

F5 NETWORKS INC
Form 10-Q
August 02, 2017
Table of Contents

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

FORM 10-Q

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

For the quarterly period ended June 30, 2017

OR

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

For the transition period from _____ to _____

Commission File Number 000-26041

F5 NETWORKS, INC.

(Exact name of registrant as specified in its charter)

WASHINGTON 91-1714307
(State or other jurisdiction of (I.R.S. Employer
incorporation or organization) 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, a smaller reporting company, or an emerging growth company. See the definitions of "large accelerated filer," "accelerated filer," "smaller reporting company," and "emerging growth company" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer	<input checked="" type="checkbox"/>	Accelerated filer	<input type="checkbox"/>
Non-accelerated filer	<input type="checkbox"/> (Do not check if a smaller reporting company)	Smaller reporting company	<input type="checkbox"/>
		Emerging growth company	<input type="checkbox"/>

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act. ☐

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 July 28, 2017 was 63,546,593.

Table of Contents

F5 NETWORKS, INC.
 QUARTERLY REPORT ON FORM 10-Q
 For the Quarter Ended June 30, 2017
 Table of Contents

	Page
<u>PART I. FINANCIAL INFORMATION</u>	
<u>Item 1. Financial Statements (unaudited)</u>	<u>3</u>
<u>Consolidated Balance Sheets — June 30, 2017 and September 30, 2016</u>	<u>3</u>
<u>Consolidated Income Statements — Three and nine months ended June 30, 2017 and 2016</u>	<u>4</u>
<u>Consolidated Statements of Comprehensive Income — Three and nine months ended June 30, 2017 and 2016</u>	<u>5</u>
<u>Consolidated Statements of Cash Flows — Nine months ended June 30, 2017 and 2016</u>	<u>6</u>
<u>Notes to Consolidated Financial Statements</u>	<u>7</u>
<u>Item 2. Management’s Discussion and Analysis of Financial Condition and Results of Operations</u>	<u>19</u>
<u>Item 3. Quantitative and Qualitative Disclosures About Market Risk</u>	<u>24</u>
<u>Item 4. Controls and Procedures</u>	<u>25</u>
<u>PART II. OTHER INFORMATION</u>	
<u>Item 1. Legal Proceedings</u>	<u>25</u>
<u>Item 1A. Risk Factors</u>	<u>25</u>
<u>Item 2. Unregistered Sales of Equity Securities and Use of Proceeds</u>	<u>27</u>
<u>Item 6. Exhibits</u>	<u>28</u>
<u>SIGNATURES</u>	<u>29</u>

Table of Contents

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

F5 NETWORKS, INC.

CONSOLIDATED BALANCE SHEETS

(unaudited, in thousands)

	June 30, 2017	September 30, 2016
ASSETS		
Current assets		
Cash and cash equivalents	\$690,912	\$ 514,571
Short-term investments	323,336	367,824
Accounts receivable, net of allowances of \$1,857 and \$2,062	295,085	268,175
Inventories	31,045	34,051
Deferred tax assets	54,010	51,601
Other current assets	51,513	52,579
Total current assets	1,445,901	1,288,801
Property and equipment, net	125,139	123,248
Long-term investments	234,587	276,375
Deferred tax assets	2,050	2,044
Goodwill	555,965	555,965
Other assets, net	54,930	59,890
Total assets	\$2,418,572	\$ 2,306,323
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities		
Accounts payable	\$44,544	\$ 34,117
Accrued liabilities	178,712	178,353
Deferred revenue	686,085	631,768
Total current liabilities	909,341	844,238
Other long-term liabilities	41,293	34,138
Deferred revenue, long-term	257,777	238,473
Deferred tax liabilities	5,554	4,212
Total long-term liabilities	304,624	276,823
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, 63,544 and 65,315 shares issued and outstanding	17,532	13,191
Accumulated other comprehensive loss	(15,458)	(13,194)
Retained earnings	1,202,533	1,185,265
Total shareholders' equity	1,204,607	1,185,262
Total liabilities and shareholders' equity	\$2,418,572	\$ 2,306,323

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 June 30,		Nine months ended June 30,	
	2017	2016	2017	2016
Net revenues				
Products	\$235,109	\$231,366	\$715,672	\$691,485
Services	282,728	265,156	836,371	778,200
Total	517,837	496,522	1,552,043	1,469,685
Cost of net revenues				
Products	43,787	40,474	129,391	123,033
Services	45,983	43,869	133,553	129,223
Total	89,770	84,343	262,944	252,256
Gross profit	428,067	412,179	1,289,099	1,217,429
Operating expenses				
Sales and marketing	160,952	156,620	490,171	470,545
Research and development	88,602	83,042	264,886	250,481
General and administrative	39,368	34,182	119,055	103,238
Litigation expense	1	(527)	(134)	8,421
Total	288,923	273,317	873,978	832,685
Income from operations	139,144	138,862	415,121	384,744
Other income, net	2,589	978	6,534	2,246
Income before income taxes	141,733	139,840	421,655	386,990
Provision for income taxes	44,071	48,051	136,637	130,070
Net income	\$97,662	\$91,789	\$285,018	\$256,920
Net income per share — basic	\$1.53	\$1.37	\$4.42	\$3.78
Weighted average shares — basic	63,935	66,851	64,539	67,990
Net income per share — diluted	\$1.52	\$1.37	\$4.38	\$3.75
Weighted average shares — diluted	64,361	67,235	65,116	68,429

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

Table of Contents

F5 NETWORKS, INC.

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(unaudited, in thousands)

	Three months ended June 30,		Nine months ended June 30,	
	2017	2016	2017	2016
Net income	\$97,662	\$91,789	\$285,018	\$256,920
Other comprehensive gain (loss):				
Foreign currency translation adjustment	444	(142)	(1,304)	1,449
Available-for-sale securities:				
Unrealized (losses) gains on securities, net of taxes of \$(88) and \$236 for the three months ended June 30, 2017 and 2016, respectively, and \$(389) and \$310 for the nine months ended June 30, 2017 and 2016, respectively	(147)	393	(649)	516
Reclassification adjustment for realized (gains) losses included in net income, net of taxes of \$171 and \$6 for the three months ended June 30, 2017 and 2016, respectively, and \$186 and \$(3) for the nine months ended June 30, 2017 and 2016, respectively	(285)	(9)	(310)	6
Net change in unrealized (losses) gains on available-for-sale securities, net of tax	(432)	384	(959)	522
Total other comprehensive gain (loss)	12	242	(2,263)	1,971
Comprehensive income	\$97,674	\$92,031	\$282,755	\$258,891
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)

	Nine months ended June 30,	
	2017	2016
Operating activities		
Net income	\$285,018	\$256,920
Adjustments to reconcile net income to net cash provided by operating activities:		
Realized (gain) loss on disposition of assets and investments	(463)	22
Stock-based compensation	133,740	118,443
Provisions for doubtful accounts and sales returns	385	876
Depreciation and amortization	45,603	42,284
Deferred income taxes	(1,307)	9,295
Changes in operating assets and liabilities:		
Accounts receivable	(27,295)	15,307
Inventories	3,007	(87)
Other current assets	1,063	(80)
Other assets	(425)	549
Accounts payable and accrued liabilities	14,270	(8,922)
Deferred revenue	73,620	72,858
Net cash provided by operating activities	527,216	507,465
Investing activities		
Purchases of investments	(255,386)	(225,226)
Maturities of investments	271,878	244,905
Sales of investments	65,857	62,836
(Increase) decrease in restricted cash	(87)	29
Acquisition of intangible assets	(4,000)	(3,250)
Purchases of property and equipment	(31,175)	(45,909)
Net cash provided by investing activities	47,087	33,385
Financing activities		
Excess tax benefit from stock-based compensation	6,471	1,596
Proceeds from the exercise of stock options and purchases of stock under employee stock purchase plan	46,959	44,848
Repurchase of common stock	(450,065)	(550,101)
Net cash used in financing activities	(396,635)	(503,657)
Net increase in cash and cash equivalents	177,668	37,193
Effect of exchange rate changes on cash and cash equivalents	(1,327)	1,944
Cash and cash equivalents, beginning of period	514,571	390,460
Cash and cash equivalents, end of period	\$690,912	\$429,597

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

Table of Contents

F5 NETWORKS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (unaudited)

1. Summary of Significant Accounting Policies

Description of Business

F5 Networks, Inc. (the “Company”) is the leading developer and provider of software-defined application services. The Company’s core technology is a full-proxy, programmable, highly-scalable software platform called TMOS, which supports a broad array of features and functions designed to ensure that applications delivered over Internet Protocol (IP) networks are secure, fast and available. The Company’s TMOS-based offerings include software products for local and global traffic management, network and application security, access management, web acceleration and a number of other network and application services. These products are available as modules that can run individually or as part of an integrated solution on the Company’s high-performance, scalable, purpose-built BIG-IP appliances and VIPRION chassis-based hardware, or as software-only Virtual Editions. The Company also offers distributed denial-of-service (DDoS) protection, application security and other application services by subscription on its cloud-based Silverline platform. In connection with its products, the Company offers a broad range of support services including consulting, training, installation and maintenance.

Basis of Presentation

The year-end 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, 2016.

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.
 - 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. 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.

Arrangement consideration is first allocated between software (consisting of nonessential and stand-alone software) and non-software deliverables. 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

Table of Contents

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 software deliverables, the Company allocates revenue between 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 VSOE of the 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 (more than 80%) 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 VSOE or TPE for non-software products. 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 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 these amounts from revenues.

Goodwill and Acquired Intangible Assets

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 Defense.Net, Inc. in fiscal year 2014, Versafe Ltd. and LineRate Systems, Inc. in fiscal year 2013, 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. For its annual goodwill impairment test in all periods to date, the Company has operated under one reporting unit and the fair value of its reporting unit has been determined by the Company’s enterprise value. The Company performs its annual goodwill

impairment test during the second fiscal quarter.

As part of the annual goodwill impairment test, the Company first performs a qualitative assessment to determine whether further impairment testing is necessary. If, as a result of its qualitative assessment, it is more-likely-than-not (i.e. greater than 50% chance) that the fair value of the Company's reporting unit is less than its carrying amount, the quantitative impairment test will be required. Otherwise, no further testing will be required.

Table of Contents

Examples of events and circumstances that might indicate that a reporting unit's fair value is less than its carrying amount 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.

If it is determined, as a result of the qualitative assessment, that it is more-likely-than-not that the fair value of the Company's 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. In March 2017, 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 considered potential impairment indicators of goodwill at June 30, 2017 and noted no indicators of impairment.

The Company's intangible assets subject to amortization are amortized using the straight-line method over their estimated useful lives, ranging from three to ten years. The Company evaluates the recoverability of intangible assets periodically by taking into account events or circumstances that may warrant revised estimates of useful lives or that indicate the asset may be impaired. The Company considered potential impairment indicators of acquired intangible assets at June 30, 2017 and noted no indicators of impairment.

Software Development Costs

The authoritative guidance requires certain internal software development costs related to software to be sold to be capitalized upon the establishment of technological feasibility. The Company's software development costs incurred subsequent to achieving technological feasibility have not been significant, and all software development costs have been expensed as research and development activities as incurred.

Internal Use Software

In accordance with the authoritative guidance, the Company capitalizes application development stage costs associated with the development of new functionality for internal-use software and software developed related to its SaaS-based product offerings. The capitalized costs are then amortized over the estimated useful life of the software, which is generally three to five years, and are included in property and equipment in the accompanying consolidated balance sheets.

Stock-Based Compensation

The Company accounts for stock-based compensation using the straight-line attribution method for recognizing compensation expense. The Company recognized \$43.2 million and \$38.4 million of stock-based compensation expense for the three months ended June 30, 2017 and 2016, respectively, and \$133.7 million and \$118.4 million of stock-based compensation expense for the nine months ended June 30, 2017 and 2016, respectively. As of June 30, 2017, there was \$168.9 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). On October 28, 2016, the Company's Board of Directors and Compensation Committee approved 1,242,170 RSUs to employees and executive officers pursuant to the Company's annual equity awards program. 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 issues incentive awards to certain current executive officers as part of its annual equity awards program. Fifty percent of the aggregate number of RSUs issued to executive officers vest in equal quarterly

increments, and 50% are subject to the Company achieving specified quarterly revenue and EBITDA goals. In each case, 70% of the quarterly performance stock grant is based on achieving at least 80% of the quarterly revenue goal set by the Company's Board of

Table of Contents

Directors, and the other 30% is based on achieving at least 80% of the quarterly EBITDA goal set by the Company's Board of Directors. The quarterly performance stock grant is paid linearly over 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 the 100% over-achievement threshold. Each goal is also capped at achievement of 200% above target.

As of June 30, 2017, the following annual equity grants for executive officers or a portion thereof are outstanding:

Grant Date	RSUs Granted	Vesting Schedule	Vesting Period	Date Fully Vested
November 1, 2016	115,347	Quarterly	4 years	November 1, 2020
November 2, 2015	145,508	Quarterly	4 years	November 1, 2019
November 1, 2014	171,575	Quarterly	4 years	November 1, 2018
November 1, 2013	231,320	Quarterly	4 years	November 1, 2017

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.

Common Stock Repurchase

On April 20, 2016, the Company announced that its Board of Directors authorized an additional \$1.0 billion for its common stock share repurchase program. This new authorization is incremental to the existing \$2.4 billion program, initially approved in October 2010 and expanded in each fiscal year. 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 June 30, 2017, the Company had repurchased and retired 3,301,167 shares at an average price of \$136.34 per share during fiscal year 2017 and the Company had \$323.7 million remaining authorized to purchase shares.

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 and are not considered participating securities that should be included in the computation of earnings per share under the two-class method.

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

	Three months ended June 30,		Nine months ended June 30,	
	2017	2016	2017	2016
Numerator				
Net income	\$97,662	\$91,789	\$285,018	\$256,920
Denominator				
Weighted average shares outstanding — basic	63,935	66,851	64,539	67,990
Dilutive effect of common shares from stock options and restricted stock units	426	384	577	439
Weighted average shares outstanding — diluted	64,361	67,235	65,116	68,429
Basic net income per share	\$1.53	\$1.37	\$4.42	\$3.78
Diluted net income per share	\$1.52	\$1.37	\$4.38	\$3.75

For the three and nine months ended June 30, 2017, there were no common shares potentially issuable from stock options 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 three and nine months ended June 30, 2016, an immaterial amount of common shares potentially issuable from stock options were excluded from the calculation of diluted earnings per share.

Table of Contents

Comprehensive Income

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

Recent Accounting Pronouncements

In May 2014, the FASB issued ASU 2014-09, Revenue from Contracts with Customers (Topic 606) (ASU 2014-09). ASU 2014-09 and the related amendments outline a new, single comprehensive model for entities to use in accounting for revenue arising from contracts with customers and supersedes most current revenue recognition guidance, including industry-specific guidance. The new model will require revenue recognition to depict the transfer of promised goods or services to customers in an amount that reflects the consideration a company expects to receive in exchange for those goods or services. The standard can be applied either retrospectively to each period presented or as a cumulative-effect adjustment as of the date of adoption. In July 2015, the FASB issued ASU 2015-14, Revenue from Contracts with Customers (Topic 606): Deferral of the Effective Date, which delays the effective date of ASU 2014-09 by one year. The updated standard is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2017 with early adoption permitted for annual reporting periods beginning after December 15, 2016.

The Company currently plans to adopt ASU 2014-09 in the first quarter of fiscal 2019. The Company has initiated an assessment of its systems, data and processes related to the implementation of this accounting standard. Under the new standard, the Company expects to defer and amortize incremental costs to obtain a contract, which are primarily commission costs, over the expected customer life rather than expensing them as incurred under current practice. Additionally, under the new standard, the Company would be required to recognize a portion of term license revenues upfront, at the time of delivery rather than ratably over the related contract period. The Company is continuing to evaluate the impact that this updated standard and the related amendments will have on its consolidated financial statements and footnote disclosures.

In July 2015, the FASB issued ASU 2015-11, Simplifying the Measurement of Inventory (ASU 2015-11), which changes the subsequent measurement of inventory from lower of cost or market to lower of cost and net realizable value. The new standard is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2016. Early adoption is permitted. The Company does not anticipate that the adoption of this standard will have a material impact on its consolidated financial statements.

In November 2015, the FASB issued ASU 2015-17, Balance Sheet Classification of Deferred Taxes (ASU 2015-17), which requires that all deferred tax assets and liabilities be classified as noncurrent in a classified balance sheet. The new standard is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2016. Early adoption is permitted as of the beginning of an interim or annual reporting period. The Company does not anticipate that the

adoption of this standard will have a material impact on its consolidated financial statements.

In February 2016, the FASB issued ASU 2016-02, Leases (Topic 842) (ASU 2016-02), which requires lessees to recognize on the balance sheet a right-of-use asset, representing its right to use the underlying asset for the lease term, and a corresponding lease liability for all leases with terms greater than twelve months. The guidance also requires qualitative and quantitative disclosures designed to assess the amount, timing and uncertainty of cash flows arising from leases. The new standard is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018, and is required to be applied with a modified retrospective approach. Early adoption is permitted. The Company is currently assessing the impact that this updated standard will have on its consolidated financial statements and footnote disclosures.

In March 2016, the FASB issued ASU 2016-09, Compensation-Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting (ASU 2016-09), which is intended to simplify several aspects of the accounting for share-based payment transactions, including the accounting for income taxes, forfeitures, and statutory tax withholding requirements, as well as classification in the statement of cash flows. The new standard is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2016. Early adoption is permitted. The Company is currently assessing the impact that this updated standard will have on its consolidated

financial statements and footnote disclosures.

In June 2016, the FASB issued ASU 2016-13, Financial Instruments - Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments (ASU 2016-13), which replaces the incurred loss impairment methodology in current GAAP with a methodology that reflects expected credit losses. The new standard is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2019. Early adoption is permitted. The Company does not anticipate that the adoption of this standard will have a material impact on its consolidated financial statements.

Table of Contents

In August 2016, the FASB issued ASU 2016-15, Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments (ASU 2016-15), which clarifies how companies present and classify certain cash receipts and cash payments in the statement of cash flows. The new standard is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2017. Early adoption is permitted, including adoption in an interim period. The Company is currently assessing the impact that this updated standard will have on its consolidated financial statements and footnote disclosures.

In November 2016, the FASB issued ASU 2016-18, Statement of Cash Flows (Topic 230): Restricted Cash (ASU 2016-18), which will require a company's cash flow statement to explain the changes during a reporting period of the totals for cash, cash equivalents, restricted cash, and restricted cash equivalents. Additionally, amounts for restricted cash and restricted cash equivalents are to be included with cash and cash equivalents if the cash flow statement includes a reconciliation of the total cash balances for a reporting period. The new standard is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2017. Early adoption is permitted. The Company does not anticipate that the adoption of this standard will have a material impact on its consolidated financial statements.

In January 2017, the FASB issued ASU 2017-01, Business Combinations (Topic 805): Clarifying the Definition of a Business (ASU 2017-01), which provides a more robust framework to use in determining when a set of assets and activities is considered a business. The new standard is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2017. Early adoption is permitted for certain transactions. The Company is currently assessing the impact that this updated standard will have on its consolidated financial statements and footnote disclosures.

In January 2017, the FASB issued ASU 2017-04, Intangibles - Goodwill and Other: Simplifying the Test for Goodwill Impairment (ASU 2017-04), which simplifies the goodwill impairment process by eliminating Step 2 from the quantitative goodwill impairment test. Under this update, an entity should perform its annual, or interim, goodwill impairment test by comparing the fair value of a reporting unit with its carrying amount. An entity should recognize an impairment charge for the amount by which the carrying amount exceeds the reporting unit's fair value; however, the loss recognized should not exceed the total amount of goodwill allocated to that reporting unit. The new standard is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2019. Early adoption is permitted for annual goodwill impairment tests performed after January 1, 2017. The Company does not anticipate that the adoption of this standard will have a material impact on its consolidated financial statements.

In March 2017, the FASB issued ASU 2017-08, Receivables-Nonrefundable Fees and Other Costs (Subtopic 310-20) - Premium Amortization on Purchased Callable Debt Securities (ASU 2017-08), which shortens the amortization period for the premium on certain purchased callable debt securities to the earliest call date. The new standard is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. Early adoption is permitted. The Company does not anticipate that the adoption of this standard will have a material impact on its consolidated financial statements.

In May 2017, the FASB issued ASU 2017-09, Compensation-Stock Compensation (ASU 2017-09), which provides clarification on when modification accounting should be used for changes to the terms or conditions of a share-based payment award. This ASU does not change the accounting for modifications but clarifies that modification accounting guidance should only be applied if there is a change to the value, vesting conditions or award classification and would not be required if the changes are considered non-substantive. The new standard is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2017. Early adoption is permitted. The Company does not anticipate that the adoption of this standard will have a material impact on its consolidated financial statements.

2. Fair Value Measurements

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.

Table of Contents

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, U.S. government agency securities and international government 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 June 30, 2017, 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 June 30, 2017	
Cash equivalents	\$5,617	\$ 1,155	\$	—\$6,772
Short-term investments				
Available-for-sale securities — certificates of deposits	—	1,999	—	1,999
Available-for-sale securities — corporate bonds and notes	—	150,573	—	150,573
Available-for-sale securities — municipal bonds and notes	—	62,193	—	62,193
Available-for-sale securities — U.S. government securities	—	100,918	—	100,918
Available-for-sale securities — U.S. government agency securities	—	7,653	—	7,653
Long-term investments				
Available-for-sale securities — corporate bonds and notes	—	130,484	—	130,484
Available-for-sale securities — municipal bonds and notes	—	30,964	—	30,964
Available-for-sale securities — U.S. government securities	—	12,942	—	12,942
Available-for-sale securities — U.S. government agency securities	—	60,197	—	60,197
Total	\$5,617	\$ 559,078	\$	—\$564,695

Table of Contents

The Company's financial assets measured at fair value on a recurring basis subject to the disclosure requirements at September 30, 2016, were as follows (in thousands):

	Fair Value Measurements at Reporting Date Using Quoted Prices in Active Markets for Identical Instruments (Level 1)			Significant Other Observable Inputs (Level 2)		Significant Unobservable Inputs (Level 3)		Fair Value at September 30, 2016
Cash equivalents	\$56,525	\$ —				\$		\$ 56,525
Short-term investments								
Available-for-sale securities — corporate bonds and notes	—	223,358				—		223,358
Available-for-sale securities — municipal bonds and notes	—	53,621				—		53,621
Available-for-sale securities — U.S. government securities	—	72,521				—		72,521
Available-for-sale securities — U.S. government agency securities	—	18,324				—		18,324
Long-term investments								
Available-for-sale securities — corporate bonds and notes	—	131,427				—		131,427
Available-for-sale securities — municipal bonds and notes	—	27,050				—		27,050
Available-for-sale securities — U.S. government securities	—	27,023				—		27,023
Available-for-sale securities — U.S. government agency securities	—	90,875				—		90,875
Total	\$56,525	\$ 644,199				\$		\$ 700,724

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 and nine months ended June 30, 2017, the Company did not recognize any impairment charges related to goodwill, intangible assets, or long-lived assets.

The carrying amounts of other current financial assets and other current financial liabilities approximate fair value due to their short-term nature.

3. Short-Term and Long-Term Investments

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

June 30, 2017	Cost or Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Certificates of deposits	\$ 1,999	\$ —	\$ —	\$ 1,999
Corporate bonds and notes	150,662	12	(101)	150,573
Municipal bonds and notes	62,191	11	(9)	62,193
U.S. government securities	101,035	—	(117)	100,918
U.S. government agency securities	7,670	—	(17)	7,653

\$ 323,557 \$ 23 \$ (244) \$323,336

Table of Contents

September 30, 2016	Cost or Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Corporate bonds and notes	\$ 223,448	\$ 38	\$ (128)	\$ 223,358
Municipal bonds and notes	53,657	1	(37)	53,621
U.S. government securities	72,497	31	(7)	72,521
U.S. government agency securities	18,318	6	—	18,324
	\$ 367,920	\$ 76	\$ (172)	\$ 367,824

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

June 30, 2017	Cost or Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Corporate bonds and notes	\$ 130,725	\$ 32	\$ (273)	\$ 130,484
Municipal bonds and notes	30,926	60	(22)	30,964
U.S. government securities	12,964	—	(22)	12,942
U.S. government agency securities	60,445	1	(249)	60,197
	\$ 235,060	\$ 93	\$ (566)	\$ 234,587

September 30, 2016	Cost or Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Corporate bonds and notes	\$ 131,273	\$ 249	\$ (95)	\$ 131,427
Municipal bonds and notes	27,017	46	(13)	27,050
U.S. government securities	26,989	36	(2)	27,023
U.S. government agency securities	90,877	52	(54)	90,875
	\$ 276,156	\$ 383	\$ (164)	\$ 276,375

The amortized cost and fair value of fixed maturities at June 30, 2017, by contractual years-to-maturity, are presented below (in thousands):

	Cost or Amortized Cost	Fair Value
One year or less	\$ 323,557	\$ 323,336
Over one year	235,060	234,587
	\$ 558,617	\$ 557,923

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 June 30, 2017 (in thousands):

	Less Than 12 Months			12 Months or Greater			Total		
June 30, 2017	Fair Value	Gross Unrealized Losses		Fair Value	Gross Unrealized Losses		Fair Value	Gross Unrealized Losses	
Corporate bonds and notes	\$ 219,354	\$ (363)	\$ 7,822	\$ (11)	\$ 227,176	\$ (374)			
Municipal bonds and notes	42,286	(31)	—	—	42,286	(31)			
U.S. government securities	113,860	(139)	—	—	113,860	(139)			
U.S. government agency securities	38,259	(192)	16,341	(74)	54,600	(266)			

Edgar Filing: F5 NETWORKS INC - Form 10-Q

Total \$413,759 \$ (725) \$24,163 \$ (85) \$437,922 \$ (810)

The Company invests in securities that are rated investment grade or better. The Company reviews the individual securities in its portfolio to determine whether a decline in a security's fair value below the amortized cost basis is other-than-

15

Table of Contents

temporary. The Company determined that as of June 30, 2017, there were no investments in its portfolio that were other-than-temporarily impaired.

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):

	June 30, 2017	September 30, 2016
Finished goods	\$21,083	\$ 23,642
Raw materials	9,962	10,409
	\$31,045	\$ 34,051

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 certain other employees, 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 generally 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 June 30, 2017 and June 30, 2016 were not considered material.

Commitments

As of June 30, 2017, 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 2033. On May 3, 2017, the Company entered into an agreement to lease approximately 515,000 square feet of office space in Seattle, Washington that will serve as its new corporate headquarters. The initial term of the lease is 14.5 years and is expected to commence on the latter of (i) April 1, 2019 or (ii) 10 months after the substantial completion date of the construction of the Premises. Base rent payments due under the lease are expected to be approximately \$359.5 million in the aggregate over the term of the lease. The Company is also responsible for certain other costs under the lease, such as certain build-out expenses, operating expenses, taxes, assessments, insurance, and utilities. There have been no other material changes in the Company's lease obligations compared to those discussed in Note 7 to its annual consolidated financial statements.

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 it gives notice of order cancellation in advance of applicable lead times. There have been no material changes in the Company's inventory purchase obligations compared to those discussed in Note 7 to its annual consolidated financial statements.

Table of Contents

Legal Proceedings

On May 1, 2013, Radware, Ltd. and Radware, Inc. (Radware), filed a complaint for patent infringement against the Company in the United States District Court for the Northern District of California seeking an unspecified amount of monetary damages, as well as interest, costs, and injunctive relief, based upon allegations that the Company infringed three Radware patents related to ISP link load balancing. The Company answered the Complaint, denied the substantive allegations, and sought a declaratory judgment that the asserted claims were invalid. The Company also counter-claimed alleging that Radware had infringed certain Company patents relating to cookie persistence. F5 was granted summary judgment of non-infringement of one of Radware's three patents, and was also granted summary judgment of non-infringement with respect to the other two patents in connection with design-arounds. F5 also took an offer of judgment as to Radware's infringement of its patents. Radware's damages claims and F5's invalidity claims proceeded to trial and on March 15, 2016, the jury returned a verdict finding that F5 had not proven that the asserted patents were invalid, that the Company willfully infringed one of the two patents and that Radware was due \$6.4 million in damages. On August 22, 2016, the Court, in response to various post-trial motions, granted F5 judgment as a matter of law on Radware's claim of willful infringement (and thus denied Radware's motion for treble damages and attorneys' fees), awarded prejudgment interest, and issued an injunction. On September 7, 2016, the Court entered judgment in the amount of \$6,870,979 in favor of Radware on its claims, and \$40,000 in favor of F5 on its counterclaim (pursuant to the offer and acceptance of judgment). On October 5, 2016, F5 moved for a new trial on invalidity. That motion was denied. F5 has appealed the denial of the motion and Radware has appealed the summary judgments of non-infringement, the district court's exclusion of certain evidence, and the grant of judgment as a matter of law on the willfulness claim. Separately, Radware has requested an award of \$192,000 in costs. F5 has objected to the request and it remains pending. F5 has posted security of \$6,895,391 to stay execution of the judgment pending appeal. The appeal is fully briefed and awaiting oral argument, which is scheduled for September 6, 2017.

In addition, on April 4, 2016, the Company sued Radware, Inc. in the United States District Court for the Western District of Washington accusing Radware of infringing three other Company patents. The Company's complaint seeks a jury trial and an unspecified amount of monetary damages, as well as interest, costs, and injunctive relief. Radware moved to dismiss the allegations of one patent but the motion was denied. Radware has also filed a counterclaim asserting that F5 is infringing Radware's U.S. patent no. 9,231,853, another ISP link load balancing patent related to the same patents involved in the California litigation. F5 has denied infringement. The parties have also filed petitions for inter partes reviews on all four patents in the litigation and the Patent Trial and Appeal Board (PTAB) has instituted the review on Radware's '853 patent. The PTAB dismissed Radware's two petitions for inter partes review of one of the three Company patents asserted against Radware- U.S. patent no. 7,742,413. In light of recent case developments, the Western District of Washington case, by stipulation, was transferred to the Northern District of California, where it has been assigned to Judge Chhabria. A case management conference is scheduled for October 12, 2017.

In addition to the above referenced matters, the Company is subject to legal proceedings, claims, and litigation arising in the ordinary course of business, including intellectual property litigation. Management believes that the Company has meritorious defenses to the allegations made in its pending cases and intends to vigorously defend these lawsuits; however, the Company is unable currently to determine the ultimate outcome of these or similar matters or the potential exposure to loss, if any. There are many uncertainties associated with any litigation and these actions or other third-party claims against the Company may cause it to incur costly litigation and/or substantial settlement charges that could have a material adverse effect on the Company's business, financial condition, results of operations, and cash flows.

The Company records an accrual for loss contingencies for legal proceedings when it believes that an unfavorable outcome is both (a) probable and (b) the amount or range of any possible loss is reasonably estimable. In fiscal 2016, the Company recorded an accrual related to the Radware litigation mentioned above of \$7.0 million for the verdict. The accrual was adjusted by immaterial amounts in the second and third quarters of fiscal 2017 to better reflect the Company's total expected litigation expense. The Company has not recorded any other accruals for loss contingencies associated with other legal proceedings.

6. Income Taxes

The effective tax rate was 31.1% and 32.4% for the three and nine months ended June 30, 2017, respectively, compared to 34.4% and 33.6% for the three and nine months ended June 30, 2016, respectively.

At June 30, 2017, the Company had \$18.6 million of unrecognized tax benefits that, if recognized, would affect the effective tax rate. It is anticipated that the Company's existing liabilities for unrecognized tax benefits will change within the next twelve months due to audit settlements or the expiration of statutes of limitations. The Company does not expect these changes to be material to the consolidated financial statements. The Company recognizes interest and, if applicable, penalties for any uncertain tax positions as a component of income tax expense.

Table of Contents

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, 2013. The Company is currently under audit by various states for fiscal years 2012 through 2015. Major jurisdictions where there are wholly owned subsidiaries of F5 Networks, Inc. which require income tax filings include the United Kingdom, Japan, Singapore and Australia. The earliest periods open for review by local taxing authorities are fiscal years 2015 for the United Kingdom, 2011 for Japan, 2012 for Singapore, and 2013 for Australia. Within the next four fiscal quarters, the statute of limitations will begin to close on the fiscal year 2014 federal income tax return, and fiscal years 2012, 2013, and 2014 state income tax returns.

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. Management has determined that the Company is organized as, and operates in, one reportable operating segment: the development, marketing and sale of application delivery networking products that optimize the security, performance and availability of network applications, servers and storage systems. 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 following presents revenues by geographic region (in thousands):

	Three months ended		Nine months ended	
	June 30,		June 30,	
	2017	2016	2017	2016
Americas:				
United States	\$269,975	\$256,518	\$791,643	\$737,792
Other	27,331	23,835	84,211	81,574
Total Americas	297,306	280,353	875,854	819,366
EMEA	121,578	117,286	377,779	367,155
Japan	22,128	24,034	71,415	71,345
Asia Pacific	76,825	74,849	226,995	211,819
	\$517,837	\$496,522	\$1,552,043	\$1,469,685

The following distributors of the Company's products accounted for more than 10% of total net revenue:

	Three months ended		Nine months ended	
	June 30,		June 30,	
	2017	2016	2017	2016
Westcon Group, Inc.	19.1 %	18.8 %	18.6 %	18.9 %
Ingram Micro, Inc.	16.8 %	14.9 %	16.4 %	14.8 %
Tech Data ¹	12.2 %	13.7 %	12.4 %	13.6 %
Arrow ECS ²	—	—	10.4 %	10.1 %

1.

On February 27, 2017, Tech Data completed the acquisition of Avnet Technology Solutions

2.

Arrow ECS accounted for under 10% of total net revenue for the three months ended June 30, 2017 and June 30, 2016

Table of Contents

The Company tracks assets by physical location. Long-lived assets consist of property and equipment, net, and are shown below (in thousands):

	June 30, 2017	September 30, 2016
United States	\$105,599	\$ 105,480
EMEA	15,544	13,789
Other countries	3,996	3,979
	\$125,139	\$ 123,248

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 in Part II, 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 software-defined application delivery services designed to ensure the fast, secure and reliable delivery of applications and data. Our products include hardware-based software, software-only solutions, cloud-based subscription services and a common management framework that enable customers to accelerate, optimize, secure and manage applications across hybrid computing infrastructures that combine traditional networks and data centers with software-defined networks, virtualized data centers and cloud-based 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.

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 BIG-IP appliances and high end VIPRION chassis and related software modules and our software-only Virtual Editions; Local Traffic Manager (LTM), DNS Services (formerly Global Traffic Manager); Advanced Firewall Manager (AFM) and Policy Enforcement Manager (PEM), that leverage the unique performance characteristics of our hardware and software architecture; and products that incorporate acquired technology, including Application Security Manager (ASM) and Access Policy Manager (APM); signaling delivery controller products (SDC); and the WebSafe, MobileSafe, Secure Web Gateway and Silverline DDoS and Application security offerings which are sold to customers on a subscription basis. 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, Silverline infrastructure, amortization of developed technology and personnel and overhead expenses. Our margins have remained relatively stable; however, factors such as sales price, product and services 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

net revenues, although we cannot provide assurance that international revenues as a percentage of net revenues will remain at current levels.

periods in the prior year. The increase in cost of net product revenues is due to a higher volume of hardware and software sales as well as an increase in sales of our subscription-based Silverline services.

Table of Contents

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 and nine months ended June 30, 2017, cost of net service revenues as a percentage of net service revenues was 16.3% and 16.0%, respectively, compared to 16.5% and 16.6% for the same periods in the prior year, respectively. The decrease in cost of net service revenues as a percentage of net service revenues is primarily due to the scalability of our existing customer support infrastructure and increased revenue from maintenance contracts. Professional services headcount at the end of June 2017 increased to 919 from 898 at the end of June 2016. In addition, cost of net service revenues included stock-based compensation expense of \$4.8 million and \$14.6 million for the three and nine months ended June 30, 2017, respectively, compared to \$4.2 million and \$12.5 million for the same periods in the prior year, respectively.

	Three months ended June 30,		Nine months ended June 30,	
	2017	2016	2017	2016
	(in thousands, except percentages)			
Operating expenses				
Sales and marketing	\$ 160,952	\$ 156,620	\$ 490,171	\$ 470,545
Research and development	88,602	83,042	264,886	250,481
General and administrative	39,368	34,182	119,055	103,238
Litigation expense	1	(527)	(134)	8,421
Total	\$ 288,923	\$ 273,317	\$ 873,978	\$ 832,685
Operating expenses (as a percentage of net revenue)				
Sales and marketing	31.1	% 31.5	% 31.6	% 32.0
Research and development	17.1	16.7	17.0	17.0
General and administrative	7.6	6.9	7.7	7.0
Litigation expense	—	(0.1)	—	0.6
Total	55.8	% 55.0	% 56.3	% 56.6

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 2.8% and 4.2% for the three and nine months ended June 30, 2017, respectively, from the comparable periods in the prior year. The increase in sales and marketing expense was primarily due to an increase of \$2.5 million and \$11.9 million in commissions and personnel costs for the three and nine months ended June 30, 2017, respectively, from the comparable periods in the prior year. The increased commissions and personnel costs were driven primarily by growth in sales and marketing employee headcount for the corresponding periods. Sales and marketing headcount at the end of June 2017 increased to 1,794 from 1,720 at the end of June 2016. Sales and marketing expense included stock-based compensation expense of \$17.5 million and \$52.7 million for the three and nine months ended June 30, 2017, respectively, compared to \$15.2 million and \$46.0 million for the same periods in the prior year, respectively.

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 6.7% and 5.8% for the three and nine months ended June 30, 2017, respectively, from the comparable periods in the prior year. The increase in research and development expense was primarily due to an increase of \$3.7 million and \$12.1 million in personnel costs for the three and nine months ended June 30, 2017, respectively, from the comparable periods in the prior year. Research and development headcount at the end of June 2017 increased to 1,240 from 1,174 at the end of June 2016. Research and development expense included stock-based compensation expense of \$13.6 million and \$41.4 million for the three and nine months ended June 30, 2017, respectively, compared to \$13.0 million and \$39.6 million for the same periods in the prior year, respectively. 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 15.2% and 15.3% for the three and nine months ended June 30, 2017, respectively, from the comparable periods in the prior year. The increase in general and administrative expense was primarily due to an increase of \$2.4 million and \$5.3 million in personnel costs for the three and nine months ended June 30, 2017, respectively, from the comparable periods in the prior year. In addition, fees paid to outside consultants for legal, audit and tax services increased \$1.0 million and \$3.0 million for the three and nine months ended June 30, 2017, respectively, from the comparable periods in the prior year. General and administrative headcount at the end of

Litigation expense. In the second quarter of fiscal 2016, we accrued a litigation expense of \$8.9 million, which included a patent-related jury verdict for \$6.4 million and \$2.5 million in legal fees and other costs associated with the litigation. The accrual was adjusted by immaterial amounts in the third and fourth quarters of fiscal 2016 and the second and third quarters of fiscal 2017 to better reflect our total expected litigation expense. See Note 5 - Commitments and Contingencies of the Notes to Financial Statements (Part I, Item 1 of this Form 10-Q) for additional information regarding this litigation.

Our worldwide effective tax rate may fluctuate based on a number of factors, including variations in projected taxable income in the various geographic locations in which we operate, changes in the valuation of our net deferred tax assets, resolution of potential exposures, tax positions taken on tax returns filed in the various geographic locations in which we operate, and the introduction of new accounting standards or changes in tax laws or interpretations thereof in the various geographic locations in which we operate. We have recorded liabilities to address potential tax exposures related to business and income tax positions we have taken that could be challenged by taxing authorities.

The ultimate resolution of these potential exposures may be greater or less than the liabilities recorded which could result in an adjustment to our future tax expense.

Table of Contents

Liquidity and Capital Resources

Cash and cash equivalents, short-term investments and long-term investments totaled \$1,248.8 million as of June 30, 2017, compared to \$1,158.8 million as of September 30, 2016, representing an increase of \$90.1 million. The increase was primarily due to cash provided by operating activities of \$527.2 million for the nine months ended June 30, 2017, which was largely offset by \$450.1 million of cash used for the repurchase of outstanding common stock under our stock repurchase program. Cash provided by operating activities for the first nine months of fiscal year 2017 resulted from net income of \$285.0 million combined with changes in operating assets and liabilities, as adjusted for various non-cash items including stock-based compensation, deferred revenue, depreciation and amortization charges. Based on our current operating and capital expenditure forecasts, we believe that our existing cash and investment balances, together with cash generated from operations should be sufficient to meet our operating requirements for at least the next twelve months.

Cash provided by investing activities was \$47.1 million for the nine months ended June 30, 2017, compared to cash provided by investing activities of \$33.4 million for the same period in the prior year. Investing activities include purchases, sales and maturities of available-for-sale securities, business acquisitions, capital expenditures and changes in restricted cash requirements. The amount of cash provided by investing activities for the nine months ended June 30, 2017 was primarily the result of the sale and maturity of investments partially offset by the purchase of investments and capital expenditures related to maintaining our operations worldwide.

Cash used in financing activities was \$396.6 million for the nine months ended June 30, 2017, compared to cash used in financing activities of \$503.7 million for the same period in the prior year. Our financing activities for the nine months ended June 30, 2017 consisted primarily of cash required for the repurchase of outstanding common stock under our stock repurchase program of \$450.1 million, partially offset by cash received from the exercise of employee stock options and stock purchases under our employee stock purchase plan of \$47.0 million.

Obligations and Commitments

As of June 30, 2017, our principal commitments consisted of obligations outstanding under operating leases. We lease our facilities under operating leases that expire at various dates through 2033. On May 3, 2017, we entered into an agreement to lease approximately 515,000 square feet of office space in Seattle, Washington that will serve as our new corporate headquarters. The initial term of the lease is 14.5 years and is expected to commence on the latter of (i) April 1, 2019 or (ii) 10 months after the substantial completion date of the construction of the Premises. Base rent payments due under the lease are expected to be approximately \$359.5 million in the aggregate over the term of the lease. We are also responsible for certain other costs under the lease, such as certain build-out expenses, operating expenses, taxes, assessments, insurance, and utilities.

We outsource the manufacturing of our pre-configured hardware platforms to contract manufacturers who assemble each product to our specifications. Our agreement with our largest contract manufacturer allows them to procure component inventory on our behalf based upon a rolling production forecast. We are contractually obligated to purchase the component inventory in accordance with the forecast, unless we give notice of order cancellation in advance of applicable lead times. There have been no material changes in our inventory purchase obligations compared to those discussed in Management's Discussion and Analysis of Financial Condition and Results of Operations included in our Annual Report on Form 10-K for the fiscal year ended September 30, 2016.

Recent Accounting Pronouncements

The anticipated impact of recent accounting pronouncements is discussed in Note 1 to the accompanying Notes to Consolidated Financial Statements of this Quarterly Report on Form 10-Q.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Interest Rate Risk. We maintain an investment portfolio of various holdings, types, and maturities. Our primary objective for holding fixed income securities is to achieve an appropriate investment return consistent with preserving principal and managing risk. At any time, a sharp rise in market interest rates could have a material adverse impact on the fair value of our fixed income investment portfolio. Conversely, declines in interest rates, including the impact from lower credit spreads, could have a material adverse impact on interest income for our investment portfolio. Our fixed income investments are held for purposes other than trading. Our fixed income investments were not leveraged as of June 30, 2017. We monitor our interest rate and credit risks, including our credit exposures to specific rating

categories and to individual issuers. As of June 30, 2017, 32.6% of our fixed income securities balance consisted of U.S. government and U.S. government agency securities. We believe the overall credit quality of our portfolio is strong.

Table of Contents

Foreign Currency Risk. The majority of our sales and expenses are denominated in U.S. dollars and as a result, we have not experienced significant foreign currency transaction gains and losses to date. Management believes there have been no material changes to our quantitative and qualitative disclosures about market risk during the nine month period ended June 30, 2017, compared to those discussed in our Annual Report on Form 10-K for the year ended September 30, 2016.

Item 4. Controls and Procedures

Our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the “Exchange Act”)) are designed to ensure that required information is properly recorded, processed, summarized and reported within the required timeframe, as specified in the rules set forth by the SEC. Our disclosure controls and procedures are also designed to ensure that information required to be disclosed is accumulated and communicated to management, including our Chief Executive Officer and Chief Financial Officer, to allow timely decisions regarding required disclosures.

Our management, with the participation of our Chief Executive Officer and Chief Financial Officer, evaluated the effectiveness of our disclosure controls and procedures as of June 30, 2017. Based upon that evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that our disclosure controls and procedures were effective as of June 30, 2017.

There were no changes in our internal control over financial reporting (as defined in Rules 13a-15(f) or 15d-15(f) of the Exchange Act) during the period covered by this quarterly report that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II — OTHER INFORMATION

Item 1. Legal Proceedings

See Note 5 - Commitments and Contingencies of the Notes to Financial Statements (Part I, Item 1 of this Form 10-Q) for information regarding legal proceedings in which we are involved.

Item 1A. Risk Factors

The following information updates, and should be read in conjunction with, the information discussed in Part I, Item 1A. “Risk Factors” in our Annual Report on Form 10-K for the fiscal year ended September 30, 2016. The risks discussed below and in our Annual Report on Form 10-K could materially affect our business, financial condition and future results. These are not the only risks facing us. Additional risks and uncertainties not currently known to us or that we currently deem to be insignificant also may materially and adversely affect our business, financial condition or operating results in the future.

Our success depends on our key personnel and our ability to hire, retain and motivate qualified executives, sales and marketing, operations, product development and professional services personnel

Our success depends, in large part, on our ability to attract, engage, retain, and integrate qualified executives and other key employees throughout all areas of our business. In order to attract and retain executives and other key employees in a competitive marketplace, we must provide a competitive compensation package, including cash- and equity-based compensation. If we do not obtain the stockholder approval needed to continue granting equity compensation in a competitive manner, our ability to attract, retain, and motivate executives and key employees could be weakened.

Failure to successfully hire executives and key employees or the loss of any executives and key employees could have a significant impact on our operations. Further, changes in our management team may be disruptive to our business, and any failure to successfully integrate key new hires or promoted employees could adversely affect our business and results of operations. In addition, we recently announced John McAdam's retirement as CEO and the appointment of François Locoh-Donou as CEO effective April 3, 2017. Transitioning to a new chief executive could be disruptive to our business and could adversely affect our business and results of operations. The complexity of our application delivery networking products and their integration into existing networks and ongoing support, as well as the sophistication of our sales and marketing effort, requires us to retain highly trained developers, professional services, customer support and sales personnel. Competition for qualified developers, professional services, customer support and sales personnel in our industry is intense, especially in Silicon Valley and Seattle where we have substantial operations and a need for highly skilled personnel, because of the limited number of people available with the necessary technical skills and understanding of our products. Also, to the extent we hire personnel from competitors,

we may be subject to allegations that they have been improperly solicited, that they have divulged proprietary or other confidential information, that they have violated non-compete obligations to their prior employers, or that their former employers own their inventions or other work product. Our ability to hire and retain these personnel may be adversely affected

Table of Contents

by volatility or reductions in the price of our common stock or our ability to get approval from shareholders to offer additional common stock to our employees, since these employees are generally granted restricted stock units. The loss of services of any of our key personnel, the inability to retain and attract qualified personnel in the future or delays in hiring qualified personnel may harm our business and results of operations.

Table of Contents

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

On April 20, 2016, the Company announced that its Board of Directors authorized an additional \$1.0 billion for its common stock share repurchase program. This new authorization is incremental to the existing \$2.4 billion program, initially approved in October 2010 and expanded in each fiscal year. 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 June 30, 2017, the Company had repurchased and retired 3,301,167 shares at an average price of \$136.34 per share during fiscal year 2017 and the Company had \$323.7 million remaining authorized to purchase shares.

Shares repurchased and retired as of June 30, 2017 are as follows (in thousands, except shares and per share data):

	Total Number of Shares Purchased	Average Price Paid per Share	Total Number of Shares Purchased per the Publicly Announced Plan	Approximate Dollar Value of Shares that May Yet be Purchased Under the Plan
October 1, 2016 — October 31, 2016	—	\$ —	—	\$ 773,743
November 1, 2016 — November 30, 2016	1,055,640	\$ 142.11	1,055,640	\$ 623,722
December 1, 2016 — December 31, 2016	—	\$ —	—	\$ 623,722
January 1, 2017 — January 31, 2017	—	\$ —	—	\$ 623,722
February 1, 2017 — February 28, 2017	1,085,862	\$ 138.16	1,085,862	\$ 473,700
March 1, 2017 — March 31, 2017	—	\$ —	—	\$ 473,700
April 1, 2017 — April 30, 2017	—	\$ —	—	\$ 473,700
May 1, 2017 — May 31, 2017	1,159,665	\$ 129.37	1,159,665	\$ 323,677
June 1, 2017 — June 30, 2017	—	\$ —	—	\$ 323,677

Table of Contents

Item 6. Exhibits

Exhibit Number	Exhibit Description
31.1*	—Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2*	—Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1*	—Certification Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
101.INS*	—XBRL Instance Document
101.SCH*	—XBRL Taxonomy Extension Schema Document
101.CAL*	—XBRL Taxonomy Extension Calculation Linkbase Document
101.DEF*	—XBRL Taxonomy Extension Definition Linkbase Document
101.LAB*	—XBRL Taxonomy Extension Label Linkbase Document
101.PRE*	—XBRL Taxonomy Extension Presentation Linkbase Document

*Filed herewith.

Table of Contents

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized on this 2nd day of August, 2017.

F5 NETWORKS, INC.

By: /s/ ANDY REINLAND

Andy Reinland

Executive Vice President,

Chief Financial Officer

(principal financial officer and principal accounting officer)