

March 23, 2016

Melvin Glapion
melvin@jcapitalresearch.com

Anne Stevenson-Yang
anne@jcapitalresearch.com

+852 2534 7405

Ubiquiti (UBNT US)

Price	USD 33.65
Rating	SELL
Price Target	USD 19.08
Difference	42%
Market Cap	USD 2.71 bln
Avg Volume	372,282 shares
P/E	15.97x

Ubiquiti (UBNT US) last share price in USD (blue) and volume (green, in mln shares)



Source: Bloomberg (March 22, 2016)

Ubiquiti Networks (UBNT US)

Unable to Connect

- ▶ **From 2010 to 2015**, Ubiquiti grew its revenues more than four times, maintained one of the highest operating margins in the telecoms equipment industry, and built a cash stockpile of nearly USD 500 mln.
- ▶ **While the company** exhibits all of the elements of a great technology bull story, recent and longstanding concerns about the source and sustainability of this company's earnings should not go unheeded.
- ▶ **For a company** with no clear competitive advantage, Ubiquiti reports margins far higher than even Cisco. It relies almost exclusively on a non-exclusive distributor model and data on key distributors is inconsistent with customs data, tax filings and other information we have gathered about their revenues.
- ▶ **Most recently**, the company reported that it had lost USD 31.8 mln in a phishing scam. However, we think that Ubiquiti may have faked the phishing scam since the USD 31.8 mln miraculously matches the amount of receivables that we believe were related to faked or accelerated revenues. The phishing scam is just the latest in a list of oddities and anomalies at the company.
- ▶ **Cash accounts for** nearly 45% of total assets, and despite 35% of the business being generated in the US, nearly 96% of cash is held in overseas accounts.
- ▶ **The company has** had a revolving door of senior executives and board members. It is currently without a CFO, and the Audit Committee is composed of two individuals, placing the company in violation of NASDAQ requirements.
- ▶ **We see the likeliest** catalyst as further 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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**UBNT founder
Robert Pera is
a former Apple
engineer.**

A Tech Fairytale?

Ubiquiti Networks (UBNT US) was founded in 2005 by Robert Pera, a former wireless engineer at Apple. According to company lore, Pera quit Apple, cashed in his stock options and began developing a suite of products geared toward a burgeoning new market in the Wireless Internet Service Providers (WISP) sector. WISPs offer internet connectivity to individuals and enterprises in locations where cable and or fiber optic networks are not available. Consequently, WISPs primarily service customers in rural areas of the US and Europe as well as those in broad swaths of Emerging Market countries. The WISP market has historically been considered highly fragmented, low-margin and comprising a motley mix of colorful organizations and characters.

When Pera had completed development of his initial products for the WISP market, according to company legend, he decided to exhibit them at an industry trade show. Demand was so strong that he managed to secure several hundred thousand dollars in orders. In addition, because he lacked the working capital to produce the volume of products ordered, Pera convinced the customers to pay up front. With cash in hand, he headed to China to get his designs into production. In a matter of months, he had fulfilled the outstanding orders and was focused on establishing UBNT as an industry player. UBNT has been booming ever since.

In late 2011, the company went public, selling over 7 mln shares at USD 15 per share and achieving a market capitalization of USD 1.4 bln. The company, however, reportedly secured only USD 30 mln in proceeds, as most of the offered shares were those of company employees. Today, the company's equity is valued at USD 2.7 bln. Robert Pera remains the chairman of the board, chief executive officer and the company's largest shareholder, with 69% of total shares outstanding.

Table 1. Revenues and Growth by Type

	2015	2014	2013	2012	2011	2010
Total Revenues						
Service Provider	418,021	450,663	285,390	321,648	NA	NA
Enterprise Technology	177,926	121,801	35,433	31,869	NA	NA
Total Revenues	595,947	572,464	320,823	353,517	197,874	136,952

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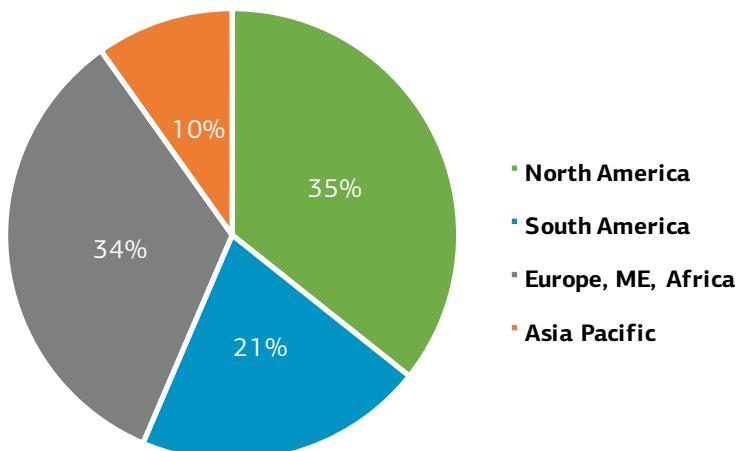
	2015	2014	2013	2012	2011	2010
Revenues as % of Total						
Service Provider	70.1%	78.7%	89.0%	91.0%		
Enterprise Technology	29.9%	21.3%	11.0%	9.0%		
% of Total	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
YoY Growth						
Service Provider	-7.2%	57.9%	-11.3%			
Enterprise Technology	46.1%	243.8%	11.2%			
% of Total	4.1%	78.4%	-9.2%	78.7%	44.5%	

Source: Company reports

The company has recorded impressive growth since the IPO. Between FY 2010 and FY 2015, UBNT grew more than 4x. Today, the company categorizes its revenues into two segments: Service Providers and Enterprise Technology. Service Provider revenues now account for 70% of total company revenues, but Enterprise Technology continues to grow as a percentage of revenues.

Service Provider sales include networking equipment base stations, radios, routers, antennae, as well as cables, mounting brackets, and Ethernet adapters. The MSRPs for products offered in this category range from USD 49 to USD 3,000 per unit.

Chart 1. UBNT's Sales by Region (2015)



Source: Company reports

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Enterprise Solutions sales are made up of products related to VoIP, video surveillance and machine-to-machine communications components. Prices range from USD 8 to USD 1,025 per item.

UBNT's end customers, WISPs, concentrate on offering services to underserved or underpenetrated markets. In developed countries, these tend to be rural areas without accessibility to copper or fiber optic cable networks. In emerging markets, larger populations and a vast number of communities are not 'wired' and as such are served exclusively by WISPs. While UBNT does not sell directly to WISPs, its distributors around the world do. UBNT derives nearly 35% of its revenues from North America. But EMEA and Latin America account for a combined 55% of total company sales.

While the UBNT story might have all of the elements of a great Silicon Valley success story—dynamic CEO, technology products, underserved markets, and great growth history—any investor eager to jump on the UBNT bandwagon should be cautioned by the following:

- ▶ Company margins are nonsensical for a company with no competitive advantage;
- ▶ Key distributors report revenue that seems to be vastly overstated upon examination of Customs data and other publicly available information;
- ▶ Accounting metrics for various key accounts are out of sync with those reported at peers; and
- ▶ Corporate governance is weak given the furious pace of turnover at the executive and Board-level;
- ▶ And, the phishing scam may have been faked to allow the company to pay down a ballooning AR balance.

The Victim Complex

We published an update on Ubiquiti Networks in February 2015, and at that time, 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 stag-

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nated, 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 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.

**UBNT
recorded a
USD 31.8
mln expense
related to the
fraud.**

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

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UBNT holds more than 90% of its cash in overseas accounts.

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 according to studies by agencies such as Kroll; 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 is 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 31.8 mln is almost exactly equal to the amount of UBNT's overstated accounts receivable, which we believe is a result of manipulated revenue recognition.

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 the 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.

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.

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Table 2. 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
Revenue	\$101,232	\$129,687	\$138,439	\$148,331	\$156,007	\$150,087	\$153,137	\$147,500	\$145,300	\$151,415	\$161,900
Accounts Receivable	35,884	35,798	36,809	49,530	54,871	65,875	72,569	69,900	66,100	63,585	64,600
QOQ % Growth in Revenue	28.1%	6.7%		7.1%	5.2%	-3.8%	2.0%	-3.7%	-1.5%	4.2%	6.9%
QOQ% Growth in Accounts Receivable	-0.2%	2.8%		34.6%	10.8%	20.1%	10.2%	-3.7%	-5.4%	-3.8%	1.6%
Reported AR	35,884	35,798	36,809	49,530	54,871	65,875	72,569	69,900	66,100	63,585	64,600
Adjusted AR (Growing in Line with Revenue)				39,439	41,480	39,906	40,717	39,218	38,633	40,259	43,047
Overstated AR				10,091	13,391	25,969	31,852	30,682	27,467	23,326	21,553
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

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 31.8 mln in outstanding AR—or pretend to. Paying the full USD 31.8 mln 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.

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A review of the uplifts in revenues in September and December shows 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 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.

Table 3. Overstated AR

	Jun-15	Sep-15	Dec-15
Beginning Balance of Overstated AR	\$30,682	\$27,467	\$23,326
Plus Addtl Overstated Revenue			
= Reported Revenue less Avg Unenhanced Qtly Revenue of \$146M	\$-	\$5,400	\$16,000
Ending Balance of Overstated AR	\$27,467	\$23,326	\$21,553
Cash Paid Resolve Overstated AR	\$3,215	\$9,541	\$17,773
Total Payments for Overstated AR			\$30,529

Source: Company reports, J Capital

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.

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Table 4. Cash Holdings

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

Source: Company reports, J Capital

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.

Why does UBNT keep so much cash abroad?

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 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

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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.

Table 5. Impacts on Cash Conversion

Period Ending:	Sep-13	Dec-13	Mar-14	Jun-14	Sep-14	Dec-14	Mar-15	Jun-15	Sep-15	Dec-15
DSO	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
Inventory Days	20.5	28.7	54.2	58.8	43.6	41.4	44.3	45.4	39.6	35.2
Days Payable	51.2	55.4	53.0	42.0	37.4	51.0	58.0	53.4	39.3	36.2
Prepaid Expenses	3.5	3.9	8.8	13.0	17.9	29.4	35.1	33.4	24.2	12.2
CCC	-4.3	-1.2	34.3	57.7	57.3	57.9	63.2	65.9	61.5	45.2

Source: Company reports, J Capital

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.

Outsized Margins

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 points less than the quarter-ended June 2014.

Table 6. Operating Margins

	Mar-14	Jun-14	Sep-14	Dec-14	Mar-15	Jun-15	Sep-15	Dec-15
Revenues	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%
COGS	82.7	87.1	89	84.1	81.5	79.1	77.9	82.8
Gross Margin	65.6	68.9	61.1	69	66	66.2	73.5	79.1
GM%	44.2%	44.2%	40.7%	45.1%	44.7%	45.6%	48.5%	48.9%
Change in bps from Year Ago					51	139	784	379

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	Mar-14	Jun-14	Sep-14	Dec-14	Mar-15	Jun-15	Sep-15	Dec-15
Operating Expenses	15.5	16.1	17.5	18.3	20.7	58.9	13.7	22.6
Opex as % of Revenue	10.5%	10.3%	11.7%	12.0%	14.0%	40.5%	9.0%	14.0%
Net Income	45.2	49.4	37.7	46.3	41.1	4.5	53.8	49.5
NI %	30.5%	31.7%	25.1%	30.2%	27.9%	3.1%	35.5%	30.6%
Change in bps From Year Ago				(261)	(2,857)	1,042	33	
Operating Cash Flows	-14.0	55.8	46.9	32.7	36.7	18.2	47.7	77.3

Source: Company reports

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.

Even here, UBNT is under threat from new entrants.

The telecoms equipment market is comprised of a core group of leading global technology companies as well as a host of smaller niche players. Ubiquiti's core competency seems to be in antennae. But even here, the company is currently under threat from new entrants. In fact, Ruckus and Mimosa are two competitors that are offering similar or better products at cheaper price points.

According to one industry professional, "Mimosa is looking at doing a UBNT-type business but at a higher quality point... Looking at undercutting UBNT." He added that barriers to entry in the industry are quite low. Despite these facts, UBNT's margins are some of the highest in the industry. In fact, UBNT's average Operating Margin from 2012 to 2015 is at 30.1%, 401 basis points better than industry leader Cisco. Aerohive has struggled to breakeven and Ruckus Wireless is barely able to achieve 4%. Aruba, now part of H-P, was also reporting negative operating margins at the time of its acquisition.

Table 7. Margin Comparison

	Average from 2012 to 2015
Ubiquiti	30.1%
Cisco	26.0%
Ruckus Wireless	3.8%

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Average from 2012 to 2015	
Aruba Networks *	-12.1%
Aerohive	-26.4%

* Data through 2014; acquired by HP in 2015 | Source: Company filings

In its most recent annual filing the company stated that “by reducing the cost of development, sales, marketing and support we are able to eliminate traditional business model inefficiencies and offer innovative solutions with disruptive price performance characteristics to our customers.” The element that allows UBNT to reduce these components is what it refers to as the ‘Ubiquiti community.’ The community is made up of users who contribute to an online forum. Yes, the secret sauce to market leading Operating Profit is **an active chat room**.

The community aids in the R&D process by providing the company with ideas and feedback that allow it to come to market faster and to work out issues sooner. Both in absolute and R&D as a % of Sales, UBNT spends next to nothing on R&D. How can Ubiquiti have superior technology if it barely invests in technology? Does the company really expect us to believe that comments in the chat room are a competitive advantage? If it was such an exceptional tool, wouldn’t other companies have figured this out?

Chart 2. Ubiquity: R&D Spend vs. Competitors

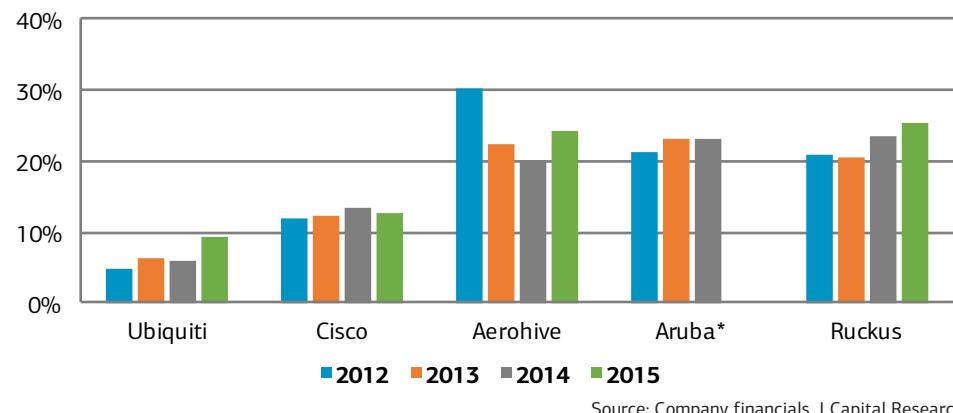


Table 8. Ubiquity: R&D Spend vs. Competitors

R&D (\$ millions)	2012	2013	2014	2015
Ubiquiti	16,699	20,955	33,962	54,600
Cisco	5,481,259	5,930,054	6,317,028	6,207,000
Aerohive	21,457	24,192	27,500	36,900

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R&D (\$ millions)	2012	2013	2014	2015
Aruba	109,448	139,746	169,328	NA
Ruckus	44,518	53,705	77,200	94,200

Source: Company filings

The ‘community’ is also critical to maintaining low SG&A. As can be observed below, while competitors spend between 25% and 60% of total revenues on SG&A, UBNT is able to operate at SG&A levels of 6% of sales. Again, all thanks to the community. Pera has stated that the Ubiquiti community forum acts as a kind of free advertising, as Ubiquiti users “evangelize” the brand.

Table 9. Free Advertising?

Sales & Marketing as %	2012	2013	2014	2015
Ubiquiti	2.5%	6.8%	4.1%	3.6%
Cisco	20.7%	19.6%	20.2%	20.0%
Aerohive	60.1%	53.9%	52.7%	54.8%
Aruba	38.4%	38.5%	37.7%	
Ruckus	26.2%	30.1%	30.2%	29.5%

Source: Company filings

Consequently, UBNT has no sales staff or direct sales team. Instead, it relies on a group of small, non-exclusive distributors. While most equipment manufacturers rely upon Tier 1 distributors such as Tech Data, Ingram Micro, Insight, UBNT is content to sell through a group of small unknown distributors. Distributors, in fact, account for 99% of Sales as UBNT does not sell a significant amount directly to end-customer WISPs.

The idea that Ubiquiti has managed to dispense with sales and marketing costs by selling only to small distributors is puzzling. None of Ubiquiti’s distributors is exclusive. Ubiquiti hardly invented the idea of selling through distributors; and if selling through distributors were a true advantage, there is nothing about the arrangement that could not be replicated by competitors. Moreover, distributors do not come free; Ubiquiti in theory should have to sell at a discount to promote sales flowing through the channel.

Regardless of how large or active it may be, we find it difficult to believe that chat rooms and small, unknown distributors eliminate the need for real R&D and SG&A in an industry as competitive as telecoms equipment.

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We found
that revenues
reported
seem to be
overstated.

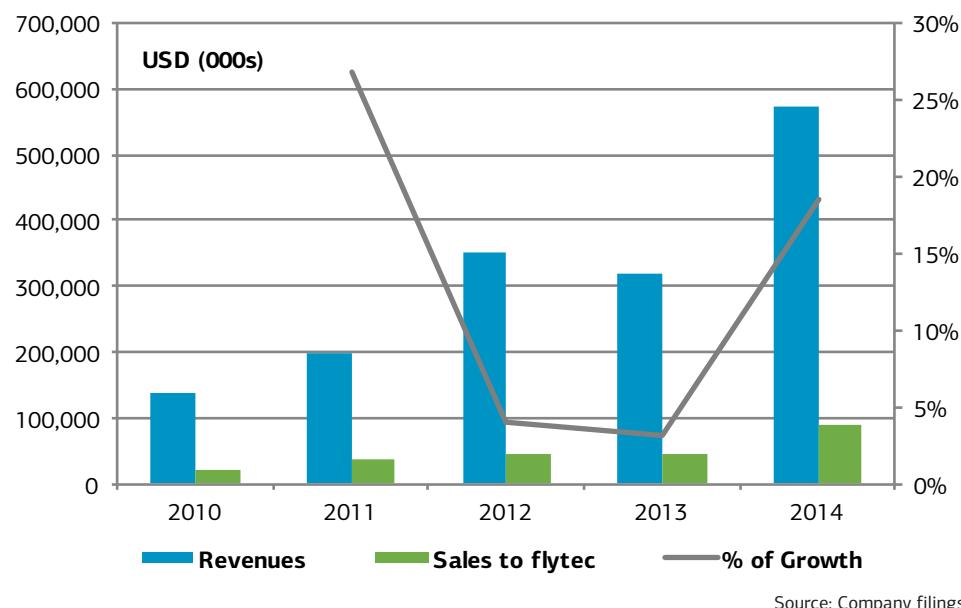
Distributor Issues

Given the outsized importance of these distributors in UBNT's financial results, we investigated the sales at several of the most critical distributors. We found that the revenues reported seem to be overstated as compared to various other sources. We also found issues that raise concerns about the integrity of the founders at one of the key distributors.

Flytec

For several years, Ubiquiti identified its largest and most important distributor as Flytec. Flytec has locations in Paraguay's Ciudad del Este and in Doral, Florida. The U.S. branch was founded in 2007, and, by 2010, the company was doing sales for Ubiquiti to the tune of USD 23 mln. In 2014, however, Ubiquiti reports that Flytec brought in USD 74 mln, accounting for fully 19% of Ubiquiti's revenue growth and 16% of Ubiquiti's revenue.

Chart 3. Flytec Revenue



How Big Is Flytec?

According to Ubiquiti's annual filings, in recent years Flytec has accounted for between 10% and 16% of its revenues. This means that Flytec should be purchasing approximately USD 15 mln of Ubiquiti equipment every quarter, or USD 60 mln per year. But according to Alexa, Flytec's Paraguayan and US websites combined provide fewer than five daily page views.

Moreover, Import Genius records for Paraguay show FOB values for im-

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ports, meaning the value of freight on board. While FOB is not a perfect measure, FOB values should roughly approximate product value. According to the Import Genius records, Ubiquiti's shipments to Flytec in Paraguay had an FOB value of only USD 13 mln USD for the 12 months ending on August 2014.

We take all this information as advisory. Of course it is possible that Flytec purchases roughly USD 50 mln USD of product in the U.S., but this would make Flytec a third of reported North America sales.

Flytec's Management

What is even more problematic than Flytec's purported purchases, however, is the company's ownership.

Flytec's founder appears to be a Brazilian national by the name of Osni Arruda. As has been pointed out by other analysts, according to [media reports](#), Arruda was arrested in Brazil in 2006, as part of a "gang specializing in smuggling goods and [in] tax evasion." [Another article](#) singles out Flytec as a purveyor of illicit goods. According to Brazilian [court documents](#), Arruda was accused of drug trafficking in 2009. The document reads, "There is concrete evidence that the investigated is involved in drug trafficking." One questions why Ubiquiti is deeply involved with a company such as Flytec given the accusations surrounding the company's founder.

Discomp

Discomp is a Czech company listed as one of Ubiquiti's European distributors. Discomp and Ubiquiti have a long history. When Ubiquiti was first listed, it claimed that Czech distributor Discomp accounted for 12% of its sales. This would put Discomp sales at roughly USD 42 mln. That is indeed an impressive showing in the Czech market. But Discomp's 2012 filings with the Czech Ministry of Justice cast serious doubt on these sales.

The document at the top of the following page is an income statement showing that Discomp's entire revenue in 2012 was 614,644 Korunas, or roughly USD 27,000.

South America Revenue

According to Ubiquiti's most recent 10-K, the company should have done USD 95.3 mln in sales to South America in 2015, USD 108.7 mln in 2014, and USD 67.4 mln in 2013. But in most of the Latin American data that is available, Ubiquiti's shipments are surprisingly small. According to Import

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Minimální závazný výkaz
informací uvedených v
Příloze č.2 k vyhl. č.
500/2002 Sb.

Účetní jednotka doručí
účetní závěrku současně s
doručením daňového
přání za dobu z příjmu
tx předloženému finančnímu
řídoucímu

Výkaz zisku a ztráty - druhové členění
ke dni **31.12.2012**
(v celých tis. CZK)

Rok	Měsíc	IČO
2012	12	25236792

Obchodní firma nebo jiný název
účetní jednotky
DISCOMP s.r.o.
Sídlo nebo bydliště účetní
jednotky a místo podnikání (když se od místu podnikání
Dopravní Za
Přez
318 00

označ.	TEXT	Skutečnost v účetním období	
		sledovaném 1	mírušém 2
I.	b		
I.	Tržby za prodej zboží	614 644	378 076
A.	Náklady vynaložené na prodané zboží	581 114	336 540
+	Obchodní marže	33 530	41 536
II.	Výkony	12 125	5 308
II. 1.	Tržby za prodej vlastních výrobků a služeb	12 125	5 308
2.	Změna stavu zásob vlastní činnosti		
3.	Aktivace		
B.	Výkonová spotřeba	26 500	17 347
1.	Spotřeba materiálu a energie	5 758	579
2.	Služby	20 742	16 768

Discomp financials | Source: Ministry of Justice of the Czech Republic

Genius, the company had only USD 2.6 mln in shipments into Ecuador and USD 1.6 mln in shipments to Colombia for the year ending in July 2014. This makes the exports to South America, while not impossible, seem far-fetched.

All told, we are forced to conclude that the overseas revenues are likely to be substantially overstated. If we take Flytec and Discomp as an indication, foreign sales could be overstated by as much as 25%.

Accounting Issues

While overstated revenues from LATAM and the Czech Republic pose a significant risk to the reliability of the UBNT's top line, a number of other accounting anomalies are evident in the company's accounting policies.

Tax-Free Overseas?

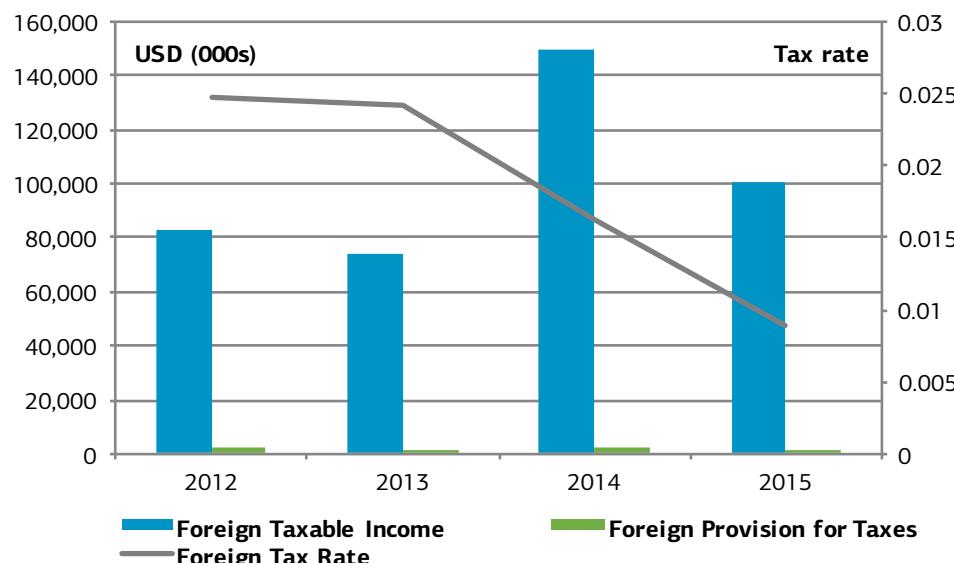
Ubiquiti does not appear to pay taxes overseas. We wonder if the 'community' has had a hand in also getting the company's tax rates down to levels unseen in the industry. Somehow, we suspect that tax authorities would be less convinced by the benefits the 'community' could bring to bear.

UBNT is reporting foreign tax expense of 0.9%. There is probably not a single country in the world whose effective tax rate is as low as 0.9%, and, unless all of Ubiquiti's overseas customers are in the Cayman Islands, the

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Bahamas, and Bermuda, such a tax rate seems impossible. Comparatively speaking, UBNT's competitors have historically paid significant sums in overseas taxes.

Chart 4. UBNT's Foreign Taxes



Source: Company filings

Table 10. Competitor Overseas Tax Payments

	Overseas Tax Basis	Provision for Foreign Taxes	Foreign Taxes
Ruckus	905	1,006	111.2%
Aruba	NA	4,450	NA
Cisco	6,891	692	10.0%
Aerohive	NA	375	NA

Source: Company filings

Every company save Ubiquiti pays taxes on overseas profits. How is it that Cisco, which likely has the capability to afford excellent tax advice, still pays 10% in taxes on its overseas profits while UBNT pays less than 1%? Once again, we are led to question the company's rationale for reporting figures so out of sync with the rest of the industry.

Deferred Revenue

Another red flag crops up in relation to Ubiquiti's payment terms with distributors. According to our research, distributors generally pay Ubiquiti

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up front in cash, often fully 90 days in advance of fulfillment. This is not uncommon in the industry. The upfront payments are often sizeable components of each companies' balance sheets. Moreover, calculations of Days Deferred Revenue are often well in excess of 40 days for most firms. Again, this is not the case for UBNT.

Table 11. Deferred Revenue Days

	2013	2014	2015
Ubiquiti	2.3	2.7	0.6
Aruba	74.3	80.5	
Ruckus*	49.0	56.0	38.8

Source: Company filings, J Capital Research (Ruckus data reflects years 2012, 2013 and 2014)

At 0.6 days, Ubiquiti's figures are far lower than its peers. We suspect that this is an indication that UBNT is aggressive in its revenue recognition policy; as opposed to reporting the revenue slowly over time, UBNT is likely reporting all of the revenue in the period in which it is received. Indeed, if Ubiquiti were to have similar DDR as peers, its revenue would have been roughly 20% lower in 2015.

Corporate Governance

A cofounder claims Pera strong-armed him into surrendering equity.

According to Forbes, CEO Robert J. Pera is a "34-year-old wireless broadband visionary." But according to a complaint filed by Ubiquiti cofounder Rommohan Malasani, Pera was emotionally unstable. Malasani claims Pera strong-armed him into surrendering much of his equity to Pera. The complaint reads:

"Pera sought to renegotiate down Malasani's ownership interest with an increase in Pera's. Pera threatened to 'stop Ubiquiti' unless Malasani agreed to the reduced ownership...Malasani did not believe he had any choice...He gave up his H1B1 visa when he left Centellax and was dependent upon [Ubiquiti] for the application for the new visa."¹

Then there is the company's revolving door of senior managers. General Counsel Jessica Zhou quit in 2013. John Ritchie, who had been CFO since the IPO, also left abruptly in 2013. Ritchie was replaced by Craig Foster. Foster soon left as well. The company was operating without a CFO when the 'email fraud' incident occurred in June 2015. After an internal inves-

¹ Malasani v. Pera

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tigation found—gasp!—lapses in the company's internal controls, UBNT hired an interim CFO through FTI Consulting. The company has yet to name a permanent CFO. Pera has stated on recent earnings calls that because there had been so many recent hires that were bad fits, UBNT is taking its time to find the right CFO.

At the same time, few independent board members have served for more than three years. When the company listed, its directors included Charles Fitzgerald, Ronald A. Sege, Robert M Van Buskirk, J William Gurley, John L Ocampo, and Peter Chung. Buskirk was chair of the audit committee. One by one, these directors have left. Fitzgerald, Ocampo, and Buskirk—the entire audit committee—left in 2013. The audit committee was then composed of Sege (the longest-serving independent board member), Steven Altman, and Rafael Torres. Torres is the audit committee chairman. Last December, Altman left the Board and his position has yet to be filled. The Audit committee is now down to two members which places UBNT in the unenviable position of being in violation of NASDAQ rules on having three independent and qualified Audit Committee members. The company has until the end of the year to rectify the issue.

All of these issues may point to just an unlucky corporation, unable to maintain staff and Board members. However, it could equally signal that this is a company that knowledgeable insiders have fled from with good reason. The question is, what do they know about this company, its business, its operations, and its financials that prompts them to leave so quickly and so regularly.

Investors should consider this as a clear red flag as it relates to the corporate governance of UBNT. At a minimum, the concern should be that there are no checks and balances on Pera and minority shareholders are placed at a distinct disadvantage.

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 mln impact of the faked Flytec revenues as discussed in our initial report and applied the current forward

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P/E of 14.4x to arrive at a valuation of USD 19.08 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.

Table 12. Margin Changes

	Mar-14	Jun-14	Sep-14	Dec-14	Mar-15	Jun-15	Sep-15	Dec-15
Revenues	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%
COGS	82.7	87.1	89	84.1	81.5	79.1	77.9	82.8
Gross Margin	65.6	68.9	61.1	69	66	66.2	73.5	79.1
GM%	44.2%	44.2%	40.7%	45.1%	44.7%	45.6%	48.5%	48.9%
Change in bps from Year Ago					51	139	784	379

Source: Company filings

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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