



February 27, 2015

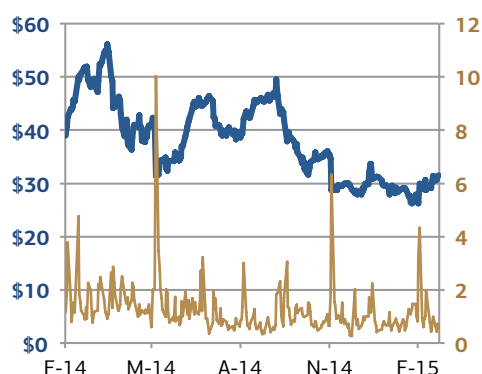
USA | Telecom Equipment

Ubiquiti Networks Inc (UBNT US)

Anne Stevenson-Yang
+1 917 929 7142
anne@jcapitalresearch.com

Matt Lowenstein
+1 646 400 1424
matt@jcapitalresearch.com

Ubiquiti Networks Inc. (UBNT) one-year share price in USD (blue) and volume (gold, in mln shares)



Source: Bloomberg, February 27, 2015

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Price	USD 31.36
Rating	SELL
Price target	USD 20.52
Difference	35%
Market Cap	USD 2.76 bln
Simple Moving Avg.	1.2 mln
P/E	15.51x

Source: Bloomberg, February 27, 2015



Prospects Dimming

+ Quarterly results deceiving

Though revenue was up 11% and profit up 8.7% YoY, this appeared to be largely a result of aggressive accruals. We believe “real,” or sustainable, revenue growth was more in the range of 4%, with profit growth even lower.

+ Bleeding cash

For a business supposedly spinning cash, Ubiquiti’s U.S. operations have a funny way of being cash-flow negative. In the last quarter, cash in the U.S. fell by USD 33 mln.

+ Reiterate SELL, PT USD 20.52

We give Ubiquiti’s net income a haircut by USD 50 mln, what we believe to be the minimum possible revenue overstatement. We then apply a stable P/E ratio to the “adjusted” net income.

Not buying the growth

Ubiquiti's problems are...ubiquitous

Ubiquiti's Q2 results were met with congratulations from analysts and accolades from the press. EPS growing to 53 cents a share and revenue growth of 11% prompted one reporter to write, "Heavy bets on new technology—costs that crippled Q1 results—are starting to pay off."¹

However, closer inspection of the most recent 10-Q reveals that these results largely derived from increasingly aggressive accounting practices. In fact, UBNT's free cash flow did not grow at all year on year. Revenue and earnings growth was accomplished with billowing DSOs and other deteriorating accounting metrics.

Table 1. Account Ratios (Days)

Period ending:	2013 Q3	2013 Q4	2014 Q1	2014 Q2	2014 Q3	2014 Q4
DSO	25.2	23.9	26.6	30.5	36.7	41.2
DDR	2.3	2.4	2.4	2.6	3.6	3.1
Inventory Days	20.5	28.7	54.2	58.8	43.6	41.4
Days payable	51.2	55.4	53	42	37.4	51
Prepaid expenses	3.5	3.9	8.8	13	17.9	29.4
CCC	-4.3	-1.2	34.3	57.7	57.3	57.9

Source: Company filings, J Capital Estimates

Ubiquiti's Cash Conversion Cycle has exploded from nearly zero a year ago to fully 57.9 days. This is a massive red flag concerning both accounting standards and Ubiquiti's core business. Either the company no longer has the same ability to turn product, or it is using aggressive standards to book revenue and costs.

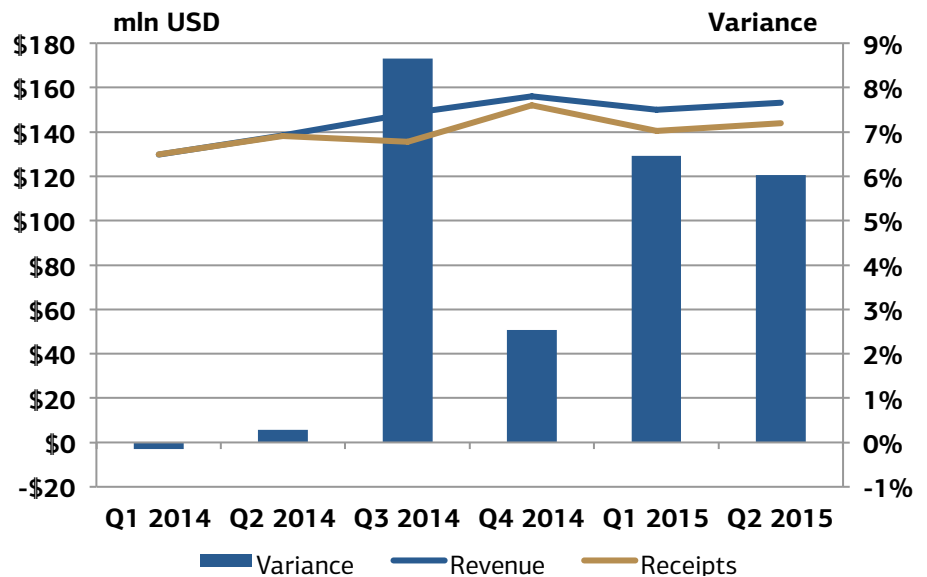
To give an idea of how playing with accounting accruals can affect revenue growth, it is instructive to look at "receipts," or revenue with accounts receivable backed out and deferred revenue added back.

¹ <http://www.fool.com/investing/general/2015/02/05/ubiquiti-networks-inc-earnings-a-big-bet-on-enterp.aspx>

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Matt Lowenstein +1 646 400 1424 matt@jcapitalresearch.com

Chart 1. Revenue vs. Receipts (USD 000s)



Source: Company filings, J Capital Estimates

As this chart shows, though UBNT claimed revenue growth of 11% YoY, receipts growth was a mere 4%. Moreover, the variance between revenue and receipts is growing. This suggests that roughly half of UBNT's revenue growth is nothing but smoke.

Another red flag is UBNT's cash flow. UBNT has shown strong operating inflows, but, remarkably, its US business appears to be hemorrhaging cash.

Chart 2. Domestic cash flow (USD 000s)

	2011	2012	2013	2014	2015 Q1	2015 Q2
Overseas cash and cash equiv.	29,600	102,800	210,400	307,600	330,800	361,600
Domestic cash and cash equiv.	46,761	19,260	17,426	39,497	60,216	27,003
Domestic cash flow	-27,501	-1,834	22,071	20,719	-33,213	
% of cash in US	61%	16%	8%	11%	15%	7%
% of North America revenue	30%	24%	25%	24%	36%	35%

Source: Company filings, J Capital Estimates

The filings show that the US operations lost USD 33 mln, or more than half of the company's cash position, in the last quarter alone. This is puzzling. Where did the cash even go? Investment in plant

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and equipment was less than USD 4 mln, and total investment outflows for the quarter were less than USD 5 mln. Moreover, this is a company that is reportedly spinning enormous amounts of operating cash. The only explanation for a cash decline is that UBNT is proactively sending cash abroad—or that its U.S. operations are significantly less profitable, perhaps even loss making, than international operations despite accounting for over a third of sales.

Problems in the channel?

We have been able to speak with an increasing number of end-users of Ubiquiti products. Our research suggests that Ubiquiti products enjoy some popularity with WISPs owing to their relatively low price point and ease of use. However, they have little by way of technology that could serve as a sustainable competitive advantage.

Moreover, we were told that, “They have too much inventory lying around. They don’t sell it. Inventory living in the warehouse. Used to be month wait. Now product is always in stock.”

Ubiquiti’s margins seem unlikely when compared with those of peers

One bull argument is that product quality and R&D are not relevant yet because Ubiquiti still has a massive potential market in the developing world. Hence, the company put out a press release on October 15 about its distribution agreement with ECS, saying, The agreement represents a strategic move for Ubiquiti’s expansion into Asian markets to bring its industry-defining broadband and enterprise solutions to customers by leveraging one of the strongest distributor networks in the region.” But our research in China suggests dim prospects.

According to distributors we spoke with, ECS has in fact been distributing Ubiquiti products for six months. However, most ECS employees we spoke with had never heard of the brand, or had nothing to do with selling it. The one product manager who offered an opinion claimed that, “Ubiquiti sales in the first two months of this year are falling because Chinese demand is falling. It sells about as well as any other product, but there is considerable inventory of about one quarter’s worth of sales.”

Risks

We view the possibility of a buyout offer from one of Ubiquiti’s many larger competitors as the most serious risk to our thesis.

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