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## THE TEXAS HEDGE REPORT

Steven McIntyre and Todd J. Stein, CFA

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### TECH COMING DOWN WITH IPO FEVER

As the Dow hits a six-year high and visions of outsized returns are again dancing in everyone's heads a la 1999, the tech sector is starting to show a great deal of frothiness. The NASDAQ, once down nearly 10% for the year just a few months ago, is now pushing double-digit gains for the year. Has this remarkable turnaround been spurred by runaway tech profits and improving business fundamentals? Quite the contrary, the tech sector has rarely looked so perched for a tremendous decline in revenues and earnings. PC box makers such as Dell, Gateway, and HP have largely laid eggs in recent earnings reports (PC sales stink), semiconductor companies such as Intel, AMD, ADI, National Semiconductor, Maxim, Linear, PMC Sierra, and a whole host of phone chip suppliers have been cutting sales and earnings guidance for the back half of the year, and networkers such as Nortel, Lucent, and even Cisco have produced far from rosy results and guidance. Software companies have also produced nothing spectacular save for Oracle low-balling a number and tripping over it. From sea to shining sea in tech, there is nothing to get excited about - let alone pay 20-30x earnings or more for obsolescing option backdating wrecks waiting to happen.

From headlines such as the utterly absurd Freescale Semiconductor LBO (a historically capital-consuming, low-returning commoditized chip pig that Motorola couldn't wait to get rid of) that will likely result in a LBO bankruptcy to Google's \$1.65 billion funny money purchase of copyright-ignoring YouTube to the collapsing put premiums across tech land, the complacency in tech is at a multi-year high. One needs to look no further than the suddenly smoking tech IPO market. Three recent tech deals have caught our attention as they seem to be "light on fundamentals" and "heavy on valuation". All three companies came out like bandits in their respective IPOs late last month as speculators chased the hype and bid up the companies to nosebleed multiples. It's easy to get caught up in the euphoria of newly public companies when financials are limited and few take the time to read through the hundred plus page IPO prospectuses filled with a litany of stomach churning risk sections. However, we decided to do the dirty work for you and have examined the prospectuses of the following companies and found a laundry list of risks and potential pitfalls investors should consider before paying ridiculous prices for these stocks.

#### Riverbed Technology

Ticker: RVBD

Stock Price: \$19.74

Market Cap: \$1.28B

Price-to-Sales: 25.5



(\$ in millions)	<u>2003</u>	<u>2004</u>	<u>2005</u>	<u>2006*</u>
Sales	\$ -	\$ 2.6	\$ 22.9	\$ 31.8
% change	N/A	N/A	795.4%	505.1%
Net Income	\$ (4.0)	\$ (9.8)	\$ (17.4)	\$ (10.3)
% change	N/A	N/A	N/A	N/A

\*six months ended June 30

### Business Description

Riverbed Technology develops products that help customers improve the performance of their applications and access to their data across wide-area networks (WAN). Steelhead, the company's flagship product, helps increase data transmission speeds across WAN by 5 to 50 times and in some cases up to 100 times according to the company. The product simplifies IT infrastructure, allowing customers to realize significant capital and operational cost savings. The company was co-founded in 2002 by Jerry Kennelly and Steven McCanne. Formerly named NBT Technology, the company switched its name to Riverbed Technology in 2003.

### Hype

Riverbed Technology priced its initial public offering at \$9.75, above its forecast of \$7-\$8.50. On September 21<sup>st</sup>, its first day of trading, the company's shares soared 57% to close at \$15.30. The shares now trade near \$20, representing a market cap of \$1.3 billion, a lofty price of 25.5 times trailing sales.

The bulls love RVBD as the WAN optimization market has been booming with an increasing amount of data traffic jamming through companies' WANs due to the growth of employees working remotely and more network applications such as VoIP taking up bandwidth. The breakneck growth in sales the past two years has bulls envisioning RVBD as a potential buyout candidate for larger tech companies. The company has also garnered media acclaim as *The Wall Street Journal* awarded the 2005 Technology Innovation Award in the Network/Broadband/Internet category to RVBD and *InfoWorld* named Steelhead a "Product of the Year" for 2005 as "Best WAN Accelerator."

### Risks

- **The company has a limited operating history.** RVBD sold its first Steelhead appliance in May of 2004 and last year was its first full year of selling this product. It's hard to see how any analyst can extrapolate the company's numbers from such a limited history and even more dumbfounding, how any investor can pay over 25x sales for a product that's relatively new to a highly competitive and volatile industry.
- **The company has yet to report a profit.** Despite revenues growing six-fold from \$5.2 million to \$31.8 million in the six months ended June 30, the company reported a loss of \$10.3 million compared to a loss of \$8.8 million a year ago. The losses are understandable for a new and growing company, but we'd feel more comfortable paying a premium multiple for a company that's at least proven it can be a profitable business.
- **Competition from Cisco is heating up.** Early last month, Cisco announced that it would roll out a software solution called WAAS (Wide-Area Application Services), which is designed to help companies optimize their networks. Riverbed acknowledged in its prospectus that



Cisco “has communicated its intent to incorporate WAN optimization functionality into certain of its router products” which “may have an adverse effect on [RVBD’s] ability to market and sell [its] products.”

- **Microsoft is also applying pressure.** The prospectus also notes that Microsoft is also likely to provide stiffer competition going forward, as the software giant is currently developing solutions “to improve the performance of its software for remote office users.” As RVBD’s products are “designed to improve the performance of many applications, including applications that are based on Microsoft protocols...improvements to Microsoft application protocols may reduce the need for [RVBD’s] products.” In reading some industry news, it appears that Microsoft partnered with Citrix in late August this year in an effort to compete against Cisco in the WAN optimization market. Many industry rags have pitted Microsoft and Cisco against each other as the primary players in this market with Riverbed, a much smaller competitor, in the background.
- **Finding buyers may be tougher than expected.** It appears many tech companies have already acquired companies similar to RVBD in recent years to compete in the WAN optimization market. Juniper Network acquired Peribit Networks, F5 Networks acquired Swan Labs, Packeteer acquired Tacit Networks, and Citrix Systems acquired Orbita Data. It’s a possibility that with many acquisitions already made, Riverbed might not be as attractive to buyers as many bulls would like to believe.

**Conclusion**

Of the three companies we are profiling in this report, RVBD has the most limited operating history and is the only one that has yet to report a profit. Despite these challenges, RVBD sports the biggest market cap at \$1.3 billion, has the highest sales multiple at over 25x, and recorded the highest jump in shares during its first trading day. Within a month of becoming public, the company’s market cap is already in the territory of F5 Networks, whose market cap is \$2.4 billion, but produces over six times RVBD’s revenues and has several years of profitability in its bag. With industry giants such as Microsoft and Cisco competing more aggressively in this field, there’s no assurance that RVBD can continue to grow and reach profitability. Riverbed’s management admits that it’s “very difficult to forecast [the company’s] future operating results.” The company has yet to report even one quarter’s worth of earnings as a public company and the stock’s already doubled. This appears irrational to us. A fool and his money are soon parted.

**DivX**

**Ticker: DIVX      Stock Price: \$22.29      Market Cap: \$745M      Price-to-Sales: 15.0**

(\$ in millions)	<u>2002</u>	<u>2003</u>	<u>2004</u>	<u>2005</u>	<u>2006*</u>
Sales	\$ 2.7	\$ 7.7	\$ 16.4	\$ 33.0	\$ 27.3
% change	N/A	187.5%	111.1%	102.1%	93.8%
Net Income	\$ (3.8)	\$ (3.9)	\$ (4.3)	\$ (2.3)	\$ 5.9
% change	N/A	N/A	N/A	N/A	N/A

\*six months ended June 30



## Business Description

DivX is a creator of software products that compresses high-quality video so that it can be efficiently shared and distributed amongst users. The company also offers the DivX Player, a software application that plays DivX enabled video content. The company's products are sold through consumer downloads online as well as licensing fees from hardware and software vendors who incorporate the DivX technology into their own product offerings. The company is also trying to enter the online video community market with its Stage6.com website. The company was co-founded by R. Jordan Greenhall and Jerome Rota in 2000 and is headquartered in San Diego, California.

## Hype

Due to strong demand, DivX priced its IPO at \$16, well above the \$12-\$14 per share that Wall Street was expecting, as the company raised \$145 million. The company's stock debuted on NASDAQ on September 22<sup>nd</sup>, a day after Riverbed Technology's highly successful public entrance, and likewise found instant demand as investors bid the stock up 16% to \$18.55. The company's stock is currently trading even higher at \$22, less than a month into its public life. The company's current market cap is \$745 million with a lofty price-to-sales multiple of 15.

As online video sharing has been a hot market especially with the success of YouTube and MySpace, the bulls appear to believe anything related to this market is an attractive company. DivX's timing has been great, especially with its software becoming increasingly popular, having been downloaded by consumers over 180 million times in the last four years, 50 million of that coming in the twelve months prior to its IPO, in order to watch videos online. Jim Cramer of *Mad Money* on CNBC also gave the stock an additional boost several days after its IPO, saying that the stock was "such a screaming buy" that it would be "criminal" not to recommend it. Cramer apparently loved the company's ties to Google (about 20% of sales come from a partnership with Google), touting, "we love Google and anything connected to Google."

## Risks

- **The company only recently became profitable.** As the financial table above shows, the company has a history of unprofitability. Although the company did become profitable this year, it remains to be seen if the company can sustain this trend going forward. Regardless, it doesn't appear that profitability is a huge issue for investors who are currently paying 15x sales for this company.
- **The company does not make much money from consumer downloads.** The company's prospectus states: "We have offered and we expect to continue to offer some of our products and technologies for reduced prices or free of charge, and we may not realize the benefits of this marketing strategy." Perusing the company's website, DivX.com, it appears that the company offers its basic DivX software for free and the pro version for \$19.99. According to a September 24, 2006 article on *SeekingAlpha.com*, the company makes little money from the consumer downloads. This tempers some of the bullish rhetoric that harps on the increasing number of consumer downloads of its DivX software.



- **The company's business with hardware device manufacturers has issues.** DivX's primary source of revenues has actually come from licensing fees from consumer hardware device manufacturers as the company's software is increasingly incorporated into consumer electronics, especially DVD players. In the first half of 2006 and in the full years 2005, 2004 and 2003, the company derived approximately 70%, 71%, 55% and 22% of total revenue from technology licensing to consumer hardware device manufacturers, "a majority of which [were] derived from sales of DVD players incorporating" DivX technology. So despite all the talk about DivX software downloads and online video sharing, the company actually generates most of its sales from consumer electronics.

Problem here is that most of these licensing agreements are for only 1 to 2 years and Philips, the largest of these customers, has its contract with DivX ending on June 30, 2007. The prospectus notes that Philips accounted for approximately 13% and 10% of total revenue in the year ended December 31, 2005 and in the first half of 2006. Simple calculation shows that Philips contributed \$4.3 million and \$2.7 million to revenue in the same respective periods. Considering that Philips is obligated to pay a minimum of \$11 million over the two year term of the agreement, that's \$5.5 million per year in fees that Philips expects to pay out. Any shortfall would require Philips to pay excess fees for sales that never happened. Judging by the fees paid thus year, it appears that fees might barely make the minimum. Philips, a 10% customer, may walk away as soon as the middle of next year if the DivX/Philips DVD players don't start flying off the shelves.

- **We don't love Google and anything connected to Google.** DivX's largest customer is currently Google, which has accounted for 20% of sales in 2006. According to *MrWaveTheory.com*, an industry blog we found, the company apparently makes money from Google every time a consumer installs the Google ToolBar and Mozilla Firefox Browser that comes bundled with the DivX player. However, this is not any preferential agreement that Google has with DivX. In early August this year, Google signed a multi-year deal with RealNetworks where both these applications would be bundled with Real's RealPlayer software. It's also easy to get these applications without having to download these media players. Therefore, as more consumers obtain these applications through alternatives to the DivX Player, revenues from Google will likely decrease. The agreement with Google also ends "upon the earlier of December 31, 2006 or the date upon which [DivX reaches] the cap on the total amounts payable by Google to [the company] under the Agreement." The company doesn't state what the cap amount is, but this could also be a potential limiting factor to the company's growth if the company has already exceeded the cap. If Google decides not to renew, that's 20% of the company's sales that would be wiped out in one fell swoop.
- **Competition is fierce in all of the company's markets.** The company lists Adobe, RealNetworks, Microsoft, and Apple as competitors that all offer their own competing video formats and are "aggressively building out their own digital-media ecosystems." The company's Stage6.com site, which the company apparently sees as a future growth driver of the business, also faces stiff competition in the online video community space occupied by the YouTube's and MySpace's of this world. Google's recent purchase of YouTube will only strengthen YouTube's presence and make it difficult for fledgling sites such as Stage6 to succeed.



- **Legal issues face the company.** The company's DivX player is used to view pirated content and DivX has "been asked by content owners to stop the display or hosting of copyrighted materials on [the company's] websites pursuant to the Digital Millennium Copyright Act." This could be a potentially significant issue if the government decides to crack down on this matter.

### Conclusion

Despite the hype surrounding the company's software downloads and online video sharing site, the company actually gets most of its business from consumer electronics and installations of unrelated software from other companies. We question whether many investors were aware of this when bidding up the stock. With expiration dates on many of its significant customer agreements looming and competitive and legal issues facing the company, we find it difficult to justify the current premium on this company.

### CommVault

Ticker: CVLT

Stock Price: \$19.00

Market Cap: \$791M

Price-to-Sales: 6.4

(\$ in millions)	<u>2002</u>	<u>2003</u>	<u>2004</u>	<u>2005</u>	<u>2006</u>
Sales	\$ 30.8	\$ 44.4	\$ 61.2	\$ 82.6	\$ 109.5
% change	N/A	44.0%	37.9%	34.9%	32.5%
Net Income	\$ (35.5)	\$ (22.1)	\$ (17.4)	\$ (5.2)	\$ 5.1
% change	N/A	N/A	N/A	N/A	N/A

### Business Description

CommVault is a provider of data management software. The company sells a suite of software applications under the QiNetix brand, which performs a variety of tasks such as data backup, archiving, snapshot management and recovery, e-mail compliance, and other data management solutions. The "oldest" of the companies covered in this report, CVLT was founded in 1988 and is headquartered in Oceanport, New Jersey, with offices all over the world.

### Hype

Debuting on the same day as DivX, CVLT found similar success in its first day as shares rose 17% to \$17. The company's shares had been priced at \$14.50, the top of its \$12.50-\$14.50 range, as the company raised \$161 million in its IPO. A more mature company than the other two companies, the company understandably trades at cheaper valuations. However, the company's current valuation multiple of 6 times sales is still very expensive in our opinion. The company's shares, which have risen 31% since its IPO to its current price of \$19, does not appear to discount the many risks and issues that we found littered in its prospectus. The bulls still love this stock and point to its continuing growth in a healthy storage industry as reason enough to justify the purchase of this stock.

### Risks

- **The company has become profitable only recently.** The company reported its first profitable year this past fiscal 2006 ended March 31, 2006. However, like DivX, we question whether this



will be sustainable and would think that investors would be better off waiting on the sidelines until profitability is repeated in future periods before paying a premium on this company.

- **“Services” is growing, but it is lower margin.** A breakdown of the company’s revenues shows that company’s services business has been growing faster than software sales. Software sales have grown 26% in each of the past two years, while services grew 42% this past year and 52% the year prior to that. Consequently, service revenues have become an increasing part of the company’s sales. The problem is that services revenue has lower margin than the company’s software revenue. The gross margin for the company’s services revenue was 71.9% for fiscal 2006 while software was 97.2%. Therefore, an increasing contribution from services revenue will continue to pressure the company’s overall margins.
- **The company’s business is tied to a few products.** According to the prospectus, a predominant portion of the company’s sales comes from its data protection software applications, which is primarily its Galaxy Backup and Recovery product. Sales of its data protection software applications constituted 90% of the company’s software revenues this past year and almost all of its services revenue. The company’s operations are therefore significantly at risk if the Galaxy product faces obsolescence, a threat that’s constantly around the corner in the storage industry, and could wipe out the company’s entire business.
- **Revenue recognition issues with the company’s software.** The company warned in its prospectus: “Our management and auditors have identified a material weakness in the design and operation of our internal controls as of March 31, 2006 which, if not properly remediated, could result in material misstatements in our financial statements in future periods.” The material weakness apparently relates to a software revenue recognition issue on certain of its business arrangements. The company has said that it has remediated the material weakness by implementing new policies and recording a reduction to revenue of approximately \$2.6 million during fiscal 2006. Although the amount is a small portion of its revenues, investors should be somewhat concerned when a software company reports revenue recognition issues, a common financial shenanigan used by crooked software companies in the past. We have no assurance yet as to whether or not the company has sufficiently addressed the material weakness or if additional material weaknesses exist. However, the market is apparently oblivious to this concern.
- **Conflicts of interest in the IPO.** Credit Suisse First Boston, the underwriter of the company’s IPO, was also a significant shareholder of the company, owning 63% of CVLT prior to the deal. In the IPO, about 43% of the shares sold were by CSFB. This represents a conflict of interest that was evidently ignored by investors. We’d feel far more confident about the company’s future prospects if the primary shareholder was retaining the vast majority of its equity long-term, but perhaps CSFB found holes in this ship and was ready to exit before it sank to the market bottom.

## Conclusion



Hypothetically, let's say none of the risks mentioned above affect the company's growth going forward. Even in this ideal world, CVLT looks expensive in our view. The company posted \$110 million in revenues this past year on 32% growth. Even though the company's revenue growth rates has come down steadily year after year, let's say that the company continues to post 32% sales growth in each of the next couple years. In this optimistic scenario, the company would reach sales of \$145 million in fiscal 2007 and \$192 million fiscal 2008. For software companies, net profit margins of 15% are about average. Using this figure, the company would record \$22 million in profits in fiscal 2007 and \$29 million in fiscal 2008. This translates into a forward P/E of 36x fiscal 2007 earnings and 27x fiscal 2008. Why are investors hungry for these sub-4% earnings yields when risk-free returns of more than 4% await them in the short dated treasuries? It's this kind of irrationality that led to the tech bubble in the late 90s with its ensuing crash. Investors have yet to learn their lesson as speculation and mo-mo investing in the tech sector remain alive and well today.

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