

F5 NETWORKS INC
Form 10-Q
February 07, 2013
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended December 31, 2012

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)

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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 by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes ☒ No ☐

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer ☒

Accelerated filer ☐

Non-accelerated filer ☐ (Do not check if a smaller reporting company)

Smaller reporting company ☐

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes ☐ No ☒

The number of shares outstanding of the registrant's common stock as of February 1, 2013 was 78,590,957.

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F5 NETWORKS, INC.

QUARTERLY REPORT ON FORM 10-Q

For the Quarter Ended December 31, 2012

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Table of Contents**PART I. FINANCIAL INFORMATION****Item 1. Financial Statements****F5 NETWORKS, INC.****CONSOLIDATED BALANCE SHEETS**

(unaudited, in thousands)

	December 31, 2012	September 30, 2012
ASSETS		
Current assets		
Cash and cash equivalents	\$ 184,563	\$ 211,181
Short-term investments	333,174	320,970
Accounts receivable, net of allowances of \$3,309 and \$3,254	209,078	185,172
Inventories	18,723	17,410
Deferred tax assets	10,335	10,362
Other current assets	35,916	30,986
Total current assets	791,789	776,081
Property and equipment, net	62,026	59,604
Long-term investments	771,300	662,803
Deferred tax assets	36,234	35,478
Goodwill	348,239	348,239
Other assets, net	28,064	28,996
Total assets	\$ 2,037,652	\$ 1,911,201
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities		
Accounts payable	\$ 32,221	\$ 27,026
Accrued liabilities	117,413	86,409
Deferred revenue	379,944	352,594
Total current liabilities	529,578	466,029
Other long-term liabilities	21,163	21,078
Deferred revenue, long-term	100,612	94,694
Total long-term liabilities	121,775	115,772
Commitments and contingencies (Note 5)		
Shareholders' equity		
Preferred stock, no par value; 10,000 shares authorized, no shares outstanding		
Common stock, no par value; 200,000 shares authorized, 78,574 and 78,715 shares issued and outstanding	315,039	326,922
Accumulated other comprehensive loss	(4,540)	(3,829)
Retained earnings	1,075,800	1,006,307
Total shareholders' equity	1,386,299	1,329,400

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Total liabilities and shareholders' equity	\$ 2,037,652	\$ 1,911,201
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The accompanying notes are an integral part of these consolidated financial statements.

Table of Contents**F5 NETWORKS, INC.****CONSOLIDATED INCOME STATEMENTS**

(unaudited, in thousands, except per share data)

	Three months ended December 31,	
	2012	2011
Net revenues		
Products	\$ 204,712	\$ 196,554
Services	160,739	125,878
Total	365,451	322,432
Cost of net revenues		
Products	31,792	33,200
Services	29,093	22,406
Total	60,885	55,606
Gross profit	304,566	266,826
Operating expenses		
Sales and marketing	122,268	106,238
Research and development	48,541	39,122
General and administrative	24,673	21,677
Total	195,482	167,037
Income from operations	109,084	99,789
Other income, net	1,550	1,861
Income before income taxes	110,634	101,650
Provision for income taxes	41,141	35,158
Net income	\$ 69,493	\$ 66,492
Net income per share basic	\$ 0.88	\$ 0.84
Weighted average shares basic	78,789	79,272
Net income per share diluted	\$ 0.88	\$ 0.83
Weighted average shares diluted	79,278	79,822

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

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F5 NETWORKS, INC.

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(unaudited, in thousands)

	Three months ended December 31,	
	2012	2011
Net income	\$ 69,493	\$ 66,492
Other comprehensive income:		
Foreign currency translation adjustment	(257)	(263)
Unrealized loss on securities, net of tax	(453)	(87)
Total other comprehensive income	(710)	(350)
Comprehensive income	\$ 68,783	\$ 66,142

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

Table of Contents**F5 NETWORKS, INC.****CONSOLIDATED STATEMENTS OF CASH FLOWS**

(unaudited, in thousands)

	Three months ended December 31,	
	2012	2011
Operating activities		
Net income	\$ 69,493	\$ 66,492
Adjustments to reconcile net income to net cash provided by operating activities:		
Realized loss on disposition of assets and investments	26	579
Stock-based compensation	26,710	22,123
Provisions for doubtful accounts and sales returns	349	415
Depreciation and amortization	9,934	5,822
Deferred income taxes	(1,265)	(598)
Changes in operating assets and liabilities:		
Accounts receivable	(24,256)	(22,601)
Inventories	(1,313)	(344)
Other current assets	(4,979)	(3,879)
Other assets	428	562
Accounts payable and accrued liabilities	36,411	26,576
Deferred revenue	33,268	36,732
Net cash provided by operating activities	144,806	131,879
Investing activities		
Purchases of investments	(313,114)	(262,499)
Maturities of investments	165,193	199,102
Sales of investments	23,020	1,886
Increase in restricted cash	(728)	(3)
Purchases of property and equipment	(7,788)	(5,857)
Net cash used in investing activities	(133,417)	(67,371)
Financing activities		
Excess tax benefit from stock-based compensation	503	1,399
Proceeds from the exercise of stock options and purchases of stock under employee stock purchase plan	11,583	9,577
Repurchase of common stock	(50,000)	(34,473)
Net cash used in financing activities	(37,914)	(23,497)
Net (decrease) increase in cash and cash equivalents	(26,525)	41,011
Effect of exchange rate changes on cash and cash equivalents	(93)	(307)
Cash and cash equivalents, beginning of period	211,181	216,784
Cash and cash equivalents, end of period	\$ 184,563	\$ 257,488

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

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F5 NETWORKS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (unaudited)

1. Summary of Significant Accounting Policies

Description of Business

F5 Networks, Inc. (the "Company") provides products and services to help companies manage their Internet Protocol (IP) traffic and file storage infrastructure efficiently and securely. The Company's application delivery networking products improve the performance, availability and security of applications on Internet-based networks. Internet traffic between network-based applications and clients passes through these devices where the content is inspected to ensure that it is safe and modified as necessary to ensure that it is delivered securely and in a way that optimizes the performance of both the network and the applications. The Company's storage virtualization products simplify and reduce the cost of managing files and file storage devices, and ensure fast, secure, easy access to files for users and applications. With the purchase of Traffix Communication Systems Ltd. (Traffix Systems) in February 2012, the Company acquired a line of Diameter signaling products that enable full connectivity, enhanced scalability, and comprehensive control for telecommunications operators. These products enable operators to control their signaling networks effectively in the migration to next-generation networks and in future expansion of their subscriber bases and service portfolios. The Company also offers a broad range of services that include consulting, training, maintenance and other technical support services.

Basis of Presentation

The year-end condensed consolidated balance sheet data was derived from audited financial statements, but does not include all disclosures required by accounting principles generally accepted in the United States of America. In the opinion of management, the unaudited consolidated financial statements reflect all adjustments, consisting only of normal recurring adjustments, necessary for their fair statement in conformity with accounting principles generally accepted in the United States of America. Certain information and footnote disclosures normally included in annual financial statements have been condensed or omitted in accordance with the rules and regulations of the Securities and Exchange Commission. The information included in this Form 10-Q should be read in conjunction with Management's Discussion and Analysis of Financial Condition and Results of Operations and financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the fiscal year ended September 30, 2012.

Certain prior year amounts, specifically relating to cash flows in connection with the disposition of investments, have been reclassified from sales of investments to maturities of investments to conform to the current year presentation in the Consolidated Statement of Cash Flows. There was no change to the net cash used in investing activities as a result of this reclassification. This reclassification did not affect total revenue, operating income or net income.

Revenue Recognition

The Company sells products through distributors, resellers, and directly to end users. Revenue is recognized provided that all of the following criteria have been met:

Persuasive evidence of an arrangement exists. Evidence of an arrangement generally consists of a purchase order issued pursuant to the terms and conditions of a distributor, reseller or end user agreement.

Delivery has occurred. The Company uses shipping or related documents, or written evidence of customer acceptance, when applicable, to verify delivery or completion of any performance terms.

The sales price is fixed or determinable. The Company assesses whether the sales price is fixed or determinable based on payment terms associated with the transaction and whether the sales price is subject to refund or adjustment.

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Collectability is reasonably assured. The Company assesses collectability primarily based on the creditworthiness of the customer as determined by credit checks and related analysis, as well as the Customer's payment history.

Revenue from the sale of products is generally 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, revenue is recognized when such rights of return lapse. In certain regions where the Company does not have the ability to reasonably estimate returns, the Company defers

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revenue on sales to its distributors until information is received from the channel partner indicating that the product has been sold to the end-user customer. Payment terms to domestic customers are generally net 30 days to net 45 days. Payment terms to international customers range from net 30 days to net 120 days based on normal and customary trade practices in the individual markets. The Company offers extended payment terms to certain customers, in which case, revenue is recognized when payments are due.

Revenues for post-contract customer support (PCS) are recognized on a straight-line basis over the service contract term. PCS includes a limited period of telephone support updates, repair or replacement of any failed product or component that fails during the term of the agreement, bug fixes and rights to upgrades, when and if available. Consulting services are customarily billed at fixed hourly 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.

The majority of the Company's products are hardware appliances which contain software essential to the overall functionality of the products. Hardware appliances are generally sold with PCS and on occasion, with consulting and/or training services. Arrangement consideration in such multiple element transactions is allocated to each element based on a fair value hierarchy, where the selling price for an element is based on vendor specific objective evidence (VSOE), if available, third-party evidence (TPE), if available and VSOE is not available; or the best estimate of selling price (BESP), if neither VSOE or TPE is available.

For sales of nonessential and stand-alone software, the Company allocates revenue for arrangements with multiple elements based on software revenue recognition guidance. Software revenue recognition guidance requires revenue earned on software arrangements involving multiple elements to be allocated to each element based on the relative fair values of those elements. The fair value of an element must be based on VSOE. Where fair value of delivered elements is not available, revenue is recognized on the residual method based on the fair value of undelivered elements. If evidence of fair value of one or more undelivered elements does not exist, all revenue is deferred and recognized at the earlier of the delivery of those elements or the establishment of fair value of the remaining undelivered elements.

The Company establishes VSOE for its products, PCS, consulting and training services based on the sales price charged for each element when sold separately. The sales price is discounted from the applicable list price based on various factors including the type of customer, volume of sales, geographic region and program level. The Company's list prices are generally not fair value as discounts may be given based on the factors enumerated above. The Company uses historical sales transactions to determine whether VSOE can be established for each of the elements. In most instances, VSOE of fair value is the sales price of actual standalone (unbundled) transactions within the past 12 month period, when a substantial majority of transactions are priced within a narrow range, which the Company has determined to be plus or minus 15% of the median sales price.

The Company believes that the VSOE of fair value of training and consulting services is represented by the billable rate per hour, based on the rates charged to customers when they purchase standalone training or consulting services. The price of consulting services is not based on the type of customer, volume of sales, geographic region or program level.

The Company is typically not able to determine TPE for its products or services. TPE is determined based on competitor prices for similar elements when sold separately. Generally, the Company's go-to-market strategy differs from that of other competitive products or services in its markets and the Company's offerings contain a significant level of differentiation such that the comparable pricing of products with similar functionality cannot be obtained. Furthermore, the Company is unable to reliably determine the selling prices on a stand-alone basis of similar products offered by its competitors.

When the Company is unable to establish selling price using VSOE or TPE, the Company uses BESP in its allocation of arrangement consideration. The objective of BESP is to determine the price at which the Company would transact a sale if the product or service were sold on a stand-alone basis. The Company is generally not able to establish VSOE for non-software product sales. Instead, the Company has been able to establish BESP through the list price, less a discount deemed appropriate to maintain a reasonable gross margin. Management regularly reviews the gross margin information. Non-software product BESP is determined through the Company's review of historical sales transactions within the past 12 month period. Additional factors considered in determining an appropriate BESP include, but are not limited to, cost of products, pricing practices, geographies, customer classes, and distribution channels.

The Company regularly validates the VSOE of fair value and BESP for elements in its multiple element arrangements. The Company accounts for taxes collected from customers and remitted to governmental authorities on a net basis and excluded from revenues.

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Goodwill

Goodwill represents the excess purchase price over the estimated fair value of net assets acquired as of the acquisition date. The Company tests goodwill for impairment on an annual basis and between annual tests when impairment indicators are identified, and goodwill is written down when impaired. Goodwill was recorded in connection with the acquisition of Traffix Systems in fiscal year 2012, Acopia Networks, Inc. in fiscal year 2007, Swan Labs, Inc. in fiscal year 2006, MagniFire Websystems, Inc. in fiscal year 2004 and uRoam, Inc. in fiscal year 2003. The Company performs its annual goodwill impairment test during the second fiscal quarter.

In September 2011, the FASB approved changes to the goodwill impairment guidance which are intended to reduce the cost and complexity of the annual impairment test. The changes provide entities the option to perform a qualitative assessment to determine whether further impairment testing is necessary. If an entity believes, as a result of its qualitative assessment, that it is more-likely-than-not (i.e. greater than 50% chance) that the fair value of a reporting unit is less than its carrying amount, the quantitative impairment test will be required. Otherwise, no further testing will be required.

The revised guidance includes examples of events and circumstances that might indicate that a reporting unit's fair value is less than its carrying amount. These include macro-economic conditions such as deterioration in the entity's operating environment or industry or market considerations; entity-specific events such as increasing costs, declining financial performance, or loss of key personnel; or other events such as an expectation that a reporting unit will be sold or a sustained decrease in the stock price on either an absolute basis or relative to peers.

The changes are effective for annual and interim goodwill impairment tests performed for fiscal years beginning after December 15, 2011. However, earlier adoption is permitted. The Company opted to early adopt this guidance for its annual goodwill impairment test performed in the second quarter of fiscal 2012.

If it is determined, as a result of the qualitative assessment, that it is more-likely-than-not that the fair value of a reporting unit is less than its carrying amount, the provisions of authoritative guidance require that the Company perform a two-step impairment test on goodwill. The first step of the test identifies whether potential impairment may have occurred, while the second step of the test measures the amount of the impairment, if any. Impairment is recognized when the carrying amount of goodwill exceeds its fair value. For its annual goodwill impairment analysis, the Company operates under one reporting unit and determines the fair value of its reporting unit based on the Company's enterprise value. In March 2012, the Company completed a qualitative assessment of potential impairment indicators and concluded that it was more-likely-than-not that the fair value of its reporting unit exceeded its carrying amount. The Company also considered potential impairment indicators at December 31, 2012 and noted no indicators of impairment.

Stock-Based Compensation

The Company accounts for stock-based compensation using the straight-line attribution method for recognizing compensation expense. The Company recognized \$26.7 million and \$22.1 million of stock-based compensation expense for the three months ended December 31, 2012 and 2011, respectively. As of December 31, 2012, there was \$138.3 million of total unrecognized stock-based compensation cost, the majority of which will be recognized over the next two years. Going forward, stock-based compensation expenses may increase as the Company issues additional equity-based awards to continue to attract and retain key employees.

The Company issues incentive awards to its employees through stock-based compensation consisting of restricted stock units (RSUs). The value of RSUs is determined using the fair value method, which in this case, is based on the number of shares granted and the quoted price of the Company's common stock on the date of grant.

The Company recognizes compensation expense for only the portion of restricted stock units that are expected to vest. Therefore, the Company applies estimated forfeiture rates that are derived from historical employee termination behavior. Based on historical differences with forfeitures of stock-based awards granted to the Company's executive officers and Board of Directors versus grants awarded to all other employees, the Company has developed separate forfeiture expectations for these two groups. The Company's estimated forfeiture rate in the first quarter of fiscal year 2013 is 5.3% for grants awarded to the Company's executive officers and Board of Directors, and 7.6% for grants awarded to all other employees. If the actual number of forfeitures differs from those estimated by management, additional adjustments to compensation expense may be required in future periods.

In November 2012, the Company granted 290,415 RSUs to certain current executive officers as part of the annual equity awards program. Fifty percent of the aggregate number of RSUs vest in equal quarterly increments over four years, until such portion of the grant is fully vested on November 1, 2016. One-eighth of the RSU grant, or a portion thereof, is subject to the Company achieving

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specified quarterly revenue and EBITDA goals during fiscal year 2013. In each case, 50% of the quarterly performance stock grant is based on achieving at least 80% of the quarterly revenue goal and the other 50% is based on achieving at least 80% of the quarterly EBITDA goal. The quarterly performance stock grant is paid linearly above 80% of the targeted goals. At least 100% of both goals must be attained in order for the quarterly performance stock grant to be awarded over 100%. Each goal is evaluated individually and subject to the 80% achievement threshold and 100% over-achievement threshold. The remaining 37.5% of this annual equity awards RSU grant shall be subject to quarterly performance based vesting for fiscal years 2014, 2015 and 2016 (12.5% in each period). The Compensation Committee of the Board of Directors will set applicable performance targets and vesting formulas for each of these periods.

In November 2011, as part of the annual review of executive compensation by the Compensation Committee of the Board of Directors and a change in the grant date for the Company's annual equity awards program for the executive officers from August 1 to November 1, the Company granted 82,968 RSUs to certain current executive officers. Fifty percent of the aggregate number of RSUs vest in equal quarterly increments over three years, until such portion of the grant is fully vested on November 1, 2014. One-sixth of the RSU grant, or a portion thereof, was subject to the Company achieving specified quarterly revenue and EBITDA goals during fiscal year 2012. In each case, 50% of the quarterly performance stock grant is based on achieving at least 80% of the quarterly revenue goal and the other 50% is based on achieving at least 80% of the quarterly EBITDA goal. The quarterly performance stock grant is paid linearly above 80% of the targeted goals. At least 100% of both goals must be attained in order for the quarterly performance stock grant to be awarded over 100%. Each goal is evaluated individually and subject to the 80% achievement threshold and 100% over-achievement threshold. The remaining 33.33% of this annual equity awards RSU grant shall be subject to quarterly performance based vesting for fiscal years 2013 and 2014 (16.66% in each period). The Compensation Committee of the Board of Directors will set applicable performance targets and vesting formulas for each of these periods.

In August 2011, the Company granted 170,390 RSUs to certain current executive officers as part of the annual equity awards program. Fifty percent of the aggregate number of RSUs granted as part of the annual equity awards program vest in equal quarterly increments over three years, until such portion of the grant is fully vested on August 1, 2014. One-sixth of the annual equity awards RSU grant, or a portion thereof, was subject to the Company achieving specified quarterly revenue and EBITDA goals during the period beginning in the fourth quarter of fiscal year 2011 through the third quarter of fiscal year 2012. In each case, 50% of the quarterly performance stock grant is based on achieving at least 80% of the quarterly revenue goal and the other 50% is based on achieving at least 80% of the quarterly EBITDA goal. The quarterly performance stock grant is paid linearly above 80% of the targeted goals. At least 100% of both goals must be attained in order for the quarterly performance stock grant to be awarded over 100%. Each goal is evaluated individually and subject to the 80% achievement threshold and 100% over-achievement threshold. The remaining 33.33% of this annual equity awards RSU grant shall be subject to performance based vesting for each of the four quarter periods beginning with the fourth quarters of fiscal years 2012 and 2013 (16.66% in each period). The Compensation Committee of the Board of Directors will set applicable performance targets and vesting formulas for each of these periods.

In August 2010, the Company granted 181,334 and 83,000 RSUs to certain current executive officers as part of the annual equity and retention awards programs, respectively. Fifty percent of the aggregate number of RSUs granted as part of the annual equity awards program vest in equal quarterly increments over three years, until such portion of the grant is fully vested on August 1, 2013. One-sixth of the annual equity awards RSU grant, or a portion thereof, was subject to the Company achieving specified quarterly revenue and EBITDA goals during the period beginning in the fourth quarter of fiscal year 2010 through the third quarter of fiscal year 2011. In each case, 50% of the quarterly performance stock grant is based on achieving at least 80% of the quarterly revenue goal and the other 50% is based on achieving at least 80% of the quarterly EBITDA goal. The quarterly performance stock grant is paid linearly above 80% of the targeted goals. At least 100% of both goals must be attained in order for the quarterly performance stock grant to be awarded over 100%. Each goal is evaluated individually and subject to the 80% achievement threshold and 100% over-achievement threshold. The remaining 33.33% of this annual equity awards RSU grant shall be subject to performance based vesting for each of the four quarter periods beginning with the fourth quarters of fiscal years 2011 and 2012 (16.66% in each period). The Compensation Committee of the Board of Directors will set applicable performance targets and vesting formulas for each of these periods. All RSUs granted as part of the retention awards program fully vest on August 1, 2013.

The Company recognizes compensation costs for awards with performance conditions when it concludes it is probable that the performance condition will be achieved. The Company reassesses the probability of vesting at each balance sheet date and adjusts compensation costs based on the probability assessment.

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On October 25, 2011, the Company announced that its Board of Directors authorized an additional \$200 million for its common stock share repurchase program. This new authorization is incremental to the existing \$400 million program, initially approved in October 2010 and expanded in August 2011. Acquisitions for the share repurchase programs will be made from time to time in private transactions or open market purchases as permitted by securities laws and other legal requirements. The programs can be terminated at any time. As of February 1, 2013, the Company had repurchased and retired 9,763,717 shares at an average price of \$68.73 per share and the Company had \$128.5 million remaining to purchase shares as part of its repurchase programs.

Earnings Per Share

Basic net income per share is computed by dividing net income by the weighted average number of common shares outstanding during the period. Diluted net income per share is computed by dividing net income by the weighted average number of common and dilutive common stock equivalent shares outstanding during the period. The Company's nonvested restricted stock awards and restricted stock units do not have nonforfeitable rights to dividends or dividend equivalents.

The following table sets forth the computation of basic and diluted net income per share (in thousands, except per share data):

	Three months ended December 31,	
	2012	2011
Numerator		
Net income	\$ 69,493	\$ 66,492
Denominator		
Weighted average shares outstanding basic	78,789	79,272
Dilutive effect of common shares from stock options and restricted stock units	489	550
Weighted average shares outstanding diluted	79,278	79,822
Basic net income per share	\$ 0.88	\$ 0.84
Diluted net income per share	\$ 0.88	\$ 0.83

An immaterial amount of common shares potentially issuable from stock options for the three months ended December 31, 2012 and 2011, are excluded from the calculation of diluted earnings per share because the exercise price was greater than the average market price of common stock for the respective period.

Comprehensive Income

Comprehensive income includes certain changes in equity that are excluded from net income. Specifically, unrealized gains (losses) on securities and foreign currency translation adjustments are included in accumulated other comprehensive loss.

Recent Accounting Pronouncements

In June 2011, the FASB issued ASU 2011-05, *Comprehensive Income, Presentation of Comprehensive Income* (ASU 2011-05), which eliminates the option of presenting other comprehensive income as part of the statement of changes in stockholders' equity and instead requires the entity to present other comprehensive income as either a single statement of comprehensive income combined with net income or as two separate but continuous statements. The amendments in this standard are to be applied retrospectively and are effective for fiscal years, and interim periods within those years beginning after December 15, 2011. The Company adopted ASU 2011-05 in the first quarter of fiscal 2013. Although the new guidance amends the presentation of comprehensive income, there are no changes to the components that are recognized in net income or other comprehensive income under existing guidance.

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In December 2011, the FASB issued ASU 2011-12, *Comprehensive Income, Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income in Accounting Standards Update No. 2011-05* (ASU 2011-12), which defers the changes in ASU 2011-05 that relate to the presentation of reclassification adjustments to other comprehensive income. No other requirements in ASU 2011-05 are affected by this deferral. Similar to ASU 2011-05, the Company adopted ASU 2011-12 in the first quarter of fiscal 2013. The adoption of ASU 2011-12 did not have an impact on the Company's consolidated financial statements.

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In accordance with the authoritative guidance on fair value measurements and disclosure under GAAP, the Company determines fair value using a fair value hierarchy that distinguishes between market participant assumptions developed based on market data obtained from sources independent of the reporting entity, and the reporting entity's own assumptions about market participant assumptions developed based on the best information available in the circumstances and expands disclosure about fair value measurements.

Fair value is the price that would be received to sell an asset or paid to transfer a liability in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants at the measurement date, essentially the exit price.

The levels of fair value hierarchy are:

Level 1: Quoted prices in active markets for identical assets and liabilities at the measurement date that the Company has the ability to access.

Level 2: Observable inputs other than quoted prices included in Level 1, such as quoted prices for similar assets and liabilities in active markets; quoted prices for identical or similar assets and liabilities in markets that are not active; or other inputs that are observable or can be corroborated by observable market data.

Level 3: Unobservable inputs for which there is little or no market data available. These inputs reflect management's assumptions of what market participants would use in pricing the asset or liability.

Level 1 investments are valued based on quoted market prices in active markets and include the Company's cash equivalent investments. Level 2 investments, which include investments that are valued based on quoted prices in markets that are not active, broker or dealer quotations, actual trade data, benchmark yields or alternative pricing sources with reasonable levels of price transparency, include the Company's certificates of deposit, corporate bonds and notes, municipal bonds and notes, U.S. government securities and U.S. government agency securities. Fair values for the Company's level 2 investments are based on similar assets without applying significant judgments. In addition, all of the Company's level 2 investments have a sufficient level of trading volume to demonstrate that the fair values used are appropriate for these investments.

A financial instrument's level within the fair value hierarchy is based upon the lowest level of any input that is significant to the fair value measurement. However, the determination of what constitutes observable requires significant judgment by the Company. The Company considers observable data to be market data which is readily available, regularly distributed or updated, reliable and verifiable, not proprietary, and provided by independent sources that are actively involved in the relevant market.

The Company's financial assets measured at fair value on a recurring basis subject to the disclosure requirements at December 31, 2012, were as follows (in thousands):

Fair Value Measurements at Reporting Date				
Using				
	Quoted Prices in Active Markets for Identical Securities (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Fair Value at December 31, 2012
Cash equivalents	\$ 20,459	\$	\$	\$ 20,459
Short-term investments				
Available-for-sale securities certificates of deposit		3,515		3,515
Available-for-sale securities corporate bonds and notes		194,238		194,238
Available-for-sale securities municipal bonds and notes		62,379		62,379
Available-for-sale securities U.S. government agency securities		73,042		73,042
Long-term investments				
Available-for-sale securities corporate bonds and notes		292,964		292,964
Available-for-sale securities municipal bonds and notes		22,022		22,022
Available-for-sale securities U.S. government securities		4,994		4,994

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Available-for-sale securities	U.S. government agency securities	446,720		446,720
Available-for-sale securities	auction rate securities		4,600	4,600
Total		\$ 20,459	\$ 1,099,874	\$ 1,124,933

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The Company's financial assets measured at fair value on a recurring basis subject to the disclosure requirements at September 30, 2012, were as follows (in thousands):

		Fair Value Measurements at Reporting Date Using			Fair Value at September 30, 2012
		Quoted Prices in Active Markets for Identical Securities (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	
Cash equivalents		\$ 35,658	\$	\$	\$ 35,658
Short-term investments					
Available-for-sale securities	certificates of deposit		3,533		3,533
Available-for-sale securities	corporate bonds and notes		193,990		193,990
Available-for-sale securities	municipal bonds and notes		63,422		63,422
Available-for-sale securities	U.S. government agency securities		60,025		60,025
Long-term investments					
Available-for-sale securities	corporate bonds and notes		229,441		229,441
Available-for-sale securities	municipal bonds and notes		30,307		30,307
Available-for-sale securities	U.S. government securities		4,995		4,995
Available-for-sale securities	U.S. government agency securities		393,310		393,310
Available-for-sale securities	auction rate securities			4,750	4,750
Total		\$ 35,658	\$ 979,023	\$ 4,750	\$ 1,019,431

Due to the auction failures of the Company's auction rate securities (ARS) that began in the second quarter of fiscal year 2008, there are still no quoted prices in active markets for similar assets as of December 31, 2012. Therefore, the Company has classified its ARS as level 3 financial assets. The following table provides a reconciliation between the beginning and ending balances of items measured at fair value on a recurring basis in the table above that used significant unobservable inputs (Level 3) (in thousands):

		Three months ended December 31,	
		2012	2011
Balance, beginning of period		\$ 4,750	\$ 13,010
Total (losses) gains realized or unrealized:			
Included in other comprehensive income		(150)	54
Balance, end of period		\$ 4,600	\$ 13,064
Unrealized (losses) gains attributable to assets still held as of end of period		(150)	54

Financial assets are considered Level 3 when their fair values are determined using pricing models, discounted cash flow methodologies or similar techniques and at least one significant model assumption or input is unobservable or there is limited market activity such that the determination of fair value requires significant judgment or estimation. Level 3 investment securities primarily include certain ARS for which there was a decrease in the observation of market pricing. At December 31, 2012, the values of these securities were estimated primarily using discounted cash flow analysis that incorporated transaction details such as contractual terms, maturity, timing and amount of future cash flows, as well as assumptions about liquidity and credit valuation adjustments of marketplace participants at December 31, 2012. Significant fluctuations in any of these inputs in isolation would result in changes in the fair value of the Company's ARS.

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The Company uses the fair value hierarchy for financial assets and liabilities. The Company's non-financial assets and liabilities, which include goodwill, intangible assets, and long-lived assets, are not required to be carried at fair value on a recurring basis. These non-financial assets and liabilities are measured at fair value on a non-recurring basis when there is an indicator of impairment, and they are recorded at fair value only when impairment is recognized. The Company reviews goodwill and intangible assets for impairment annually, during the second quarter of each fiscal year, or as circumstances indicate the possibility of impairment. The Company monitors the carrying value of long-lived assets for impairment whenever events or changes in circumstances indicate its carrying amount may not be recoverable. During the three months ended December 31, 2012, the Company did not recognize any impairment charges related to goodwill, intangible assets, or long-lived assets.

3. Short-Term and Long-Term Investments

Short-term investments consist of the following (in thousands):

	Cost or Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
December 31, 2012				
Certificates of deposit	\$ 3,513	\$ 2	\$	\$ 3,515
Corporate bonds and notes	193,854	401	(17)	194,238
Municipal bonds and notes	62,278	113	(12)	62,379
U.S. government agency securities	73,045	15	(18)	73,042
	\$ 332,690	\$ 531	\$ (47)	\$ 333,174

	Cost or Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
September 30, 2012				
Certificates of deposit	\$ 3,528	\$ 5	\$	\$ 3,533
Corporate bonds and notes	193,548	482	(40)	193,990
Municipal bonds and notes	63,371	61	(10)	63,422
U.S. government agency securities	60,010	15		60,025
	\$ 320,457	\$ 563	\$ (50)	\$ 320,970

Long-term investments consist of the following (in thousands):

	Cost or Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
December 31, 2012				
Corporate bonds and notes	\$ 292,374	\$ 896	\$ (306)	\$ 292,964
Municipal bonds and notes	21,969	59	(6)	22,022
Auction rate securities	5,000		(400)	4,600
U.S. government securities	4,985	9		4,994
U.S. government agency securities	446,416	394	(90)	446,720
	\$ 770,744	\$ 1,358	\$ (802)	\$ 771,300

	Cost or Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
September 30, 2012				

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Corporate bonds and notes	\$ 228,438	\$ 1,063	\$ (60)	\$ 229,441
Municipal bonds and notes	30,177	138	(8)	30,307
Auction rate securities	5,000		(250)	4,750
U.S. government securities	4,983	12		4,995
U.S. government agency securities	392,959	389	(38)	393,310
	\$ 661,557	\$ 1,602	\$ (356)	\$ 662,803

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The amortized cost and fair value of fixed maturities at December 31, 2012, by contractual years-to-maturity, are presented below (in thousands):

	Cost or Amortized Cost	Fair Value
One year or less	\$ 332,690	\$ 333,174
Over one year	770,744	771,300
	\$ 1,103,434	\$ 1,104,474

The following table summarizes investments that have been in a continuous unrealized loss position for less than 12 months and those that have been in a continuous unrealized loss position for more than 12 months as of December 31, 2012 (in thousands):

	Less Than 12 Months		12 Months or Greater		Total	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
December 31, 2012						
Corporate bonds and notes	\$ 152,461	\$ (320)	\$ 3,006	\$ (3)	\$ 155,467	\$ (323)
Municipal bonds and notes	18,351	(18)			18,351	(18)
Auction rate securities			4,600	(400)	4,600	(400)
U.S. government agency securities	153,556	(108)			153,556	(108)
Total	\$ 324,368	\$ (446)	\$ 7,606	\$ (403)	\$ 331,974	\$ (849)

The Company invests in securities that are rated investment grade or better. The unrealized losses on investments for the first three months of fiscal year 2013 were primarily caused by reductions in the values of the ARS due to the illiquid markets.

ARS are variable-rate debt securities. The Company limits its investments in ARS to securities that carry an AAA/A- (or equivalent) rating from recognized rating agencies and limits the amount of credit exposure to any one issuer. At the time of the Company's initial investment and at the date of this report, all ARS were in compliance with the Company's investment policy. In the past, the auction process allowed investors to obtain immediate liquidity if so desired by selling the securities at their face amounts. Liquidity for these securities has historically been provided by an auction process that resets interest rates on these investments on average every 7- 35 days. However, as has been reported in the financial press, the disruptions in the credit markets adversely affected the auction market for these types of securities. The Company does not intend to sell nor is it more likely than not that it will be required to sell these investments before their anticipated recovery.

4. Inventories

The Company outsources the manufacturing of its pre-configured hardware platforms to contract manufacturers, who assemble each product to the Company's specifications. As protection against component shortages and to provide replacement parts for its service teams, the Company also stocks limited supplies of certain key product components. The Company reduces inventory to net realizable value based on excess and obsolete inventories determined primarily by historical usage and forecasted demand. Inventories consist of hardware and related component parts and are recorded at the lower of cost or market (as determined by the first-in, first-out method).

Inventories consist of the following (in thousands):

	December 31, 2012	September 30, 2012
Finished goods	\$ 14,596	\$ 13,565

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Raw materials	4,127	3,845
	\$ 18,723	\$ 17,410

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5. Commitments and Contingencies

Guarantees and Product Warranties

In the normal course of business to facilitate sales of its products, the Company indemnifies other parties, including customers, resellers, lessors, and parties to other transactions with the Company, with respect to certain matters. The Company has agreed to hold the other party harmless against losses arising from a breach of representations or covenants, or out of intellectual property infringement or other claims made against certain parties. These agreements may limit the time within which an indemnification claim can be made and the amount of the claim. The Company has entered into indemnification agreements with its officers and directors, and the Company's bylaws contain similar indemnification obligations to the Company's agents. It is not possible to determine the maximum potential amount under these indemnification agreements due to the limited history of prior indemnification claims and the unique facts and circumstances involved in each particular agreement.

The Company offers warranties of one year for hardware for those customers without service contracts, with the option of purchasing additional warranty coverage in yearly increments. The Company accrues for warranty costs as part of its cost of sales based on associated material product costs and technical support labor costs. Accrued warranty costs as of December 31, 2012 and December 31, 2011 were not material.

Commitments

As of December 31, 2012, the company's principal commitments consisted of obligations outstanding under operating leases. The company leases its facilities under operating leases that expire at various dates through 2023. There have been no material changes in the company's principal lease commitments compared to those discussed in the Form 10-K.

The Company currently has arrangements with contract manufacturers and other suppliers for the manufacturing of its products. The arrangement with the primary contract manufacturer allows them to procure component inventory on the Company's behalf based on a rolling production forecast provided by the Company. The Company is obligated to the purchase of component inventory that the contract manufacturer procures in accordance with the forecast, unless they give notice of order cancellation in advance of applicable lead times. As of December 31, 2012, the Company was committed to purchase approximately \$16.6 million of such inventory during the next 30 day period.

Legal Proceedings

The Company is not aware of any pending legal proceedings that, individually or in the aggregate, would have a material adverse effect on the Company's business, operating results, or financial condition. The Company may in the future be party to litigation arising in the ordinary course of business, including claims that we allegedly infringe upon third-party intellectual property rights. Such claims, even if not meritorious, could result in the expenditure of significant financial and managerial resources.

6. Income Taxes

The effective tax rate was 37.2% and 34.6% for the three months ended December 31, 2012 and 2011, respectively. The increase in effective tax rate is primarily due to the expiration of the United States federal credit for Increasing Research Activities at December 31, 2011 and an increase in non-deductible stock-based compensation attributable to foreign based employees.

At December 31, 2012, the Company has classified approximately \$5.4 million of unrecognized tax liabilities as a non-current liability. It is reasonably possible that the Company's existing liabilities for uncertain tax benefits may change within the next twelve months primarily due to the expiration of statutes of limitations. At this time the Company cannot reasonably estimate a range of potential changes in such benefits.

The Company recognizes interest and, if applicable, penalties for any uncertain tax positions. This interest and penalty expense will be a component of income tax expense. For the three months ended December 31, 2012, the Company accrued an immaterial amount of interest expense related to its liability for unrecognized tax benefits. All unrecognized tax benefits, if recognized, would affect the effective tax rate.

The Company and its subsidiaries are subject to U.S. federal income tax as well as the income tax of multiple state and foreign jurisdictions. The Company has concluded all U.S. federal income tax matters for fiscal years through September 30, 2008. Major jurisdictions where there are wholly owned subsidiaries of F5 Networks, Inc. which require income tax filings include the United Kingdom, Japan, Australia and Germany. The earliest periods open for review by local taxing authorities are fiscal years 2010 for the United Kingdom and Japan, and 2007 for Australia and Germany. Within the next four fiscal quarters, the statute of limitations will begin to close on the fiscal years ended 2008 and 2009 tax returns filed in various states and the fiscal year ended 2009 federal income tax return.

Table of Contents**7. Geographic Sales and Significant Customers**

Operating segments are defined as components of an enterprise for which separate financial information is available and evaluated regularly by the chief operating decision-maker, or decision-making group, in deciding how to allocate resources and in assessing performance. The Company does business in four main geographic regions: the Americas (primarily the United States); Europe, the Middle East, and Africa (EMEA); Japan; and the Asia Pacific region (APAC). The Company's chief operating decision-making group reviews financial information presented on a consolidated basis accompanied by information about revenues by geographic region. The Company's foreign offices conduct sales, marketing and support activities. Revenues are attributed by geographic location based on the location of the customer. The Company's assets are primarily located in the United States and not allocated to any specific region. Therefore, geographic information is presented only for net revenue.

The following presents revenues by geographic region (in thousands):

	Three months ended December 31,	
	2012	2011
Americas:		
United States	\$ 194,838	\$ 170,986
Other	18,179	18,722
Total Americas	213,017	189,708
EMEA	82,858	68,072
Japan	18,043	20,202
Asia Pacific	51,533	44,450
	\$ 365,451	\$ 322,432

Three worldwide distributors of the Company's products accounted for 16.9%, 15.2%, and 11.0% of total net revenue for the three month period ended December 31, 2012. Two worldwide distributors of the Company's products accounted for 17.9% and 13.7% of total net revenue for the three month period ended December 31, 2011. Two worldwide distributors accounted for 11.2% and 10.3% of the Company's accounts receivable as of December 31, 2012. One worldwide distributor accounted for 15.6% of the Company's accounts receivable as of December 31, 2011. No other distributors accounted for more than 10% of total net revenue or receivables.

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

The following discussion of our financial condition and results of operations contains forward-looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934 and Section 27A of the Securities Act of 1933. These statements include, but are not limited to, statements about our plans, objectives, expectations, strategies, intentions or other characterizations of future events or circumstances and are generally identified by the words expects, anticipates, intends, plans, believes, seeks, estimates, and similar expressions. These forward-looking statements are based on current information and expectations and are subject to a number of risks and uncertainties. Our actual results could differ materially from those expressed or implied by these forward-looking statements. Factors that could cause or contribute to such differences include, but are not limited to, those discussed under Item 1A. Risk Factors herein and in other documents we file from time to time with the Securities and Exchange Commission. We assume no obligation to revise or update any such forward-looking statements.

Overview

We are a global provider of appliances consisting of software and hardware and services that help companies efficiently and securely manage the delivery, optimization and security of application and data traffic on Internet-based networks, and to optimize the performance and utilization of data storage infrastructure and other network resources. We market and sell our products primarily through multiple indirect sales channels in the Americas (primarily the United States); Europe, the Middle East, and Africa (EMEA); Japan; and the Asia Pacific region (APAC). Enterprise customers (Fortune 1000 or Business Week Global 1000 companies) in the technology, telecommunications, financial services, transportation, education, manufacturing and health care industries, along with government customers, continue to make up the largest

percentage of our customer base.

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Our management team monitors and analyzes a number of key performance indicators in order to manage our business and evaluate our financial and operating performance on a consolidated basis. Those indicators include:

Revenues. The majority of our revenues are derived from sales of our application delivery networking (ADN) products including our high end VIPRION chassis and related software modules; BIG-IP Local Traffic Manager, BIG-IP Global Traffic Manager, BIG-IP Link Controller, BIG-IP Application Security Manager, BIG-IP Edge Gateway, BIG-IP WAN Optimization module, BIG-IP Access Policy Manager, WebAccelerator; FirePass SSL VPN appliance; Traffix diameter signaling products; and ARX file virtualization products. We also derive revenues from the sales of services including annual maintenance contracts, training and consulting services. We carefully monitor the sales mix of our revenues within each reporting period. We believe customer acceptance rates of our new products and feature enhancements are indicators of future trends. We also consider overall revenue concentration by customer and by geographic region as additional indicators of current and future trends.

Cost of revenues and gross margins. We strive to control our cost of revenues and thereby maintain our gross margins. Significant items impacting cost of revenues are hardware costs paid to our contract manufacturers, third-party software license fees, amortization of developed technology and personnel and overhead expenses. Our margins have remained relatively stable; however, factors such as sales price, product mix, inventory obsolescence, returns, component price increases and warranty costs could significantly impact our gross margins from quarter to quarter and represent significant indicators we monitor on a regular basis.

Operating expenses. Operating expenses are substantially driven by personnel and related overhead expenses. Existing headcount and future hiring plans are the predominant factors in analyzing and forecasting future operating expense trends. Other significant operating expenses that we monitor include marketing and promotions, travel, professional fees, computer costs related to the development of new products, facilities and depreciation expenses.

Liquidity and cash flows. Our financial condition remains strong with significant cash and investments and no long term debt. The increase in cash and investments for the first three months of fiscal year 2013 was primarily due to net income from operations, with operating activities providing cash of \$144.8 million. This increase was partially offset by \$50.0 million of cash used to repurchase outstanding common stock under our stock repurchase program in the first three months of fiscal year 2013. Going forward, we believe the primary driver of cash flows will be net income from operations. Capital expenditures for the first three months of fiscal year 2013 were comprised primarily of information technology infrastructure and equipment purchases to support the growth of our core business activities, and expenses related to the addition and expansion of our worldwide facilities. We will continue to evaluate possible acquisitions of, or investments in businesses, products, or technologies that we believe are strategic, which may require the use of cash.

Balance sheet. We view cash, short-term and long-term investments, deferred revenue, accounts receivable balances and days sales outstanding as important indicators of our financial health. Deferred revenues increased in the first quarter of fiscal year 2013 due to growth in the amount of annual maintenance contracts purchased on new products and maintenance renewal contracts related to our existing product installation base. Our days sales outstanding for the first quarter of fiscal year 2013 was 51.

Summary of Critical Accounting Policies and Estimates

The preparation of our financial condition and results of operations requires us to make judgments and estimates that may have a significant impact upon our financial results. We believe that, of our significant accounting policies, the following require estimates and assumptions that require complex, subjective judgments by management, which can materially impact reported results: revenue recognition; reserve for doubtful accounts; reserve for product returns; reserve for warranties; accounting for income taxes; stock-based compensation; investments; goodwill impairment; and the fair value measurements of financial assets and liabilities. None of these accounting policies and estimates have significantly changed since our annual report on Form 10-K for the year ended September 30, 2012 (Form 10-K). Critical accounting policies and estimates are more fully described in Management's Discussion and Analysis of Financial Condition and Results of Operations in the Form 10-K. Actual results may differ from these estimates under different assumptions or conditions.

Results of Operations

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The following discussion and analysis should be read in conjunction with our consolidated financial statements, related notes and risk factors included elsewhere in this Quarterly Report on Form 10-Q.

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	Three months ended December 31,	
	2012	2011
	(in thousands, except percentages)	
Net Revenues		
Products	\$ 204,712	\$ 196,554
Services	160,739	125,878
Total	\$ 365,451	\$ 322,432
Percentage of net revenues		
Products	56.0%	61.0%
Services	44.0	39.0
Total	100.0%	100.0%

Net revenues. Total net revenues increased 13.3% for the three months ended December 31, 2012, from the same period in the prior year. Overall revenue growth for the three months ended December 31, 2012 was primarily due to increased service and product revenues as a result of our increased installed base of products and increased demand for our core ADN products, including our application security products. International revenues represented 46.7% of total net revenues for the three months ended December 31, 2012, compared to 47.0% for the same period in the prior year. We expect international sales will continue to represent a significant portion of net revenues, although we cannot provide assurance that international revenues as a percentage of net revenues will remain at current levels.

Net product revenues increased 4.2% for the three months ended December 31, 2012, from the same period in the prior year. The increase in net product revenues for the three months ended December 31, 2012 was primarily due to an increase of \$8.2 million in sales of our ADN products from the same period in the prior year. Sales of our ADN products represented 98.8% of product revenues for the three months ended December 31, 2012, compared to 98.7% of product revenues for the three months ended December 31, 2011.

Net service revenues increased 27.7% for the three months ended December 31, 2012, from the same period in the prior year. The increase in net service revenues was primarily due to increases in the purchase or renewal of maintenance contracts driven by additions to our installed base of products.

Avnet Technology Solutions, Ingram Micro, and Westcon, three of our worldwide distributors, accounted for 16.9%, 15.2%, and 11.0% of our total net revenue for the three months ended December 31, 2012, respectively. Avnet Technology Solutions and Ingram Micro accounted for 17.9% and 13.7% of our total net revenue for the three months ended December 31, 2011, respectively. Avnet Technology Solutions and Ingram Micro accounted for 11.2% and 10.3% of our accounts receivable as of December 31, 2012, respectively. Avnet Technology Solutions accounted for 15.6% of our accounts receivable as of December 31, 2011. No other distributors accounted for more than 10% of total net revenue or receivables.

	Three months ended December 31,	
	2012	2011
	(in thousands, except percentages)	
Cost of net revenues and Gross Margin		
Products	\$ 31,792	\$ 33,200
Services	29,093	22,406
Total	60,885	55,606
Gross profit	\$ 304,566	\$ 266,826
Percentage of net revenues and Gross Margin (as a percentage of related net revenue)		
Products	15.5%	16.9%
Services	18.1	17.8

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Total	16.7	17.2
Gross profit	83.3%	82.8%

Cost of net product revenues. Cost of net product revenues consist of finished products purchased from our contract manufacturers, manufacturing overhead, freight, warranty, provisions for excess and obsolete inventory and amortization expenses in connection with developed technology from acquisitions. Cost of net product revenues decreased 4.2% for the three months ended December 31, 2012, as compared to the same period in the prior year.

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Cost of net service revenues. Cost of net service revenues consist of the salaries and related benefits of our professional services staff, travel, facilities and depreciation expenses. For the three months ended December 31, 2012, cost of net service revenues as a percentage of net service revenues were 18.1%, compared to 17.8% for the three months ended December 31, 2011. Professional services headcount at the end of December 2012 increased to 701 from 538 at the end of December 2011. In addition, cost of net service revenues included stock-based compensation expense of \$2.6 million for the three months ended December 31, 2012, compared to \$2.2 million for the same period in the prior year.

	Three months ended December 31,	
	2012	2011
	(in thousands, except percentages)	
Operating expenses		
Sales and marketing	\$ 122,268	\$ 106,238
Research and development	48,541	39,122
General and administrative	24,673	21,677
Total	\$ 195,482	\$ 167,037
Operating expenses (as a percentage of net revenue)		
Sales and marketing	33.5%	33.0%
Research and development	13.3	12.1
General and administrative	6.7	6.7
Total	53.5%	51.8%

Sales and marketing. Sales and marketing expenses consist of salaries, commissions and related benefits of our sales and marketing staff, the costs of our marketing programs, including public relations, advertising and trade shows, travel, facilities, and depreciation expenses. Sales and marketing expenses increased 15.1% for the three months ended December 31, 2012, from the comparable period in the prior year. The increase in sales and marketing expense was primarily due to an increase of \$11.7 million in

commissions and personnel costs. The increased commissions and personnel costs were driven primarily by growth in sales and marketing employee headcount and increased sales volume for the corresponding periods. Sales and marketing headcount at the end of December 2012 increased to 1,296 from 1,141 at the end of December 2011. Sales and marketing expense included stock-based compensation expense of \$10.6 million for the three months ended December 31, 2012, compared to \$9.1 million for the same period in the prior year. The increase in sales and marketing expense was also due to investments in marketing promotions and initiatives aimed at promoting our brand and creating market awareness of our technology and our products.

Research and development. Research and development expenses consist of the salaries and related benefits of our product development personnel, prototype materials and other expenses related to the development of new and improved products, facilities and depreciation expenses. Research and development expenses increased 24.1% for the three months ended December 31, 2012, from the comparable period in the prior year. The increase in research and development expense was primarily due to an increase of \$7.4 million in personnel costs for the three months ended December 31, 2012, from the comparable period in the prior year. Research and development headcount at the end of December 2012 increased to 802 from 646 at the end of December 2011. Research and development expense included stock-based compensation expense of \$7.8 million for the three months ended December 31, 2012, compared to \$5.8 million for the same period in the prior year. We expect research and development expenses to remain consistent as a percentage of net revenue in the foreseeable future.

General and administrative. General and administrative expenses consist of the salaries, benefits and related costs of our executive, finance, information technology, human resource and legal personnel, third-party professional service fees, bad debt charges, facilities and depreciation expenses. General and administrative expenses increased 13.8% for the three months ended December 31, 2012, from the comparable period in the prior year. The increase in general and administrative expense was primarily due to an increase of \$1.5 million in personnel costs for the three months ended December 31, 2012, from the comparable period in the prior year. Stock-based compensation expense was \$5.4 million for the three months ended December 31, 2012, compared to \$4.7 million for the same period in the prior year. General and administrative headcount at the end of December 2012 increased to 328 from 291 at the end of December 2011.

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	Three months ended December 31,	
	2012	2011
	(in thousands, except percentages)	
Other income and income taxes		
Income from operations	\$ 109,084	\$ 99,789
Other income, net	1,550	1,861
Income before income taxes	110,634	101,650
Provision for income taxes	41,141	35,158
Net income	\$ 69,493	\$ 66,492