

F5 NETWORKS INC  
Form 10-Q  
August 05, 2011

**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, 2011**

**OR**

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

**For the transition period from to**

**Commission File Number 000-26041**

**F5 NETWORKS, INC.**

(Exact name of registrant as specified in its charter)

**WASHINGTON**

(State or other jurisdiction of  
incorporation or organization)

**91-1714307**

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

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

(Address of principal executive offices and zip code)

**(206) 272-5555**

(Registrant's telephone number, including area code)

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

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

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

(Do not check if a smaller  
reporting company)

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

The number of shares outstanding of the registrant's common stock as of August 2, 2011 was 80,726,859.

**F5 NETWORKS, INC.**  
**QUARTERLY REPORT ON FORM 10-Q**  
**For the Quarter Ended June 30, 2011**  
**Table of Contents**

	<b>Page</b>
<b><u>PART I. FINANCIAL INFORMATION</u></b>	
<u>Item 1. Financial Statements (unaudited)</u>	
<u>Consolidated Balance Sheets June 30, 2011 and September 30, 2010</u>	3
<u>Consolidated Income Statements Three months and nine months ended June 30, 2011 and 2010</u>	4
<u>Consolidated Statement of Shareholders Equity Nine months ended June 30, 2011</u>	5
<u>Consolidated Statements of Cash Flows Nine months ended June 30, 2011 and 2010</u>	6
<u>Notes to Consolidated Financial Statements</u>	7
<u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	17
<u>Item 3. Quantitative and Qualitative Disclosures About Market Risk</u>	31
<u>Item 4. Controls and Procedures</u>	31
<b><u>PART II. OTHER INFORMATION</u></b>	
<u>Item 1. Legal Proceedings</u>	31
<u>Item 1A. Risk Factors</u>	31
<u>Item 2. Unregistered Sales of Equity Securities and Use of Proceeds</u>	32
<u>Item 6. Exhibits</u>	33
<b><u>SIGNATURES</u></b>	34
<u>Exhibit Index</u>	35
<u>EX-31.1</u>	
<u>EX-31.2</u>	
<u>EX-32.1</u>	
<u>EX-101 INSTANCE DOCUMENT</u>	
<u>EX-101 SCHEMA DOCUMENT</u>	
<u>EX-101 CALCULATION LINKBASE DOCUMENT</u>	
<u>EX-101 LABELS LINKBASE DOCUMENT</u>	
<u>EX-101 PRESENTATION LINKBASE DOCUMENT</u>	
<u>EX-101 DEFINITION LINKBASE DOCUMENT</u>	

**Table of Contents****PART I. FINANCIAL INFORMATION****Item 1. Financial Statements**

**F5 NETWORKS, INC.**  
**CONSOLIDATED BALANCE SHEETS**  
(unaudited, in thousands)

	<b>June 30, 2011</b>	<b>September 30, 2010</b>
<b>ASSETS</b>		
Current assets		
Cash and cash equivalents	\$ 299,804	\$ 168,754
Short-term investments	285,530	259,742
Accounts receivable, net of allowances of \$2,821 and \$4,319	154,741	112,132
Inventories	17,941	18,815
Deferred tax assets	9,197	8,767
Other current assets	30,015	37,745
Total current assets	797,228	605,955
Property and equipment, net	42,323	34,157
Long-term investments	471,567	433,570
Deferred tax assets	38,169	37,864
Goodwill	234,700	234,700
Other assets, net	13,147	15,946
Total assets	\$ 1,597,134	\$ 1,362,192
<b>LIABILITIES AND SHAREHOLDERS EQUITY</b>		
Current liabilities		
Accounts payable	\$ 34,070	\$ 21,180
Accrued liabilities	59,721	61,768
Deferred revenue	255,226	204,137
Total current liabilities	349,017	287,085
Other long-term liabilities	16,300	16,153
Deferred revenue, long-term	66,649	55,256
Total long-term liabilities	82,949	71,409
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, 80,727 and 80,355 shares issued and outstanding	505,117	517,215
Accumulated other comprehensive loss	(3,460)	(3,241)
Retained earnings	663,511	489,724

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Total shareholders' equity	1,165,168	1,003,698
Total liabilities and shareholders' equity	\$ 1,597,134	\$ 1,362,192

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

3

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**Table of Contents**

**F5 NETWORKS, INC.**  
**CONSOLIDATED INCOME STATEMENTS**  
(unaudited, in thousands, except per share data)

	<b>Three months ended</b>		<b>Nine months ended</b>	
	<b>June 30,</b>		<b>June 30,</b>	
	<b>2011</b>	<b>2010</b>	<b>2011</b>	<b>2010</b>
Net revenues				
Products	\$ 179,327	\$ 147,393	\$ 524,529	\$ 396,170
Services	111,386	83,081	312,690	231,528
<b>Total</b>	<b>290,713</b>	<b>230,474</b>	<b>837,219</b>	<b>627,698</b>
Cost of net revenues				
Products	31,803	29,328	94,840	82,789
Services	20,645	15,251	57,244	42,335
<b>Total</b>	<b>52,448</b>	<b>44,579</b>	<b>152,084</b>	<b>125,124</b>
Gross profit	238,265	185,895	685,135	502,574
Operating expenses				
Sales and marketing	93,633	77,219	269,790	212,505
Research and development	35,245	30,889	102,358	86,743
General and administrative	21,126	17,658	61,656	49,627
<b>Total</b>	<b>150,004</b>	<b>125,766</b>	<b>433,804</b>	<b>348,875</b>
Income from operations	88,261	60,129	251,331	153,699
Other income, net	1,889	3,561	6,002	7,557
Income before income taxes	90,150	63,690	257,333	161,256
Provision for income taxes	27,601	23,195	83,546	58,338
Net income	\$ 62,549	\$ 40,495	\$ 173,787	\$ 102,918
Net income per share basic	\$ 0.77	\$ 0.51	\$ 2.15	\$ 1.30
Weighted average shares basic	80,866	79,864	80,773	79,386
Net income per share diluted	\$ 0.77	\$ 0.50	\$ 2.13	\$ 1.27
Weighted average shares diluted	81,497	81,031	81,655	80,870

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

Table of Contents

**F5 NETWORKS, INC.**  
**CONSOLIDATED STATEMENT OF SHAREHOLDERS EQUITY**  
(unaudited, in thousands)

	Nine months ended June 30, 2011				Total Shareholders Equity
	Common Stock		Accumulated Other Comprehensive Income/(Loss)	Retained Earnings	
	Shares	Amount			
<b>Balance, September 30, 2010</b>	80,355	\$ 517,215	\$ (3,241)	\$ 489,724	\$ 1,003,698
Exercise of employee stock options	142	2,197			2,197
Issuance of stock under employee stock purchase plan	256	18,932			18,932
Issuance of restricted stock	1,048				
Repurchase of common stock	(1,074)	(121,526)			(121,526)
Tax benefit from employee stock transactions		20,686			20,686
Stock-based compensation		67,613			67,613
Comprehensive income:					
Net income				173,787	
Foreign currency translation adjustment			(529)		
Unrealized gain on securities, net of tax			310		
Comprehensive income					173,568
<b>Balance, June 30, 2011</b>	80,727	\$ 505,117	\$ (3,460)	\$ 663,511	\$ 1,165,168

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)

	<b>Nine months ended</b>	
	<b>June 30,</b>	
	<b>2011</b>	<b>2010</b>
<b>Operating activities</b>		
Net income	\$ 173,787	\$ 102,918
Adjustments to reconcile net income to net cash provided by operating activities:		
Realized gain on disposition of assets and investments	(203)	(117)
Stock-based compensation	67,613	50,991
Provisions for doubtful accounts and sales returns	453	794
Depreciation and amortization	15,715	17,923
Deferred income taxes	(387)	10,659
Gain on auction rate securities put option		(1,491)
Loss on trading auction rate securities		1,491
Changes in operating assets and liabilities, net of amounts acquired:		
Accounts receivable	(43,062)	3,350
Inventories	874	(3,927)
Other current assets	8,452	(10,380)
Other assets	(365)	(1,651)
Accounts payable and accrued liabilities	10,086	154
Deferred revenue	62,481	56,507
Net cash provided by operating activities	295,444	227,221
<b>Investing activities</b>		
Purchases of investments	(692,812)	(571,072)
Sales and maturities of investments	629,766	397,702
Investment of restricted cash	(406)	(26)
Acquisition of intangible assets	(80)	
Purchases of property and equipment	(20,544)	(10,119)
Net cash used in investing activities	(84,076)	(183,515)
<b>Financing activities</b>		
Excess tax benefits from stock-based compensation	20,221	16,419
Proceeds from the exercise of stock options and purchases of stock under employee stock purchase plan	21,131	29,338
Repurchase of common stock	(121,526)	(55,000)
Net cash used in financing activities	(80,174)	(9,243)
Net increase in cash and cash equivalents	131,194	34,463
Effect of exchange rate changes on cash and cash equivalents	(144)	(1,487)
Cash and cash equivalents, beginning of period	168,754	110,837
Cash and cash equivalents, end of period	\$ 299,804	\$ 143,813



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

6

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**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) provides products and services to help companies manage their Internet Protocol (IP) traffic and file storage infrastructure efficiently and securely. The Company's application delivery networking products improve the performance, availability and security of applications on Internet-based networks. Internet traffic between network-based applications and clients passes through these devices where the content is inspected to ensure that it is safe and modified as necessary to ensure that it is delivered securely and in a way that optimizes the performance of both the network and the applications. The Company's storage virtualization products simplify and reduce the cost of managing files and file storage devices, and ensure fast, secure, easy access to files for users and applications. The Company also offers a broad range of services that include consulting, training, maintenance and other technical support services.

**Basis of Presentation**

The year end condensed consolidated balance sheet data was derived from audited financial statements, but does not include all disclosures required by accounting principles generally accepted in the United States of America. In the opinion of management, the unaudited consolidated financial statements reflect all adjustments, consisting only of normal recurring adjustments, necessary for their fair statement in conformity with accounting principles generally accepted in the United States of America. Certain information and footnote disclosures normally included in annual financial statements have been condensed or omitted in accordance with the rules and regulations of the Securities and Exchange Commission. The information included in this Form 10-Q should be read in conjunction with Management's Discussion and Analysis of Financial Condition and Results of Operations and financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the fiscal year ended September 30, 2010.

Certain reclassifications have been made to the prior year's financial statements to conform to the fiscal year 2011 presentation. Such reclassifications did not affect total revenues, operating income or net income.

**Revenue Recognition**

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

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

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

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

*Collectability is reasonable 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.

In certain regions where the Company does not have the ability to reasonably estimate returns, the Company defers revenue on sales to its distributors until they have received information from the channel partner indicating that the product has been sold to the end-user customer. Payment terms to domestic customers are generally net 30 days to net 45 days. Payment terms to international customers range from net 30 days to net 120 days based on normal and customary trade practices in the individual markets. The Company offers extended payment terms to certain customers, in which case, revenue is recognized when payments are due.

**Table of Contents**

Whenever product, training services and post-contract customer support ( PCS ) elements are sold together, a portion of the sales price is allocated to each element based on their respective fair values as determined when the individual elements are sold separately. Revenue from the sale of products is 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, it recognizes revenue when such rights of return lapse. Revenues for 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.

In October 2009, the Financial Accounting Standards Board ( FASB ) amended the accounting standards for revenue recognition to remove from the scope of industry-specific software revenue recognition guidance any tangible products containing software components and non-software components that operate together to deliver the products essential functionality. In addition, the FASB amended the accounting standards for certain multiple element revenue arrangements to:

Provide updated guidance on whether multiple elements exist, how the elements in an arrangement should be separated, and how the arrangement consideration should be allocated to the separate elements;

Require an entity to allocate arrangement consideration to each element based on a selling price 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; and

Eliminate the use of the residual method and require an entity to allocate arrangement consideration using the selling price hierarchy.

The Company adopted this guidance in the first quarter of fiscal year 2011 on a prospective basis for applicable arrangements originating or materially modified after October 1, 2010. The impact of this adoption was not material to the Company's financial position and results of operations for the three and nine months ended June 30, 2011.

The majority of the Company's products are hardware appliances which contain software essential to the overall functionality of the products. Accordingly, the Company no longer recognizes revenue on sales of these products in accordance with the industry-specific software revenue recognition guidance.

For all transactions entered into prior to the first quarter of fiscal year 2011 and for sales of nonessential and stand-alone software after October 1, 2010, the Company allocates revenue for arrangements with multiple elements based on the software revenue recognition guidance. Software revenue recognition guidance requires revenue earned on software arrangements involving multiple elements to be allocated to each element based on the relative fair values of those elements. The fair value of an element must be based on VSOE. Where fair value of certain elements is not available, revenue is recognized on the residual method based on the fair value of undelivered elements. If evidence of the 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.

For transactions entered into subsequent to the adoption of the amended revenue recognition standards that are multiple-element arrangements, the arrangement consideration is allocated to each element based on the relative selling prices of all of the elements in the arrangement using the fair value hierarchy in the amended revenue recognition guidance.

Consistent with the methodology used under the previous accounting guidance, the Company establishes VSOE for its products, training services, PCS and consulting 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 believes that the fair value of its consulting services is represented by the billable consulting rate per hour, based on the rates they charge customers

when they purchase standalone consulting services. The price of consulting services is not based on the type of customer, volume of sales, geographic region or program level.

**Table of Contents**

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 that are priced within a reasonable range, which the Company has determined to be plus or minus 15% of the median sales price of each respective price list.

VSOE of PCS is based on standalone sales since the Company does not provide stated renewal rates to its customers. In accordance with the Company's PCS pricing practice (supported by standalone renewal sales), renewal contracts are priced as a percentage of the undiscounted product list price. The PCS renewal percentages may vary, depending on the type and length of PCS purchased. The Company offers standard and premium PCS, and the term generally ranges from one to three years. The Company employs a bell-shaped-curve approach in evaluating VSOE of fair value of PCS. Under this approach, the Company considers VSOE of the fair value of PCS to exist when a substantial majority of its standalone PCS sales fall within a narrow range of pricing.

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

When the Company is unable to establish selling price of its non-software elements 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 determines BESP for a product or service by considering multiple factors including, but not limited to, cost of products, gross margin objectives, pricing practices, geographies, customer classes and distribution channels.

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

**Goodwill**

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

The Company performs its annual goodwill impairment test during the second fiscal quarter, or whenever events or changes in circumstances indicate that the carrying amount of goodwill may not be recoverable. The first step of the test identifies whether potential impairment may have occurred, while the second step of the test measures the amount of the impairment, if any. Impairment is recognized when the carrying amount of goodwill exceeds its fair value. For its annual goodwill impairment analysis, the Company operates under one reporting unit. The Company determined the fair value of its reporting unit based on the Company's enterprise value. In March 2011, the Company completed its annual impairment test and concluded there was no impairment of goodwill. The Company also considered potential impairment indicators at June 30, 2011 and noted no indicators of impairment.

**Stock-Based Compensation**

The Company accounts for stock-based compensation using the straight-line attribution method for recognizing compensation expense. The Company recognized \$22.9 million and \$17.4 million of stock-based compensation expense for the three months ended June 30, 2011 and 2010, respectively, and \$67.6 million and \$51.0 million for the nine months ended June 30, 2011 and 2010, respectively. As of June 30, 2011, there was \$55.7 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 July 29, 2011, the Company's Compensation Committee approved 833,739 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.

**Table of Contents**

The Company recognizes compensation expense for only the portion of restricted stock units that are expected to vest. Therefore, the Company applies estimated forfeiture rates that are derived from historical employee termination behavior. Based on historical differences with forfeitures of stock-based awards granted to the Company's executive officers and Board of Directors versus grants awarded to all other employees, the Company has developed separate forfeiture expectations for these two groups. The Company's estimated forfeiture rate in the third quarter of fiscal year 2011 is 2.7% for grants awarded to the Company's executive officers and Board of Directors, and 9.7% for grants awarded to all other employees. If the actual number of forfeitures differs from those estimated by management, additional adjustments to compensation expense may be required in future periods.

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

In August 2009, the Company granted 420,000 RSUs to certain current executive officers. Fifty percent of the aggregate number of RSUs granted at such time vest in equal quarterly increments over two years, until such portion of the grant is fully vested on August 1, 2011. Twenty-five percent of the RSU grant, or a portion thereof, was subject to the Company achieving specified quarterly revenue and EBITDA goals during the period beginning in the fourth quarter of fiscal year 2009 through the third quarter of fiscal year 2010 and the remaining twenty-five percent was subject to the Company achieving specified quarterly revenue and EBITDA goals during the period beginning in the fourth quarter of fiscal year 2010 through the third quarter of fiscal year 2011. In each case, 50% of the quarterly performance stock grant is based on achieving at least 80% of the quarterly revenue goal and the other 50% is based on achieving at least 80% of the quarterly EBITDA goal. The quarterly performance stock grant is paid linearly above 80% of the targeted goals. At least 100% of both goals must be attained in order for the quarterly performance stock grant to be awarded over 100%. Each goal is evaluated individually and subject to the 80% achievement threshold and 100% over-achievement threshold.

The 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 October 22, 2008, the Company announced that its Board of Directors approved a program to repurchase up to an additional \$200 million of the Company's outstanding common stock. As of September 30, 2010, the Company had \$37.6 million remaining to

**Table of Contents**

purchase shares as part of this repurchase program. On October 26, 2010, the Company announced that its Board of Directors approved a new program to repurchase up to an additional \$200 million of the Company's outstanding common stock. 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 August 2, 2011, the Company had repurchased and retired 5,666,566 shares at an average price of \$51.09 per share and the Company had \$110.2 million remaining to purchase shares as part of its repurchase programs.

**Earnings Per Share**

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

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

	<b>Three months ended June 30,</b>		<b>Nine months ended June 30,</b>	
	<b>2011</b>	<b>2010</b>	<b>2011</b>	<b>2010</b>
<b>Numerator</b>				
Net income	\$ 62,549	\$ 40,495	\$ 173,787	\$ 102,918
<b>Denominator</b>				
Weighted average shares outstanding - basic	80,866	79,864	80,773	79,386
Dilutive effect of common shares from stock options and restricted stock units	631	1,167	882	1,484
Weighted average shares outstanding - diluted	81,497	81,031	81,655	80,870
Basic net income per share	\$ 0.77	\$ 0.51	\$ 2.15	\$ 1.30
Diluted net income per share	\$ 0.77	\$ 0.50	\$ 2.13	\$ 1.27

An immaterial amount of common shares potentially issuable from stock options for the three and nine months ended June 30, 2011 and 2010, are excluded from the calculation of diluted earnings per share because the exercise price was greater than the average market price of common stock for the respective periods.

**Comprehensive Income**

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

	<b>Three months ended June 30,</b>		<b>Nine months ended June 30,</b>	
	<b>2011</b>	<b>2010</b>	<b>2011</b>	<b>2010</b>
Net Income	\$ 62,549	\$ 40,495	\$ 173,787	\$ 102,918
Unrealized gain (loss) on securities, net of tax	1,273	(277)	310	(1,088)
Foreign currency translation adjustment	(101)	(724)	(529)	(1,170)
Total comprehensive income	\$ 63,721	\$ 39,494	\$ 173,568	\$ 100,660



**Recent Accounting Pronouncements**

Management believes there have been no significant changes during the nine months ended June 30, 2011, to the items disclosed as recently adopted accounting pronouncements in Management's Discussion and Analysis of Financial Condition and Results of Operations in the Company's Annual Report on Form 10-K for the year ended September 30, 2010. For a further discussion, refer to the Recent Accounting Pronouncements discussion contained therein.

**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

**Table of Contents**

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/FONT>

All current directors and executive officers as a group (6 persons) (6)

404,409 57,500 461,909 5.7%

\* Ownership is less than one percent.

- (1) Number of shares subject to exercisable options reflects our common stock that could be acquired within sixty days of the record date, April 17, 2012, upon the exercise of options granted pursuant to our stock incentive plans.
- (2) Based on 8,095,042 shares of our common stock outstanding as of April 17, 2012.
- (3) Includes 3,250 shares held in his individual retirement account. Does not include 60,500 restricted stock units. Mr. Armstrong has pledged 362,180 shares of our common stock to secure a line of credit.

- (4) Does not include 12,000 restricted stock units.
- (5) Effective May 24, 2012, Mr. Garrison will no longer serve as a member of our board of directors.
- (6) Does not include Mr. Lenehan, who is a director nominee but not a current director.

### Section 16(a) Beneficial Ownership Reporting Compliance

Section 16(a) of the Securities Exchange Act of 1934, as amended, requires our directors and executive officers and persons who own more than 10 percent of our common stock to file reports of ownership and changes in ownership with the Securities and Exchange Commission (SEC). Based solely upon our review of the Forms 3, 4 and 5 filed during 2011, and written representations from certain reporting persons that no Forms 5 were required, we believe, with the exception noted below, that all required reports were timely filed. A Form 4 for Mr. Leslie to report his sale of stock in December 2011 was inadvertently filed late on April 18, 2012.

### Stock Ownership of Certain Beneficial Owners

Based on filings with the SEC, the table below shows the beneficial owners of more than five percent of our outstanding common stock. Unless otherwise indicated, all information is presented as of April 17, 2012, and all shares beneficially owned are held with sole voting and investment power.

Name and Address of Beneficial Owner	Total Number of Shares Beneficially Owned	Percent of Outstanding Shares (1)
Carl E. Berg (2)  10050 Bandley Drive  Cupertino, California 95014	1,405,000	17.4%
Dimensional Fund Advisors LP (3)  Palisades West, Building One  6300 Bee Cave Road  Austin, Texas 78746	544,221	6.7%
Ingalls & Snyder LLC (4)  61 Broadway  New York, New York 10006	1,344,838	16.6%
Moffett Holdings, L.L.C. (5)  1615 Poydras Street, Suite 2279  New Orleans, Louisiana 70112	625,000	7.7%

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- (1) Based on 8,095,042 shares of our common stock outstanding as of April 17, 2012.
- (2) Based on a Schedule 13D filed with the SEC on January 11, 2012, as amended on January 12, 2012.
- (3) Based on an amended Schedule 13G filed with the SEC on February 14, 2012. Dimensional Fund Advisors LP, an investment adviser registered under Section 203 of the Investment Advisors Act of 1940, furnishes investment advice to four investment companies registered under the Investment Company Act of 1940, and serves as investment manager to certain other commingled group trusts and separate accounts (such investment companies, trusts and accounts, collectively referred to as the Funds ). In certain cases, subsidiaries of Dimensional Fund Advisors LP may act as an adviser or sub-adviser to certain Funds. In its role as investment advisor, sub-adviser and/or manager, neither Dimensional Fund Advisors LP or its subsidiaries (collectively, Dimensional ) possess voting and/or investment power over the securities of the Issuer that are owned by the Funds, and may be deemed to be the beneficial owner of the shares of the Issuer held by the Funds. However, all securities reported in the Schedule 13G are owned by the Funds. Dimensional disclaims beneficial ownership of such securities. Dimensional Fund Advisors LP has sole voting power over 540,220 shares and sole investment power over 544,221 shares.

- (4) Based on an amended Schedule 13G filed with the SEC on February 7, 2012. Ingalls & Snyder LLC is a registered broker dealer and a registered investment advisor. Amounts reported include shares owned by clients of Ingalls & Snyder in accounts managed under investment advisory contracts. Ingalls & Snyder has no voting power but shares investment power over all of the shares beneficially owned.
- (5) Based on a Schedule 13D filed with the SEC on March 23, 2012, jointly by Moffett Holdings, L.L.C. ( MHLLC ) and James R. Moffett. MHLLC and Mr. Moffett share voting and investment power over all of the shares beneficially owned.

## Executive Officer Compensation

### Executive Compensation Tables

The table below summarizes the total compensation paid to or earned by our named executive officers for the fiscal years ended December 31, 2011 and 2010. Mr. Armstrong and Ms. Pickens were the only executive officers whom we employed during the fiscal years ended December 31, 2011 and 2010.

**2011 Summary Compensation Table**

Name and Principal Position	Year	Salary	Bonus	Stock Awards (1)	All Other Compensation (2)	Total
<b>William H. Armstrong III</b>	2011	\$ 400,000	\$ 400,000	\$ 298,800	\$ 52,924	\$ 1,151,724
Chairman of the Board,	2010	400,000	500,000	126,250	53,227	1,079,477
President & Chief Executive Officer						
<b>Erin D. Pickens</b>	2011	235,000	75,000	69,720	45,441	425,161
Senior Vice President &	2010	235,000	100,000	35,350	42,894	413,244
Chief Financial Officer						

- (1) On January 27, 2011, our corporate personnel committee awarded 30,000 restricted stock units to Mr. Armstrong and 7,000 restricted stock units to Ms. Pickens. The restricted stock units will ratably convert into shares of our common stock over a four-year period beginning on February 15, 2012, or, if earlier, upon a termination of employment due to death, disability or retirement, or upon a change of control of the company. The restricted stock units are valued on the date of grant at the closing sale price per share of our common stock.
- (2) Consists of contributions to defined contribution plans, payments for life insurance policies, director fees and automobile allowances as follows:

Name	Date	Plan Contributions	Life Insurance Premiums	Director Fees	Automobile Allowance
William H. Armstrong III	2011	\$ 32,500	\$ 2,727	\$ 6,000	\$ 11,697
Erin D. Pickens	2011	32,500	2,727		10,214



Outstanding Equity Awards as of December 31, 2011

Name	Option Awards (1)			Stock Awards		
	Number of Securities Underlying Unexercised Options Exercisable	Number of Securities Underlying Unexercised Options Unexercisable	Option Exercise Price (2)	Option Expiration Date	Equity Incentive Plan Awards: Number of Unearned Shares, Units or Other Rights That Have Not Vested (3)	Equity Incentive Plan Awards: Market or Payout Value of Unearned Shares, Units or Other Rights That Have Not Vested (4)
William H. Armstrong III	17,500		\$ 16.015	12/30/2014	52,875	\$ 412,954
Erin D. Pickens					9,625	\$ 75,171

- (1) The stock options were granted on December 30, 2004, and became exercisable in 25 percent annual increments on each of the first four anniversaries of the date of grant and have a term of 10 years.
- (2) The exercise price of each outstanding stock option reflected in this table was determined by reference to (1) the average of the high and low quoted per share sale price on the grant date, or if there are no reported sales on such date, on the last preceding date on which any reported sale occurred or (2) such greater price as determined by the corporate personnel committee. In March 2007, the corporate personnel committee revised its policies going forward to provide that for purposes of our stock incentive plans, the fair market value of our common stock will be determined by reference to the closing sale price on the grant date.
- (3) Unless the award is forfeited or vesting is accelerated because of a termination of employment or change in control as described below under Potential Payments upon Termination or Change in Control, the restricted stock units held by the named executive officers will vest and be paid out in an equivalent number of shares of our common stock as follows:

Name	RSUs	Vesting Date
Mr. Armstrong	6,750	02/09/12
	7,500	02/15/12
	3,125	02/26/12
	6,750	02/09/13
	7,500	02/15/13
	3,125	02/26/13
	7,500	02/15/14

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	3,125	02/26/14
	7,500	02/15/15
Ms. Pickens	1,750	02/15/12
	875	02/26/12
	1,750	02/15/13
	875	02/26/13
	1,750	02/15/14
	875	02/26/14
	1,750	02/15/15

- (4) The market value of the unvested restricted stock units reflected in this table was based on the \$7.81 closing market price per share of our common stock on December 30, 2011.



## Potential Payments upon Termination or Change in Control

Pursuant to the terms of our stock incentive plans and the agreements thereunder, a termination of employment under certain circumstances and a change of control will result in the vesting of outstanding stock options and restricted stock units, as described below.

**Stock Options.** Upon termination of employment as a result of death, disability or retirement, the portion of any outstanding stock options that would have become exercisable within one year of such termination of employment will vest. In addition, upon a change of control of the company, all unvested stock options will vest.

**Restricted Stock Units.** Upon (1) termination of employment as a result of death, disability or retirement, or termination of employment by the company without cause at the discretion of the corporate personnel committee, or (2) a change of control of the company, the executives outstanding restricted stock units will vest.

**Change of Control Agreements.** On March 9, 2010, we entered into change of control agreements with Mr. Armstrong and Ms. Pickens that will expire on March 31, 2013. The agreements with Mr. Armstrong and Ms. Pickens entitle each executive to receive additional benefits in the event of the termination of his or her employment under certain circumstances following a change of control. Each agreement provides that if, during the three-year period following a change of control, the company or its successor terminates the executive other than by reason of death, disability or cause, or the executive voluntarily terminates his employment for good reason, the executive will receive:

any accrued but unpaid salary and a pro-rata bonus for the year in which he or she was terminated;

a lump-sum cash payment equal to 2.99 times the sum of (a) the executive's base salary in effect at the time of termination and (b) the highest annual bonus awarded to the executive during the three fiscal years immediately preceding the termination date; or, in Ms. Pickens' case, if such three-year period includes fiscal year 2009, the bonus amount for fiscal year 2009 shall be annualized; and

continuation of insurance and welfare benefits until the earlier of (a) December 31 of the first calendar year following the calendar year of the termination or (b) the date the executive accepts new employment.

The benefits provided under the agreements are in addition to the value of any options to acquire shares of our common stock, the exercisability of which is accelerated pursuant to the terms of any stock option agreement, any restricted stock units, the vesting of which is accelerated pursuant to the terms of the restricted stock unit agreement, and any other incentive or similar plan adopted by us. If any part of the payments or benefits received by the executive in connection with a termination following a change of control constitutes an excess parachute payment under Section 4999 of the Internal Revenue Code, the executive will receive the greater of (1) the amount of such payments and benefits reduced so that none of the amount constitutes an excess parachute payment, net of income taxes, or (2) the amount of such payments and benefits, net of income taxes and net of excise taxes under Section 4999 of the Internal Revenue Code.

The following table quantifies the potential payments to our named executive officers under the contracts, arrangements or plans discussed above, for various scenarios involving a change of control or termination of employment of each of our named executive officers, assuming a December 31, 2011 termination date, and where applicable, using the closing price of our common stock of \$7.81 (as reported on NASDAQ on December 30, 2011). The table does not include amounts that may be payable under our 401(k) plan.

Name	Lump Sum Severance Payment	Options (Unvested and Accelerated) (1)	Restricted Stock Units (Unvested and Accelerated) (2)	Health Benefits	Total
<b>William H. Armstrong III</b>					
Retirement, Death, Disability	N/A	N/A	\$ 412,954	N/A	\$ 412,954
Termination after Change of Control (3)	\$ 2,691,000	N/A	412,954	\$ 24,381	3,128,335
<b>Erin D. Pickens</b>					
Retirement, Death, Disability	N/A	N/A	75,171	N/A	75,171
Termination after Change of Control (3)	1,001,650	N/A	75,171	18,371	1,095,192

- (1) None of the named executive officers held any unexercisable options as of December 31, 2011.
- (2) The value of the restricted stock units that would have vested for each named executive officer is based on \$7.81, the closing price of our common stock on December 30, 2011.
- (3) Pursuant to the terms of the executive's change of control agreement, the total payments may be subject to reduction if such payments result in the imposition of an excise tax under Section 280G of the Internal Revenue Code.

## Audit Committee Report

The audit committee is currently composed of three directors, Michael D. Madden, Chairman, Bruce G. Garrison and James C. Leslie, all of whom are independent, as defined by SEC rules and in the listing standards of NASDAQ. In addition, the board has determined that each of Messrs. Garrison, Leslie and Madden qualifies as an audit committee financial expert, as such term is defined by the rules of the SEC. Effective May 24, 2012, Mr. Garrison will no longer serve as a member of our board of directors or the audit committee. We operate under a written charter approved by us and adopted by the board of directors. Our primary function is to assist the board of directors in fulfilling the board's oversight responsibilities by monitoring (1) the company's continuing development and effectiveness of its system of financial reporting and internal controls, (2) the operation and integrity of the system of financial reporting and the integrity of the financial statements, (3) the company's compliance with legal and regulatory requirements, (4) the qualifications and independence of the company's independent registered public accounting firm, and (5) the performance of the company's independent registered public accounting firm and internal auditors.

We oversee the company's financial reporting process on behalf of the board. Our responsibility is to monitor this process, but we are not responsible for developing and consistently applying the company's accounting principles and practices, preparing and maintaining the integrity of the company's financial statements and maintaining an appropriate system of internal controls, auditing the company's financial statements and the effectiveness of internal control over financial reporting, or reviewing the company's unaudited interim financial statements. Those are the responsibilities of management and the company's independent registered public accounting firm, respectively.

During 2011 management assessed the effectiveness of the company's system of internal control over financial reporting in connection with the company's compliance with Section 404 of the Sarbanes-Oxley Act of



2002. We reviewed and discussed with management, the internal auditor and BKM Sowan Horan, LLP (BKM) management's report on internal control over financial reporting and BKM's report on their audit of the company's internal control over financial reporting as of December 31, 2011, both of which are included in the company's annual report on Form 10-K for the year ended December 31, 2011.

#### **Appointment of Independent Registered Public Accounting Firm; Financial Statement Review**

In March 2011, in accordance with our charter, we appointed BKM as the company's independent registered public accounting firm for 2011. We have reviewed and discussed the company's audited financial statements for the year 2011 with management and BKM. Management represented to us that the audited financial statements fairly present, in all material respects, the financial condition, results of operations and cash flows of the company as of and for the periods presented in the financial statements in accordance with accounting principles generally accepted in the United States, and BKM provided an opinion to the same effect.

We have received from BKM the written disclosures and the letter required by applicable requirements of the Public Company Accounting Oversight Board regarding the independent accountant's communications with the audit committee concerning independence, and we have discussed with BKM their independence from the company and management. We have also discussed with BKM the matters required to be discussed by Statement on Auditing Standards No. 61, as amended (AICPA, Professional Standards, Vol. 1, AU section 380), as adopted by the Public Company Accounting Oversight Board in Rule 3200T.

In addition, we have discussed with BKM the overall scope and plans for their audit, and have met with them and management to discuss the results of their examination, their understanding and evaluation of the company's internal controls as they considered necessary to support their opinion on the financial statements for the year 2011, and various factors affecting the overall quality of accounting principles applied in the company's financial reporting. BKM also met with us without management being present to discuss these matters.

In reliance on these reviews and discussions, we recommended to the board of directors, and the board of directors approved, the inclusion of the audited financial statements referred to above in the company's annual report on Form 10-K for the year ended December 31, 2011.

#### **Internal Audit**

We also review the company's internal audit function, including the selection and compensation of the company's internal auditor. In March 2011, in accordance with our charter, our committee appointed Holtzman Partners, LLP (formerly, Holtzman Moellenberg Panozzo & Perkins, LLP) as the company's internal auditor for 2011.

Dated: April 17, 2012

Michael D. Madden, Chairman

Bruce G. Garrison

James C. Leslie

#### **Independent Registered Public Accounting Firm**

#### **Changes in Independent Registered Public Accounting Firm**

On June 24, 2010, the audit committee approved the dismissal of Travis Wolff LLP as our independent registered public accounting firm, and the engagement of BKM to serve as our new independent registered public accounting firm. This change in independent registered public accounting firms, which resulted from key personnel involved in serving the company leaving Travis Wolff to form BKM, was effective immediately.

During the the interim period between December 31, 2009 and June 24, 2010, there were no disagreements between the company and Travis Wolff on any matter of accounting principles or practices, financial statement

disclosure or auditing scope or procedure which, if not resolved to Travis Wolff's satisfaction, would have caused Travis Wolff to make reference to the subject matter of the disagreement in connection with its report for such years; and there were no reportable events as defined in Item 304(a)(1)(iv) or (v) of Regulation S-K.

In accordance with Item 304(a)(3) of Regulation S-K, we provided Travis Wolff with a copy of the foregoing disclosures. A copy of Travis Wolff's letter, dated June 24, 2010, stating its agreement with the above statements was filed as Exhibit 16.1 to our Current Report on Form 8-K filed with the SEC on June 30, 2010.

During the fiscal year ended December 31, 2009 and through June 24, 2010, neither the company nor anyone acting on its behalf consulted BKM with respect to the application of accounting principles to a specified transaction, either completed or proposed, or the type of audit opinion that might be rendered on our consolidated financial statements, or any other matters or reportable events listed in Items 304(a)(1)(iv) and (v) of Regulation S-K.

#### Fees and Related Disclosures for Accounting Services

The following table discloses the aggregate fees billed for professional services rendered by BKM in 2011 and 2010:

	2011	2010
Audit Fees	\$ 173,000	\$ 105,370
Audit-Related Fees (1)	180,000	
Tax Fees		
All Other Fees		

(1) Relates to services rendered in connection with the construction audit of the W Austin Hotel & Residences project.

The audit committee has determined that the provision of the services described above is compatible with maintaining the independence of our independent registered public accounting firm.

#### Pre-Approval Policies and Procedures

The audit committee's policy is to pre-approve all audit services, audit-related services and other services permitted by law provided by our independent registered public accounting firm. In accordance with that policy, the committee annually pre-approves a list of specific services and categories of services, including audit, audit-related and other services, for the upcoming or current fiscal year, subject to specified cost levels. Any service that is not included in the approved list of services must be separately pre-approved by the audit committee. In addition, if fees for any service exceed the amount that has been pre-approved, then payment of additional fees for such service must be specifically pre-approved by the audit committee; however, any proposed service that has an anticipated or additional cost of no more than \$15,000 may be pre-approved by the Chairperson of the audit committee, provided that the total anticipated costs of all such projects pre-approved by the Chairperson during any fiscal quarter does not exceed \$30,000.

At each regularly scheduled audit committee meeting, management updates the committee on the scope and anticipated cost of (1) any service pre-approved by the Chairperson since the last meeting of the committee and (2) the projected fees for each service or group of services being provided by our independent registered public accounting firm. Since the May 2003 effective date of the SEC rules stating that an auditor is not independent of an audit client if the services it provides to the client are not appropriately approved, each service provided by our independent registered public accounting firm has been approved in advance by the audit committee. During 2011, none of those services required use of the *de minimis* exception to pre-approval contained in the SEC's rules.

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### **Proposal No. 3: Ratification of the Appointment of our Independent Registered Public Accounting Firm**

In March 2012, in accordance with our charter, we appointed BKM as the company's independent registered public accounting firm for 2012. Our audit committee and board of directors seek stockholder ratification of the audit committee's appointment of BKM as our independent registered public accounting firm to audit our and our subsidiaries' financial statements for the year 2012. If the stockholders do not ratify the appointment of BKM, our audit committee will reconsider this appointment. Representatives of BKM are expected to be present at the meeting to respond to appropriate questions, and those representatives will also have an opportunity to make a statement if they desire to do so.

#### **Vote Required to Ratify the Appointment of our Independent Registered Public Accounting Firm**

Approval of this proposal requires the affirmative vote of a majority of the common stock present in person or by proxy and entitled to vote. For more information on the voting requirements, see [Questions and Answers about the Proxy Materials, Annual Meeting and Voting](#).

#### **Recommendation of the Board of Directors**

**OUR BOARD UNANIMOUSLY RECOMMENDS THAT YOU VOTE FOR THE RATIFICATION OF THE APPOINTMENT OF OUR INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM.**

### **Certain Transactions**

#### **MHLLC Transaction**

On March 15, 2012, we entered into a Stock Purchase Agreement (the "Purchase Agreement") with Moffett Holdings, L.L.C. ("MHLLC") pursuant to which we sold to MHLLC 625,000 shares of our common stock for an aggregate purchase price of \$5.0 million, or \$8.00 per share. As of the record date, MHLLC owned approximately 7.7% of our outstanding common stock.

In connection with the issuance and sale of the shares of our common stock, we entered into an Investor Rights Agreement with MHLLC, dated March 15, 2012 (the "Investor Rights Agreement"), pursuant to which, among other things, the size of our board of directors was increased from four to five members and MHLLC was granted the right to designate one individual to serve on our board of directors as long as MHLLC and its affiliates beneficially own at least 5.0% of the issued and outstanding shares of our common stock. Charles W. Porter was appointed to the board as the designated director of MHLLC pursuant to the Investor Rights Agreement.

Also under the Investor Rights Agreement, MHLLC and its affiliates are limited or prohibited from, among other things, (1) acquiring an additional amount of our securities if the acquisition would result in MHLLC and its affiliates having beneficial ownership of more than 24.9% of the outstanding shares of our common stock, (2) commencing any tender offer or exchange for any of our securities, (3) making or proposing a merger or acquisition involving us, (4) calling a meeting or initiating any stockholder proposal, (5) soliciting proxies or (6) forming, joining, or in any way participating in or entering into agreements with a group (as defined in Section 13(d)-3 of the Securities Exchange Act of 1934) with regard to us. These restrictions will terminate upon the last to occur of (1) the first date on which no director designated by MHLLC has served on the board for the preceding six months and (2) the date that MHLLC and its affiliates beneficially own less than 5.0% of the issued and outstanding shares of our common stock. In addition, until the six-month anniversary of the date of the Investor Rights Agreement, MHLLC will be prohibited, subject to certain exceptions, from transferring, selling, assigning, pledging or otherwise disposing of, directly or indirectly, the shares of our common stock acquired pursuant to the Purchase Agreement.

Subject to the terms and conditions of the Investor Rights Agreement, we also granted MHLLC certain registration rights with respect to the shares of our common stock acquired pursuant to the Purchase Agreement.

The Investor Rights Agreement provides that upon the written request of MHLLC at any time on or after the six-month anniversary of the date of the Investor Rights Agreement, we shall, within sixty days of our receipt of such notice, (1) prepare and file with the Securities and Exchange Commission a shelf registration statement with respect to the shares of our common stock issued and sold to MHLLC under the Purchase Agreement (the Registrable Securities ) that would permit some or all of the Registrable Securities to be resold in registered transactions and (2) use our commercially reasonable efforts to maintain the effectiveness of the shelf registration statement while MHLLC holds Registrable Securities.

#### **Joint Venture with MHLLC**

On February 28, 2011, we entered into a joint venture with MHLLC for the development of Parkside Village, a 92,473-square-foot retail project in the Circle C community. The project consists of a 33,650-square-foot full-service movie theater and restaurant, a 13,890-square-foot medical clinic and five other retail buildings, including a 14,933-square-foot building, a 10,000-square-foot building, two 7,500-square-foot buildings and a stand-alone 5,000-square-foot building.

The company's initial capital contributions to the joint venture totaled \$3.1 million, which consisted of a 23.03 acre tract of land located in Austin, Texas, the related property and development agreements for the land and other project costs incurred by the company before February 28, 2011. MHLLC made initial capital contributions to the joint venture totaling \$1.0 million and made additional capital contributions of \$2.8 million to fund the development of the project. As of December 31, 2011, capital contributions totaled \$3.1 million for the company and \$3.8 million for MHLLC. The joint venture has a construction loan with Comerica Bank to finance the development of Parkside Village.

The company is the manager of the joint venture, and after the partners are repaid their original capital contributions and a preferred return on those contributions, the company will receive 80 percent of any distributions and MHLLC will receive 20 percent. As the manager of the joint venture with a majority of the voting and profit interest (80 percent), the company consolidates this joint venture in its financial statements.

**STRATUS PROPERTIES INC.**

**Proxy Solicited on Behalf of the Board of Directors for**

**Annual Meeting of Stockholders to be held on May 24, 2012**

The undersigned hereby appoints William H. Armstrong III and Kenneth N. Jones, or either of them, as proxies, with full power of substitution, to vote the shares of the undersigned in Stratus Properties Inc. at the Annual Meeting of Stockholders to be held on Thursday, May 24, 2012, at 9:30 a.m., Central Time, and at any adjournment thereof, on all matters coming before the meeting. **The proxies will vote: (1) as you specify on the back of this proxy card, (2) as the Board of Directors recommends where you do not specify your vote on a matter listed on the back of this proxy card, and (3) as the proxies decide on any other matter properly coming before the meeting.**

If you wish to vote on all matters as the Board of Directors recommends, please sign, date and return this proxy card. If you wish to vote on items individually, please also mark the appropriate boxes on the back of this proxy card.



**PLEASE MARK, SIGN, DATE AND RETURN THIS PROXY CARD PROMPTLY**

**IN THE ENCLOSED ENVELOPE**

(continued on reverse side)

p **FOLD AND DETACH HERE** p



Please mark **X**  
 your votes as  
 indicated in  
 this example

**The Board of Directors recommends a vote FOR Items 1 and 2 below.**

	<b>FOR</b>	<b>WITHHOLD</b>		<b>FOR</b>	<b>AGAINST</b>	<b>ABSTAIN</b>
<b>Item 1</b> – Election of the two Class II director nominees.	..	..	<b>Item 2</b> – Ratification of the appointment of BKM Sowan Horan, LLP as our independent registered public accounting firm.	..	..	..
Nominees are:						
William H. Lenehan						
James C. Leslie						
FOR, except withhold vote from following nominee: _____						

Signature(s) \_\_\_\_\_ Dated: \_\_\_\_\_  
 \_\_\_\_\_, 2012

You may specify your votes by marking the appropriate boxes on this side. You need not mark any boxes, however, if you wish to vote all items in accordance with the Board of Directors' recommendation.

If your votes are not specified, this proxy will be voted FOR Items 1 and 2.

p FOLD AND DETACH HERE p

**STRATUS PROPERTIES INC. OFFERS STOCKHOLDERS OF RECORD**

**TWO WAYS TO SUBMIT YOUR VOTING INSTRUCTIONS**

Your Internet submission of voting instructions authorizes the named proxies to vote your shares in the same manner as if you had returned your proxy card. We encourage you to use this cost effective and convenient way of voting, 24 hours a day, 7 days a week.

**INTERNET SUBMISSION OF VOTING**

**SUBMITTING VOTING INSTRUCTIONS**

**INSTRUCTIONS**

**BY MAIL**

Visit <http://www.ivselection.com/stratus12>. Have your proxy card ready and follow the instructions on your screen. You will

Simply mark, sign and date your proxy card and return it in the postage-paid envelope to Kenneth N. Jones, General

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incur only your usual Internet charges. Available 24 hours a day,  
7 days a week until 11:59 p.m., Central Time, on May 24, 2012.

Counsel and Secretary, Stratus Properties Inc., P.O. Box  
17149, Wilmington, Delaware 19885-9810. If you are  
submitting voting instructions by Internet, please do not mail  
your proxy card.

**IMPORTANT NOTICE REGARDING THE AVAILABILITY OF PROXY MATERIALS FOR THE STOCKHOLDER MEETING  
TO BE HELD ON MAY 24, 2012.**

**This proxy statement and the 2011 Annual Report are available at <http://www.edocumentview.com/STRS>.**