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New Rec: F5 Networks	(FFIV: \$101.06)	February 24, 2013
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Position: Sell

Target: \$70

	Dec-12	Mar-13e	Jun-13e	Sep-13e	F2012a	F2013e
Rev (\$Ms)	365.5	375.4	387.6	403.7	1,377.2	1,532.1
Adj. EPS	1.14	1.20	1.23	1.26	4.38	4.83
Y/Y Gro	11%	10%	8%	13%	16%	10%
GAAP EPS	0.88	0.95	0.98	1.01	3.45	3.81
PE (Adj.)	na	na	na	na	23.1x	20.1x
PSR	na	na	na	na	5.8x	5.2x
Cons (Adj.)	na	1.23	1.27	1.37	na	5.01

Shares Out: 79.3M

Market Cap: \$8.0B

FYE Sep

Concept:

1. Large-scale "cloud" service providers (Amazon, Google, etc.) appear to be bypassing F5's off-the-shelf ADCs in favor of commodity hardware. Hardware accounts for ~2/3rds of F5 sales.

2. Server workloads in traditional data centers (F5's biggest market) are expected to peak in 2013 as workloads shift to the "cloud" (where F5 should benefit less than expected).
3. Among enterprises, data center consolidation and the construction of "private clouds" appear to improve ADC utilization and permit enterprises to purchase less ADC hardware capacity.
4. F5 is trying to offset hardware declines by expanding into ancillary markets like security, but our contacts suggest this will be challenging. Security modules represent <10% of F5 sales.
4. Resellers are shifting their business models away from hardware and towards more profitable cloud services, expecting enterprise hardware sales to decline. ~85% of F5 sales go through resellers.

Summary: F5 Networks (FFIV), based in Seattle, WA, designs and sells Application Delivery Controllers (ADCs), a hardware appliance used in data centers. The core function of the ADC is load balancing, whereby incoming traffic is inspected and allocated more efficiently across the servers in a data center, boosting productivity. F5's customers purchase the hardware platform (called BIG-IP), and can also purchase registration keys to unlock a variety of software modules that run on the hardware, and which cover a broad array of functions (SSL offloading, application firewalls, etc.). Customers pay a one time fee to purchase the hardware and software, plus an annual maintenance fee to access F5's service and software updates.

Bulls view F5 as a play on data center growth, server virtualization, and cloud computing. "Street" analysts (correctly) point out that F5 dominates the market for high-end ADCs in enterprise data centers, holding an estimated 50%-60% market share at present, and commanding >80% gross margins (and >30% operating margins), despite its hardware-based model. Bulls expect F5 to maintain this dominant market position, while benefiting from the seemingly limitless growth in data center infrastructure and network traffic.

We are skeptical, based on our variant view of F5's core ADC market. Data center infrastructure is consolidating in a relatively small number of very large service providers (including providers of cloud infrastructure-as-a-service [IaaS] like Amazon and Rackspace). It appears, based on our research, that these entities are generally bypassing F5's off-the-shelf ADC hardware appliances in favor of commodity hardware or custom-built equipment. There appear to be two main reasons for this. The first is cost. As evidenced by its high margins, F5 sells its hardware at very high prices (~\$400k for the highest end appliance). By building their own hardware from commodity components, large-scale users can realize substantial per-unit cost savings (we estimate a minimum of 50%). Our contacts suggest that Google, Amazon, Rackspace, and Akamai all use primarily self-built or commodity hardware in place of off-the-shelf ADC appliances. Our contacts make it clear that there are overwhelming incentives to do so when operating on a large scale.

The other reason is that large-scale cloud providers (and to a growing extent, sophisticated enterprises building “private clouds”) are moving toward a software-driven networking approach in which hardware is treated as a commoditized pool of assets, rather than a series of valuable, discrete components. “The fundamental principle of the cloud model,” one contact at a major IaaS provider told us, “is that no piece of hardware is special” and, under this approach, can fail without causing a wider disruption. This contrasts with F5’s traditional hardware-based model, in which a network may rely on a single, powerful hardware appliance (often sitting next to a backup appliance which may go virtually unused, but is required in case the primary box should fail).

To the extent that data center capacity becomes increasingly concentrated in large service provider infrastructures, therefore, demand for F5’s hardware appliances should decline. Cisco recently projected that, in North America and in Europe, the volume of server workloads in traditional data centers will peak in 2013 and 2015, respectively, while “cloud” workloads are expected to grow by 100% in N. America and 165% in Europe between 2012 and 2015. We think this mix shift is the primary factor behind the slowdown in F5’s product sales. “Our customers are definitely buying less hardware now,” says one contact at a large service provider. Based on the company’s disclosures, we estimate that sales of F5’s core BIG-IP appliances have fallen sequentially for the last 3 quarters.

Within F5’s strongest market (i.e. traditional enterprise data centers) data center consolidation and the move toward “private cloud” architectures appear to reduce the need to purchase ADC hardware capacity. For example, one contact at a very large enterprise told us that, by building a private cloud infrastructure, he was able to reduce the number of ADC appliances in his data centers from 66 to 16. We think this is especially negative for F5 because the more sophisticated enterprises that are implementing private clouds appear to constitute F5’s traditionally strongest customer base (i.e. larger enterprises with more complex IT requirements). Further, we are told some enterprises are increasingly using IaaS to offload rapidly growing or “spikey” applications from their own data centers – for example, an online advertising campaign, or seasonal e-commerce traffic – eliminating the need to over-purchase data center capacity (including ADCs) in order to handle unpredictable or erratic traffic flows.

F5 is attempting to sustain its growth by expanding into ancillary software products, especially security. The idea is to take advantage of its existing “base” in the data center, and layer more add-on software modules on top of each BIG-IP box. However, our contacts (including several former F5 employees) are skeptical that F5 will succeed in offsetting the declining hardware business. This is partially because, while customers are familiar with the core BIG-IP load balancing functionality, moving beyond that core functionality to the advanced add-ons is

“out of most customers’ comfort zone,” we are told, and requires a much longer evaluation and sales process. According to one contact, “deep knowledge is lacking” in terms of understanding how to even use the more advanced modules.

With regard to security in particular, we are told that F5’s products are likely to appeal mainly to the largest, most sophisticated customers, since “putting core firewall functionality on top of an ADC represents a fundamental shift” in data center architecture. F5 has disclosed that, while growing ~90% Y/Y, its two core security products represented < 7% of FY12 product revenues.

Meanwhile, based on conversations with IT resellers over the last year, it appears that these businesses are shifting focus away from hardware and toward the sale of cloud services. IT resellers account for about 85% of F5 sales, so this is a very important development. In part, this is an offensive move for resellers, as cloud services carry more than double the gross margins of hardware, and clouds creates “stickier” customer relationships. However, it is also a defensive move, as resellers tell us they anticipate a general decline in hardware consumption by SMBs and enterprises, as data capacity increasingly consolidates. Making this shift appears to be a major priority for resellers. According to a contact at Ingram Micro (15% of F5 sales): “If a [reseller] partner, even with well-established, long-term, end-user customers, does not find a new way to do business [i.e. by shifting from hardware to services], they will not be in business in two years.” “‘Cloud’ is a bad word to us” due to its effect on hardware sales, joked a contact at Avnet, F5’s largest distributor (17% of sales). In a telling move, Avnet itself has built a data center to offer cloud IaaS services to its clients, and we were told this is a major sales objective for its consultants. It appears that resellers are increasingly incentivized to push clients away from hardware and toward more profitable cloud services, a major negative development for F5.

We last initiated FFIV as a short recommendation in April 2012. At that time, following several quarters of deceleration, “street” analysts were expecting FFIV’s product revenue growth to re-accelerate from the mid-teens back into the 20% range. Instead, product sales continued to decelerate, and grew only 4% Y/Y (estimated +2% organic) in the December quarter. FFIV management and the “street” attributed this to temporary “macro” weakness, and once again expect a strong re-acceleration in product revenues to high-teens growth rates by 2H13, helped along by a recent hardware refresh. Based on our research, we are skeptical that this re-acceleration will materialize, and we are modeling product revenue growth in the low-to-mid single digits over the next several quarters (we assume essentially flat growth in the core ADC business, partially offset by ~40%-60% growth rates in security, which may prove generous to FFIV).

We expect that, should their expectations for product re-acceleration be dashed a second time, bullish “street” analysts will question their assumption that FFIV is a high-growth technology stock deserving >20x multiples to non-GAAP EPS, and start viewing it as a mature hardware company struggling to transition to an increasingly software-driven industry. Our price target of \$70 represents 14x our calendar year 2013 non-GAAP EPS projection of \$4.98, or 17.6x our CY13 GAAP EPS projection of \$3.97. Since we are using non-GAAP EPS, we do not give FFIV credit for \$16/share in net cash (putting a 14x multiple on our GAAP number, plus the \$16 in cash, would also put us at \$70). This multiple represents 1.4x our estimated non-GAAP EPS growth rate of 10%. By comparison, we look at NetApp (NTAP), which consensus has growing ~10% over the medium term, and which trades at 13.9x CY13 non-GAAP EPS despite having net cash representing 37% of its market cap.

Background:

F5 Networks (FFIV), based in Seattle, WA, was founded in 1996 (for an interesting account of F5’s origins, OWS recommends the 1999 book, *The Visionary Position*). The company designs and sells an Application Delivery Controller (ADC), a hardware appliance used in data centers. The core function of an ADC is load balancing, whereby incoming data traffic is inspected and allocated more efficiently across the servers (either physical servers or virtual machines) in a data center. This reduces bottlenecks and maximizes the productivity of each individual server. F5’s ADC is a “full proxy” appliance, which means it can examine longer streams of data packets and deal with them more intelligently, rather than simply passing them along one packet at a time.

The hardware platform for F5’s ADCs is called BIG-IP. This is a box that sits in front of the servers in a data center (i.e. at the “edge” of the network) where it receives incoming traffic. F5 sells a range of BIG-IP appliances across the performance spectrum (typically measured by the amount of traffic throughput the appliance can handle at one time), from 1Gb/s (costing ~\$20k) to 42Gb/s (costing ~\$125k). In 2008, F5 introduced a new variety of BIG-IP called VIPRION, which is based on a chassis and up to 4 blades, offering somewhat easier scaling for the customer. A VIPRION 2400 chassis costs \$10k, plus \$60k per blade (so \$250k for a chassis and four blades). At the highest end, we are told a 4-blade VIPRION 4400 appliance costs ~\$400k. F5 is currently in the process of refreshing its hardware product lines, with improved performance in terms of throughput. The company has disclosed that its average order size (hardware and software) is ~\$90k.

All BIG-IP appliances come with F5’s Local Traffic Manager (LTM) software module, the standard load balancing function. Customers pay a one-time

fee to purchase the hardware, and can also pay a one-time fee to unlock a variety of add-on software modules. These include Global Traffic Manager (GTM), which does load balancing across geographically dispersed data centers, Application Security Manager (ASM), which is an application firewall, Web Accelerator for optimizing web traffic, etc. F5 management has disclosed that software revenues are increasing as a percentage of the total. However, we estimate that hardware accounts for roughly ~2/3rds of F5 revenues.

F5's strategy has been to expand beyond the core load balancing market by getting customers to use the BIG-IP box as a hardware base for these ancillary functions, particularly in the security area. The company has disclosed that product revenues from its two main security software modules (Access Policy Manager and Application Security Manager) represented 6.7% of FY12 (end-Sep) product revenues, and grew 90% Y/Y. Its competitors in this area include Cisco, Juniper, Check Point, and Palo Alto Networks.

F5 also offers software-only versions of each of its products, which it calls Virtual Editions (VEs). Performance-wise, the new line of VEs max out at 3Gb/s of traffic throughput (i.e. near the bottom end of the hardware range), up from only 1GB/s previously. Historically, F5 had positioned the VEs as a niche complement to its hardware-based ADCs, suitable mostly for test environments (where a customer wants to try out the BIG-IP without buying the box, or to test how a new application works together with BIG-IP in a closed environment). However, recently FFIV management has been touting the VE business more aggressively as a way for F5 to participate in cloud (as customers can license a VE to run on top of Amazon AWS or other IaaS providers). We are told that VE sales do not represent a meaningful portion of F5's revenues.

The operating system, which runs on BIG-IP, is called TMOS. In 2011, F5 released version 11 of TMOS, which introduced "virtual clustered multiprocessing" (vCMP) capability for the VIPRION platform. This allows the user to spin up multiple virtualized ADCs within a single hardware box (much as in server virtualization), which boosts hardware utilization. The charge to enable 4 vADCs is \$10k, with an additional \$10k cost to increase the number to 16 vADCs. However, virtualization also reduces the need to purchase additional hardware capacity. F5 is set to release an updated version of TMOS this year.

In February 2012, F5 paid \$129MM to acquire Traffix, which sells a hardware appliance used for load balancing and Diameter signaling in telecom/wireless applications. Diameter is a standard network signaling protocol used for 4G, IP-based wireless data standards such as LTE. Traffix was estimated by "street" analysts to be doing \$3MM-\$4MM in quarterly revenues at the time of acquisition, though F5 does not break this out. Traffix' competitors include Acme

Packet (which Oracle plans to acquire) and Tekelec. F5 also acquired a start-up SDN (software-defined networking) company called LineRate in Feb-2013 (terms were not disclosed).

According to a 2Q12 Gartner estimate, F5 has approximately 48% market share in the total ADC market, followed by Citrix at 14%, Cisco at 11%, Radware at 8%, A10 Networks at 5%, and Other at 13%. Citrix has been taking share, because its ADC products are usually tied in to the sale when enterprises adopt its Virtual Desktop solutions, and because it is more widely used among big service providers like Amazon and Terremark (though, as we discuss below, our contacts suggest this is precisely because Citrix's Netscaler ADC software is fairly hardware-agnostic). We understand that Cisco's load balancing products are lower-functionality and are built into its switch and router appliances. It does not compete with F5 and others in the higher-end of the market, hence it has lost significant share of the total ADC market over the past several years.

F5's revenues are split between products (56%) and services (44%). Product sales are the one-time payments made for hardware appliances and software registration keys, while service revenues consist of annual contracts for access to F5's maintenance and software updates. We estimate that, within product sales, revenues are split roughly two-thirds / one-third between hardware and software. Gross margins for both segments are 82%-84%. By customer vertical, FY12 sales were split across telecom (23%), financial (20%), technology (17%), US Federal government (7%), non-USF government (6%), and other (mainly enterprise, 28%). (We note that "telecom" appears to include a substantial portion of enterprise-related sales, as telecoms often purchase hardware for their enterprise co-location customers.) These weights have not changed meaningfully over the past few years, excepting Technology, which has fallen from >20% in 2011 to only 13% in the Dec-12 quarter. Management attributed this to customers using more in-house solutions, which would appear to support our thesis.

Geographically, F5's sales are split between the Americas (primarily US, 58%), EMEA (21%), APAC ex-Japan (14%), and Japan (7%), with no significant mix changes in recent years. Approximately 85% of sales go through value-added resellers or channel partners. Avnet (17% of sales), Ingram Micro (15%), and Westcon (10%) are F5's largest customers. In recent years, Tech Data has also been listed as a 10% customer.

Discussion:

1. Large-scale "cloud" service providers appear to be bypassing F5's off-the-shelf ADC appliances in favor of commodity hardware. Hardware accounts for ~2/3rds of F5 sales.

Throughout the course of our research, we have confirmed that Google, Amazon, Rackspace, and Akamai mainly use self-built or commodity hardware in place of off-the-shelf ADC boxes from vendors like F5. (We note that, although Citrix touts Amazon and other service providers as customers for its NetScaler ADCs, our contacts suggest this is precisely because the NetScaler software, unlike F5, is flexible with regard to the hardware it runs on, and that NetScaler is likely not used for the primary, scaled-out load balancing function). It appears that, as data center infrastructure consolidates in a smaller number of large service providers (including providers of infrastructure-as-a-service [IaaS]), the economies of scale create an overwhelming incentive to use custom or commodity hardware. For this reason, we think that, as consolidation continues, other large data processors will, likewise, adopt the strategy of those companies in our sample.

The primary reason is cost. Our contacts suggest there are three major sources of cost savings from using custom or commodity hardware. First, as evidenced by its >80% gross margins, FFIV is extracting a meaningful surplus from the sale of high-priced hardware units. However, we are told that BIG-IP appliances are fairly simple from a hardware standpoint – the advanced functions rely on simply adding more CPU and memory to a box, like a standard server. “Simple load balancing could be done nicely on a dedicated hardware appliance, and that is how the industry worked in the early days,” one contact told us. “However, as needs grew more complex, the original hardware companies like F5 morphed into software companies . . . At the high end, F5 is competing on the software level only, except in its case you cannot choose the hardware on which you run the software.”

Said another: “You pretty much have this generic hardware inside a box, and you’re loading software onto it. At what point does that ‘hardware’ load balancer really become a ‘software’ load balancer?” Although specifically designed to run ADC software, because an ADC box uses generic components (FPGAs, CPU, memory, etc.), there is nothing from a hardware perspective that inherently requires that ADC software run on a dedicated appliance. Therefore, sophisticated users appear to have little difficulty in using self-built servers or custom hardware, and extracting F5’s sizable surplus for themselves. Intense price competition in the IaaS business makes capturing this surplus a growing priority.

The second source of savings is derived from the fact that BIG-IP is a general purpose, off-the-shelf product. By using custom hardware, we are told, users can avoid paying for those components (e.g. extra cache) that are not required for their specific use.

The third source comes from time and labor. An off-the-shelf product requires a meaningful amount of time to configure, while pre-configured custom hardware can be plugged directly into the network and run immediately. One contact at a major Internet company joked with us that, even if he were forced to buy enough BIG-IPs to run on his network, there “isn’t enough time in the universe” to configure them all manually. It is clear that the largest users are going to great lengths to eliminate configuration time. We are told that, when a custom Google server was mistakenly shipped to another company’s data center, the other company couldn’t get it to work at all – because it had been pre-configured to plug directly into Google’s network with zero configuration necessary.

Rackspace uses Zeus software (i.e. Riverbed’s Stingray product) atop self-built server hardware for load-balancing its public cloud IaaS service. Rackspace estimates the cost savings at greater than 50%, compared to buying hardware ADCs from a vendor like F5, and it gets superior performance. We estimate the cost savings are equivalent or higher for service providers of larger scale than Rackspace (\$1B revenue), and which, we are told, tend to design their own load balancing software from the ground up, typically using open-source code as a foundation.

Customization appears to be a high priority for the largest users, as they tend to have very specialized hardware and software requirements, and their scale makes it worthwhile to invest in designing tools specific to their needs. For example, it is public knowledge that Google and Facebook build their own custom server hardware from commodity components. Google publicly unveiled its custom server design in early 2009, surprising many with the degree to which it tweaked the basic architecture to save on costs (e.g. altering the power supply to transmit at 12 volts only, due to slightly better efficiency transferring power over copper wires at 12 volts rather than 5 volts).

Meanwhile, in 2011 Facebook launched its Open Compute Project (www.opencompute.org) in which it makes its designs for cost-efficient servers and data center infrastructure “open-source”: as the website states, “We decided to honor our hacker roots and challenge convention by custom designing and building our software, servers and data centers from the ground up – and then share these technologies as they evolve.” It claims 24% lower cost of ownership than other “state of the art” data centers. “The proliferation of open source hardware is going to increasingly put pressure on hardware vendors like F5,” according to one contact.

Based on our research and discussions with knowledgeable people, we think the broader trend is that value is generally being abstracted from the hardware level and into the software level. Large-scale cloud providers (and to a growing extent,

sophisticated enterprises building “private clouds”) are moving toward a software-driven networking approach in which hardware is treated as a commoditized pool of assets, rather than a series of valuable, discrete components (with “choke points” vulnerable to failure). “We are moving away from dedicated ASIC [that is, hardware dedicated to a specific software application] in every way possible,” one contact at a large service provider told us. “I think [branded] hardware is going the way of the dodo,” said the Chief Architect of a small cloud provider.

“Now that unit-level reliability doesn’t matter,” said another contact at a very large IaaS company, “we’re going to put a software layer over it, and not only do we expect [hardware] to fail, we’re going to encourage it to fail, so we can improve our recovery process.” This philosophy contrasts with F5’s traditional hardware-based model, in which a network may rely on a single, powerful hardware appliance (often sitting next to a backup appliance which may go virtually unused, but is required in case the primary box should fail). As a result, “the F5 people are worried about the cloud issue,” one former F5 salesperson told us.

Despite this, “street” analysts tout data center consolidation and “cloud” growth as major positives for F5, seemingly unaware of the factors described above. This may be due in part to the fact that F5 lists major companies like Facebook, Rackspace, and Amazon among its customers (though without disclosing the size or nature of these relationships). This, however, may be somewhat misleading. Our contacts suggest this is due to two reasons: first, companies like Rackspace use BIG-IPs for certain of its managed hosting (i.e. non public cloud) services; and second, that the very large companies likely have a few off-the-shelf ADCs “kicking around” for certain general purposes that aren’t tied to the scalable portion of their business. In either case, it appears that F5 will gain little from the high-growth portions of these businesses.

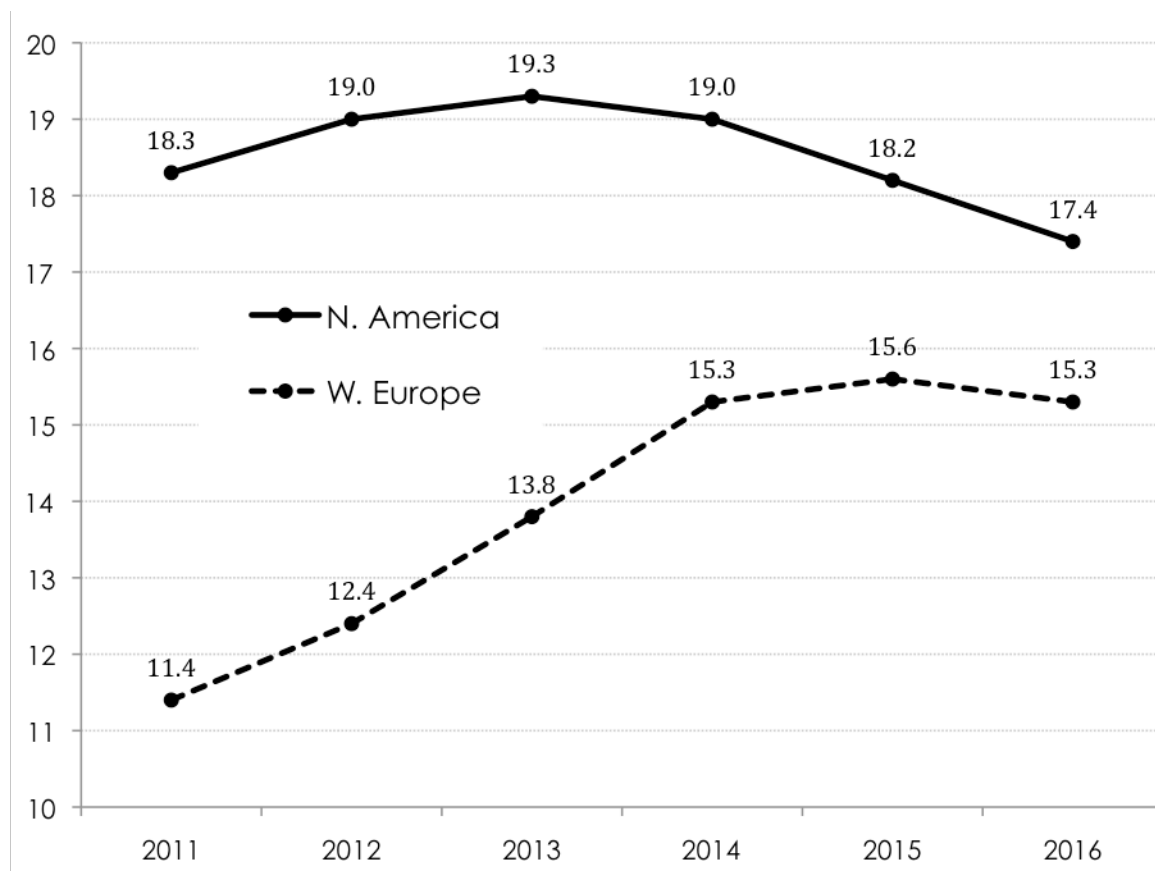
2. Server workloads in traditional data centers (F5’s biggest market) are expected to peak in 2013 as workload volumes shift to cloud providers (where F5 should benefit far less than expected).

It is clear that cloud and IaaS providers in particular are experiencing rapid growth. This is due, first, to economies of scale. In a 2010 report, Microsoft estimated the total cost of ownership (per unit of computing power) of a 100k server data center to be 80% below that of a 1k server data center, and estimated that large enterprises’ unit costs could be reduced by 10x by utilizing a public cloud over an on-premise private cloud (>25x for SMBs). The second reason is specialization: when computing resources are provided “as a service” by a third party (whether IaaS, PaaS or SaaS), it permits the user to shift focus higher on the

value chain, rather than invest time and resources into managing its own infrastructure.

Cisco recently issued a report (“Cisco Global Cloud Index: Forecast and Methodology, 2011-2016”) in which it forecast that 2/3rds of all server workloads (a unit measure of CPU usage) would be processed in cloud data centers by 2016, up from an estimated 46% in 2012. Critically for F5, Cisco forecast that workload volumes in traditional data centers (F5’s biggest market) would peak in North America in 2013 and in Western Europe in 2015, and fall thereafter (Chart 1). These two geographies represent 58% and 21% of F5’s revenues, respectively.

Chart 1. Cisco forecast of traditional data center workload volumes (in millions)



Interestingly, since we last recommended selling FFIV (in April 2012), with the same thesis (i.e. that F5 is being mostly shut out of cloud architectures), the company has changed its tone notably with regard to the cloud, and appears to be touting the virtual editions of its products (VEs) more aggressively. For illustration, when asked about software-only ADCs at a November 2011 CSFB tech conference, F5’s CEO said, “We have software solutions of all our modules . .

. But the reality is, if you want any robust performance solution, you need to get the hardware.” At that time, FFIV management held that it didn’t expect VEs to “ever” represent a material portion of revenue. Now F5 appears to be drawing more attention to its VE offerings as its way to participate in cloud growth (for instance, F5 VEs are now available for customers to use on top of Amazon’s IaaS). We note this year’s 10-K was changed to include the following sentence: “*We also offer virtual editions (software only versions) of our ADN software (referred to as VEs) that can run on physical or virtual servers and allow our customers to deploy our products in virtualized and cloud environments.*” However, as one former F5 employee told us, “This is two years too late . . . If you’re not an integral component of cloud architecture you’re going to miss the next big wave of growth.”

We think VEs are unlikely to offset the revenue decline from hardware over the longer term. First, this is simply because F5 is not receiving the revenue from the (high-margin) hardware component of the sale (which we estimate represents > 70% of the total). Second, VEs reduce the need to purchase additional hardware appliances for backup purposes: often customers will have 2 BIG-IPs in a data center; one to do all the work, and the other to sit idle in case the first one breaks down. Third, in those cases where a service provider *is* using F5 VEs (which we think is limited to some small IaaS providers), we are told that higher utilization of the shared VE on the service provider’s infrastructure eliminates or greatly reduces the need for the service provider’s customers to purchase their own hardware appliances.

One additional negative for F5, we are told, is the rise of “shadow IT” in directing large enterprises’ tech spending. “Shadow IT” refers to tech-oriented people within the individual business units of an enterprise (as opposed to the designated IT unit) purchasing IaaS services directly to run their own applications, bypassing the core IT budget. Aside from contributing to the mix shift to IaaS cloud, this is a negative development for F5, our contacts say, because these people typically aren’t familiar with F5: “It’s so much a part of the nuts-and-bolts of the underlying network technology,” one contact said, “that typically only a true IT shop would know F5 well.”

3. Within traditional enterprise data centers (F5’s strongest market), data center consolidation and the construction of “private clouds” appear to improve ADC utilization and permit enterprises to purchase less ADC hardware capacity.

It appears that more sophisticated enterprises are moving to establish “private cloud” architectures in their own data centers. This effectively follows the same approach as public cloud (treating hardware as a shared pool of commodity resources, on which the high-value software functions can draw as needed), except

access is restricted to the enterprise's own users or to its customers. Based on our conversations, we think these "private clouds" meaningfully boost the utilization of network hardware, and therefore represent a threat to F5.

For example, we spoke with the Chief Architect at a very large enterprise (and F5 customer), which is running data centers both for internal business use and to provide a service to millions of outside customers. This contact said that prior to changing its architecture to a private cloud, "everything was hodgepodge" and poorly utilized. However, by moving to a private cloud model, "we were able to eliminate hundreds of [hardware] devices" by improving utilization. Our contact specifically said that he reduced the number of ADC appliances running in his data centers from 66 to 16. We think this is especially negative for F5 because the more sophisticated enterprises that are implementing private clouds appear to represent F5's traditionally strongest customer base (i.e. larger enterprises with more complex IT requirements).

Meanwhile, larger enterprises are increasingly using IaaS to offload rapidly growing or "spikey" applications from their own data centers – for example, an online advertising campaign, or seasonal e-commerce traffic. The point is to eliminate the need to over-purchase data center capacity (including ADCs) in order to handle unpredictable or erratic traffic flows. This over-provisioning can represent a major expense for certain businesses. For example, Microsoft estimates that holiday web traffic can be 4x normal load for a major retailer. In a specialized case like TurboTax, peak load can be 10x average. In cases where traffic growth is particularly rapid or unpredictable (for instance, when an online gaming company releases a new game and is uncertain how successful it will be), public IaaS provides the flexibility to scale up as needed with little warning (or to avoid over-purchasing capacity in case the game is a flop). As enterprises increasingly avoid buying more capacity than they need, this should prove a headwind for F5.

We note also that, within traditional enterprise data centers, Citrix's NetScaler ADC appears to enjoy a strong advantage among customers adopting Citrix's Virtual Desktop technology (VDI), as Citrix cross-sells its NetScaler ADC to these customers. According to one of our contacts, "NetScalers are very cheap or almost free when you buy them with other Citrix stuff." This, along with its exposure to some cloud-based service providers (see our point regarding Citrix and Amazon, above), has led to significantly higher ADC growth at Citrix (+38% Y/Y in the most recent quarter). Although our contacts point out that F5 still enjoys a strong advantage when VDI is not a factor in an enterprise sale, we think the continued penetration of VDI into the traditional enterprise could lead to further market share losses for F5.

4. F5 is trying to sustain its growth by expanding into ancillary markets, especially security, but our contacts suggest this will be challenging.

F5's strategy appears to focus on layering as many ancillary software products on top of its BIG-IP appliance as possible, taking advantage of its existing hardware "base" within the data center to attack other key functions beyond load balancing. The focus for this strategy is security, where F5 is trying to position the BIG-IP as a convenient platform at the edge of the data center for hosting a variety of security functions, most notably a firewall.

However, our contacts (including several former F5 employees) are skeptical that security will offset F5's declining hardware business. There are multiple reasons for their skepticism. First, we hear that F5's sales force is less effective when expanding beyond core BIG-IP functionality: "they don't know how to sell firewalls," one contact (a former F5 sales executive) told us. This is exacerbated by the fact that security sales, we are told, are made to a different group of people within a customer's organization versus those that buy load balancing, and the security group tends to "speak a different language."

More importantly, contacts tell us that putting core firewall functionality on top of a BIG-IP box is more complex than simply turning on the firewall module – rather, it requires a "fundamental" shift in the design of a data center's architecture. This means an F5 security sale requires significant customer education and a far longer sales cycle. "It's a no-brainer to deploy core load balancing functionality," said a former F5 sales executive, but "once you move beyond that, there are lots more decision criteria, lots of bells and whistles, to think about . . . customers are confused about the value proposition of F5 versus the other stuff out there in the marketplace." For this reason, our contacts suggest that F5's security products are likely to appeal primarily to the largest, most sophisticated customers. Our discussions with a large, sophisticated enterprise customer of F5 (who was using a variety of ancillary software modules, including security), would appear to support this: "It requires a lot of work," to use the advanced functions of a BIG-IP, this contact said.

One contact at a large provider of IaaS and co-location services (i.e. where an enterprise owns and manages its own hardware, but locates it within a service provider's data center) noted that his enterprise customers are increasingly relying on his company (i.e. the service provider) to take care of security for them. "Application firewalls [like F5's] are getting pushed outside the data center, so as to not waste compute cycles on this stuff," he said. "Enterprises want their tech guys focused on better applications and value-added projects," rather than security, which he likened to buying insurance: "[Security] is never going to differentiate me . . . I don't want to spend too much on it, but I want to spend enough to get by."

As a result, he thinks F5 would need to increasingly sell its security products to the large service providers taking on these functions for their enterprise clients. However, as noted above, we think these are precisely the type of entities that are bypassing F5.

F5 has disclosed that, while growing ~90% Y/Y, its two core security products still represented < 7% of FY12 product revenues. We model continued high growth at 40%-60% over the next several quarters, which may prove generous to the company, given the challenges discussed above.

5. Resellers are shifting their business models away from hardware sales and towards more profitable cloud services, expecting enterprise hardware sales to decline. IT resellers account for about 85% of F5 sales, so this is a very important development to watch.

Our discussions with IT resellers over the past year make it clear that a major, multi-year shift is happening in these businesses. As hardware becomes increasingly commoditized (we are told that a reseller would have to “be a genius” to earn double digit gross margins on hardware), and, as enterprises increasingly consume less hardware (instead shifting capacity to large cloud providers), resellers are refocusing their efforts on selling higher-margin cloud services. “What we’ve done is a reaction to the fact that we know there’ll be less hardware sold to a smaller market,” a contact at Ingram Micro (15% of F5 sales) told us recently. Making this shift appears to be a major priority for resellers. “We tell our [reseller] partners, ‘We don’t care if you buy your [cloud] services from us,’” this contact said, “But we do care that you buy cloud services, because if you don’t, you’ll probably go out of business and we want to keep distributing [product] to you.”

There are a few reasons this shift is taking place. First, given the very low margins on hardware, the expectation is that, as enterprises consume less hardware over time, any meaningful reduction in hardware sales could push a reseller into insolvency. Second, margins are far higher on cloud services (as it is a higher-touch business and it is more difficult to make straightforward price comparisons). We are told that, whereas gross margins on hardware are “single digits,” the margins on cloud services average closer to 20%, and the most skilled resellers can get markups of 30%-40%. Third, cloud is a recurring revenue business, so it reduces the volatility of revenues, and it results in “stickier” customers than a one-time hardware sale.

Every reseller with whom we spoke last year had some form of high-priority cloud strategy – some (like Ingram Micro) were reselling cloud capacity from the major IaaS players like Rackspace (depending on the service purchased, Ingram Micro’s reseller customers can re-brand a cloud product under their own name);

others (like Avnet, 17% of F5 sales) have built their own data centers to provide cloud IaaS to customers. We also confirmed this trend at other large IT resellers, including Atos Origin, Insight Enterprises, and CGI Group. In all cases, it appears that resellers are increasingly incentivized to push clients away from hardware and toward more profitable cloud services, a negative development for F5.

6. Recent results

F5 reported results for the Dec-12 quarter on January 23. Total revenues of \$365.5MM (+13.3% Y/Y) were roughly in line with the “street’s” \$366.6MM projection and within management’s prior guidance of \$363MM-\$370MM. Product revenues of \$204.7MM were up +4.2% Y/Y. We estimate that, excluding Traffix (acquired Feb-2012), organic product revenues only grew approximately +2%. This was despite a relatively easy Y/Y comp of +14.6% in the Dec-11 quarter. Service revenues of \$160.7MM were up +27.7% Y/Y. Non-GAAP EPS of \$1.14 (+11% Y/Y) was a penny below consensus, and at the low end of management’s \$1.14-\$1.16 guidance. Non-GAAP earnings growth was below revenue growth primarily because of deleveraging on the S&M and R&D expense lines. GAAP EPS (which includes stock-based compensation) was \$0.88.

F5 provided guidance for the March 2013 quarter of \$370MM-\$380MM in revenues (9%-12% Y/Y) and \$1.21-\$1.24 in non-GAAP EPS (11%-14% Y/Y). At this midpoint, this was below prior consensus for \$379MM in revenues, but above prior consensus of \$1.20 in non-GAAP EPS. F5 does not give annual guidance.

7. Financial assumptions

We forecast total revenue growth of +11% Y/Y in FQ2 (ending March), +10% in FQ3 (ending June), and +11% for the full FY2013 (ending September). This compares to “street” estimates of total revenue growth of +11%, +13%, and +13% for FQ2, FQ3, and FY2013, respectively. The difference in our estimate is derived primarily from slower Product revenue growth, which we project to be +1% Y/Y in FQ2, +3% Y/Y in FQ3, and +4% Y/Y in FY2013. Within our Product revenue line, we assume roughly flat growth in FFIV’s core ADC business (we estimate growth was about -2% Y/Y in the December quarter), partially offset by growth of 45%-60% in security over the next several quarters (which we think may be generous to the company), and by >30% Y/Y growth in Traffix (which we think represents a low single-digit percentage of F5’s product revenues at present). We project Service revenue growth of +25% Y/Y in FQ2, +20% Y/Y in FQ3, and +23% Y/Y in FY2013.

We model (GAAP) product gross margin expansion of 100bps in FY2013, driven by a higher mix of software versus hardware revenues. We assume negative

S&M leverage of 80bps in FY2013 (the first quarter saw 60bps of deleverage), caused by relatively flat product sales and longer sales cycles in security.

8. Valuation

“Street” bulls continue to argue that FFIV is a high-growth technology company deserving >20x multiples to non-GAAP earnings. However, with adj. EPS growth falling into the ~10% range recently, and with FFIV having already once disappointed expectations for product growth re-acceleration within the last 12 months, we think that “street” analysts will be forced to re-evaluate their growth assumptions should FFIV’s product revenues again fail to take off, as we expect. Our research suggests that FFIV is a mature hardware company struggling to manage the transition to an increasingly software-driven industry.

Our price target of \$70 represents 14x our calendar year 2013 non-GAAP EPS projection of \$4.98, or 17.6x our CY13 GAAP EPS projection of \$3.97. Since we are using non-GAAP EPS, we do not give FFIV credit for \$16/share in net cash (putting a 14x multiple on our GAAP number, plus the \$16 in cash, would also put us at \$70). This multiple represents 1.4x our estimated non-GAAP EPS growth rate of 10%. By comparison, we look at NetApp (NTAP), which consensus has growing ~10% over the medium term, and which trades at 13.9x CY13 non-GAAP EPS despite having net cash representing 37% of its market cap.

10. Risks

FFIV management has said it expects the recent hardware refresh to contribute to a re-acceleration of growth in the second half of FY2013 (ending September). Our conversations with salespeople suggest that the refresh shouldn’t have a meaningful effect, and FFIV management has admitted that it hasn’t seen any evidence of “pent up” customer demand, as customers wait for the new hardware to come out before buying. Nevertheless, there is a risk that FFIV’s hardware refresh could boost sales beyond our expectations.

Another risk surrounds Cisco’s decision to stop putting R&D dollars into its aging ACE load balancing appliances. FFIV management has suggested this represents a significant opportunity for it to take additional share from Cisco, which we think has been written off as a serious player in the higher-end ADC space for a long time now. Based on our discussions, we don’t think market share gains from Cisco are going to have a significant effect on FFIV’s product sales. Some “street” analysts have voiced skepticism regarding this, as well. We note that Cisco is officially recommending that its customers use Citrix NetScaler ADCs, and that Cisco and Citrix claim to be working to develop better integration between NetScaler and Cisco’s networking products.

The biggest risk concerns timing – given the lack of detailed industry data, and the fact that FFIV discloses little in the way of underlying metrics to track, it is difficult to precisely model the growth of the end-markets for each of the various forms of data center infrastructure (IaaS, etc.), or to model replacement cycles with a high degree of accuracy.

11. Financial projections

Annual projections (FYE Sep-30)	FY09	FY10	FY11	FY12	FY13E	FY14E
Product revenues	406.5	561.1	722.0	818.6	846.8	883.0
Service revenues	246.6	320.8	429.9	558.7	685.3	801.3
Total revenues	653.1	882.0	1,151.8	1,377.2	1,532.1	1,684.3
COGS	142.7	172.0	208.0	236.2	258.2	282.6
Gross profit	510.4	710.0	943.8	1,141.1	1,273.9	1,401.7
Sales & marketing	225.2	293.2	370.7	445.6	509.3	560.0
R&D	103.7	118.3	138.9	177.4	200.2	219.0
G&A	55.2	68.5	83.5	91.8	102.8	112.0
Restructuring & other	4.3	0.0	0.0	0.0	0.0	0.0
EBIT (GAAP)	121.9	230.0	350.7	426.3	461.6	510.7
Other income	9.7	7.6	10.1	5.9	5.8	5.6
Pre-tax income	131.6	237.6	360.8	432.2	467.4	516.3
Taxes	40.1	86.5	119.4	157.0	166.0	178.8
Net income (GAAP)	91.5	151.2	241.4	275.2	301.4	337.5
Diluted shares	80.1	81.0	81.5	79.7	79.1	79.0
Diluted EPS (GAAP)	\$1.14	\$1.86	\$2.96	\$3.45	\$3.81	\$4.27
<u>Non-GAAP adjustment</u>						
Stock comp	56.1	70.8	89.7	95.2	106.8	106.8
Restructuring	3.9	1.0	0.0	5.6	4.0	2.2
EBIT (non-GAAP)	182.3	300.8	440.4	527.1	572.5	619.7
Net income (non-GAAP)	134.6	203.8	308.3	280.8	382.4	415.5
Diluted EPS (non-GAAP)	\$1.69	\$2.52	\$3.79	\$4.38	\$4.83	\$5.26

Y/Y Change	FY09	FY10	FY11	FY12	FY13E	FY14E
Product revenues	-10.2%	38.0%	28.7%	13.4%	3.5%	4.3%
Service revenues	25.0%	30.1%	34.0%	30.0%	22.7%	16.9%
Total revenues	0.4%	35.0%	30.6%	19.6%	11.2%	9.9%
COGS	-4.2%	20.5%	21.0%	13.5%	9.3%	9.5%
Gross profit	1.8%	39.1%	32.9%	20.9%	11.6%	10.0%
Sales & marketing	-5.1%	30.2%	26.4%	20.2%	14.3%	10.0%
R&D	0.3%	14.1%	17.4%	27.7%	12.9%	9.4%
G&A	-1.4%	24.0%	21.9%	9.9%	12.1%	8.9%
Restructuring & other	-17.9%	N/A	N/A	N/A	N/A	N/A
EBIT (GAAP)	22.8%	88.6%	52.5%	21.6%	8.3%	10.6%
Other income	-48.7%	-21.6%	32.3%	-41.4%	-2.7%	-2.6%
Pre-tax income	11.3%	80.5%	51.8%	19.8%	8.1%	10.5%
Taxes	-8.7%	115.6%	38.0%	31.6%	5.7%	7.7%
Net income (GAAP)	23.1%	65.1%	59.7%	14.0%	9.5%	12.0%
Diluted shares	-4.0%	1.2%	0.5%	-2.2%	-0.7%	-0.2%
Diluted EPS (GAAP)	28.3%	63.1%	58.9%	16.6%	10.3%	12.1%
<u>Non-GAAP adjustment</u>						
Stock cmp	28.5%	26.2%	26.8%	6.0%	12.2%	0.0%
Restructuring	16.5%	-75.5%	N/A	N/A	N/A	N/A
EBIT (non-GAAP)	10.4%	65.0%	46.4%	19.7%	8.6%	8.3%
Net inc (non-GAAP)	11.0%	51.4%	51.3%	-8.9%	36.2%	8.7%
Diluted EPS (non-GAAP)	16.2%	49.2%	50.4%	15.5%	10.4%	8.8%

% of Sales	FY09	FY10	FY11	FY12	FY13E	FY14E
Product revenues	62.2%	63.6%	62.7%	59.4%	55.3%	52.4%
Service revenues	37.8%	36.4%	37.3%	40.6%	44.7%	47.6%
Total revenues	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
COGS	21.9%	19.5%	18.1%	17.1%	16.9%	16.8%
Gross profit	78.1%	80.5%	81.9%	82.9%	83.1%	83.2%
Sales & marketing	34.5%	33.2%	32.2%	32.4%	33.2%	33.2%
R&D	15.9%	13.4%	12.1%	12.9%	13.1%	13.0%
G&A	8.5%	7.8%	7.3%	6.7%	6.7%	6.6%
Restructuring & other	0.7%	0.0%	0.0%	0.0%	0.0%	0.0%
EBIT (GAAP)	18.7%	26.1%	30.4%	31.0%	30.1%	30.3%
Other income	1.5%	0.9%	0.9%	0.4%	0.4%	0.3%
Pre-tax income	20.2%	26.9%	31.3%	31.4%	30.5%	30.7%
Taxes	6.1%	9.8%	10.4%	11.4%	10.8%	10.6%
Net income (GAAP)	14.0%	17.1%	21.0%	20.0%	19.7%	20.0%
<u>Non-GAAP adjustment</u>						
Stock cmp	8.6%	8.0%	7.8%	6.9%	7.0%	6.3%
Restructuring	0.6%	0.1%	0.0%	0.4%	0.3%	0.1%
EBIT (non-GAAP)	27.9%	34.1%	38.2%	38.3%	37.4%	36.8%
Net inc (non-GAAP)	20.6%	23.1%	26.8%	20.4%	25.0%	24.7%

Quarterly projections

	Mar-12	Jun-12	Sep-12	Dec-12	Mar-13E	Jun-13E	Sep-13E
Product revenues	205.2	207.1	209.7	204.7	207.6	212.6	221.8
Service revenues	134.5	145.5	152.8	160.7	167.7	174.9	181.9
Total revenues	339.6	352.6	362.6	365.5	375.4	387.6	403.7
COGS	57.6	60.3	62.7	60.9	63.3	65.6	68.3
Gross profit	282.0	292.3	299.9	304.6	312.1	322.0	335.3
Sales & marketing	111.0	112.1	116.3	122.3	123.9	128.3	134.8
R&D	43.6	47.0	47.7	48.5	48.8	50.4	52.5
G&A	22.8	23.3	24.0	24.7	25.2	26.0	27.0
EBIT (GAAP)	104.7	110.0	111.8	109.1	114.2	117.3	121.0
Other income	1.4	1.7	0.9	1.6	1.4	1.4	1.4
Pre-tax income	106.1	111.7	112.7	110.6	115.6	118.7	122.4
Taxes	37.5	39.4	45.0	41.1	40.5	41.6	42.8
Net income (GAAP)	68.6	72.3	67.7	69.5	75.2	77.2	79.6
Diluted shares	79.8	79.7	79.4	79.3	79.2	79.0	79.0
Diluted EPS (GAAP)	\$0.86	\$0.91	\$0.85	\$0.88	\$0.95	\$0.98	\$1.01
<u>Non-GAAP adjustment</u>							
Stock comp	23.3	23.4	26.3	26.7	26.7	26.7	26.7
EBIT (non-GAAP)	130.1	135.3	139.8	136.8	141.9	145.0	148.7
Net income (non-GAAP)	87.1	90.6	88.7	90.6	95.1	97.1	99.5
Diluted EPS (non-GAAP)	\$1.09	\$1.14	\$1.12	\$1.14	\$1.20	\$1.23	\$1.26

Y/Y Change	Mar-12	Jun-12	Sep-12	Dec-12	Mar-13E	Jun-13E	Sep-13E
Product revenues	18.1%	15.5%	6.2%	4.2%	1.2%	2.7%	5.8%
Service revenues	29.5%	30.6%	30.4%	27.7%	24.8%	20.2%	19.0%
Total revenues	22.4%	21.3%	15.2%	13.3%	10.5%	9.9%	11.3%
COGS	13.7%	14.9%	12.1%	9.5%	10.0%	8.8%	9.0%
Gross profit	24.3%	22.7%	15.9%	14.1%	10.6%	10.1%	11.8%
Sales & marketing	24.2%	19.7%	15.2%	15.1%	11.6%	14.5%	15.9%
R&D	26.3%	33.3%	30.6%	24.1%	12.0%	7.2%	9.9%
G&A	14.8%	10.3%	9.8%	13.8%	10.4%	11.5%	12.6%
EBIT (GAAP)	25.8%	24.6%	12.6%	9.3%	9.1%	6.7%	8.2%
Pre-tax income	25.2%	23.9%	9.0%	8.8%	9.0%	6.3%	8.6%
Taxes	28.3%	42.7%	25.7%	17.0%	8.0%	5.5%	-4.9%
Net income (GAAP)	23.5%	15.6%	0.2%	4.5%	9.5%	6.7%	17.5%
Diluted shares	-2.3%	-2.3%	-1.7%	-0.7%	-0.7%	-0.8%	-0.5%
Diluted EPS (GAAP)	26.4%	18.3%	1.8%	5.2%	10.3%	7.6%	18.1%
<u>Non-GAAP adjustment</u>							
Stock comp	7.3%	2.0%	19.0%	20.7%	14.4%	14.3%	1.4%
EBIT (non-GAAP)	23.9%	21.7%	15.1%	12.2%	9.1%	7.2%	6.4%
Net income (non-GAAP)	21.9%	14.1%	4.1%	10.2%	9.2%	7.2%	12.2%
Diluted EPS (non-GAAP)	24.7%	16.7%	5.8%	10.9%	10.0%	8.1%	12.8%

% of Sales	Jun-11	Sep-11	Dec-11	Mar-12	Jun-12E	Sep-12E	Dec-12E
Product revenues	60.4%	58.7%	57.8%	56.0%	55.3%	54.9%	54.9%
Service revenues	39.6%	41.3%	42.2%	44.0%	44.7%	45.1%	45.1%
Total revenues	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
COGS	17.0%	17.1%	17.3%	16.7%	16.9%	16.9%	16.9%
Gross profit	83.0%	82.9%	82.7%	83.3%	83.1%	83.1%	83.1%
Sales & marketing	32.7%	31.8%	32.1%	33.5%	33.0%	33.1%	33.4%
R&D	12.8%	13.3%	13.2%	13.3%	13.0%	13.0%	13.0%
G&A	6.7%	6.6%	6.6%	6.8%	6.7%	6.7%	6.7%
EBIT (GAAP)	30.8%	31.2%	30.8%	29.8%	30.4%	30.3%	30.0%
Other income	0.4%	0.5%	0.3%	0.4%	0.4%	0.4%	0.3%
Pre-tax income	31.2%	31.7%	31.1%	30.3%	30.8%	30.6%	30.3%
Taxes	11.0%	11.2%	12.4%	11.3%	10.8%	10.7%	10.6%
Net income (GAAP)	20.2%	20.5%	18.7%	19.0%	20.0%	19.9%	19.7%
<u>Non-GAAP adjustment</u>							
Stock comp	6.9%	6.6%	7.3%	7.3%	7.1%	6.9%	6.6%
EBIT (non-GAAP)	38.3%	38.4%	38.6%	37.4%	37.8%	37.4%	36.8%
Net income (non-GAAP)	25.6%	25.7%	24.5%	24.8%	25.3%	25.1%	24.7%

Financial metrics

Price	\$101.06
Shares	79.3
MV	\$8,014
Net cash	\$1,289
EV	\$6,725

Book value	\$1,386
Tang. book value	\$1,038

(FYE Sep-30)	<u>FY12</u>	<u>FY13E</u>	<u>FY14E</u>
EBIT (GAAP)	426.3	461.6	510.7
EBITDA (GAAP)	461.4	501.4	550.7
SCF (NI + D&A - CapEx)	286.1	310.4	343.7
FCF (CFFO - CapEx)	465.6	458.5	476.1
CapEx	-29.9	-34.8	-36.0
EV/EBITDA	14.6x	13.4x	12.2x
EV/(EBITDA - CapEx)	15.6x	14.4x	13.1x
D&A	35.1	39.7	40.0