

March 9, 2016

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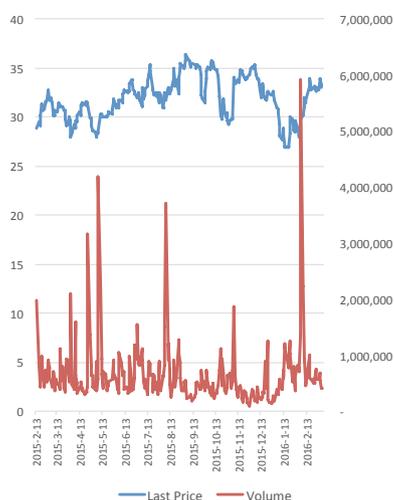
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**Ubiquiti Networks (UBNT US)**

Price	USD 33.02
<b>J Cap rating</b>	<b>SELL</b>
<b>J Cap Price Target</b>	<b>USD 19.08</b>
Difference	42%
Market Cap	USD 2.72 bln
Av Volume	373,282 shares
P/E	19.50x

**One-Year Share Price and Volume**



Source: Bloomberg March 6, 2016

## Ubiquiti Networks (UBNT US) The Victim Complex

- ▶ **We think Ubiquiti may have faked the phishing scam** that caused the company to take a charge of USD 31.8 mln. The USD 31.8 mln miraculously matches the amount of receivables that we believe were related to faked or accelerated revenues.
- ▶ **Essentially, it appears** that UBNT extended itself a loan from its overseas affiliates to pay off balances that were getting too high than paid back those affiliates with the write-off.
- ▶ **This one-time write-off made operating metrics look better** than they really are. UBNT operates a low-value business in network gear with, we think, far lower margins and cash flows than the company reports.
- ▶ **We see the likeliest catalyst** as regulatory scrutiny by the SEC but we cannot predict when this could happen.
- ▶ **To arrive at our USD 19.08 valuation**, we annualize the most recent quarter's revenue, assume flat growth, and net out USD 50 mln in what we believe were inappropriately recorded revenues from distributor Flytec. We apply the current 14.4x multiple.

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For no obvious reason, things turned around for UBNT in the quarters ended September and December 2015.

## Fraud: Who is the real victim here?

■ By Melvin Glapion and Anne Stevenson-Yang

When we published our last update on Ubiquiti Networks in February 2015, the company was at a crossroads. While it had reported impressive improvements in gross and operating margins, its operating cash flows had begun to decelerate. In fact, our analysis showed that UBNT's Cash Conversion Cycle (CCC), a measure of the amount of time it takes to convert a sale into cash, had gone from 0 to an astounding 57 days over the course of six months. We projected continued deterioration in UBNT's financials and titled our update, "Prospects Dimming."

And dim they did. In the quarters ended March and June 2015, UBNT continued bleeding cash, as its CCC stalled at 57 days. Gross margins stagnated, and operating margins fell each quarter successively. And then, for no obvious reason, things turned around in the quarters ended September and December 2015: gross margins jumped 780 basis points and then 380 basis points over prior year quarter, net income in the September quarter hit its highest level in two years, and cash flows from operations in the December 2015 quarter were more than twice those reported in the prior year quarter.

What accounts for such a dramatic turnaround, you might ask: change in management, a new strategic direction or possibly improving market conditions? Well, none of the above, actually. The real reason UBNT has been able to construct a turnaround is because it was 'robbed.' And, in our view, it used the 'robbery' as a way of shoring up its financial statements.

Therefore, we believe that UBNT's recent performance is the result of a perpetrating a fraud, while pretending to be a victim of one.

### Opportunity Knocks

Ubiquiti reported in its annual filings for the year ended June 30, 2015 that it had been the victim of an internet phishing scam commonly referred to as CFO-impersonation fraud. UBNT would not have been the first company to fall victim to this type of fraud.

The FBI had been alerting U.S. companies about this particular fraud for

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CFO-impersonation frauds have typically resulted in losses of no more than USD 10 mln per incident and are often completed in a handful of transactions.

several years. Media articles have estimated that more than USD 1 bln had been lost as a result of this scam in the period October 2013 to June 2015. The fraud begins with a series of emails that are sent to accounting staff, seemingly from the CEO or CFO. The email usually alerts the staffer to the fact that the company is engaged in some critical strategic initiative (a merger, for example) and that funds need to be urgently wired to a third party. The staffer is also instructed to maintain complete confidentiality regarding the email and the wires.

According to UBNT's 10-K filing, UBNT staff wired USD 46.7 mln in multiple transactions from its Hong Kong bank in early June. UBNT stated that it was able to recover USD 8.1 mln of the cash quickly and that another USD 6.8 mln is likely to be recovered in the near term. UBNT stated that it recorded a USD 31.8 mln expense related to the fraud.

Given the frequency of this particular fraud, one might be inclined to take UBNT's word that it had suffered a loss of nearly 30% of its reported revenue for the quarter, but there are some unique elements to UBNT's fraud claim worthy of closer inspection:

- ▶ Fraudsters targeted the right accounts: UBNT claims that it is confident that none of its employees were behind the fraud, but it is interesting to note that while the company is based in the United States and derives more than 35% of its revenues from North America, the fraudsters were savvy enough to target the company's Asian staff and Asian-based operations; UBNT holds more than 90% of its cash in overseas accounts, so the fraudsters would have had to know this in order to successfully get USD 46.7 mln wired.
- ▶ More money lost in more transactions than normal: CFO-impersonation frauds have typically resulted in losses of no more than USD 10 mln per incident and are often completed in a handful of transactions; based upon UBNT's disclosure and reports in the press, UBNT staff wired USD 46.7 mln via a large number of wire transfers.
- ▶ Unlikely to recover via insurance: UBNT stated that it not certain that it will recover the monies lost through insurance coverage.
- ▶ Amount lost matches amount needed to pay off bloated accounts receivable: Most interesting however, is that the fraud expense charge of USD 31.8M is almost exactly equal to the amount of UBNT's overstated accounts receivable, which we believe is a result of manipulated revenue recognition.

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The write-off matches the amount of money we believe UBNT is dragging into the income statement through aggressive revenue recognition and that could not actually be collected from customers.

## Uncanny Coincidence

The write-off matches the amount of money we believe UBNT is dragging into the income statement through aggressive revenue recognition and that could not actually be collected from customers. One of metrics we use to monitor aggressive or potentially artificial revenue recognition is growth in revenue against growth in accounts receivable. If growth in accounts receivable outstrips growth in revenue, the company is likely to be engaging in revenue acceleration or manipulation.

UBNT shows clear evidence of its revenue enhancement in the quarters ending March, June, September, and December 2014. Growth in AR greatly exceeds growth in revenue for each of these periods shaded red below. The company is aggressively recording revenues that are not resulting in cash payments but instead in IOUs in the form of AR.

### UBNT's Aggressive Revenue Recognition

	Jun-13	Sep-13	Dec-13	Mar-14	Jun-14	Sep-14	Dec-14	Mar-15	Jun-15	Sep-15	Dec-15
<b>Revenue</b>	\$101,232	\$129,687	\$138,439	\$148,331	\$156,007	\$150,087	\$153,137	\$147,500	\$145,300	\$151,415	\$161,900
<b>Accounts Receivable</b>	35,884	35,798	36,809	49,530	54,871	65,875	72,569	69,900	66,100	63,585	64,600
<b>QOQ % growth in Revenue</b>		28.1%	6.7%	<b>7.1%</b>	<b>5.2%</b>	<b>-3.8%</b>	<b>2.0%</b>	-3.7%	-1.5%	4.2%	6.9%
<b>QOQ% growth in Accounts Receivable</b>		-0.2%	2.8%	34.6%	10.8%	20.1%	10.2%	-3.7%	-5.4%	-3.8%	1.6%
<b>Reported AR</b>	35,884	35,798	36,809	49,530	54,871	65,875	72,569	69,900	66,100	63,585	64,600
<b>Adjusted AR (growing in line with Revenue)</b>				39,439	41,480	39,906	40,717	39,218	38,633	40,259	43,047
<b>Overstated AR</b>				<b>10,091</b>	<b>13,391</b>	<b>25,969</b>	<b>31,852</b>	<b>30,682</b>	<b>27,467</b>	<b>23,326</b>	<b>21,553</b>
Overstated AR as % of Reported AR				20.4%	24.4%	39.4%	43.9%	43.9%	41.6%	36.7%	33.4%

Source: Company reports and J Capital

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We estimated the amount of reported AR is attributable to the accelerated revenue by assuming that AR should have grown at the same rate as revenue for each period. We call this normalized number the Adjusted AR. By subtracting the Adjusted AR from the Reported AR, we see that the amount of Overstated AR by the end of the acceleration phase in December 2014 stands at USD 31.8 mln and accounts for nearly 45% of reported AR (shaded in yellow above).

Such a sizeable AR balance was a chief contributor to the deteriorating cash flow conversion that we mentioned earlier. If UBNT could monetize the AR, it could also pay down some of its rapidly expanding Accounts Payables balances. The USD 31.8 mln could go a long way to solving many of UBNT's accounting issues.

## How to Eliminate Fake Receivables and Create New Ones

We believe that UBNT claimed to have been a victim of a fraud so that it could divert cash from its overseas bank accounts to a number of related parties and entities. Those related parties then proceeded to pay off approximately USD 31.8M in outstanding AR—or pretend to. Paying the full USD 31.8M at once would be easy to observe in the quarterly changes of the AR balances. So UBNT obscured the payments by paying down the balance in the months just after the fraud. Also to further obscure the payments and to provide uplift to the quarters ended September and December 2015 UBNT recorded additional fake revenue and receivables.

A review of the uplifts in revenues in September and December show huge jumps over the March and June results. Recall that the March and June quarters showed declines in AR, so they likely had minimal to no revenue acceleration associated with the reported revenues. Hence, we believe in CY2015, average quarterly revenues were running around USD 146 mln per quarter, assuming no revenue acceleration.

The reported income figures for September (USD 151 mln) and December (USD 162 mln) seem to have been supported by revenue acceleration as we see AR growth accelerating again. We believe that UBNT was adding additional Overstated AR in the periods ended September and December 2015. The total amount of Overstatement is USD 21 mln ([USD 151 mln - USD 146 mln] + [USD 162 mln - USD 146 mln])

We believe that UBNT claimed to have been a victim of a fraud so that it could divert cash from its overseas bank accounts to a number of related parties and entities.

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We believe paying down the USD 31 mln balance of overstated AR generated in CY 2014, while concurrently adding additional overstated AR of USD 21 mln for CY 2015, allowed UBNT to reduce its reported net AR balance and improve the look of both its balance sheet and income statement. Based upon data from the chart where we computed overstated AR above, we were able to determine that UBNT likely received 'payments' from related parties that eliminated the older outstanding AR balances. The payments would have likely happened as follows: USD 3.2 mln paid the June quarter, USD 9.5 mln paid in the September quarter and USD 17.8 mln paid in the December quarter. Total payments of USD 30.5 mln.

	Jun-15	Sep-15	Dec-15
<b>Begining Balance of Overstated AR</b>	\$30,682	\$27,467	\$23,326
<b>Plus Addtl Overstated Revenue = Reported Revenue less Avg Unenhanced Qtly Revenue of \$146M</b>	\$-	\$5,400	\$16,000
<b>Ending Balance of Overated AR</b>	\$27,467	\$23,326	\$21,553
<b>Cash paid resolve Overtated AR</b>	\$3,215	\$9,541	\$17,773
<b>Total Payments for Overstated AR</b>			\$30,529

Source: Company financials, J Capital Research

## Don't forget to pay us back

Once it had put the USD 31.8 mln in cash to use, UBNT then began the process of sending the money back to its place of origin—UBNT's overseas accounts.

	2011	2012	2013	2014	Mar-15	Jun-15	Sep-15	Dec-15
<b>Overseas cash and cash equivalents</b>	29,600	102,800	210,400	307,600	392,300	397,000	410,100	476,900
<b>Domestic cash and cash equivalents</b>	46,761	19,260	17,426	39,497	58,900	49,400	26,000	19,800
<b>Domestic cash change in flows QoQ</b>		-27,501	-1,834	22,071	19,403	-9,500	-23,400	-6,200
<b>% of Cash in US</b>	61%	16%	8%	11%	13%	11%	6%	4%
<b>% of North America revenue</b>	30%	24%	25%	24%	31%	31%	35%	35%

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UBNT transferred from its domestic to overseas accounts, USD 9.5 mln, USD 23.4 mln and USD 6.2 mln in the quarters ended June, September, and December 2015, respectively. The total amount transferred over the final nine months of 2015 approximated USD 39 mln. We believe that much of the USD 39 mln that disappeared from the domestic cash balances was moved into the overseas cash balances to replace funds that had been used to pay off overstated AR.

We find it odd that, while the U.S. operations account for nearly 35% of revenues, UBNT keeps less than 4% of its cash balances in the U.S. Instead, UBNT prefers to keep nearly USD 500 mln in cash overseas where:

- ▶ It has little to no capex commitments;
- ▶ It earns minimal interest;
- ▶ It is subject to significant taxes on repatriation;
- ▶ It only just recently was a 'victim' of a massive fraud.

The large overseas cash balance is perhaps an indication that UBNT prefers it there for just these types of events—opportunities to manipulate its financial statements when necessary.

## Deteriorating Performance was Ubiquitous, until after June 2015

In our update of February 2015, we highlighted that UBNT had been actively manipulating its accounts to show a consistently profitable and growing technology company. A number of the concerns we highlighted were:

- ▶ **UBNT reports minimal deferred revenues**, resulting in Deferred Revenue Days of less than three, while many of the industry's leaders, such as Ruckus, and Aruba (now part of H-P), were reporting DDR in excess of 56 days; those figures suggested that UBNT was aggressively accelerating its recognition of revenues;
- ▶ **UBNT reports gross and operating margins well in excess of those for Cisco, Ruckus, Aero-hive, and others**, despite the fact that Ubiquiti has limited brand recognition, has not developed a technological advantage, and has no dedicated sales force, opting instead to rely upon a unique 'community' of non-exclusive distributors to grow its sales;

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- ▶ Customs records for shipments to Ubiquiti's leading distributor, Flytec, **do not support UBNT's contention** that Flytec sold USD 50-60 mln in UBNT product annually; and
- ▶ **Flytec's founder has been implicated in the trafficking of illicit goods.**

We included a discussion of potential catalysts and pointed to the poor and deteriorating level of cash conversion as a concern. We forecast that continued degradation in the CCC could negatively impact financial and operating performance over the next several quarters.

Indeed, in the quarters ended December 2014 and March and June 2015, UBNT suffered rapid deterioration in CCC. A central cause for the deterioration related to the company's reliance on accelerated revenue recognition, which was reflected in a 40% increase in Days Sales Outstanding from June 2014 to June 2015. A 150% increase in 'Pre-Paid Expenses' further impacted CCC. Why UBNT would accelerate its prepayments at a time of financial stress is unclear and raises questions as to whether these are truly discretionary pre-payments.

Period ending:	Sep-13	Dec-13	Mar-14	Jun-14	Sep-14	Dec-14	Mar-15	Jun-15	Sep-15	Dec-15
<b>DSO</b>	25.2	23.9	26.6	30.5	36.7	41.2	44.1	42.7	39.1	36.1
DDR	2.3	2.4	2.4	2.6	3.6	3.1	2.3	2.2	2.1	2.1
<b>Inventory Days</b>	20.5	28.7	54.2	58.8	43.6	41.4	44.3	45.4	39.6	35.2
<b>Days payable</b>	51.2	55.4	53.0	42.0	37.4	51.0	58.0	53.4	39.3	36.2
<b>Prepaid expenses</b>	3.5	3.9	8.8	<b>13.0</b>	<b>17.9</b>	<b>29.4</b>	<b>35.1</b>	33.4	24.2	12.2
CCC	-4.3	-1.2	34.3	<b>57.7</b>	<b>57.3</b>	<b>57.9</b>	<b>63.2</b>	65.9	61.5	45.2

The periods after June 2015 (post 'fraud'), however, show more robust CCC, primarily as a result of dramatic declines in the Days Sales Outstanding and Days Payables Outstanding.

With respect to margins, the story is quite similar. For the March and June 2015 quarters, gross margins held steady at around 45% while operating margins continued to degrade. Note that June 2015 results include in OPEX the USD 38.1 mln related to fraud loss; excluding this cost, net income margin would have been 25%, 660 basis point less than the quarter-ended June 2014.

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	Mar-14	Jun-14	Sep-14	Dec-14	Mar-15	Jun-15	Sep-15	Dec-15
<b>Revenues</b>	148.3	156	150.1	153.1	147.5	145.3	151.4	161.9
% growth in revenues		5.2%	-3.8%	2.0%	-3.7%	-1.5%	4.2%	6.9%
<b>COGS</b>	82.7	87.1	89	84.1	81.5	79.1	77.9	82.8
<b>Gross Margin</b>	65.6	68.9	61.1	69	66	66.2	73.5	79.1
<b>GM%</b>	44.2%	44.2%	40.7%	<b>45.1%</b>	<b>44.7%</b>	<b>45.6%</b>	<b>48.5%</b>	48.9%
change in bps from year ago					<b>51</b>	<b>139</b>	<b>784</b>	<b>379</b>
<b>Operating Expenses</b>	15.5	16.1	17.5	<b>18.3</b>	<b>20.7</b>	<b>58.9</b>	<b>13.7</b>	22.6
<b>Opex as % of Revenue</b>	10.5%	10.3%	11.7%	<b>12.0%</b>	<b>14.0%</b>	<b>40.5%</b>	<b>9.0%</b>	14.0%
<b>Net Income</b>	45.2	49.4	37.7	<b>46.3</b>	<b>41.1</b>	<b>4.5</b>	<b>53.8</b>	49.5
<b>NI %</b>	30.5%	31.7%	25.1%	<b>30.2%</b>	<b>27.9%</b>	<b>3.1%</b>	<b>35.5%</b>	30.6%
change in bps from year ago					<b>(261)</b>	<b>(2,857)</b>	<b>1,042</b>	33
<b>Operating Cash Flows</b>	-14.0	55.8	46.9	<b>32.7</b>	<b>36.7</b>	<b>18.2</b>	<b>47.7</b>	77.3

However, after June 2015, UBNT experienced a dramatic turnaround: revenues increased dramatically, margins jumped 780 and 380 basis points over prior year quarters, and operating cash flows continued to grow, reflecting an improvement in the working capital accounts discussed in earlier in relation to the cash conversion cycle.

## Valuation

UBNT is difficult to model as it relies upon accelerated and possibly fake sales, has historically relied upon accrual accounting tricks to show impressive results and holds much of its cash balance overseas, raising questions about access to cash by the equity investors.

For our valuation, we have taken the results of the quarter ended March 2015, the only recent quarter that shows no revenue acceleration, and annualized them. We netted out the USD 50 mIn impact of the faked Flytec revenues as discussed in our initial report and applied the current forward P/E of 14.4x to arrive at a valuation of USD 19.10 per share.

## Catalysts

On at least two separate occasions recently, the SEC has issued comment letters to UBNT asking for further disclosure regarding trends and metrics on margins by product category. UBNT has resisted each time by stating that it believes that (a) its current disclosures are sufficient and (b) that movements have not been material. However, as a result of its improved balance sheet, CCC, and income statements as reported in over the last several quarters, changes in margins are now very material. In fact, increases at the gross margin level for Sep-15 and Dec-15 reveal growth of 784 and 379 basis points over the same quarter in the prior year.

	Mar-14	Jun-14	Sep-14	Dec-14	Mar-15	Jun-15	Sep-15	Dec-15
<b>Revenues</b>	148.3	156	150.1	153.1	147.5	145.3	151.4	161.9
<b>% growth in revenues</b>		5.2%	-3.8%	2.0%	-3.7%	-1.5%	4.2%	6.9%
<b>COGS</b>	82.7	87.1	89	84.1	81.5	79.1	77.9	82.8
<b>Gross Margin</b>	65.6	68.9	61.1	69	66	66.2	73.5	79.1
<b>GM%</b>	44.2%	44.2%	40.7%	45.1%	44.7%	45.6%	48.5%	48.9%
<b>change in bps from year ago</b>					51	139	784	379

Greater detail about the source of its growth in revenues and costs is likely to lead to more evidence of UBNT's manipulations.

## Risks

In the last two years, UBNT has rewarded investors with decent dividend payouts and share repurchases. The company could fund them either with cash on hand or with debt.

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