchased, from a third party, approximately 16 million shares of common stock of Artel Solutions Group Holdings Limited ("Artel"), which represents an approximate 1% ownership percentage. Artel is one of the Company's primary partners in the Asia Pacific Region. The Company paid approximately \$1.3 million for the shares, which represented the then fair value of Artel's common stock as traded on the Hong Kong Stock Exchange. The Company intends to hold the investment for a period in excess of one year. The investment will be considered "Available for Sale" and is included in the investments in the balance sheet. Subsequent changes in the fair value of the common stock will be reflected as a component of comprehensive income on the balance sheet.

**Comprehensive Loss**

The following table sets forth a reconciliation of net loss to comprehensive loss, net of tax:

|   | Three months ended<br>December 31, |                  |
|---|------------------------------------|------------------|
|   | 2001                               | 2000             |
|   | (in thousands)                     |                  |
| Net loss                                | \$ (2,071)                         | \$(8,931)        |
| Unrealized gain on investments          | 51                                 | 750              |
| Foreign currency translation adjustment | (184)                              | 114              |
|   | <u>\$ (2,204)</u>                  | <u>\$(8,067)</u> |

## F5 NETWORKS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
(unaudited)

## Net Loss Per Share

Basic net loss per share is computed by dividing the net loss by the weighted average number of common shares outstanding during the period. Diluted net loss per share is computed by dividing net loss by the weighted average number of common and dilutive common stock equivalent shares outstanding during the period. The Company excludes the impact of dilutive common stock equivalent shares from the calculation of diluted net loss per share when the inclusion of such elements would be anti-dilutive.

The follow sets forth the computation of basic and diluted net loss per share for the three months ended December 31, 2001 and 2000:

|   | Three months ended<br>December 31,    |                  |
|---|---------------------------------------|------------------|
|   | 2001                                  | 2000             |
|   | (in thousands, except per share data) |                  |
| <b>Numerator:</b>   |                                       |                  |
| Net loss  | \$ (2,071)                            | \$ (8,931)       |
| <b>Denominator:</b>   |                                       |                  |
| Weighted average shares outstanding — basic                                   | 24,883                                | 21,677           |
| Dilutive effect of common shares from stock options                           | —                                     | —                |
| Dilutive effect of common shares from warrants                                | —                                     | —                |
| Weighted average shares outstanding — diluted                                 | 24,883                                | 21,677           |
| <b>Basic and diluted net loss per share</b>                                   | <b>\$ (0.08)</b>                      | <b>\$ (0.41)</b> |
| <b>Antidilutive securities not included in net loss per share calculation</b> | <b>2,283</b>                          | <b>1,236</b>     |

## Recent Accounting Pronouncements

In July of 2001, the Financial Accounting Standards Board (“FASB”) issued Statement of Financial Accounting Standard (“SFAS”) No. 141 “Business Combinations” which is effective for all business combinations initiated after July 1, 2001. SFAS No. 141, supersedes APB Opinion No. 16, Business Combinations, and FASB Statement No. 38, Accounting for Pre-acquisition Contingencies of Purchased Enterprises and requires that all business combinations be accounted for using the purchase method of accounting. Further, SFAS No. 141 requires certain intangibles to be recognized as assets apart from goodwill if they meet certain criteria and also requires expanded disclosures regarding the primary reasons for consummation of the combination and the allocation of the purchase price paid to the assets acquired and liabilities assumed by major balance sheet caption. We do not believe the standard will have a significant impact on our financial position.

In July of 2001, the FASB issued SFAS No. 142 “Goodwill and Other Intangible Assets” which is effective for fiscal years beginning after December 15, 2001. SFAS No. 142 supercedes APB Opinion No. 17, Intangible Assets, and addresses financial accounting and reporting for intangible assets acquired individually or with a group of other assets and the accounting and reporting for goodwill and other intangible assets subsequent to their acquisition. Under the model set forth in SFAS No. 142, goodwill is no longer amortized to earnings, but instead be subject to periodic testing for impairment. We do not believe the standard will have a significant impact on our financial position.

F5 NETWORKS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
(unaudited)

In July 2001, the FASB issued SFAS No. 143, "Accounting for Asset Retirement Obligations." FASB 143 addresses financial accounting and reporting for obligations associated with the retirement of tangible long-lived assets and the associated asset retirement costs. It applies to legal obligations associated with the retirement of long-lived assets that result from the acquisition, construction, development, and (or) the normal operation of a long-lived asset, except for certain obligations of lessees. The provisions of FAS 143 will be effective for fiscal years beginning after June 15, 2002, however early application is permitted. We do not believe the standard will have a significant impact on our financial statements.

In August 2001, the FASB issued SFAS No. 144 "Accounting for the Impairment or Disposal of Long-Lived Assets." This Statement addresses financial accounting and reporting for the impairment or disposal of long-lived assets. This Statement supersedes FASB Statement No. 121, Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of, and the accounting and reporting provisions of APB Opinion No. 30, Reporting the Results of Operations — Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions, for the disposal of a segment of a business. The provisions of FAS 144 will be effective for fiscal years beginning after December 15, 2001. We are currently evaluating the implications of adoption of the standard and anticipates adopting its provisions in fiscal year 2002.

**Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**

*The following Management's Discussion and Analysis of Financial Condition and Results of Operations should be read in conjunction with our consolidated financial statements and notes thereto contained in the Company's annual report on Form-10K filed with the Securities and Exchange Commission on December 28, 2001. Our discussion contains forward-looking statements, within the meaning of the Private Securities Litigation Reform Act of 1995, based upon current expectations. These forward-looking statements include, but are not limited to, statements about our plans, objectives, expectations and intentions and other statements that are not historical facts. Because these forward-looking statements involve risks and uncertainties, our actual results and the timing of certain events could differ materially from those anticipated in these forward-looking statements as a result of certain factors, including those set forth under "Risk Factors" and "Business" in the Company's Form 10-K for the fiscal year ended September 30, 2001, and elsewhere in this report.*

**Overview**

F5 Networks, Inc. ("F5") is a leading provider of integrated Internet traffic and content management solutions designed to improve the availability and performance of Internet-based servers and applications. Our Internet traffic products monitor and manage local and geographically dispersed servers and intelligently direct traffic to the server best able to handle a user's request. Our content management products enable network managers to increase access to content by capturing and storing it at points between production servers and end-users and ensure that newly published or updated files and applications are replicated uniformly across all target servers. When combined with our network management tools, these products help organizations optimize their network server availability and performance and cost-effectively manage their Internet infrastructure.

Currently, we derive approximately 65% of our net revenues from sales of the BIG-IP product line, and we expect to derive a significant portion of our net revenues from sales of the BIG-IP product line in the future. For the three months ended December 31, 2001, no individual customer represented more than 10% of our total revenues.

Net revenues derived from customers located outside of the United States were \$8.5 million and \$7.6 million for the three months ended December 31, 2001 and 2000, respectively. We plan to continue to make significant investments in our international operations, particularly in the European and the Asia Pacific markets. International revenues are expected to continue to represent a significant portion of our net revenues, although we cannot be assured that these revenues as a percentage of net revenues will remain at their current levels.

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Customers who purchase our products have the option to receive installation services and an initial customer support contract, typically covering a 12-month period. We generally combine the software license, appliance, installation, and customer support elements of our products into a package with a single price. We allocate a portion of the sales price to each element of the bundled package based on their respective fair values as determined when the individual elements are sold separately. Customers may also purchase consulting services, training and renew their initial customer support contract.

Revenues from the sale of our appliances and software licenses are generally recognized when the product has been shipped and the reseller or end user is obligated to pay for the product. When rights of return are present and we cannot estimate returns, we recognize revenue when such rights lapse. Estimated sales returns are based on historical experience by product and specific identification are recorded at the time revenues are recognized. Revenue for installation services is recognized when the product has been installed at the customer's site. Revenues for customer support are recognized on a straight-line basis over the service contract term. Consulting services are customarily billed at fixed rates, plus out-of-pocket expenses, and revenues are recognized when the consulting has been completed. Training revenue is recognized when the training has been completed.

Our ordinary payment terms to our domestic customers are net 30 days. Our ordinary payment terms to our international customers are net 60 days. We have offered extended payment terms beyond ordinary terms to some customers. For these arrangements, revenue is recognized over the term of the arrangement.

In view of the rapidly changing nature of our business, our limited operating history and the current economic conditions, we believe that period-to-period comparisons of net revenues and operating results are not necessarily meaningful and should not be relied upon as indicators of future performance. To achieve profitability we will need to increase our net revenues and manage operating expenses.

We have recorded a total of \$8.3 million of stock compensation costs since our inception through December 31, 2001. These charges represent the difference between the exercise price and the deemed fair value of certain stock options granted to our employees and outside directors. These options generally vest ratably over a four-year period. We are amortizing these costs using an accelerated method as prescribed by FASB interpretation No. 28 ("FIN No. 28") and have recorded stock compensation charges of \$2.6 million, \$2.1 million, and \$2.5 million for the years ended September 30, 2001, 2000, and 1999, respectively and \$133,000 and \$576,000 for the three months ended December 31, 2001 and 2000 respectively.

We expect to recognize amortization expense related to unearned compensation of approximately \$443,000, \$83,000 and \$10,000 during the years ended September 30, 2002, 2003, and 2004, respectively. We cannot guarantee, however, that we will not accrue additional stock compensation costs in the future.

## Results of Operations

|                                      | Three months ended<br>December 31, |           |
|--------------------------------------|------------------------------------|-----------|
|                                      | 2001                               | 2000      |
|                                      | (unaudited)                        |           |
| <b>Statement of Operations Data:</b> |                                    |           |
| Net revenues:                        |                                    |           |
| Product revenue                      | \$ 20,658                          | \$ 17,733 |
| Service revenue                      | 6,367                              | 7,000     |
|                                      | <hr/>                              | <hr/>     |
| Total net revenue                    | \$ 27,025                          | \$ 24,733 |
| Percent of net revenues:             |                                    |           |
| Product revenue                      | 76.4%                              | 71.7%     |
| Service revenue                      | 23.6                               | 28.3      |
|                                      | <hr/>                              | <hr/>     |
| Total net revenue                    | 100.0%                             | 100.0%    |

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*Net revenues* . Net revenues consist of sales of our products, which include software licenses, appliances, and services. Service revenues include revenue from installation, service and support agreements provided as part of the initial product sale, sales of extended service and support contracts, consulting services, and training.

*Product revenues* . Product revenues increased by 16.5% to \$20.7 million for the three months ended December 31, 2001 from \$17.7 million for the same period in the prior year. The increase in quarterly product revenues was primarily due to an increase in the quantity of our products sold through our international indirect sales channels and an increase in OEM revenue. This increase also reflects the addition of new customers, as well as, repeat sales to existing customers.

*Service revenues* . Service revenues decreased by 9.0% to \$6.4 million for the three months ended December 31, 2001 from \$7.0 million for the three months ended December 31, 2000. This decrease was a result of a reduction in maintenance revenue due to a larger percentage of our international resellers handling service and installation on our behalf.

International net revenues totaled \$8.5 million for the three months ended December 31, 2001 and \$6.4 million for the three months ended December 31, 2000. We expect international sales will continue to represent a significant portion of net revenues, although we cannot assure you that international sales as a percentage of net revenues will remain at current levels.

In the future, our average selling prices may decrease as we leverage our channel model with a greater percentage of sales going through resellers and distributors and, to a lesser extent, due to increased competition. This decrease may have a negative impact on our gross margin.

### Gross Margin:

|                            | Three months ended<br>December 31, |          |
|----------------------------|------------------------------------|----------|
|                            | 2001                               | 2000     |
|                            | (unaudited)                        |          |
| Cost of net revenues:      |                                    |          |
| Products                   | \$ 5,963                           | \$ 8,086 |
| Services                   | 2,694                              | 3,584    |
|                            | <hr/>                              | <hr/>    |
| Total cost of net revenues | 8,657                              | 11,670   |
| Product gross margin       | \$ 14,695                          | \$ 9,647 |
| Services gross margin      | \$ 3,673                           | \$ 3,416 |
| Percentage of net revenue: |                                    |          |
| Products                   | 22.0%                              | 32.7%    |
| Services                   | 10.0                               | 14.5     |
|                            | <hr/>                              | <hr/>    |
| Total cost of net revenues | 32.0                               | 47.2     |
| Product gross margin       | 71.1%                              | 54.4%    |
| Services gross margin      | 57.7%                              | 48.8%    |

*Cost of net revenues*. Cost of net revenues consists primarily of hardware components and outsourced and internal manufacturing costs, fees for third-party software products integrated into our products, service and support personnel and an allocation of our facilities and depreciation expenses.

*Cost of product revenues* . Cost of product revenues decreased by 26.3% to \$6.0 million for the three months ended December 31, 2001 from \$8.1 million for the three months ended December 31, 2000 and decreased as a percentage of net revenues to 22.0% from 32.7% for the same period. This decrease as a percentage of net revenues was due

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primarily to a decline in component costs. Certain of our components are subject to significant price fluctuations based on market supply and demand. In the future component pricing may increase significantly due to limited supply and may have a negative impact on our gross margin. In addition, manufacturing headcount decreased to 13 at December 31, 2001 from 23 at December 31, 2000.

*Cost of service revenues* . Cost of service revenues decreased by 24.8% to \$2.7 million for the three months ended December 31, 2001 from \$3.6 million for the same period in the prior year. Cost of service revenues decreased as a percentage of net revenues to 10.0% from 14.5% for the same period. This decrease was primarily due to a decrease in average service and support headcount to 74 at December 31, 2001 from 86 at December 31, 2000.

### Operating expenses:

|                                       | Three months ended<br>December 31, |           |
|---------------------------------------|------------------------------------|-----------|
|                                       | 2001                               | 2000      |
|                                       | (unaudited)                        |           |
| Operating expenses:                   |                                    |           |
| Sales and marketing                   | \$ 12,440                          | \$ 13,451 |
| Research and development              | 4,137                              | 4,844     |
| General and administrative            | 4,045                              | 4,688     |
| Restructuring charges                 | —                                  | 1,071     |
| Amortization of unearned compensation | 133                                | 576       |
|                                       | \$ 20,755                          | \$ 24,630 |
| Percentage of net revenue:            |                                    |           |
| Sales and marketing                   | 46.0%                              | 54.4%     |
| Research and development              | 15.3                               | 19.6      |
| General and administrative            | 15.0                               | 19.0      |
| Restructuring charges                 | —                                  | 4.3       |
| Amortization of unearned compensation | 0.5                                | 2.3       |
|                                       | 76.8%                              | 99.6%     |

*Sales and marketing* . Our sales and marketing expenses consist primarily of salaries, commissions and related benefits of our sales and marketing staff, costs of our marketing programs, including public relations, advertising and trade shows and an allocation of our facilities and depreciation expenses. Sales and marketing expenses decreased by 7.5% to \$12.4 million for the three months ended December 31, 2001 from \$13.5 million for the same period in the prior year. This decrease was due primarily to a decrease in international marketing and promotions due to a decline in marketing co-op and trade show activities. We have also implemented cost control measures in travel, advertising, marketing, and allocated facilities expenses, as well as other discretionary spending areas. In addition sales and marketing headcount decreased to 211 at December 31, 2001 from 258 at December 31, 2000.

*Research and development* . Our research and development expenses consist primarily of salaries and related benefits for our product development personnel and an allocation of our facilities and depreciation expenses. Research and development expenses decreased by 14.6% to \$4.1 million for the three months ended December 31, 2001 from \$4.8 million for the three months ended December 31, 2000. This decrease was due primarily to a reduction in hiring and the related costs, and a decrease in the use of contractors during the three months ended December 31, 2001 as compared to December 31, 2000. Our future success is dependent in a large part on the continued enhancement of our current products and our ability to develop new, technologically advanced products that meet the sophisticated needs of our customers. We expect research and development expenses to remain consistent as a percentage of net revenue in the foreseeable future.

*General and administrative* . Our general and administrative expenses consist primarily of salaries, benefits and related costs of our executive, finance, information technology, human resource and legal personnel, third-party professional service fees, and an allocation of our facilities and depreciation expenses. General and administrative expenses decreased by 13.7% to \$4.0 million for the three months ended December 31, 2001 from \$4.7 million for



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the three months ended December 31, 2000. This decrease was due primarily to a decrease in bad debt expense attributable to the implementation of a policy to evaluate customers' credit worthiness prior to extending them credit.

### Other Income and Taxes:

|                                | Three months ended<br>December 31, |                   |
|--------------------------------|------------------------------------|-------------------|
|                                | 2001                               | 2000              |
|                                | (unaudited)                        |                   |
| Other Income and Taxes:        |                                    |                   |
| Loss from operations           | \$(2,387)                          | \$(11,567)        |
| Other income, net              | 505                                | 199               |
|                                | <u>          </u>                  | <u>          </u> |
| Loss before income taxes       | (1,882)                            | (11,368)          |
| Income tax provision (benefit) | 189                                | (2,437)           |
|                                | <u>          </u>                  | <u>          </u> |
| Net loss                       | \$(2,071)                          | \$ (8,931)        |
|                                | <u>          </u>                  | <u>          </u> |
| Percentage of net revenue:     |                                    |                   |
| Loss from operations           | (8.8)%                             | (46.8)%           |
| Other income, net              | 1.8                                | 0.8               |
| Loss before income taxes       | (7.0)                              | (46.0)            |
| Income tax provision           | 0.7                                | (9.9)             |
|                                | <u>          </u>                  | <u>          </u> |
| Net loss                       | (7.7)%                             | (36.1)%           |
|                                | <u>          </u>                  | <u>          </u> |

*Other income, net.* Other income, net, consists primarily of interest income, interest expense, and foreign currency exchange gains and losses. Other income, net was \$505,000 for the three months ended December 31, 2001 and \$199,000 for the three months ended December 31, 2000. This increase in other income, net, is primarily due to an increase in interest income related to an increase in the average cash equivalents and investments balance during the period ended December 31, 2001 as compared to the period ended December 31, 2000.

*Income taxes.* Income tax expense of \$189,000 for the three months ended December 31, 2001 primarily relates to foreign income taxes associated with our international operations.

In the fourth quarter of fiscal 2001, the changes in the economic environment caused us to re-evaluate the need for a full valuation allowance. Based upon the weight of all of the available positive and negative evidence, we have recorded a full valuation allowance to completely offset our deferred tax assets.

### Liquidity and Capital Resources

|   | Three months ended<br>December 31, |           |
|---|------------------------------------|-----------|
|   | 2001                               | 2000      |
|   | (unaudited)                        |           |
| Working capital                                 | \$73,367                           | \$ 52,720 |
| Cash and cash equivalents                       | 13,680                             | 12,431    |
| Cash provided by (used in) operating activities | 3,345                              | (11,664)  |
| Cash used in investing activities               | (9,186)                            | (407)     |
| Cash provided by (used in) financing activities | 1,251                              | (106)     |

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Cash and cash equivalents increased to \$13.7 million at December 31, 2001 from \$12.4 million at December 31, 2000, an increase of \$1.3 million. Cash provided by operating activities was \$3.3 million for the three months ended December 31, 2001 as compared to cash used in operating activities of \$11.7 million for the three months ended December 31, 2000. This increase is primarily the result of a reduction in operating loss and inventory management. Inventory management remains an area of focus as we balance the need to maintain strategic inventory levels with the need to ensure competitive lead times. In the future we may also require a larger inventory of products in order to provide better availability to customers and achieve purchasing efficiencies. Any such increase can be expected to reduce cash, cash equivalents and investments.

Cash used in investing activities was \$9.2 million for the three months ended December 31, 2001 compared to \$407,000 for the same period in the prior year. The decrease in investing activities was primarily the result of cash investment purchases, including the \$1.3 million investment in Artel during the three months ended December 31, 2001. Cash provided by financing activities for the three months ended December 31, 2001 was \$1.2 million due to stock option exercises as compared to cash used in financing activities of \$106,000 for the same period last year.

We expect that our existing cash balances and cash from operations will be sufficient to meet our anticipated working capital and capital expenditures for the foreseeable future.

As of December 31, 2001, our principal commitments consisted of obligations outstanding under operating leases. In April 2000, we entered into a lease agreement on two buildings for a new corporate headquarters. The lease commenced in July 2000 on the first building; and the lease on the second building commenced in October 2000. The lease for both buildings expires in 2012 with an option for renewal. We established a restricted escrow account in connection with this lease agreement. Under the term of the lease, a \$6.0 million irrevocable standby letter of credit is required through November 2012, unless the lease is terminated before then. This amount has been included on our balance sheet as of December 31, 2001 as a component of restricted cash. We have surplus office space of approximately 14,000 square feet, which is subleased until 2003 and approximately 110,000 square feet, which is subleased until 2012.

### ***Item 3. Quantitative and Qualitative Disclosure About Market Risk***

***Interest Rate Risk.*** We do not hold derivative financial instruments in our investment portfolio. The Board of Directors authorized one transaction to purchase and sell publicly traded company options in fiscal 2001. Our cash equivalents consist of high-quality securities, as specified in our investment policy guidelines. The policy limits the amount of credit exposure to any one issue or issuer to a maximum of 20% of the total portfolio with the exception of treasury securities, commercial paper and money market funds, which are exempt from size limitation. The policy limits all short-term investments to mature in two years or less, with the average maturity being one year or less. These securities are subject to interest rate risk and a decrease in interest rates could have an adverse impact on earnings for our investment portfolio. We do not currently hedge against these interest rate exposures.

As of December 31, 2001, our cash equivalents mature within three months and our short-term investments mature, on average, within one year. Therefore, as of December 31, 2001, we believe the reported amounts of cash equivalents and short-term investments to be reasonable approximations of fair value and the market risk arising from our holdings to be minimal. We maintain investment portfolio holdings of various issuers, types, and maturities, the majority of which are corporate bonds and government securities. These securities are generally classified as available for sale and, consequently, are recorded on the balance sheet at fair value with unrealized gains or losses reported as a separate component of accumulated other comprehensive income.

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| December 31, 2001:                    | Maturing in          |                          |                       |           | Fair value |
|---------------------------------------|----------------------|--------------------------|-----------------------|-----------|------------|
|                                       | Three months or less | Three months to one year | Greater than one year | Total     |            |
|                                       | (in thousands)       |                          |                       |           |            |
| Included in cash and cash equivalents | \$ 1,322             | —                        | —                     | \$ 1,322  | \$ 1,322   |
| Weighted average interest rate        | 2.422%               | —                        | —                     | —         | —          |
| Included in investments               | —                    | \$ 15,050                | \$ 43,689             | \$ 58,739 | \$ 58,739  |
| Weighted average interest rates       | —                    | 2.450%                   | 3.354%                | —         | —          |

The following sensitivity analysis presents hypothetical changes of our investment in Artel Solutions Group Holdings Limited (“Artel”), classified as “Available for Sale” as of December 31, 2001. This modeling technique measures the hypothetical change in fair values arising from selected hypothetical changes in the stock price of Artel. We selected stock price fluctuations of plus or minus 15%, 35%, and 50% based on the historical fluctuation of the common stock.

| Security | Fair Value at 12/31/2001 (in thousands) | Valuation of Security Give X% Increase in Securities Price (in thousands) |          |          | Valuation of Security Give X% Decrease in Securities Price (in thousands) |        |        |
|----------|---|---|----------|----------|---|--------|--------|
|          |   | 15%   | 35%      | 50%      | 15%   | 35%    | 50%    |
| Artel    | \$ 1,302                                | \$ 1,497  | \$ 1,758 | \$ 1,953 | \$ 1,107  | \$ 846 | \$ 651 |

**Foreign Currency Risk.** The majority of our sales and expenses are denominated in U.S. dollars and as a result, we have not experienced significant foreign exchange gains and losses to date. While we have conducted some transactions in foreign currencies during the fiscal year ended September 31, 2001 and the three months ended December 31, 2001 and expect to continue to do so, we do not anticipate that foreign exchange gains and losses will be significant. We have not engaged in foreign currency hedging to date, however we may do so in the future.

The Artel investment is considered “Available for Sale” and is included in the investments in the balance sheet. Subsequent changes in the fair value of the common stock will be reflected as a component of comprehensive income in the balance sheet. This investment is subject to foreign currency exchange rate risk.

## PART II — OTHER INFORMATION

### Item 1. Legal Proceedings

Reference is made to Item 3, Legal Proceedings in our Annual Report on Form 10-K for the year ended September 30, 2001, filed December 28, 2001 for descriptions of our legal proceedings. We continue to believe that the resolution of these legal proceedings will not have a material, adverse effect on us and there have been no material developments since our 10-K filing.

### Item 6. Exhibits and Reports on Form 8-K

#### (a) Exhibits:

- 3.1 — Second Amended and Restated Articles of Incorporation of the Registrant(1)
- 3.2 — Amended and Restated Bylaws of the Registrant(1)

(1) Incorporated by reference from Registration Statement on Form S-1, File No. 333-75817.

#### (b) Reports on Form 8-K:

No reports on Form 8-K were filed during the first quarter of fiscal 2002.

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Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized on this 14th day of February, 2002.

F5 Networks, Inc.  
(Registrant)

By: /s/ Steven Coburn

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Steven Coburn  
Chief Financial Officer

(Duly Authorized Officer and  
Principal Financial and Accounting Officer)

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