



FORM 10-Q

Riverbed Technology, Inc. - RVBD

Filed: October 25, 2007 (period: September 30, 2007)

Quarterly report which provides a continuing view of a company's financial position

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PART I.

FINANCIAL INFORMATION

Item 1 Condensed Consolidated Financial Statements

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**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 September 30, 2007

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: 001-33023

Riverbed Technology, Inc.
(Exact name of registrant as specified in its charter)

Delaware
(State or Other Jurisdiction of
Incorporation or Organization)

03-0448754
(I.R.S. Employer
Identification Number)

199 Fremont Street
San Francisco, California 94105
(Address of Principal Executive Offices including Zip Code)

(415) 247-8800
(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 is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer ☐ Accelerated filer ☐ Non-accelerated filer ☒

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 of the registrant's common stock, par value \$0.0001, outstanding as of October 23, 2007 was: 70,706,908.

Riverbed Technology, Inc.
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RIVERBED TECHNOLOGY, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS
As of September 30, 2007 and December 31, 2006
(in thousands, except per share data)

	September 30, 2007 (unaudited)	December 31, 2006
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 169,345	\$ 105,330
Marketable securities	62,192	3,999
Trade receivables, net of allowances of \$592 and \$472 as of September 30, 2007 and December 31, 2006, respectively	37,604	18,148
Other receivables	779	118
Inventory	9,946	7,452
Prepaid expenses and other current assets	4,418	5,438
Total current assets	<u>284,284</u>	<u>140,485</u>
Fixed assets, net	12,498	7,718
Other assets	5,727	2,566
Total assets	<u>\$ 302,509</u>	<u>\$ 150,769</u>
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	\$ 15,540	\$ 11,113
Accrued compensation and related benefits	11,940	8,285
Other accrued liabilities	10,828	2,931
Deferred revenue	22,502	16,837
Total current liabilities	<u>60,810</u>	<u>39,166</u>
Deferred revenue non-current	5,182	2,245
Other long-term liabilities	257	378
Total long-term liabilities	<u>5,439</u>	<u>2,623</u>
Stockholders' equity:		
Preferred stock, \$0.0001 par value – 30,000 shares authorized, no shares outstanding	—	—
Common stock and additional paid-in-capital; \$0.0001 par value – 600,000 shares authorized; 70,705 and 66,180 shares issued and outstanding as of September 30, 2007 and December 31, 2006, respectively	277,389	162,033
Deferred stock-based compensation	(3,862)	(5,704)
Accumulated deficit	(37,362)	(47,333)
Accumulated other comprehensive income (loss)	95	(16)
Total stockholders' equity	<u>236,260</u>	<u>108,980</u>
Total liabilities and stockholders' equity	<u>\$ 302,509</u>	<u>\$ 150,769</u>

See Notes to Condensed Consolidated Financial Statements.

RIVERBED TECHNOLOGY, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(in thousands, except per share amounts)
(unaudited)

	Three months ended September 30,		Nine months ended September 30,	
	2007	2006	2007	2006
Revenue:				
Product	\$ 50,847	\$ 19,303	\$ 127,876	\$ 44,169
Support and services	10,460	3,595	25,772	7,385
Ratable product and related support and services	<u>2,003</u>	<u>1,720</u>	<u>6,448</u>	<u>4,828</u>
Total revenue	<u>63,310</u>	<u>24,618</u>	<u>160,096</u>	<u>56,382</u>
Cost of revenue:				
Cost of product	13,533	6,211	35,542	14,576
Cost of support and services	3,994	1,304	9,697	2,851
Cost of ratable product and related support and services	<u>613</u>	<u>390</u>	<u>1,813</u>	<u>1,446</u>
Total cost of revenue	<u>18,140</u>	<u>7,905</u>	<u>47,052</u>	<u>18,873</u>
Gross profit	<u>45,170</u>	<u>16,713</u>	<u>113,044</u>	<u>37,509</u>
Operating expenses:				
Sales and marketing	25,139	12,181	63,035	31,768
Research and development	10,890	4,930	27,384	12,712
General and administrative	<u>7,177</u>	<u>2,347</u>	<u>16,814</u>	<u>6,014</u>
Total operating expenses	<u>43,206</u>	<u>19,458</u>	<u>107,233</u>	<u>50,494</u>
Operating income (loss)	<u>1,964</u>	<u>(2,745)</u>	<u>5,811</u>	<u>(12,985)</u>
Other income (expense), net	<u>2,754</u>	<u>(275)</u>	<u>7,028</u>	<u>(294)</u>
Income (loss) before provision for income taxes	4,718	(3,020)	12,839	(13,279)
Provision for income taxes	<u>1,950</u>	<u>77</u>	<u>2,868</u>	<u>155</u>
Net income (loss)	<u>\$ 2,768</u>	<u>\$ (3,097)</u>	<u>\$ 9,971</u>	<u>\$ (13,434)</u>
Net income (loss) per common share:				
Basic	<u>\$ 0.04</u>	<u>\$ (0.16)</u>	<u>\$ 0.15</u>	<u>\$ (0.91)</u>
Diluted	<u>\$ 0.04</u>	<u>\$ (0.16)</u>	<u>\$ 0.14</u>	<u>\$ (0.91)</u>
Shares used in computing net income (loss) per common share:				
Basic	69,069	19,034	67,397	14,705
Diluted	74,360	19,034	72,934	14,705
Stock-based compensation expense included in above:				
Cost of product	\$ 27	\$ —	\$ 68	\$ —
Cost of support and services	806	93	1,798	198
Sales and marketing	4,455	1,055	10,741	2,189
Research and development	2,511	551	5,958	1,178
General and administrative	<u>1,564</u>	<u>381</u>	<u>3,614</u>	<u>867</u>
Total stock-based compensation expense	<u>\$ 9,363</u>	<u>\$ 2,080</u>	<u>\$ 22,179</u>	<u>\$ 4,432</u>

See Notes to Condensed Consolidated Financial Statements.

RIVERBED TECHNOLOGY, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)
(unaudited)

	Nine months ended September 30,	
	2007	2006
Operating Activities:		
Net income (loss)	\$ 9,971	\$ (13,434)
Adjustments to reconcile net income (loss) to net cash provide by (used in) operating activities:		
Depreciation and amortization	3,418	1,261
Stock-based compensation	22,179	4,432
Revaluation and amortization of warrants	—	658
Provision for trade receivable allowances	243	271
Changes in operating assets and liabilities:		
(Increase) in trade receivables	(19,888)	(6,235)
(Increase) in inventory	(4,459)	(3,305)
(Increase) in prepaid expenses and other assets	(174)	(2,438)
Increase in accounts payable and other current liabilities	12,139	5,549
Increase in income taxes payable	2,645	123
Increase in deferred revenue	9,051	9,483
Net cash provided by (used in) operating activities	<u>35,125</u>	<u>(3,635)</u>
Investing Activities:		
Capital expenditures	(5,707)	(3,690)
Purchase of available for sale securities, net of maturities	(58,152)	—
Increase in other assets	(2,100)	(1,400)
Net cash used in investing activities	<u>(65,959)</u>	<u>(5,090)</u>
Financing Activities:		
Proceeds from issuance of convertible preferred stock, net of issuance costs	—	19,915
Proceeds from public offerings, net of issuance costs	87,681	87,412
Proceeds from issuance of common stock, net of repurchases	7,094	167
Payments of debt	—	(938)
Net cash provided by financing activities	<u>94,775</u>	<u>106,556</u>
Effect of exchange rate changes on cash and cash equivalents	<u>74</u>	<u>19</u>
Net increase in cash and cash equivalents	64,015	97,850
Cash and cash equivalents at beginning of period	<u>105,330</u>	<u>10,410</u>
Cash and cash equivalents at end of period	<u>\$ 169,345</u>	<u>\$ 108,260</u>

See Notes to Condensed Consolidated Financial Statements.

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(unaudited)****1. ORGANIZATION AND SIGNIFICANT ACCOUNTING POLICIES****Organization**

Riverbed Technology, Inc. was founded in May 2002 and has developed a comprehensive solution to the fundamental problems of wide-area distributed computing. Our Steelhead[®] appliances enable our customers simply and efficiently to improve the performance of their applications and access to their data over wide area networks, or WANs. We began commercial shipments of our products in May 2004.

Public Offerings

In September 2006, we completed our initial public offering, or IPO, of common stock in which we sold and issued 9,990,321 shares of our common stock, including 1,290,321 shares sold by us pursuant to the underwriters' exercise of their over-allotment option, at an issue price of \$9.75 per share. We raised a total of \$97.4 million in gross proceeds from the IPO, or approximately \$87.4 million in net proceeds after deducting underwriting discounts and commissions of \$6.8 million and other offering costs of \$3.1 million. Upon the closing of the IPO, all shares of convertible preferred stock outstanding automatically converted into 39,441,439 shares of common stock.

In February 2007, we completed a follow-on public offering of common stock in which we sold and issued 2,854,671 shares of our common stock, including 250,000 shares sold by us pursuant to the underwriters' partial exercise of their over-allotment option, at an issue price of \$32.50 per share. As a result of the offering, we raised a total of \$92.8 million in gross proceeds, or approximately \$87.7 million in net proceeds after deducting underwriting discounts and commissions of \$4.2 million and other offering costs of \$0.9 million.

Significant Accounting Policies***Basis of Presentation***

The condensed consolidated financial statements include our accounts and the accounts of our wholly owned subsidiaries. Intercompany transactions and balances have been eliminated. The accompanying condensed consolidated balance sheet as of September 30, 2007, the condensed consolidated statements of operations for the three and nine months ended September 30, 2007 and September 30, 2006, and the condensed consolidated statements of cash flows for the nine months ended September 30, 2007 and September 30, 2006 are unaudited. The accompanying statements should be read in conjunction with the audited consolidated financial statements and related notes contained in our Annual Report on Form 10-K for the year ended December 31, 2006.

The accompanying condensed consolidated financial statements have been prepared in accordance with United States generally accepted accounting principles, or GAAP, pursuant to the rules and regulations of the Securities and Exchange Commission, or SEC. They do not include all of the financial information and footnotes required by GAAP for complete financial statements. We believe the unaudited condensed consolidated financial statements have been prepared on the same basis as the audited financial statements and include all adjustments necessary for the fair presentation of our statement of financial position as of September 30, 2007, and our results of operations for the three and nine months ended September 30, 2007 and September 30, 2006, and our cash flows for the nine months ended September 30, 2007 and September 30, 2006. All adjustments are of a normal recurring nature. The results for the three and nine months ended September 30, 2007 are not necessarily indicative of the results to be expected for any subsequent quarter or for the fiscal year ending December 31, 2007.

Other than the adoption of the provisions of Financial Accounting Standards Board Interpretation No. 48, *Accounting for Uncertainty in Income Taxes – an interpretation of FASB Statement No. 109*, or FIN 48, there have been no significant changes in our accounting policies during the three and nine months ended September 30, 2007 as compared to the significant accounting policies described in our Annual Report on Form 10-K for the year ended December 31, 2006.

Use of Estimates

GAAP requires us to make certain estimates and judgments that can affect the reported amounts of assets and liabilities as of the date of the consolidated financial statements, as well as the reported amounts of revenue

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and expenses during the periods presented. Significant estimates and assumptions made by management include the determination of the fair value of stock awards issued, the allowance for doubtful accounts, warranty reserves, inventory valuation and income taxes. We believe that the estimates and judgments upon which we rely are reasonable based upon information available to us at the time that these estimates and judgments were made. To the extent there are material differences between these estimates and actual results, our consolidated financial statements will be affected.

Revenue Recognition

Our software is integrated on appliance hardware and is essential to the functionality of the product. As a result, we account for revenue in accordance with Statement of Position, or SOP, 97-2, *Software Revenue Recognition*, as amended by SOP 98-9, *Modification of SOP 97-2, Software Revenue Recognition, With Respect to Certain Transactions*, for all transactions involving the sale of software. We recognize product revenue when all of the following have occurred:

(1) we have entered into a legally binding arrangement with a customer; (2) delivery has occurred, which is when product title transfers to the customer; (3) customer payment is deemed fixed or determinable and free of contingencies and significant uncertainties; and (4) collection is probable.

Product revenue consists of revenue from sales of our appliances. Product sales include a perpetual license to our software. Product revenue is generally recognized upon transfer of title at shipment, assuming all other revenue recognition criteria are met. Shipping charges billed to customers are included in product revenue and the related shipping costs are included in cost of product revenue. Product revenue on sales to resellers is recorded once we have received persuasive evidence of an end-user and all other revenue recognition criteria have been met.

Substantially all of our products have been sold in combination with support services, which consist of software updates and support. Software updates provide customers with rights to unspecified software product upgrades and to maintenance releases and patches released during the term of the support period. Support includes internet access to technical content, telephone and internet access to technical support personnel and hardware support. Revenue for support services is recognized on a straight-line basis over the service contract term, which is typically one year.

We use the residual method to recognize revenue when a product agreement includes one or more elements to be delivered at a future date and vendor specific objective evidence, or VSOE, of the fair value of all undelivered elements exists. Through September 30, 2007, in virtually all of our contracts, the only element that remained undelivered at the time of delivery of the product was support and updates. Under the residual method, the fair value of the undelivered elements is deferred and the remaining portion of the contract fee is recognized as product revenue. If evidence of the fair value of one or more undelivered elements does not exist, all revenue is generally deferred and recognized when delivery of those elements occurs or when fair value can be established. When the undelivered element for which we do not have a fair value is support, revenue for the entire arrangement is bundled and recognized ratably over the support period. Revenue related to these arrangements is included in ratable product and related support and services revenue in the accompanying condensed consolidated statements of operations. VSOE of fair value for elements of an arrangement is based upon the normal pricing and discounting practices for those services when sold separately and for support and updates is additionally measured by the renewal rate offered to the customer. Prior to the third quarter of 2005, we had not established VSOE for the fair value of support contracts provided to our reseller class of customers. As such, prior to the third quarter of 2005, we recognized all revenue on transactions sold through resellers ratably over the term of the support contract, typically one year. Beginning in the third quarter of 2005, we determined that we had established VSOE of fair value of support for products sold to resellers, and began recognizing product revenue upon delivery, provided the remaining criteria for revenue recognition had been met.

Our fees are typically considered to be fixed or determinable at the inception of an arrangement, generally based on specific products and quantities to be delivered. Substantially all of our contracts do not include rights of return or acceptance provisions. To the extent that our agreements contain such terms, we recognize revenue once the acceptance provisions or right of return lapses. Payment terms to customers generally range from net 30 to 60 days. In the event payment terms are provided that differ from our standard business practices, the fees are deemed to not be fixed or determinable and revenue is recognized when the payments become due, provided the remaining criteria for revenue recognition have been met.

We assess the ability to collect from our customers based on a number of factors, including credit worthiness of the customer and past transaction history of the customer. If the customer is not deemed credit worthy, we defer all revenue from the arrangement until payment is received and all other revenue recognition criteria have been met.

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Stock-Based Compensation

Prior to January 1, 2006, we accounted for employee stock options using the intrinsic value method in accordance with Accounting Principles Board, or APB, Opinion No. 25, *Accounting for Stock Issued to Employees*, and Financial Accounting Standards Board Interpretation, or FIN, 44, *Accounting for Certain Transactions Involving Stock Compensation, an Interpretation of APB No. 25*, and had adopted the disclosure only provisions of Statement of Financial Accounting Standards, or SFAS, No. 123, *Accounting for Stock-Based Compensation*, and SFAS No. 148, *Accounting for Stock-Based Compensation — Transition and Disclosure*, using the minimum value method.

In accordance with APB 25, stock-based compensation expense, which is a non-cash charge, resulted from stock option grants at exercise prices that, for financial reporting purposes, were deemed to be below the estimated fair value of the underlying common stock on the date of grant. We recorded deferred stock-based compensation relative to options accounted for under APB 25 of \$9.3 million and \$567,000 in the years ended December 31, 2005 and 2004, respectively, which is being amortized over the service period, which generally corresponds to the vesting period of the applicable options on a straight-line basis. During the three and nine months ended September 30, 2007, we amortized \$566,000 and \$1.7 million, respectively, of deferred compensation expense, net of reversals, related to these options, and in the three and nine months ended September 30, 2006, we amortized \$943,000 and \$2.3 million, respectively.

Effective January 1, 2006, we adopted the fair value recognition provisions of SFAS 123(R), *Share-Based Payment*, using the modified prospective transition method, which requires us to apply the provisions of SFAS 123(R) to new awards granted, and to awards modified, repurchased or cancelled, after the effective date. Under this method, stock-based compensation expense recognized beginning January 1, 2006 is based on a combination of the following: (a) the grant-date fair value of stock option and employee stock purchase plan awards granted or modified after January 1, 2006; and (b) the amortization of deferred stock-based compensation related to stock option awards granted prior to January 1, 2006, which was calculated using the intrinsic value method as previously permitted under APB 25.

Under SFAS 123(R), we estimated the fair value of stock options granted using the Black-Scholes option-pricing formula and a single option award approach. This model utilizes the estimated fair value of common stock and requires that, at the date of grant, we use the expected term of the option, the expected volatility of the price of our common stock, risk free interest rates and expected dividend yield of our common stock. This fair value is then amortized on a straight-line basis over the requisite service periods of the awards, which is generally the vesting period. Options typically vest either 25% of the shares one year after the options' vesting commencement date and the remainder ratably on a monthly basis over the following three years, or ratably on a monthly basis over four years. On September 20, 2006, we implemented our Employee Stock Purchase Plan, or Purchase Plan. Purchase Plan shares typically vest over 2 years, and include two purchase dates per year.

The fair value of options granted and Purchase Plan shares were estimated at the date of grant using the following assumptions:

	Three months ended September 30,		Nine months ended September 30,	
	2007	2006	2007	2006
Employee and Director Stock Options				
Expected life in years	4.5	4.5	4.5	4.5-6.1
Risk-free interest rate	4.2%	4.6%	4.2% - 4.9%	4.6% - 5.1%
Volatility	57%	65%	57%-62%	65%-81%
Weighted average fair value of grants	\$20.02-\$24.40	\$4.66-\$9.35	\$14.03-\$24.40	\$3.67-9.35
Purchase Plan (1)				
Expected life in years			0.5-2.0	
Risk-free interest rate			4.9%-5.0%	
Volatility			38%-46%	
Weighted average fair value of grants			\$30.99-\$36.42	

(1) There were no Purchase Plan shares granted in the three months ended September 30, 2007.

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The expected term represents the period that stock-based awards are expected to be outstanding, giving consideration to the contractual terms of the stock-based awards, vesting schedules and expectations of future employee behavior as influenced by changes to the terms of our stock-based awards. For the three and nine months ended September 30, 2007, we have elected to use the simplified method of determining the expected term as permitted by SEC Staff Accounting Bulletin 107. The computation of expected volatility for the three and nine months ended September 30, 2007 is based on the historical volatility of comparable companies from a representative peer group selected based on industry and market capitalization data. As required by SFAS 123(R), we estimate expected forfeitures and recognize compensation costs only for those equity awards expected to vest.

As of September 30, 2007, the total compensation cost related to stock-based awards granted under SFAS 123(R) to employees and directors but not yet recognized was approximately \$88.7 million, net of estimated forfeitures of \$4.3 million. This cost will be amortized on a straight-line basis over the vesting period, which is typically 4 years. Amortization in the three and nine months ended September 30, 2007, was \$5.8 million and \$12.0 million, respectively, and was \$1.1 million and \$2.1 million in the three and nine months ended September 30, 2006, respectively.

As of September 30, 2007, there was \$12.4 million left to be amortized under our Purchase Plan, which will be amortized over the remaining Purchase Plan offering period, which is between 11 to 19 months. Amortization in the three and nine months ended September 30, 2007 was \$3.0 million and \$8.5 million, respectively. There was no amortization in the nine months ended September 30, 2006 as the plan was not yet implemented.

Inventory Valuation

Inventory consists of hardware and related component parts and are stated at the lower of cost (on a first-in, first-out basis) or market. A portion of our inventory relates to evaluation units located at customer locations as some of our customers test our equipment prior to purchasing. Inventory that is obsolete or in excess of our forecasted demand is written down to its estimated realizable value based on historical usage, expected demand, and evaluation unit conversion rate and age. Inherent in our estimates of market value in determining inventory valuation are estimates related to economic trends, future demand for our products and technological obsolescence of our products. Inventory write-downs are reflected as cost of product and amounted to approximately \$135,000 and \$935,000 in the three and nine months ended September 30, 2007, respectively, and \$491,000 and \$1.1 million in the three and nine months ended September 30, 2006, respectively.

Accounting for Income Taxes

We use the asset and liability method of accounting for income taxes in accordance with SFAS 109, *Accounting for Income Taxes*. Under this method, income tax expenses or benefits are recognized for the amount of taxes payable or refundable for the current year and for deferred tax liabilities and assets for the future tax consequences of events that have been recognized in our consolidated financial statements or tax returns. The measurement of current and deferred tax assets and liabilities are based on provisions of currently enacted tax laws. The effects of future changes in tax laws or rates are not contemplated.

As part of the process of preparing consolidated financial statements, we are required to estimate our income taxes and tax contingencies in each of the tax jurisdictions in which we operate prior to the completion and filing of tax returns for such periods. This process involves estimating actual current tax expense together with assessing temporary differences in the treatment of items for tax purposes versus financial accounting purposes that may create net deferred tax assets and liabilities.

We record a valuation allowance to reduce our deferred tax assets to the amount we believe is more likely than not to be realized. In assessing the need for a valuation allowance, we have considered our historical levels of income, expectations of future taxable income and on-going tax planning strategies. Because of the uncertainty of the realization of the deferred tax assets, we have recorded a full valuation allowance against our deferred tax assets. Realization of our deferred tax assets is dependent primarily upon future U.S. taxable income.

We adopted the provisions of FIN 48 on January 1, 2007. The application of this Interpretation requires a two-step process that separates recognition from measurement. We recorded no increases or decreases to the tax reserves for uncertain tax positions upon implementing FIN 48 and this assessment has not changed as of September 30, 2007. We have elected to record interest and penalties recognized in accordance with FIN 48 in the financial statements as income

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taxes. Any subsequent change in classification of FIN 48 interest and penalties will be treated as a change in accounting principle subject to the requirements of SFAS 154, *Accounting Changes and Error Corrections*.

Warranty Reserve

Upon shipment of products to our customers, we provide for the estimated cost to repair or replace products that may be returned under warranty. Our warranty period is typically 12 months from the date of shipment to the end-user customer for hardware and 90 days for software. For existing products, the reserve is estimated based on actual historical and expected experience. For new products, the warranty reserve is based on historical experience of similar products until such time as sufficient historical data has been collected for the new product. Warranty reserves amounted to approximately \$1.2 million and \$735,000 at September 30, 2007 and December 31, 2006, respectively.

The following is a summary of the warranty reserve activity for the nine months ended September 30, 2007:

<u>(in thousands)</u>	<u>December 31, 2006</u>	<u>Additions charged to operations</u>	<u>Warranty costs incurred</u>	<u>September 30, 2007</u>
Warranty reserve	\$ 735	\$ 1,620	\$ (1,198)	\$ 1,157

Deferred Inventory Costs

When our products have been delivered, but the product revenue associated with the arrangement has been deferred as a result of not meeting the revenue recognition criteria in SOP 97-2, we also defer the related inventory costs for the delivered items in accordance with Accounting Research Bulletin 43, *Restatement and Revision of Accounting Research Bulletins*. Deferred inventory costs amounted to approximately \$1.8 million and \$3.5 million at September 30, 2007 and December 31, 2006, respectively, and are included in prepaid expenses and other current assets in the condensed consolidated balance sheets.

Spares

We hold spare parts to service our customers who purchase support. We classify spare parts as other long term assets and amortize the spares over an estimated useful life of three years. At September 30, 2007 and December 31, 2006 we had \$1.3 million and \$876,000, respectively, of spare inventory, net of accumulated amortization.

Concentrations of Risk

Financial instruments that are potentially subject to concentrations of credit risk consist primarily of cash, cash equivalents, marketable securities, and trade receivables. Investment policies have been implemented that limit investments to investment grade securities. The risk with respect to trade receivables is mitigated by credit evaluations we perform on our customers and by the diversification of our customer base. Collateral is not required for trade receivables. No customer represented more than 10% of our revenue for the three and nine months ended September 30, 2007 and September 30, 2006.

We outsource the production of our hardware to third-party manufacturing facilities. We rely on purchase orders or long-term contracts with our contract manufacturers. At September 30, 2007, we had no long-term contractual commitment with any manufacturer; however, we did have a 90 day commitment totaling \$4.9 million.

2. NET INCOME (LOSS) PER COMMON SHARE

Basic net income (loss) per common share is computed by dividing net income (loss) by the weighted average number of vested common shares outstanding during the period. Diluted net income (loss) per common share is computed by giving effect to all potential dilutive common shares, including options and common stock subject to repurchase.

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The following table sets forth the computation of income (loss) per share:

(in thousands, except per share data)	Three months ended September 30,		Nine months ended September 30,	
	2007	2006	2007	2006
Net income (loss)	\$ 2,768	\$ (3,097)	\$ 9,971	\$ (13,434)
Weighted average common shares outstanding - basic	69,069	19,034	67,397	14,705
Dilutive effect of employee stock plans	5,291	—	5,537	—
Weighted average common shares outstanding - diluted	74,360	19,034	72,934	14,705
Basic net income (loss) per share	\$ 0.04	\$ (0.16)	\$ 0.15	\$ (0.91)
Diluted net income (loss) per share	\$ 0.04	\$ (0.16)	\$ 0.14	\$ (0.91)

The following weighted average outstanding options, common stock subject to repurchase and convertible preferred stock were excluded from the computation of diluted net income (loss) per common share for the periods presented because including them would have had an antidilutive effect:

(in thousands)	Three months ended September 30,		Nine months ended September 30,	
	2007	2006	2007	2006
Options to purchase common stock	3,471	6,222	2,721	5,490
Common stock subject to repurchase	—	2,768	—	2,768
Convertible preferred stock and warrants (as converted basis)	—	35,193	—	37,546

3. CASH, CASH EQUIVALENTS, MARKETABLE SECURITIES AND RESTRICTED CASH

Cash, Cash Equivalents and Marketable Securities

Cash and cash equivalents consist primarily of highly liquid investments in time deposits held at major banks, commercial paper, United States government agency discount notes, money market mutual funds and other money market securities with remaining maturities at date of purchase of 90 days or less. The carrying value of cash and cash equivalents at September 30, 2007 and December 31, 2006 was approximately \$169.3 million and \$105.3 million, respectively, and the weighted average interest rates were 5.1% and 5.3%, respectively.

Marketable securities, which are classified as available for sale at September 30, 2007, are carried at fair value, with the unrealized gains and losses, net of tax, reported as a separate component of stockholders' equity. Marketable securities consist of commercial paper and certificates of deposit with original maturities of one year or less. As of September 30, 2007 and December 31, 2006, the amortized cost of marketable securities equals fair value.

Restricted Cash

Pursuant to certain lease agreements and as security for our merchant services agreement with our financial institution, we are required to maintain cash reserves, classified as restricted cash. Current restricted cash totaled \$141,000 at September 30, 2007 and \$121,000 at December 31, 2006, respectively. Long-term restricted cash totaled \$3.5 million and \$1.5 million at September 30, 2007 and December 31, 2006, respectively. Long-term restricted cash is included in other assets in the condensed consolidated balance sheets and consists primarily of \$3.0 million held as collateral for letters of credit for the security deposit on the leases of our corporate headquarters and is restricted until the end of the lease terms on August 30, 2010 and July 31, 2014.

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4. INVENTORY

Inventory consists primarily of hardware and related component parts and are stated at the lower of cost (on a first-in, first-out basis) or market. Inventory is comprised of the following:

<u>(in thousands)</u>	<u>September 30, 2007</u>	<u>December 31, 2006</u>
Raw materials	\$ 325	\$ 320
Finished goods	9,621	7,132
Total	<u>\$ 9,946</u>	<u>\$ 7,452</u>

5. FIXED ASSETS

Fixed assets are stated at the lower of cost or net realizable value. Depreciation is calculated using the straight-line method over the estimated useful lives of the respective assets, which is typically two to five years. Leasehold improvements are amortized using the straight-line method over the shorter of the lease term or estimated useful life of the asset. Repair and maintenance costs are expensed as incurred.

Fixed assets consisted of the following:

<u>(in thousands)</u>	<u>Estimated Useful Lives</u>	<u>September 30, 2007</u>	<u>December 31, 2006</u>
Computer hardware and equipment	3 years	\$ 8,580	\$ 5,467
Leasehold improvements	2-5 years	5,175	2,646
Furniture and fixtures	3 years	2,464	965
Software	2-5 years	1,983	1,411
Total fixed assets		18,202	10,489
Accumulated depreciation and amortization		(5,704)	(2,771)
Fixed assets, net		<u>\$ 12,498</u>	<u>\$ 7,718</u>

6. DEFERRED REVENUE

Deferred revenue consisted of the following:

<u>(in thousands)</u>	<u>September 30, 2007</u>	<u>December 31, 2006</u>
Product	\$ 2,290	\$ 2,895
Support and services	17,102	9,456
Ratable product and related support and services	3,110	4,486
Deferred revenue, current	22,502	16,837
Deferred revenue, non-current	5,182	2,245
Total deferred revenue	<u>\$ 27,684</u>	<u>\$ 19,082</u>

Deferred product revenue relates to arrangements where not all revenue recognition criteria have been met. Deferred support revenue represents customer payments made in advance for annual support contracts. Support contracts are typically billed on a per annum basis in advance and revenue is recognized ratably over the support period. Deferred ratable product and related support and services revenue consists of deferred revenue on transactions where VSOE of fair value of support had not been established and the entire arrangement is being recognized ratably over the support period.

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7. LEASE COMMITMENTS

We lease our facilities under non-cancelable operating lease agreements. Future minimum commitments for these operating leases in place as of September 30, 2007 with a remaining non-cancelable lease term in excess of one year are as follows:

<u>(in thousands)</u>	<u>September 30, 2007</u>
2007 (the three months ended December 31)	\$ 926
2008	4,894
2009	4,585
2010	4,692
2011 and thereafter	16,668
Total	<u>\$ 31,765</u>

The terms of certain lease agreements provide for rental payments on a graduated basis. We recognize rent expense on the straight-line basis over the lease period and have accrued for rent expense incurred but not paid. Rent expense under operating leases was \$1.5 million and \$3.5 million for the three and nine months ended September 30, 2007, respectively, and \$563,000 and \$1.4 million for the three and nine months ended September 30, 2006, respectively.

On September 26, 2006, we entered into an Agreement of Sublease, or Sublease, for new corporate headquarters, and on March 21, 2007 entered into another lease agreement to expand our corporate headquarters as well as extend the term of the existing Sublease mentioned above. The terms of the leases are from February 1, 2007 and March 31, 2007, respectively, to July 31, 2014. The aggregate minimum lease commitment for the combined leases is \$21.3 million and is included in the table above. We have entered into two letters of credit totaling \$3.0 million to serve as security deposits for the leases which is included in other assets in the condensed consolidated balance sheet. In addition, one of the leases requires an increase of approximately \$500,000 to the letter of credit in 2009.

On July 3, 2007, we entered into a lease agreement for office space in Sunnyvale, California. The term of the lease is for five years and seven months commencing on January 1, 2008. Early commencement may take place if we choose to occupy the space earlier at which time the term of the lease will be extended to include the period of time from occupation until January 1, 2008. The aggregate minimum lease commitment is \$4.7 million and is reflected in the table above. On July 2, 2007, we entered into a letter of credit in the amount \$500,000 to serve as the security deposit for the lease.

8. COMMON STOCK

In July 2002, our board of directors adopted the 2002 Stock Plan, or 2002 Plan. In September 2006, all shares of common stock available for grant under the 2002 Plan transferred to the 2006 Equity Incentive Plan, or 2006 Plan.

In April and May 2006, our board of directors approved the 2006 Plan, the Purchase Plan, and the 2006 Director Stock Option Plan, which became effective upon our IPO. The following number of shares are reserved under these plans as of September 30, 2007:

	<u>Shares</u>
2006 Equity Incentive Plan	6,309,014
2006 Employee Stock Purchase Plan	2,161,803
2006 Director Option Plan	750,000

Options issued under our stock option plans are generally for periods not to exceed 10 years and are issued at the fair value of the shares of common stock on the date of grant. Options typically vest either 25% of the shares one year after the options' vesting commencement date and the remainder ratably on a monthly basis over the following three years, or ratably on a monthly basis over four years. Options granted under the 2002 Plan prior to May 31, 2006 have a maximum term of ten years. Beginning May 31, 2006, options granted under the 2002 and 2006 Plans had a maximum term of seven years. Prior to March 28, 2006, employees in the United States had the right to exercise their options granted under the 2002 Plan prior to vesting. For options granted beginning March 28, 2006, optionees may only exercise vested shares. Any unvested stock issued under the 2002 Plan is subject to repurchase by us. Grants made pursuant to the 2006 Plan do not provide for the immediate exercise of options.

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The Purchase Plan became effective on September 20, 2006, the effective date of the registration statement relating to our IPO. Under the Purchase Plan, employees may purchase shares of common stock through payroll deductions at a price per share that is 85% of the lesser of the fair market value of our common stock as of the beginning of an applicable offering period or the applicable purchase date, with purchases generally every six months. Employees' payroll deductions may not exceed 15% of their compensation. Employees may purchase up to 2,000 shares per purchase period provided that the value of the shares purchased in any calendar year may not exceed \$25,000, as calculated pursuant to the Purchase Plan.

The following tables summarize information about stock options outstanding:

	Shares Available	Options Outstanding	Weighted Average Exercise Price Per Share
	(in thousands, except per share amounts)		
Balance, December 31, 2006	3,333	7,044	\$ 6.18
Additional options authorized	3,559	—	
Granted	(4,390)	4,390	\$ 35.56
Exercised	—	(1,265)	\$ 3.16
Repurchased	—	—	
Canceled	285	(285)	\$ 13.51
Balance, September 30, 2007	2,787	9,884	\$ 19.40

The range of exercise prices for options outstanding at September 30, 2007 was \$0.05 to \$48.50.

Range of Exercise Price	Options Outstanding as of September 30, 2007 (in thousands)	Weighted Average Remaining Contractual Life (in years)	Weighted Average Exercise Price Per Share	Aggregate Intrinsic Value (in thousands)
\$ 0.05 - \$ 0.60	869	7.51	\$ 0.39	
\$ 0.61 - \$ 5.75	1,575	8.12	\$ 3.43	
\$ 5.76 - \$16.72	2,554	6.08	\$ 6.64	
\$16.73 - \$34.12	3,297	6.45	\$ 30.46	
\$34.13 - \$48.50	1,589	6.76	\$ 43.21	
\$ 0.05 - \$48.50	9,884	6.76	\$ 19.40	\$ 212,707

The aggregate intrinsic value is calculated as the difference between the exercise price of the underlying stock option awards and the closing price of our common stock at September 28, 2007 (the last trading day of the quarter.) During the three and nine months ended September 30, 2007, the aggregate intrinsic value of stock option awards exercised was \$14.3 million and \$43.0 million, respectively, determined at the date of option exercise.

At September 30, 2007 and December 31, 2006, there were 1,375,707 and 2,372,000 shares, respectively, subject to repurchase under all common stock repurchase agreements. The cash received from the sale of these shares is initially recorded as a liability and is subsequently reclassified to common stock as the shares vest. At September 30, 2007 and December 31, 2006, there was \$418,000 and \$659,000, respectively, recorded in accrued liabilities and other long-term liabilities related to the issuance of these shares.

9. INCOME TAXES

For the three and nine months ended September 30, 2007 we generated operating profits. After applying our available net federal and state operating loss and tax credit carryforwards, our tax provision for the three and nine months ended September 30, 2007 consisted of federal, foreign and state provisions for income tax.

As of December 31, 2006, we recorded a full valuation allowance against our net deferred tax assets due to operating losses incurred since inception. Realization of deferred tax assets is dependent upon future earnings, if any, the

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timing and amount of which are uncertain. Accordingly, the net deferred tax assets were fully offset by a valuation allowance. If not utilized, the federal and state net operating loss and tax credit carryforwards will expire between 2013 and 2026. Utilization of these net operating losses and credit carryforwards may be subject to an annual limitation due to provisions of the Internal Revenue Code of 1986, as amended, that are applicable if we experience an "ownership change" that may occur, for example, by a change in significant shareholder allocation or equity structure.

For the three and nine months ended September 30, 2007, our tax provision includes a deferred tax benefit for the projected reduction in the valuation allowance as a result of forecasted taxable income and corresponding utilization of net operating losses and tax credit carryforwards. In determining future taxable income, we make assumptions to forecast federal, state and international operating income, the reversal of temporary differences, and the implementation of any feasible and prudent tax planning strategies. The assumptions require significant judgment regarding the forecasts of future taxable income, and are consistent with our forecasts used to manage our business. We intend to maintain the remaining valuation allowance until sufficient further positive evidence exists to support a reversal of, or decrease, in the valuation allowance.

We are subject to potential income tax audits on open tax years by any taxing jurisdiction for which we operate in. The taxing authorities of the most significant jurisdictions are the United States Internal Revenue Service and California Franchise Tax Board. Since all filed federal and California franchise tax returns have shown operating losses, we do not anticipate any material adjustments to the provisions relating to these returns. Currently, in accordance with the general rules of the respective tax jurisdictions, the tax years open for potential examination are 2004-2006 for federal and 2003-2006 for California.

10. SEGMENT INFORMATION

SFAS No. 131, *Disclosures about Segments of an Enterprise and Related Information*, establishes standards for reporting information about operating segments. Operating segments are defined as components of an enterprise about which separate financial information is available that is evaluated regularly by the chief operating decision maker, or decision making group, in deciding how to allocate resources and in assessing performance. Our chief operating decision maker is our Chief Executive Officer. Our Chief Executive Officer reviews financial information presented on a consolidated basis, accompanied by information about revenue by geographic region for purposes of allocating resources and evaluating financial performance. We have one business activity and there are no segment managers who are held accountable for operations, operating results and plans for levels or components below the consolidated unit level. Accordingly, we are considered to be in a single reporting segment and operating unit structure.

Revenue by geography is based on the billing address of the customer. The following table sets forth revenue and long-lived assets by geographic area.

Revenue

(in thousands)	Three months ended September 30,		Nine months ended September 30,	
	2007	2006	2007	2006
Domestic revenue	\$ 38,736	\$ 18,516	\$ 101,198	\$ 41,150
International revenue	24,574	6,102	58,898	15,232
Total revenue	<u>\$ 63,310</u>	<u>\$ 24,618</u>	<u>\$ 160,096</u>	<u>\$ 56,382</u>

Long-lived Assets

(in thousands)	September 30, 2007	December 31, 2006
Domestic long-lived assets	\$ 12,155	\$ 7,509
International long-lived assets	343	209
Total long-lived assets	<u>\$ 12,498</u>	<u>\$ 7,718</u>

11. LEGAL MATTERS

On October 9, 2007, Quantum Corporation served us with a lawsuit, filed in the United States District Court, Northern District of California, alleging patent infringement. Quantum seeks unspecified damages and injunctive relief. We believe that this action is without merit and we intend to vigorously defend against these claims. We currently are unable to estimate the possible loss or range of loss associated with this action.

From time to time, we may be involved in various legal proceedings arising in the ordinary course of business. There are no other matters at September 30, 2007 that, in the opinion of management, might have a material adverse effect on our financial position, results of operations or cash flows.

12. NEW ACCOUNTING PRONOUNCEMENTS

In September 2006, the FASB issued Statement No. 157, *Fair Value Measurements*, which defines fair value, establishes a framework for measuring fair value and expands fair value measurement disclosures. SFAS 157 is effective for fiscal years beginning after November 15, 2007. We are currently evaluating the impact of the pending adoption of SFAS 157 on our consolidated financial statements.

In February 2007, the FASB issued Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities, including an amendment of FASB Statement No. 115*, which allows an entity the irrevocable option to elect fair value for the initial and subsequent measurement for certain financial assets and liabilities under an instrument-by-instrument election. Subsequent measurements for the financial assets and liabilities an entity elects to fair value will be recognized in earnings. SFAS 159 also establishes additional disclosure requirements. SFAS 159 is effective for fiscal years beginning after November 15, 2007, with early adoption permitted provided that the entity also adopts SFAS 157. We are currently evaluating the impact of the adoption of SFAS 159 on our consolidated financial statements.

In June 2007, the FASB ratified EITF 07-3, *Accounting for Non-Refundable Advance Payments for Goods or Services Received for Use in Future Research and Development Activities*. EITF 07-3 requires that non-refundable advance payments for goods or services that will be used or rendered for future research and development activities be deferred and capitalized and recognized as an expense as the goods are delivered or the related services are performed. EITF 07-3 is effective, on a prospective basis, for fiscal years beginning after December 15, 2007. We are currently evaluating the impact of the pending adoption of EITF 07-3 on our consolidated financial statements.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

The following discussion and analysis of our financial condition and results of operations should be read in conjunction with the consolidated financial statements and related notes included elsewhere in this Form 10-Q. The information in this Form 10-Q contains forward-looking statements within the meaning of Section 27A of the Securities Act, and Section 21E of the Exchange Act. Such statements are based upon current expectations that involve risks and uncertainties. Any statements contained herein that are not statements of historical facts may be deemed to be forward-looking statements. For example, words such as "may," "will," "should," "estimates," "predicts," "potential," "continue," "strategy," "believes," "anticipates," "plans," "expects," "intends" and similar expressions are intended to identify forward-looking statements. Our actual results and the timing of certain events may differ significantly from the results discussed in the forward-looking statements. Factors that might cause or contribute to such a discrepancy include, but are not limited to, those discussed elsewhere in this Form 10-Q in the section titled "Risk Factors" and the risks discussed in our other SEC filings. We undertake no obligation to publicly release any revisions to the forward-looking statements after the date of this Form 10-Q.

Overview

We were founded in May 2002 by experienced industry leaders with a vision to improve the performance of wide-area distributed computing. Having significant experience in caching technology, our executive management team understood that existing approaches failed to address adequately all of the root causes of this poor performance. We determined that these performance problems could be best solved by simultaneously addressing inefficiencies in software applications and wide area networks, or WANs, as well as insufficient or unavailable bandwidth. This innovative approach served as the foundation of the development of our products. We began commercial shipments of our products in May 2004 and now offer twelve models of our Steelhead appliances as well as our Central Management Console and Interceptor.

In August 2007 we began selling our new Steelhead[®] Mobile product line, which includes a software client version of our Steelhead appliances, which delivers LAN-like application performance to any employee, whether on the road, working from home or connected wirelessly in the office. This product was not a significant portion of our revenue in the third quarter of 2007.

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We are headquartered in San Francisco, California. Our personnel are located throughout the United States and in numerous countries worldwide. We expect to continue to add personnel in the United States and internationally to provide additional geographic sales, research and development, general and administrative, and technical support coverage.

In September 2006, we completed our initial public offering, or IPO, of common stock in which we sold and issued 9,990,321 shares of our common stock, at an issue price of \$9.75 per share. We raised a total of \$97.4 million in gross proceeds from the IPO, or approximately \$87.4 million in net proceeds after deducting underwriting discounts and commissions of \$6.8 million and other offering costs of \$3.1 million. Upon the closing of the IPO, all shares of convertible preferred stock outstanding automatically converted into 39,441,439 shares of common stock.

In February 2007, we completed a follow-on public offering of common stock in which we sold and issued 2,854,671 shares of our common stock, including 250,000 shares sold by us pursuant to the underwriters' partial exercise of their over-allotment option, at an issue price of \$32.50 per share. As a result of the offering, we raised a total of \$92.8 million in gross proceeds, or approximately \$87.7 million in net proceeds after deducting underwriting discounts and commissions of \$4.2 million and other offering costs of \$0.9 million.

We believe that our current value proposition, which enables customers to improve the performance of their applications and access to their data across WANs, while also offering the ability to simplify IT infrastructure and realize significant capital and operations cost savings, should allow us to continue to grow our business. Our product revenue growth rate will depend significantly on continued growth in the wide-area data services, or WDS, market and our ability to continue to attract new customers in that market and generate additional sales from existing customers. Our growth in support and services revenue is dependent upon increasing the number of products under support contracts, which is dependent on both growing our installed base of customers and renewing existing support contracts. Our future profitability and rate of growth will be directly affected by the continued acceptance of our products in the marketplace, as well as the timing and size of orders, product mix, average selling prices and costs of our products and general economic conditions. Our ability to maintain profitability will also be affected by the extent to which we must incur additional expenses to expand our sales, marketing, development, and general and administrative capabilities to grow our business. The largest component of our expenses is personnel costs. Personnel costs consist of salaries, benefits and incentive compensation for our employees, including commissions for sales personnel and stock-based compensation. We expect that each of these expenses will continue to grow in absolute dollars and generally decrease as a percentage of revenue over time.

Revenue. We derive our revenue from sales of our products and support and services. Our revenue has grown rapidly since we began shipping products in May 2004, increasing from \$2.6 million for the year ended December 31, 2004 to \$160.1 million in the nine months ended September 30, 2007. As of September 30, 2007, our products had been sold to over 3,000 customers.

We sell our products directly through our sales force and indirectly through resellers. We derived 71% of our revenue through indirect channels in the nine months ended September 30, 2006 and 90% of our revenue through indirect channels in the nine months ended September 30, 2007. We expect revenue from resellers to continue to constitute a substantial majority of our future revenue.

Cost of Revenue. Cost of product revenue consists of the costs of the appliance hardware, manufacturing personnel, manufacturing, shipping and logistics costs, and expenses for inventory obsolescence and warranty obligations. We utilize third parties in jointly developing and manufacturing our Steelhead appliance hardware, embed our proprietary software and perform shipping logistics. Cost of support and service revenue is primarily comprised of the personnel costs of providing technical support and professional services. Cost of ratable product and related support and services consists of hardware, support and service costs related to transactions recognized ratably. As we expand internationally and into other sectors, we may incur additional costs to conform our products to comply with local laws or local product specifications. In addition, as we expand internationally, we will continue to hire additional technical support personnel to support our growing international customer base.

Gross Margin. Our gross margin has been and will continue to be affected by a variety of factors, including the mix and average selling prices of our products, support and services, new product introductions and enhancements, the cost of our appliance hardware, and the mix of distribution channels through which our products are sold.

Operating Expenses. Operating expenses consist of sales and marketing, research and development and general and administrative expenses. Personnel-related costs are the most significant component of each of these expense categories. We grew from 325 employees at December 31, 2006 to 551 employees at September 30, 2007. We expect to

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continue to hire significant numbers of new employees to support our anticipated growth. The timing of these additional hires has and could materially affect our operating expenses, both in absolute dollars and as a percentage of revenue, in any particular period.

Sales and marketing expenses represent the largest component of our operating expenses and include personnel costs, sales commissions, marketing programs and facilities costs. Marketing programs are intended to generate revenue from new and existing customers, and are expensed as incurred. We expect sales and marketing expenses to increase as we hire additional personnel and spend more on marketing programs with the intent to grow our revenue. The majority of our international personnel are engaged in sales, marketing and support activities. The percentage of sales and marketing expenses incurred internationally grew from 11% in 2004 to 28% in the nine months ended September 30, 2007.

Research and development expenses primarily include personnel costs and facilities costs. Quality assurance, infrastructure, depreciation and related costs of product quality efforts are also included. We expense research and development expenses as incurred. We are devoting substantial resources to the continued development of additional functionality for existing products and the development of new products. We intend to continue to invest significantly in our research and development efforts because we believe they are essential to maintaining our competitive position. Investments in research and development personnel costs are expected to increase in total dollars. Investments in research and development assets will affect our liquidity by increasing cash used in investing activities.

General and administrative expenses consist primarily of personnel costs related to our executive, finance, human resource, information technology and legal organizations, and fees for professional services. Professional services include outside legal, audit and information technology consulting costs.

Stock-Based Compensation Expense. Effective January 1, 2006, we began to measure and recognize compensation expense for all stock-based payments at fair value, in accordance with Statement of Financial Accounting Standard No. 123 (revised 2004), *Share-Based Payment*, or SFAS 123(R). Prior to the adoption of SFAS 123(R) we accounted for stock options under the intrinsic value method in accordance with Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees*, or APB 25. In the fourth quarter of 2006, we implemented the 2006 Employee Stock Purchase Plan, or Purchase Plan. Under the Purchase Plan, employees may purchase shares of common stock at a price per share that is 85% of the lesser of the fair market value of our common stock as of the beginning or the end of a purchase period. The Purchase Plan is compensatory and results in compensation expense to be accounted for under SFAS 123(R). We expect to continue to incur significant stock-based compensation expense.

Other Income (expense), net. Other income (expense), net primarily includes interest income on cash balances and marketable securities. Cash has historically been invested primarily in money market funds. In 2006, other income (expense), net included the impact of recording our outstanding preferred stock warrants at fair value. Subsequent to our IPO, we were no longer required to remeasure our warrants to fair value.

Critical Accounting Policies and Estimates

Our consolidated financial statements are prepared in accordance with United States generally accepted accounting principles, or GAAP. These accounting principles require us to make certain estimates and judgments that can affect the reported amounts of assets and liabilities as of the date of the consolidated financial statements, as well as the reported amounts of revenue and expenses during the periods presented. We believe that the estimates and judgments upon which we rely are reasonable based upon information available to us at the time that these estimates and judgments are made. To the extent there are material differences between these estimates and actual results, our consolidated financial statements could be adversely affected.

The accounting policies that reflect our more significant estimates and judgments and which we believe are the most critical to aid in fully understanding and evaluating our reported financial results include revenue recognition, stock-based compensation, inventory valuation and accounting for income taxes.

Revenue Recognition

Our software is integrated on appliance hardware and is essential to the functionality of the product. As a result, we account for revenue in accordance with Statement of Position, or SOP, 97-2, *Software Revenue Recognition*, as amended by SOP 98-9, *Modification of SOP 97-2, Software Revenue Recognition, With Respect to Certain Transactions*, for all transactions involving the sale of software. We recognize product revenue when all of the following have occurred: (1) we have entered into a legally binding arrangement with a customer; (2) delivery has occurred, which is when product title transfers to the customer; (3) customer payment is deemed fixed or determinable and free of contingencies and significant uncertainties; and (4) collection is probable.

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Product revenue consists of revenue from sales of our appliances. Product sales include a perpetual license to our software. Product revenue is generally recognized upon transfer of title at shipment, assuming all other revenue recognition criteria are met. Shipping charges billed to customers are included in product revenue and the related shipping costs are included in cost of product revenue. Product revenue on sales to resellers is recorded once we have received persuasive evidence of an end-user and all other revenue recognition criteria have been met.

Substantially all of our products have been sold in combination with product support services, which consist of software updates and support. Software updates provide customers with rights to unspecified software product upgrades and to maintenance releases and patches released during the term of the support period. Support includes internet access to technical content, telephone and internet access to technical support personnel and hardware support. Revenue for support services is recognized on a straight-line basis over the service contract term, which is typically one year.

We use the residual method to recognize revenue when a product agreement includes one or more elements to be delivered at a future date and vendor specific objective evidence, or VSOE, of the fair value of all undelivered elements exists. Through September 30, 2007, in virtually all of our contracts, the only element that remained undelivered at the time of delivery of the product was support and updates. Under the residual method, the fair value of the undelivered elements is deferred and the remaining portion of the contract fee is recognized as product revenue. If evidence of the fair value of one or more undelivered elements does not exist, all revenue is generally deferred and recognized when delivery of those elements occurs or when fair value can be established. When the undelivered element is support, revenue for the entire arrangement is bundled and recognized ratably over the support period. Revenue related to these arrangements is included in ratable product and related support and services revenue in the accompanying consolidated statements of operations. VSOE of fair value for elements of an arrangement is based upon the normal pricing and discounting practices for those services when sold separately, and for product support and updates, is additionally measured by the renewal rate offered to the customer. Prior to the third quarter of 2005, we had not established VSOE for the fair value of support contracts provided to our reseller class of customers. As such, prior to the third quarter of 2005, we recognized all revenue on transactions sold through resellers ratably over the term of the support contract, typically one year. Beginning in the third quarter of 2005, we determined that we had established VSOE of fair value of support for products sold to resellers, and began recognizing product revenue upon title transfer at shipment, provided the remaining criteria for revenue recognition had been met.

Our fees are typically considered to be fixed or determinable at the inception of an arrangement, generally based on specific products and quantities to be delivered. Substantially all of our contracts do not include rights of return or acceptance provisions. To the extent that our agreements contain such terms, we recognize revenue once the acceptance provisions or right of return lapses. Payment terms to customers generally range from net 30 to 60 days. In the event payment terms are provided that differ from our standard business practices, the fees are deemed to not be fixed or determinable and revenue is recognized when the payments become due, provided the remaining criteria for revenue recognition have been met.

We assess the ability to collect from our customers based on a number of factors, including credit worthiness of the customer and past transaction history of the customer. If the customer is not deemed credit worthy, we defer all revenue from the arrangement until payment is received and all other revenue recognition criteria have been met.

Stock-Based Compensation

Prior to January 1, 2006, we accounted for employee stock options using the intrinsic value method in accordance with Accounting Principles Board, or APB, Opinion No. 25, *Accounting for Stock Issued to Employees*, and Financial Accounting Standards Board Interpretation, or FIN, 44, *Accounting for Certain Transactions Involving Stock Compensation, an Interpretation of APB No. 25* and had adopted the disclosure only provisions of Statement of Financial Accounting Standards, or SFAS, No. 123, *Accounting for Stock-Based Compensation*, and SFAS No. 148, *Accounting for Stock-Based Compensation — Transition and Disclosure*, using the minimum value method.

In accordance with APB 25, stock-based compensation expense, which is a non-cash charge, resulted from stock option grants at exercise prices that, for financial reporting purposes, were deemed to be below the estimated fair value of the underlying common stock on the date of grant. We recorded deferred stock-based compensation relative to options accounted for under APB 25 of \$9.3 million and \$567,000 in the years ended December 31, 2005 and 2004, respectively, which is being amortized over the service period, which generally corresponds to the vesting period of the applicable options on a straight-line basis. During the three and nine months ended September 30, 2007, we amortized \$566,000 and \$1.7 million, respectively, of deferred compensation expense, net of reversals, related to these options, and in the three and nine months ended September 30, 2006, we amortized \$943,000 and \$2.3 million, respectively.

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Effective January 1, 2006, we adopted the fair value recognition provisions of SFAS 123(R), *Share-Based Payment*, using the modified prospective transition method, which requires us to apply the provisions of SFAS 123(R) to new awards granted, and to awards modified, repurchased or cancelled, after the effective date. Under this method, stock-based compensation expense recognized beginning January 1, 2006 is based on a combination of the following: (a) the grant-date fair value of stock option awards and employee stock purchase plan shares granted or modified after January 1, 2006; and (b) the amortization of deferred stock-based compensation related to stock option awards granted prior to January 1, 2006, which was calculated using the intrinsic value method as previously permitted under APB 25.

Under SFAS 123(R), we estimated the fair value of stock options granted using a Black-Scholes option-pricing formula and a single option award approach. This model utilizes the estimated fair value of common stock and requires that, at the date of grant, we use the expected term of the option, the expected volatility of the price of our common stock, risk free interest rates and expected dividend yield of our common stock. This fair value is then amortized on a straight-line basis over the requisite service periods of the awards, which is generally the vesting period. Options typically vest either 25% of the shares one year after the options' vesting commencement date and the remainder ratably on a monthly basis over the following three years, or ratably on a monthly basis over four years. On September 20, 2006, we implemented our Purchase Plan. Shares granted under the Purchase Plan typically vest over two years, and include two purchase dates per year.

The fair value of options granted and Purchase Plan shares were estimated at the date of grant using the following assumptions:

	Three months ended September 30,		Nine months ended September 30,	
	2007	2006	2007	2006
Employee and Director Stock Options				
Expected life in years	4.5	4.5	4.5	4.5-6.1
Risk-free interest rate	4.2%	4.6%	4.2%-4.9%	4.6%-5.1%
Volatility	57%	65%	57%-62%	65%-81%
Weighted average fair value of grants	\$20.02-\$24.40	\$4.66-\$9.35	\$14.03-\$24.40	\$3.67-\$9.35
Purchase Plan (1)				
Expected life in years			0.5-2.0	
Risk-free interest rate			4.9%-5.0%	
Volatility			38%-46%	
Weighted average fair value of grants			\$30.99-\$36.42	

(1) There were no Purchase Plan shares granted in the three months ended September 30, 2007.

The expected term represents the period that stock-based awards are expected to be outstanding, giving consideration to the contractual terms of the stock-based awards, vesting schedules and expectations of future employee behavior as influenced by changes to the terms of our stock-based awards. For the three and nine months ended September 30, 2007, we have elected to use the simplified method of determining the expected term as permitted by SEC Staff Accounting Bulletin 107. The computation of expected volatility for the three and nine months ended September 30, 2007, is based on the historical volatility of comparable companies from a representative peer group selected based on industry and market capitalization data. As required by SFAS 123(R), we estimate expected forfeitures and recognize compensation costs only for those equity awards expected to vest.

As of September 30, 2007, the total compensation cost related to stock-based awards granted under SFAS 123(R) to employees and directors but not yet recognized was approximately \$88.7 million, net of estimated forfeitures of \$4.3 million. This cost will be amortized on a straight-line basis over the vesting period, which is typically 4 years. Amortization in the three and nine months ended September 30, 2007 was \$5.8 million and \$12.0 million, respectively, and was \$1.1 million and \$2.1 million in the three and nine months ended September 30, 2006, respectively.

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As of September 30, 2007, there was \$12.4 million left to be amortized under our Purchase Plan, which will be amortized over the remaining Purchase Plan offering period, which is between 11 to 19 months. Amortization in the three and nine months ended September 30, 2007 was \$3.0 million and \$8.5 million, respectively. There was no amortization in the nine months ended September 30, 2006 as the plan was not yet implemented.

Inventory Valuation

Inventory consists of hardware and related component parts and are stated at the lower of cost (on a first-in, first-out basis) or market. A portion of our inventory relates to evaluation units located at customer locations as some of our customers test our equipment prior to purchasing. Inventory that is obsolete or in excess of our forecasted consumption is written down to estimated realizable value based on historical usage, expected demand and evaluation unit conversion rate and age. Inherent in our estimates of market value in determining inventory valuation are estimates related to economic trends, future demand for our products and technological obsolescence of our products. If future demand or market conditions are less favorable than our projections, additional inventory write-downs could be required and would be reflected in cost of product in the period the revision is made. Inventory write-downs are reflected as cost of product and amounted to approximately \$135,000 and \$935,000 for the three and nine months ended September 30, 2007, respectively, and \$491,000 and \$1.1 million for the three and nine months ended September 30, 2006, respectively.

Accounting for Income Taxes

We use the asset and liability method of accounting for income taxes in accordance with SFAS 109, *Accounting for Income Taxes*. Under this method, income tax expenses or benefits are recognized for the amount of taxes payable or refundable for the current year and for deferred tax liabilities and assets for the future tax consequences of events that have been recognized in our consolidated financial statements or tax returns. The measurement of current and deferred tax assets and liabilities are based on provisions of currently enacted tax laws. The effects of future changes in tax laws or rates are not contemplated.

As part of the process of preparing consolidated financial statements, we are required to estimate our income taxes and tax contingencies in each of the tax jurisdictions in which we operate prior to the completion and filing of tax returns for such periods. This process involves estimating actual current tax expense together with assessing temporary differences in the treatment of items for tax purposes versus financial accounting purposes that may create net deferred tax assets and liabilities.

We record a valuation allowance to reduce our deferred tax assets to the amount we believe is more likely than not to be realized. In assessing the need for a valuation allowance, we have considered our historical levels of income, expectations of future taxable income and on-going tax planning strategies. Because of the uncertainty of the realization of the deferred tax assets, we have recorded a full valuation allowance against our deferred tax assets. Realization of our deferred tax assets is dependent primarily upon future U.S. taxable income. Based on our forecast of earnings and our continual assessment regarding the realizability of our deferred tax assets, we may release some portion or all our of valuation allowance in future periods. Such release could have a significant impact on our effective tax rate.

We adopted the provisions of FIN 48 on January 1, 2007. The application of this Interpretation requires a two-step process that separates recognition from measurement. We recorded no increases or decreases to the tax reserves for uncertain tax positions upon implementing FIN 48 and this assessment has not changed as of September 30, 2007. We have elected to record interest and penalties recognized in accordance with FIN 48 in the financial statements as income taxes. Any subsequent change in classification of FIN 48 interest and penalties will be treated as a change in accounting principle subject to the requirements of SFAS 154, *Accounting Changes and Error Corrections*.

Results of Operations

Revenue

We derive our revenue from sales of our appliances and product support and services. We began shipping our products in May 2004.

Product revenue primarily consists of revenue from sales of our Steelhead appliances and is typically recognized upon shipment. Support and services revenue includes unspecified software license updates and product support. Support revenue is recognized ratably over the contractual period, which is typically one year.

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Service revenue includes professional services and training, which to date has not been significant, and is recognized as the services are performed. Ratable product and related support and services revenue includes revenue from arrangements in which product and support are bundled and no VSOE of fair value for support pricing in the arrangements exists. The total revenue from these arrangements is recognized ratably over the support period, typically one year.

(dollars in thousands)	Three months ended September 30,		Nine months ended September 30,	
	2007	2006	2007	2006
Total Revenue by Type:				
Product	\$ 50,847	\$ 19,303	\$ 127,876	\$ 44,169
Support and services	10,460	3,595	25,772	7,385
Ratable product and related support and services	2,003	1,720	6,448	4,828
Total Revenue:	\$ 63,310	\$ 24,618	\$ 160,096	\$ 56,382
% Revenue by Type:				
Product	80%	78%	80%	78%
Support and services	17%	15%	16%	13%
Ratable product and related support and services	3%	7%	4%	9%
Total Revenue by Geography:				
Domestic	38,736	18,516	101,198	41,150
International	24,574	6,102	58,898	15,232
% Revenue by Geography:				
Domestic	61%	75%	63%	73%
International	39%	25%	37%	27%
Total Revenue by Sales Channel:				
Direct	7,516	8,088	16,795	16,611
Indirect	55,794	16,530	143,301	39,771
% Revenue by Sales Channel:				
Direct	12%	33%	10%	29%
Indirect	88%	67%	90%	71%

Quarter Ended September 30, 2007 Compared to the Quarter Ended September 30, 2006: Product revenue increased in the three months ended September 30, 2007 as compared to the three months ended September 30, 2006 due primarily to an increase in new customers and additional purchases by existing customers. As of September 30, 2007, our products had been sold to over 3,000 customers, compared to over 1,300 customers as of September 30, 2006. We believe the market for our products has grown due to increasingly distributed organizations, which increases dependence on timely access to data and applications.

Substantially all of our customers purchase support when they purchase our products. The increase in support and services revenue on an absolute basis and as a percentage of total revenues is a result of increased product and first year support sales combined with the renewal of support contracts by existing customers. As our customer base grows, we expect the proportion of revenue generated from support and services to increase over time.

In the three months ended September 30, 2007, we derived 88% of our revenue from indirect channels compared to 67% in the three months ended September 30, 2006. This increase in indirect channel revenue is due to our increased focus on expanding our indirect channel sales. We expect indirect channel revenue to continue to be a significant portion of our revenue.

We generated 39% of our revenue in the three months ended September 30, 2007 compared to 25% in the three months ended September 30, 2006 from international locations. We continue to expand into international locations and introduce our products in new markets and expect international revenue to increase in absolute dollars.

Nine Months Ended September 30, 2007 Compared to the Nine Months Ended September 30, 2006: Product revenue increased in the nine months ended September 30, 2007 due primarily to an increase in new customers and additional purchases by existing customers.

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Support and services revenue increased in the nine months ended September 30, 2007 in line with the significant increase in product revenue and the renewal of support contracts for existing customers.

Cost of Revenue and Gross Margin

Cost of product revenue consists of the costs of appliance hardware, manufacturing, shipping and logistics costs and expenses for inventory obsolescence and warranty obligations. Cost of support and service revenue consists of salary and related costs of technical support personnel. Cost of ratable product and related support and services consists of hardware, support and service costs related to transactions recognized ratably.

(dollars in thousands)	Three months ended September 30,		Nine months ended September 30,	
	2007	2006	2007	2006
Revenue:				
Product	\$ 50,847	\$ 19,303	\$ 127,876	\$ 44,169
Support and services	10,460	3,595	25,772	7,385
Ratable product and related support and services	2,003	1,720	6,448	4,828
Total revenue	<u>63,310</u>	<u>24,618</u>	<u>160,096</u>	<u>56,382</u>
Cost of revenue:				
Cost of product	13,533	6,211	35,542	14,576
Cost of support and services	3,994	1,304	9,697	2,851
Cost of ratable product and related support and services	613	390	1,813	1,446
Total cost of revenue	<u>18,140</u>	<u>7,905</u>	<u>47,052</u>	<u>18,873</u>
Gross profit	<u>\$ 45,170</u>	<u>\$ 16,713</u>	<u>\$ 113,044</u>	<u>\$ 37,509</u>
Gross margin for product	73%	68%	72%	67%
Gross margin for support and services	62%	64%	62%	61%
Gross margin for ratable product and related support and services	69%	77%	72%	70%
Total gross margin	71%	68%	71%	67%

Quarter Ended September 30, 2007 Compared to the Quarter Ended September 30, 2006: The increase in cost of product revenue was due primarily to increased hardware costs associated with higher revenue. Cost of support and services revenue increased as we added more technical support headcount domestically and abroad to support our growing customer base. Technical support and services headcount was 60 employees as of September 30, 2007 compared to 28 employees as of September 30, 2006.

Gross margins increased to 71% in the three months ended September 30, 2007 from 68% in the three months ended September 30, 2006 primarily due to higher margins on product revenue as a result of lower unit product costs that were partially offset by lower gross margins on support and services as a result of investing in technical support headcount in order to provide support to our growing customer base.

Nine Months Ended September 30, 2007 Compared to the Nine Months Ended September 30, 2006: The increase in the cost of product revenue was primarily due to increased hardware costs associated with higher revenue. The increase in cost of support and services revenue was due to increased personnel related costs as a result of increased headcount.

Gross margins increased to 71% in the nine months ended September 30, 2007 from 67% in the nine months ended September 30, 2006 primarily due to higher margins on product revenue primarily as a result of lower unit product costs.

Sales and Marketing Expenses

Sales and marketing expenses primarily include personnel costs, sales commissions, marketing programs and facilities costs.

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(dollars in thousands)	Three months ended September 30,		Nine months ended September 30,	
	2007	2006	2007	2006
Sales and marketing expenses	\$ 25,139	\$ 12,181	\$ 63,035	\$ 31,768
Percent of total revenue	40%	49%	39%	56%

Quarter Ended September 30, 2007 Compared to the Quarter Ended September 30, 2006: The increase in sales and marketing expenses was primarily due to an increase in the number of sales and marketing employees, as sales and marketing headcount grew to 250 employees as of September 30, 2007 from 138 employees as of September 30, 2006. The increase in employees resulted in higher salary expense, employee related benefits and fees for recruitment of new employees. Additionally, commission expense increased in the three months ended September 30, 2007 as compared to the three months ended September 30, 2006 due to the substantial increase in revenue. Salaries, bonuses and commissions accounted for \$4.9 million, marketing related activities accounted for \$1.2 million, facilities and information technology expenses attributable to sales and marketing accounted for \$1.3 million, and travel and entertainment expenses accounted for \$964,000 of the \$13.0 million increase in sales and marketing expenses. Stock-based compensation, which was \$4.5 million in the three months ended September 30, 2007 compared to \$1.1 million in the three months ended September 30, 2006, accounted for approximately \$3.4 million of the increase in sales and marketing expenses.

We plan to continue to make significant investments in sales and marketing with the intent to add new customers and increase penetration within our existing customer base by increasing the number of sales personnel worldwide, expanding our domestic and international sales and marketing activities, building brand awareness and sponsoring additional marketing events. We expect future sales and marketing expenses to continue to increase and continue to be our most significant operating expense. Generally sales personnel are not immediately productive and sales and marketing expenses do not immediately result in revenue. Hiring additional sales personnel reduces short-term operating margins until the sales personnel become productive and generate revenue. Accordingly, the timing of sales personnel hiring and the rate at which they become productive will affect our future performance.

Nine Months Ended September 30, 2007 Compared to the Nine Months Ended September 30, 2006: The increase in sales and marketing expenses was primarily due to an increase in the number of sales and marketing employees. The increase in employees resulted in higher salary expense, employee related benefits and fees for recruitment of new employees. Additionally, commission expense increased in the nine months ended September 30, 2007 as compared to the nine months ended September 30, 2006 due to the substantial increase in revenue. Salaries, bonuses and commissions accounted for \$11.1 million, marketing related activities accounted for \$3.1 million, facilities and information technology expenses attributable to sales and marketing accounted for \$3.2 million, and travel and entertainment expenses accounted for \$2.2 million of the \$31.3 million increase in sales and marketing expenses. Stock-based compensation, which was \$10.7 million in the nine months ended September 30, 2007 compared to \$2.2 million in the nine months ended September 30, 2006, accounted for approximately \$8.5 million of the increase in sales and marketing expenses.

Research and Development Expenses

Research and development expenses primarily consist of personnel costs and facilities costs. We expense research and development expenses as incurred.

(dollars in thousands)	Three months ended September 30,		Nine months ended September 30,	
	2007	2006	2007	2006
Research and development expenses	\$ 10,890	\$ 4,930	\$ 27,384	\$ 12,712
Percent of total revenue	17%	20%	17%	23%

Quarter Ended September 30, 2007 Compared to the Quarter Ended September 30, 2006: Research and development expenses increased in the three months ended September 30, 2007 compared to the three months ended September 30, 2006 due to an increase in personnel and facility-related costs as a result of research and development headcount increasing to 168 employees as of September 30, 2007 from 108 employees as of September 30, 2006. Salaries and bonuses accounted for \$1.8 million and facilities and information technology expenses accounted for \$1.3 million of the \$6.0 million increase in research and development expenses. Stock-based compensation, which was \$2.5 million in the three months ended September 30, 2007 compared to \$551,000 in the three months ended September 30, 2006,

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accounted for \$2.0 million of the increase in research and development expenses. We plan to continue to invest in research and development as we develop new products and make further enhancements to existing models.

Nine Months Ended September 30, 2007 Compared to the Nine Months Ended September 30, 2006: Research and development expenses increased in the nine months ended September 30, 2007 compared to the nine months ended September 30, 2006 due to an increase in personnel and facility-related costs. Salaries and bonuses accounted for \$4.0 million and facilities and information technology expenses accounted for \$3.7 million of the \$14.7 million increase in research and development expenses. Stock-based compensation, which was \$6.0 million in the nine months ended September 30, 2007 compared to \$1.2 million in the nine months ended September 30, 2006, accounted for \$4.8 million of the increase in research and development expenses.

General and Administrative Expenses

General and administrative expenses consist primarily of compensation for personnel and facilities costs related to our executive, finance, human resources, information technology and legal organizations, and fees for professional services. Professional services include legal, audit and information technology consulting costs.

(dollars in thousands)	Three months ended September 30,		Nine months ended September 30,	
	2007	2006	2007	2006
General and administrative expenses	\$ 7,177	\$ 2,347	\$ 16,814	\$ 6,014
Percent of total revenue	11%	10%	11%	11%

Quarter Ended September 30, 2007 Compared to the Quarter Ended September 30, 2006: The increase in general and administrative expenses for the three months ended September 30, 2007 compared to the three months ended September 30, 2006 is due to an increase in personnel costs, primarily as a result of headcount increasing to 69 employees as of September 30, 2007 from 29 employees as of September 30, 2006, and an increase in professional services fees. Salaries and bonuses accounted for \$700,000 and professional service fees accounted for approximately \$1.9 million of the \$4.8 million increase in general and administrative expenses. Professional service fees increased due to increased Sarbanes-Oxley compliance fees, contract labor, information technology consulting fees and audit fees. Stock-based compensation, which was \$1.6 million in the three months ended September 30, 2007 compared to \$381,000 in the three months ended September 30, 2006, accounted for approximately \$1.2 million of the increase in general and administrative expenses.

Nine Months Ended September 30, 2007 Compared to the Nine Months Ended September 30, 2006: The increase in general and administrative expenses for the nine months ended September 30, 2007 compared to the nine months ended September 30, 2006 is due to an increase in personnel costs and an increase in professional services fees. Salaries and bonuses accounted for \$1.7 million and professional service fees accounted for approximately \$4.4 million of the \$10.8 million increase in general and administrative expenses. Professional service fees increased due to increased Sarbanes-Oxley compliance fees, contract labor, information technology consulting fees and audit fees. Stock-based compensation, which was \$3.6 million in the nine months ended September 30, 2007 compared to \$867,000 in the nine months ended September 30, 2006, accounted for approximately \$2.7 million of the increase in general and administrative expenses.

Other Income (Expense), Net

Other income (expense), net consists primarily of interest income, interest expense, and foreign currency exchange gains (losses).

(dollars in thousands)	Three months ended September 30,		Nine months ended September 30,	
	2007	2006	2007	2006
Interest income	\$ 2,866	\$ 275	\$ 7,293	\$ 701
Interest expense	—	(63)	—	(207)
Other	(112)	(487)	(265)	(788)
Total other income (expense), net	\$ 2,754	\$ (275)	\$ 7,028	\$ (294)

Quarter Ended September 30, 2007 Compared to the Quarter Ended September 30, 2006: Other income (expense), net, increased in the three months ended September 30, 2007 primarily due to interest income on higher cash balances. In September 2006, we received net IPO proceeds of \$87.4 million and in February 2007, we received net follow-on public offering proceeds of \$87.7 million. We did not have interest expense in the third quarter of 2007, as we paid off the balance of our credit facility on October 2, 2006.

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Nine Months Ended September 30, 2007 Compared to the Nine Months Ended September 30, 2006: Other income (expense), net, increased in the nine months ended September 30, 2007 primarily due to interest income on higher cash balances. We did not have interest expense in the first three quarters of 2007, as we paid off the balance of our credit facility on October 2, 2006. Other expense decreased due to recording our preferred stock warrants to fair value in 2006 and no such adjustment was required in 2007. In the nine months ended September 30, 2006 we recognized a \$644,000 charge to record our preferred stock warrants at fair value of warrant expense. Subsequent to our IPO, we were no longer required to record the warrants to fair value. Other expense in the nine months ended September 30, 2007 consists of foreign currency losses.

Provision for Income Taxes

Prior to the first quarter of 2007, we had incurred operating losses and, accordingly, had not recorded a provision for income taxes for any of the periods presented other than foreign provisions for income tax. For the three and nine months ended September 30, 2007, we generated operating profits. After applying our available net operating loss and tax credit carryforwards and considering our remaining valuation allowance, our tax provision accrued for the three and nine months ended September 30, 2007 consists of federal, foreign and state provisions for income tax.

As of December 31, 2006, we recorded a valuation allowance against our net deferred tax assets due to operating losses incurred since inception. Realization of deferred tax assets is dependent upon future earnings, if any, the timing and amount of which are uncertain. Accordingly, the net deferred tax assets were fully offset by a valuation allowance. If not utilized, the federal and state net operating loss and tax credit carryforwards will expire between 2013 and 2026. Utilization of these net operating losses and credit carryforwards may be subject to an annual limitation due to provisions of the Internal Revenue Code of 1986, as amended, that are applicable if we experience an "ownership change" that may occur, for example, by a change in significant shareholder allocation or equity structure.

For the three and nine months ended September 30, 2007, our tax provision includes a deferred tax benefit for the projected reduction in the valuation allowance as a result of forecasted taxable income and corresponding utilization of net operation losses and tax credit carryforwards. In determining future taxable income, we make assumptions to forecast federal, state and international operating income, the reversal of temporary differences, and the implementation of any feasible and prudent tax planning strategies. The assumptions require significant judgment regarding the forecasts of future taxable income, and are consistent with our forecasts used to manage our business. We intend to maintain the remaining valuation allowance until sufficient further positive evidence exists to support a reversal of, or decrease, in the valuation allowance.

If our recent trend of profitability continues, we may determine that there is sufficient positive evidence to support a reversal of, or decrease in, the valuation allowance. If we were to reverse all or some part of our valuation allowance and recognize all or some part of our deferred tax assets, our financial statements in the period of reversal would reflect an increase in assets on our balance sheet and a corresponding tax benefit to our statement of operations in the amount of the reversal.

Our effective tax rate for 2007 has fluctuated on a quarterly basis and could continue to fluctuate in the fourth quarter of 2007. Our effective tax rate is and can be affected by such items as disqualifying dispositions of stock from the Purchase Plan and incentive stock options, by changes in the valuation of our deferred tax assets or liabilities, changes in actual results versus our estimates, or by changes in tax laws, regulations, accounting principles, or interpretations thereof. In addition, we are subject to potential income tax audits on open tax years by any taxing jurisdiction for which we operate in. The taxing authorities of the most significant jurisdictions are the United States Internal Revenue Service and California Franchise Tax Board. Since all filed federal and California franchise tax returns have shown operating losses, we do not anticipate any material adjustments to the provisions relating to these returns. Currently, in accordance with the general rules of the respective tax jurisdictions, the tax years open for potential examination are 2004-2006 for federal and 2003-2006 for California.

Liquidity and Capital Resources

<u>(in thousands)</u>	<u>As of September 30, 2007</u>	<u>As of December 31, 2006</u>
Working capital	\$ 223,474	\$ 101,319
Cash and cash equivalents	169,345	105,330
Marketable securities	62,192	3,999

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(in thousands)	Nine months ended September 30,	
	2007	2006
Cash provided by (used in) operating activities	\$ 35,125	\$ (3,635)
Cash used in investing activities	(65,959)	(5,090)
Cash provided by financing activities	94,775	106,556

Cash and Cash Equivalents

Cash and cash equivalents consist of highly liquid investments in time deposits held at major banks, commercial paper, United States government agency discount notes, money market mutual funds and other money market securities with maturities at the date of purchase of 90 days or less.

Pursuant to certain lease agreements and as security for our merchant services agreement with our financial institution, we are required to maintain cash reserves, classified as restricted cash. Current restricted cash totaled \$141,000 at September 30, 2007 and \$121,000 at December 31, 2006, and long-term restricted cash totaled \$3.5 million and \$1.5 million at September 30, 2007 and December 31, 2006, respectively. Long-term restricted cash is included in other assets in the condensed consolidated balance sheets and consists primarily of \$3.0 million held as collateral for letters of credit for the security deposit on the leases of our corporate headquarters and is restricted until the end of the lease terms on August 30, 2010 and July 31, 2014.

Cash Flows from Operating Activities

Our largest source of operating cash flows is cash collections from our customers. Our primary uses of cash from operating activities are for personnel related expenditures, product costs, outside services, rent payments and capital investments in technology costs. Our cash flows from operating activities will continue to be affected principally by the extent to which we grow our revenue and spend on hiring personnel in order to grow our business. The timing of hiring sales personnel in particular affects cash flows as there is a lag between the hiring of sales personnel and the generation of revenue and cash flows from sales personnel.

Cash provided by operating activities was \$35.1 million in the nine months ended September 30, 2007 compared to cash used in operations of \$3.6 million in the nine months ended September 30, 2006 primarily due to increased profitability. In the first nine months of 2006, we experienced negative cash flows from operations as we continued to expand our business and build our infrastructure domestically and internationally.

Since the fourth quarter of 2004, we have expanded our operations internationally. Our sales contracts are typically denominated in United States dollars and as such, the increase in our revenue derived from international customers has not affected our cash flows from operations. As we fund our international operations, our cash and cash equivalents are affected by changes in exchange rates. To date, the foreign currency effect on our cash and cash equivalents has not been material.

Cash Flows from Investing Activities

Cash flows used in investing activities primarily relate to investments in marketable securities and capital expenditures to support our growth.

Cash used in investing activities increased in the nine months ended September 30, 2007 compared to the nine months ended September 30, 2006 due to purchases of marketable securities. Additionally, capital expenditures increased in the first nine months of 2007 compared to 2006 primarily resulting from leasehold improvement additions associated with our new corporate headquarters. Restricted cash outlays increased in the first nine months of 2007 due to the cash collateralized \$1.6 million letter of credit required for the new corporate headquarters.

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Cash Flows from Financing Activities

Prior to September 2006, we financed our operations primarily through private sales of convertible preferred stock totaling \$56.3 million and collections from customers and, to a lesser extent, borrowings under our credit facility. In February 2006, we sold 3,738,318 shares of our Series D convertible preferred stock for net proceeds of \$19.9 million. In September 2006, we completed our IPO and received net proceeds of \$87.4 million. In February 2007, we completed a follow-on public offering of our common stock and received net proceeds of \$87.7 million.

On June 7, 2004, we entered into a loan and security agreement with a financial institution for a \$2.5 million credit facility, and we borrowed \$1.4 million and \$1.1 million in 2004 and 2005, respectively. We made principal payments of \$625,000 in the first six months of 2006 and repaid the remaining balance on our loan on October 2, 2006.

We believe that our net proceeds from operations, together with our cash balance at September 30, 2007, will be sufficient to fund our projected operating requirements for at least the next 12 months. Our future capital requirements will depend on many factors, including our rate of revenue growth, the expansion of our sales and marketing activities, the timing and extent of expansion into new territories, the timing of introductions of new products and enhancements to existing products, and the continuing market acceptance of our products. We may enter into arrangements for potential investments in, or acquisitions of, complementary businesses, services or technologies, which also could require us to seek additional equity or debt financing. Additional funds may not be available on terms favorable to us or at all.

Contractual Obligations

The following is a summary of our contractual obligations as of September 30, 2007:

	<u>Total</u>	<u>Remaining three months of 2007</u>	<u>2008</u>	<u>2009</u>	<u>2010</u>	<u>2011 and beyond</u>
			(in thousands)			
Contractual Obligations						
Operating leases	\$31,765	\$ 926	\$4,894	\$4,585	\$4,692	\$16,668
Purchase obligations (1)(2)	<u>5,543</u>	<u>4,927</u>	<u>293</u>	<u>323</u>	<u>—</u>	<u>—</u>
Total contractual obligations	<u>\$37,308</u>	<u>\$ 5,853</u>	<u>\$5,187</u>	<u>\$4,908</u>	<u>\$4,692</u>	<u>\$16,668</u>

- (1) Represents amounts associated with agreements that are enforceable, legally binding and specify terms, including: fixed or minimum quantities to be purchased; fixed, minimum or variable price provisions; and the approximate timing of payment. Obligations under contracts that we can cancel without a significant penalty are not included in the table above.
- (2) Purchase obligations in the remaining three months of 2007 primarily consist of obligations under a contract manufacturing agreement.

Off-Balance Sheet Arrangements

At September 30, 2007 and December 31, 2006, we did not have any relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance or special purpose entities, which would have been established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes, nor did we have any undisclosed material transactions or commitments involving related persons or entities.

Other

At September 30, 2007 and December 31, 2006, we did not have commercial commitments under lines of credit, standby repurchase obligations or other such debt arrangements.

Recent Accounting Pronouncements

See Note 12 of "Notes to Consolidated Financial Statements" for recent accounting pronouncements that could have an effect on us.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

Foreign Currency Risk

Our sales contracts are denominated in United States dollars and therefore our revenue is not subject to foreign currency risk. Our operating expenses and cash flows are subject to fluctuations due to changes in foreign currency exchange rates, particularly changes in the British pound, Euro and Singapore dollar. To date, we have not entered into any hedging contracts since exchange rate fluctuations have had little impact on our operating results and cash flows.

Interest Rate Sensitivity

We had unrestricted cash and cash equivalents totaling \$169.3 million and \$105.3 million at September 30, 2007 and December 31, 2006, respectively. These amounts were invested primarily in money market funds. The unrestricted cash and cash equivalents are held for working capital purposes. We do not enter into investments for trading or speculative purposes. We believe that we do not have any material exposure to changes in the fair value as a result of changes in interest rates. Declines in interest rates, however, will reduce future investment income. If overall interest rates had fallen by 10% in 2007, our interest income would have declined approximately \$566,000 assuming consistent investment levels.

Item 4. Controls and Procedures

We evaluated the effectiveness of the design and operation of our disclosure controls and procedures as of September 30, 2007, the end of the period covered by this report on Form 10-Q. This evaluation (the controls evaluation) was done under the supervision and with the participation of our management, including our Chief Executive Officer (CEO) and Chief Financial Officer (CFO).

Disclosure controls and procedures means controls and other procedures that are designed to provide reasonable assurance that information required to be disclosed in the reports that we file or submit under the Exchange Act, such as this report on Form 10-Q, is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed such that information is accumulated and communicated to our management, including the CEO and CFO, as appropriate to allow timely decisions regarding required disclosure.

Based upon the controls evaluation, our CEO and CFO have concluded that as of September 30, 2007, our disclosure controls and procedures were effective to provide reasonable assurance that information required to be disclosed in our Exchange Act reports is recorded, processed, summarized and reported within the time periods specified by the SEC and to ensure that material information relating to the Company and our consolidated subsidiaries is made known to management, including the CEO and CFO.

There were no changes in our internal control over financial reporting that occurred during the third quarter of 2007 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting. Internal control over financial reporting means a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles.

We are required to comply with Section 404 of the Sarbanes-Oxley Act of 2002 by our fiscal year ending December 31, 2007. The notification of such compliance is due no later than the time we file our annual report for the fiscal year ending December 31, 2007. We believe we will have adequate resources and expertise, both internal and external, in place to meet this requirement. However, there is no guarantee that our efforts will result in a management assurance, or an attestation by the independent auditors, that internal controls over financial reporting were adequate in their design and/or operation.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

We are subject to various claims, complaints and legal actions in the normal course of business from time to time, including the Quantum lawsuit discussed separately in this Form 10-Q. There can be no assurance that existing or future legal proceedings arising in the ordinary course of business or otherwise will not have a material adverse effect on our business, consolidated financial position, results of operations or cash flow.

Item 1A. Risk Factors

Set forth below and elsewhere in this quarterly report on Form 10-Q, and in other documents we file with the SEC, are risks and uncertainties that could cause actual results to differ materially from the results contemplated by the forward-looking statements contained in this quarterly report on Form 10-Q. Because of the following factors, as well as other variables affecting our operating results, past financial performance should not be considered as a reliable indicator of future performance and investors should not use historical trends to anticipate results or trends in future periods.

Risks Related to Our Business and Industry

We compete in new and rapidly evolving markets and have a limited operating history, which make it difficult to predict our future operating results.

We were incorporated in May 2002 and shipped our first Steelhead appliance in May 2004. We have a limited operating history and offer a single line of products in an industry characterized by rapid technological change. It is very difficult to forecast our future operating results. You should consider and evaluate our prospects in light of the risks and uncertainty frequently encountered by early stage companies in rapidly evolving markets characterized by rapid technological change, changing customer needs, evolving industry standards and frequent introductions of new products and services. As we encounter rapidly changing customer requirements and increasing competitive pressures, we likely will be required to reposition our product and service offerings and introduce new products and services. We may not be successful in doing so in a timely and appropriately responsive manner, or at all. Furthermore, because we compete in an early stage market, many of our target customers have not purchased products similar to ours and might not have a specific budget for the purchase of our products and services. All of these factors make it difficult to predict our future operating results.

Our operating results may fluctuate significantly, which makes our future results difficult to predict and could cause our operating results to fall below expectations or our guidance.

Our operating results may fluctuate due to a variety of factors, many of which are outside of our control. As a result, comparing our operating results on a period-to-period basis may not be meaningful. You should not rely on our past results as an indication of our future performance. In addition, revenues in any quarter are largely dependent on customer contracts entered into during that quarter. Moreover, a significant portion of our quarterly sales typically occurs during the last month of the quarter, which we believe reflects customer buying patterns of products similar to ours and other products in the technology industry generally. As a result, our quarterly operating results are difficult to predict even in the near term. If our revenue or operating results fall below the expectations of investors or securities analysts or below any guidance we may provide to the market, the price of our common stock would likely decline substantially. We are rapidly expanding the number of personnel, programs and infrastructure to accommodate and facilitate anticipated future growth. If revenues are less than anticipated, then our financial results would be adversely affected.

In addition to other risk factors listed in this “Risk Factors” section, factors that may affect our operating results include:

- fluctuations in demand, including due to seasonality, for our products and services;
- fluctuations in sales cycles and prices for our products and services;
- reductions in customers’ budgets for information technology purchases and delays in their purchasing cycles;
- the timing of recognizing revenue in any given quarter as a result of software revenue recognition rules, including the extent to which sales transactions in a given period are unrecognizable until a future period or, conversely, the satisfaction of revenue recognition rules in a given period resulting in the recognition of revenue from transactions initiated in prior periods;
- the sale of our products in the timeframes we anticipate, including the number and size of orders in each quarter;
- our ability to develop, introduce and ship in a timely manner new products and product enhancements that meet customer requirements;

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- the timing of product releases or upgrades by us or by our competitors;
- any significant changes in the competitive dynamics of our markets, including new entrants or substantial discounting of products;
- our ability to control costs, including our operating expenses and the costs of the components we purchase;
- volatility in our stock price, which may lead to higher stock compensation expenses pursuant to Statement of Financial Accounting Standards No. 123(R);
- general economic conditions in our domestic and international markets; and
- unpredictable fluctuations in our effective tax rate due to disqualifying dispositions of stock from the employee stock purchase plan and incentive stock options, changes in the valuation of our deferred tax assets or liabilities, changes in actual results versus our estimates, or changes in tax laws, regulations, accounting principles, or interpretations thereof.

We have a history of losses and we may not maintain profitability in the future.

We achieved profitability for the first time in the three months ended March 31, 2007. We experienced a net loss of \$15.8 million for the year ended December 31, 2006. As of September 30, 2007, our accumulated deficit was \$37.4 million. We may incur significant losses in the future for a number of reasons, including those discussed in other risk factors and factors that we cannot foresee. We expect to make significant expenditures related to the development of our business, including expenditures to hire additional personnel relating to sales and marketing and technology development. In addition, as a public company, we incur significant legal, accounting and other expenses that we did not incur as a private company. We would have to generate and sustain significantly increased revenue to maintain profitability. Our revenue growth trends in prior periods are not likely to be sustainable, and we may not achieve sufficient revenue to maintain profitability.

We face intense competition that could reduce our revenue and adversely affect our financial results.

The market for our products is highly competitive and we expect competition to intensify in the future. Other companies may introduce new products in the same markets we serve or intend to enter.

This competition could result in increased pricing pressure, reduced profit margins, increased sales and marketing expenses and failure to increase, or the loss of, market share, any of which would likely seriously harm our business, operating results or financial condition.

Competitive products may in the future have better performance, lower prices and broader acceptance than our products. Many of our current or potential competitors have longer operating histories, greater name recognition, larger customer bases and significantly greater financial, technical, sales, marketing and other resources than we do. Potential customers may prefer to purchase from their existing suppliers rather than a new supplier regardless of product performance or features. Currently, we face competition from a number of established companies, including Cisco Systems (which acquired Actona Technologies), Juniper Networks (which acquired Peribit Networks), F5 Networks (which acquired Swan Labs), Packeteer (which acquired Tacit Networks), Citrix Systems (which acquired Orbital Data) and Blue Coat Systems. We also face competition from a large number of smaller private companies and new market entrants.

We expect increased competition from other established and emerging companies if our market continues to develop and expand. For example, third parties currently selling our products could market products and services that compete with our products and services. In addition, some of our competitors have made acquisitions or entered into partnerships or other strategic relationships with one another to offer a more comprehensive solution than they individually had offered. We expect this trend to continue as companies attempt to strengthen or maintain their market positions in an evolving industry and as companies enter into partnerships or are acquired. Many of the companies driving this consolidation trend have significantly greater financial, technical and other resources than we do and are better positioned to acquire and offer complementary products and technologies. The companies resulting from these possible consolidations may create more compelling product offerings and be able to offer greater pricing flexibility, making it more difficult for us to compete effectively, including on the basis of price, sales and marketing programs, technology or product functionality. Continued industry consolidation may adversely impact customers' perceptions of the viability of smaller and even medium-sized technology companies and consequently customers' willingness to purchase from such companies. These pressures could materially adversely affect our business, operating results and financial condition.

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We also face competitive pressures from other sources. For example, Microsoft has announced its intention to improve the performance of its software for remote office users. Our products are designed to improve the performance of many applications, including applications that are based on Microsoft protocols. Accordingly, improvements to Microsoft application protocols may reduce the need for our products, adversely affecting our business, operating results and financial condition. Improvement in other application protocols or in the Transmission Control Protocol (TCP), the underlying transport protocol for most WAN traffic, could have a similar effect. In addition, we market our products, in significant part, on the anticipated cost savings to be realized by organizations if they are able to avoid the purchase of costly IT infrastructure at remote sites by purchasing our products. To the extent other companies are able to reduce the costs associated with purchasing and maintaining servers, storage or applications to be operated at remote sites, our business, operating results and financial condition could be adversely affected.

We rely on indirect distribution partners, including value-added resellers, to sell our products, and disruptions to, or our failure to develop and manage, our distribution channels and the processes and procedures that support them effectively could adversely affect our business.

Our future success is highly dependent upon establishing and maintaining successful relationships with a variety of indirect distribution partners. A substantial majority of our revenue is derived through indirect channel sales and we expect indirect channel sales to continue to account for a substantial majority of our total revenue. Accordingly, our revenue depends in large part on the effective performance of these channel partners. By relying on indirect channels, we may have little or no contact with the ultimate users of our products, thereby making it more difficult for us to establish brand awareness, ensure sell-through of our products necessary for us to recognize revenue, ensure proper delivery and installation of our products, service ongoing customer requirements and respond to evolving customer needs.

Recruiting and retaining qualified channel partners and training them in our technology and product offerings requires significant time and resources. In order to develop and expand our distribution channel, we must continue to scale and improve our processes and procedures that support our channel, including investment in systems and training, and those processes and procedures may become increasingly complex and difficult to manage. We have no long-term contracts or minimum purchase commitments with any of our value-added resellers or other indirect distributors, and our contracts with these channel partners do not prohibit them from offering products or services that compete with ours. Our competitors may be effective in providing incentives to existing and potential channel partners to favor their products, to choose not to partner with us, or to prevent or reduce sales of our products. Our channel partners may choose not to offer our products exclusively or at all. Our failure to establish and maintain successful relationships with channel partners would likely materially adversely affect our business, operating results and financial condition.

We rely on third parties to perform shipping and other logistics functions on our behalf. A failure or disruption at a logistics partner would adversely impact our business.

Currently, we use third party logistics partners to perform storage, packaging, shipment and handling for us. We intend to utilize additional logistics service providers in connection with any expansion of our international sales. Although the logistics services required by us may be readily available from a number of providers, it is time consuming and costly to qualify and implement these relationships. Therefore, if one or more of our logistics partners suffers an interruption in its business, or experiences delays, disruptions or quality control problems in its operations, or we have to change or add additional logistics partners, our ability to ship products to our customers would be delayed and our business, operating results and financial condition would be adversely affected.

If functionality similar to that offered by our products is incorporated into existing network infrastructure products, organizations may decide against adding our appliances to their network, which would have an adverse effect on our business.

Other providers of network infrastructure products are offering or announcing functionality aimed at addressing the problems addressed by our products. For example, Cisco Systems incorporates WAN optimization functionality into certain of its router blades. The inclusion of, or the announcement of intent to include, functionality perceived to be similar to that offered by our products in products that are already generally accepted as necessary components of network architecture or in products that are sold by more established vendors may have an adverse effect on our ability to market and sell our products. Furthermore, even if the functionality offered by other network infrastructure providers is more limited than our products, a significant number of customers may elect to accept such limited functionality in lieu of adding additional appliances from an additional vendor. Many organizations have invested substantial personnel and financial resources to design and operate their networks

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and have established deep relationships with other providers of network infrastructure products, which may make them reluctant to add new components to their networks, particularly from new vendors. In addition, an organization's existing vendors or new vendors with a broad product offering may be able to offer concessions that we are not able to match because we currently offer only a single line of products and have fewer resources than many of our competitors. If organizations are reluctant to add additional network infrastructure from new vendors or otherwise decide to work with their existing vendors, our business, operating results and financial condition will be adversely affected.

If we are unable to protect our intellectual property rights, our competitive position could be harmed or we could be required to incur significant expenses to enforce our rights.

We depend on our ability to protect our proprietary technology. We rely on trade secret, patent, copyright and trademark laws and confidentiality agreements with employees and third parties, all of which offer only limited protection. Despite our efforts, the steps we have taken to protect our proprietary rights may not be adequate to preclude misappropriation of our proprietary information or infringement of our intellectual property rights, and our ability to police such misappropriation or infringement is uncertain, particularly in countries outside of the United States. Further, with respect to patent rights, we do not know whether any of our pending patent applications will result in the issuance of patents or whether the examination process will require us to narrow our claims, and even if patents are issued, they may be contested, circumvented or invalidated over the course of our business. Moreover, the rights granted under any issued patents may not provide us with proprietary protection or competitive advantages, and, as with any technology, competitors may be able to develop similar or superior technologies to our own now or in the future. Protecting against the unauthorized use of our products, trademarks and other proprietary rights is expensive, difficult and, in some cases, impossible. Litigation may be necessary in the future to enforce or defend our intellectual property rights, to protect our trade secrets or to determine the validity and scope of the proprietary rights of others. Such litigation could result in substantial costs and diversion of management resources, either of which could harm our business, operating results and financial condition. Furthermore, many of our current and potential competitors have the ability to dedicate substantially greater resources to enforce their intellectual property rights than we do. Accordingly, despite our efforts, we may not be able to prevent third parties from infringing upon or misappropriating our intellectual property.

Claims by others that we infringe their proprietary technology could harm our business.

Third parties have claimed and may in the future claim that our products or technology infringe their proprietary rights. For example, on October 9, 2007, Quantum Corporation served us with a lawsuit, filed in the United States District Court, Northern District of California, alleging patent infringement. We expect that infringement claims may increase as the number of products and competitors in our market increases and overlaps occur. In addition, as we have gained greater visibility and market exposure as a public company, we face a higher risk of being the subject of intellectual property infringement claims. Any claim of infringement by a third party, even those without merit, could cause us to incur substantial costs defending against the claim, and could distract our management from our business. Furthermore, we could be subject to a judgment or voluntarily enter into a settlement, either of which could require us to pay substantial damages. A judgment or settlement could also include an injunction or other court order that could prevent us from offering our products. In addition, we might elect or be required to seek a license for the use of such intellectual property, which may not be available on commercially reasonable terms or at all, or if available, the payments under such license may harm our operating results and financial condition. Alternatively, we may be required to develop non-infringing technology, which could require significant effort and expense and may ultimately not be successful. Any of these events pursuant to existing or future infringement claims could seriously harm our business, operating results and financial condition. Third parties may also assert infringement claims against our customers and channel partners. Any of these claims would require us to initiate or defend potentially protracted and costly litigation on their behalf, regardless of the merits of these claims, because we generally indemnify our customers and channel partners from claims of infringement of proprietary rights of third parties. If any of these claims succeed, we may be forced to pay damages on behalf of our customers or channel partners, which could have a material adverse effect on our business, operating results and financial condition.

Our sales cycles can be long and unpredictable, and our sales efforts require considerable time and expense. As a result, our sales are difficult to predict and may vary substantially from quarter to quarter, which may cause our operating results to fluctuate significantly.

The timing of our revenue is difficult to predict. Our sales efforts involve educating our customers about the use and benefit of our products, including their technical capabilities and potential cost savings to an organization. Customers typically undertake a significant evaluation process that has in the past resulted in a lengthy sales cycle, in some cases over twelve months. We spend substantial time, effort and money in our sales efforts without any assurance that our efforts will produce any sales. In addition, product purchases are frequently subject to budget constraints, multiple approvals, and unplanned administrative, processing and other delays. If sales expected from a specific customer for a particular quarter are not realized in that quarter or at all, our business, operating results and financial condition could be materially adversely affected.

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We are susceptible to shortages or price fluctuations in our supply chain. Any shortages or price fluctuations in components used in our products could delay shipment of our products, which could materially adversely affect our business.

Shortages in components that we use in our products are possible and our ability to predict the availability of such components may be limited. Some of these components are available only from limited sources of supply. For example, our Steelhead appliances depend on network bypass cards to provide a fail-to-wire capability. These bypass cards use high speed relays available only from a limited number of vendors. In addition, our ability to timely deliver products to our customers would be materially adversely impacted if we needed to qualify replacements for the systems, motherboards, chassis and storage adapters used in our Steelhead appliances. We would be similarly affected by shortages in the availability, or the complete unavailability, of the central processing units, bypass cards, disks, fans and power supplies that we use in our appliances. Specifically, the unavailability of any of these components would prevent us from shipping products because each of these components is necessary to the proper functioning of our appliances. In addition, the lead times associated with certain components are lengthy and preclude rapid changes in quantity requirements and delivery schedules.

Any growth in our business or the economy is likely to create greater pressures on us and our suppliers to project overall component demand accurately and to establish optimal component inventory levels. In addition, increased demand by third parties for the components we use in our products may lead to decreased availability and higher prices for those components. We carry very little inventory of our product components, and we rely on our suppliers to deliver necessary components to our contract manufacturers in a timely manner based on forecasts we provide. We rely on both purchase orders and long-term contracts with our suppliers. As a result, even if available, we may not be able to secure sufficient components at reasonable prices or of acceptable quality to build products in a timely manner, which would seriously impact our ability to deliver products to our customers, and our business, operating results and financial condition would be adversely affected.

If we fail to predict accurately our manufacturing requirements, we could incur additional costs or experience manufacturing delays which would harm our business. We are dependent on contract manufacturers, and changes to those relationships, expected or unexpected, may result in delays or disruptions that could harm our business.

We depend on independent contract manufacturers who use standard components to manufacture and assemble our products. We rely on purchase orders or long-term contracts with our contract manufacturers. Some of our contract manufacturers are not obligated to supply products to us for any specific period, in any specific quantity or at any specific price. Our orders may represent a relatively small percentage of the overall orders received by our contract manufacturers from their customers. As a result, fulfilling our orders may not be considered a priority by one or more of our contract manufacturers in the event the contract manufacturer is constrained in its ability to fulfill all of its customer obligations in a timely manner. We provide demand forecasts to our contract manufacturers. If we overestimate our requirements, the contract manufacturers may assess charges or we may have liabilities for excess inventory, each of which could negatively affect our gross margins. Conversely, because lead times for required materials and components vary significantly and depend on factors such as the specific supplier, contract terms and the demand for each component at a given time, if we underestimate our requirements, the contract manufacturers may have inadequate materials and components required to produce our products, which could interrupt manufacturing of our products and result in delays in shipments and deferral or loss of revenue.

Although the contract manufacturing services required to manufacture and assemble our products may be readily available from a number of established manufacturers, it is time consuming and costly to qualify and implement contract manufacturer relationships. Therefore, if one or more of our contract manufacturers suffers an interruption in its business, or experiences delays, disruptions or quality control problems in its manufacturing operations, or we have to choose to change or add additional contract manufacturers, our ability to ship products to our customers would be delayed and our business, operating results and financial condition would be adversely affected.

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If we lose key personnel or are unable to attract and retain personnel on a cost-effective basis, our business would be harmed.

Our success is substantially dependent upon the performance of our senior management and key technical and sales personnel. Our management and employees can terminate their employment at any time, and the loss of the services of one or more of our executive officers or other key employees could harm our business. Our success also is substantially dependent upon our ability to attract additional personnel for all areas of our organization, particularly in our sales, research and development and customer service departments. Competition for qualified personnel is intense, and we may not be successful in attracting and retaining such personnel on a timely basis, on competitive terms, or at all. If we are unable to attract and retain the necessary technical, sales and other personnel on a cost-effective basis, especially in light of our recent and anticipated growth, our business, operating results and financial condition would be adversely affected.

We may not generate positive returns on our research and development investments.

Developing our products is expensive, and the investment in product development may involve a long payback cycle. In the three and nine months ended September 30, 2007, our research and development expenses were \$10.9 million and \$27.4 million, respectively, or approximately 17% of our total revenue in these periods. Our future plans include significant investments in research and development and related product opportunities. We believe that we must continue to dedicate a significant amount of resources to our research and development efforts to maintain our competitive position. These investments may take several years to generate positive returns, if ever.

Our ability to sell our products is highly dependent on the quality of our support and services offerings, and our failure to offer high quality support and services would have a material adverse effect on our sales and results of operations.

Once our products are deployed within our customers' networks, our customers depend on our support organization to resolve any issues relating to our products. A high level of support is critical for the successful marketing and sale of our products. If we or our channel partners do not effectively assist our customers in deploying our products, succeed in helping our customers quickly resolve post-deployment issues, and provide effective ongoing support, it would adversely affect our ability to sell our products to existing customers and could harm our reputation with potential customers. In addition, as we expand our operations internationally, our support organization will face additional challenges including those associated with delivering support, training and documentation in languages other than English. As a result, our failure to maintain high quality support and services would have a material adverse effect on our business, operating results and financial condition.

If we fail to manage future growth effectively, our business would be harmed.

We have expanded our operations significantly since inception and anticipate that further significant expansion will be required. This future growth, if it occurs, will place significant demands on our management, infrastructure and other resources. To manage any future growth, we will need to hire, integrate and retain highly skilled and motivated employees. We will also need to continue to improve our financial and management controls, reporting systems and procedures. We have converted to a new enterprise resource planning software system that has replaced a substantial majority of our prior finance, sales and inventory management systems. We may encounter delays or difficulties in connection with this conversion, including loss of data and decreases in productivity as our personnel become familiar with new systems. If we experience any delays or difficulties, either in connection with this new enterprise resource planning system or other controls, systems and procedures, our ability to properly run our business could be adversely affected. For example, deficiencies in our internal controls over financial reporting could result in loss of revenue, improper revenue recognition, or errors in our financial statements. If we do not effectively manage our growth, our business, operating results and financial condition would be adversely affected.

If we do not successfully anticipate market needs and develop products and product enhancements that meet those needs, or if those products do not gain market acceptance, our business and financial results will be adversely affected.

We may not be able to anticipate future market needs or be able to develop new products or product enhancements to meet such needs, either on a timely basis or at all. For example, our failure to address additional application-specific protocols, particularly if our competitors are able to provide such functionality, could adversely affect our business. In addition, any new products or product enhancements that we introduce, including our recently introduced Steelhead Mobile product, may not achieve any significant degree of market acceptance or be accepted into our sales channel by our channel partners, which would adversely affect our business, operating results and financial condition.

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Organizations are increasingly concerned with the security of their data, and to the extent they elect to encrypt data being transmitted from the point of the end-user in a format that we're not able to decrypt, rather than only across the WAN, our products will become less effective.

Our products are designed to remove the redundancy associated with repeated data requests over a WAN, either through a private network or a virtual private network (VPN). The ability of our products to reduce such redundancy depends on our products' ability to recognize the data being requested. Our products currently detect and decrypt some forms of encrypted data. Since most organizations currently encrypt most of their data transmissions only between sites and not on the LAN, the data is not encrypted when it passes through our appliances. For those organizations that elect to encrypt their data transmissions from the end-user to the server in a format that we're not able to decrypt, our products will offer little performance improvement unless we are successful in incorporating additional functionality into our appliances that address those encrypted transmissions. Our failure to provide such additional functionality could adversely affect our business, operating results and financial condition.

Adverse economic conditions or reduced information technology spending may adversely impact our business.

Our business depends on the overall demand for information technology, and in particular for Wide-area Data Services, and on the economic health of our current and prospective customers. The market we serve is emerging and the purchase of our products involves material changes to established purchasing patterns and policies. In addition, the purchase of our products is often discretionary and may involve a significant commitment of capital and other resources. Weak economic conditions, or a reduction in information technology spending even if economic conditions improve, would likely adversely impact our business, operating results and financial condition in a number of ways, including longer sales cycles, lower prices for our products and services and reduced unit sales.

If our products do not interoperate with our customers' networks, installations will be delayed or cancelled, which would harm our business.

Our products must interoperate with our customers' existing networks, which often have different specifications, utilize multiple protocol standards and products from multiple vendors, and contain multiple generations of products that have been added over time. If we find errors in the existing software or defects in the hardware used in our customers' networks or problematic network configurations or settings, as we have in the past, we may have to modify our software or hardware so that our products will interoperate with our customers' networks. This could cause longer installation times for our products and could cause order cancellations, either of which would adversely affect our business, operating results and financial condition. In addition, government and other customers may require our products to comply with certain security or other certifications and standards. If our products are late in achieving or fail to achieve compliance with these certifications and standards, we may be disqualified from selling our products to such customers, which would adversely affect our business, operating results and financial condition.

Our products are highly technical and may contain undetected software or hardware errors, which could cause harm to our reputation and adversely affect our business.

Our products, including software product upgrades and releases, are highly technical and complex and, when deployed, are critical to the operation of many networks. Our products have contained and may contain undetected errors, defects or security vulnerabilities. Some errors in our products may only be discovered after a product has been installed and used by customers. Any errors, defects or security vulnerabilities discovered in our products after commercial release could result in loss of revenue or delay in revenue recognition, loss of customers and increased service and warranty cost, any of which could adversely affect our business, operating results and financial condition. Any such errors, defects or security vulnerabilities could also adversely affect the market's perception of our products and business, and could result in a decline in the trading price of our common stock. In addition, we could face claims for product liability, tort or breach of warranty, including claims relating to changes to our products made by our channel partners. Our contracts with customers contain provisions relating to warranty disclaimers and liability limitations, which may not be upheld. Defending a lawsuit, regardless of its merit, is costly and may divert management's attention and adversely affect the market's perception of us and our products. In addition, if our business liability insurance coverage proves inadequate or future coverage is unavailable on acceptable terms or at all, our business, operating results and financial condition could be adversely impacted.

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We may engage in future acquisitions that could disrupt our business, cause dilution to our stockholders and harm our business, operating results and financial condition.

In the future we may acquire other businesses, products or technologies. We have not made any acquisitions to date. Our ability as an organization to make acquisitions is unproven. We may not be able to find suitable acquisition candidates and we may not be able to complete acquisitions on favorable terms, if at all. If we do complete acquisitions, we may not ultimately strengthen our competitive position or achieve our goals, or may be viewed negatively by customers, financial markets or investors. In addition, any acquisitions that we make could lead to difficulties in integrating personnel and operations from the acquired businesses and in retaining and motivating key personnel from these businesses. Acquisitions may disrupt our ongoing operations, divert management from day-to-day responsibilities, increase our expenses and adversely impact our business, operating results and financial condition. Future acquisitions may reduce our cash available for operations and other uses and could result in an increase in amortization expense related to identifiable assets acquired, potentially dilutive issuances of equity securities or the incurrence of debt, which could harm our business, operating results and financial condition.

Our international sales and operations subject us to additional risks that may adversely affect our operating results.

In 2005, we derived approximately 18% of our revenue from customers outside the United States. This number increased to approximately 37% in the nine months ended September 30, 2007. We have sales and technical support personnel in numerous countries worldwide. We expect to continue to add personnel in additional countries. Our international operations subject us to a variety of risks, including:

- the difficulty of managing and staffing international offices and the increased travel, infrastructure and legal compliance costs associated with multiple international locations;
- difficulties in enforcing contracts and collecting accounts receivable, and longer payment cycles, especially in emerging markets;
- tariffs and trade barriers and other regulatory or contractual limitations on our ability to sell or develop our products in certain foreign markets;
- increased exposure to foreign currency exchange rate risk; and
- reduced protection for intellectual property rights in some countries.

International customers may also require that we localize our products. The product development costs for localizing the user interface of our products, both graphical and textual, could be a material expense to us if the software requires extensive modifications. To date, such changes have not been extensive and the costs have not been material.

As we continue to expand our business globally, our success will depend, in large part, on our ability to anticipate and effectively manage these and other risks associated with our international operations. Our failure to manage any of these risks successfully could harm our international operations and reduce our international sales, adversely affecting our business, operating results and financial condition.

Our use of open source and third-party software could impose limitations on our ability to commercialize our products.

We incorporate open source software into our products. Although we monitor our use of open source closely, the terms of many open source licenses have not been interpreted by United States courts, and there is a risk that such licenses could be construed in a manner that could impose unanticipated conditions or restrictions on our ability to commercialize our products. In such event, we could be required to seek licenses from third parties in order to continue offering our products, to re-engineer our products or to discontinue the sale of our products in the event re-engineering cannot be accomplished on a timely basis, any of which could adversely affect our business, operating results and financial condition.

We also incorporate certain third-party technologies, including software programs, into our products and may need to utilize additional third-party technologies in the future. However, licenses to relevant third-party technology may not continue to be available to us on commercially reasonable terms, or at all. Therefore, we could face delays in product releases until equivalent technology can be identified, licensed or developed, and integrated into our current products. These delays, if they occur, could materially adversely affect our business, operating results and financial condition. We currently use third-party software programs in our Steelhead appliances, our Interceptor appliances, our Central Management Console appliances and our recently announced Steelhead Mobile software client and controller. For example, in our Steelhead appliances, we use third-party software to configure a storage adapter for specific redundant disk setups as well as to initialize and diagnose hardware on certain models, and in our Central Management Console

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and Steelhead Mobile Controller appliances we use third-party software to help manage statistics and reporting. Each of these software programs is currently available from only one vendor. As a result, any disruption in our access to these software programs could result in significant delays in our product releases and could require substantial effort to locate or develop a replacement program. If we decide in the future to incorporate into our appliances any other software program licensed from a third party, and the use of such software program is necessary for the proper operation of our appliances, then our loss of any such license would similarly adversely affect our ability to release our products in a timely fashion.

We are subject to governmental export and import controls that could subject us to liability or impair our ability to compete in international markets.

Our products are subject to U.S. export controls and may be exported outside the U.S. only with the required level of export license or through an export license exception, because we incorporate encryption technology into our products. In addition, various countries regulate the import of certain encryption technology and have enacted laws that could limit our ability to distribute our products or could limit our customers' ability to implement our products in those countries. Changes in our products or changes in export and import regulations may create delays in the introduction of our products in international markets, prevent our customers with international operations from deploying our products throughout their global systems or, in some cases, prevent the export or import of our products to certain countries altogether. Any change in export or import regulations or related legislation, shift in approach to the enforcement or scope of existing regulations, or change in the countries, persons or technologies targeted by such regulations, could result in decreased use of our products by, or in our decreased ability to export or sell our products to, existing or potential customers with international operations. For example, we will need to comply with Waste Electrical and Electronic Equipment Directive laws, which are being adopted by certain European Economic Area countries on a country-by-country basis. Failure to comply with these and similar laws on a timely basis, or at all, could have a material adverse effect on our business, operating results and financial condition. Any decreased use of our products or limitation on our ability to export or sell our products would likely adversely affect our business, operating results and financial condition.

We incur significant costs as a result of operating as a public company, and our management devotes substantial time to new compliance initiatives.

We incur significant legal, accounting and other expenses as a public company, including costs resulting from regulations regarding corporate governance practices. For example, the listing requirements of the Nasdaq Stock Market's Global Market require that we satisfy certain corporate governance requirements relating to independent directors, audit committees, distribution of annual and interim reports, stockholder meetings, stockholder approvals, solicitation of proxies, conflicts of interest, stockholder voting rights and codes of conduct. Our management and other personnel devote a substantial amount of time to these compliance initiatives. Moreover, these rules and regulations have increased our legal and financial compliance costs and will make some activities more time-consuming and costly. For example, these rules and regulations could make it more difficult for us to attract and retain qualified persons to serve on our board of directors, our board committees or as executive officers.

In addition, the Sarbanes-Oxley Act requires, among other things, that we maintain effective internal control over financial reporting and disclosure controls and procedures. In particular, for the year ending December 31, 2007, we must perform system and process evaluation and testing of our internal control over financial reporting to allow management and our independent registered public accounting firm to report on the effectiveness of our internal control over financial reporting, as required by Section 404 of the Sarbanes-Oxley Act. Our testing, or the subsequent testing by our independent registered public accounting firm, may reveal deficiencies in our internal control over financial reporting that are deemed to be material weaknesses. Our compliance with Section 404 will require that we incur substantial expense and expend significant management time on compliance-related issues. Moreover, if we are not able to comply with the requirements of Section 404 in a timely manner, or if we or our independent registered public accounting firm identify deficiencies in our internal control over financial reporting that are deemed to be material weaknesses, the market price of our stock would likely decline and we could be subject to sanctions or investigations by the Nasdaq Stock Market's Global Market, the SEC or other regulatory authorities, which would require additional financial and management resources.

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If we need additional capital in the future, it may not be available to us on favorable terms, or at all.

We have historically relied on outside financing and cash flow from operations to fund our operations, capital expenditures and expansion. We may require additional capital from equity or debt financing in the future to fund our operations or respond to competitive pressures or strategic opportunities. We may not be able to secure timely additional financing on favorable terms, or at all. The terms of any additional financing may place limits on our financial and operating flexibility. If we raise additional funds through further issuances of equity, convertible debt securities or other securities convertible into equity, our existing stockholders could suffer significant dilution in their percentage ownership of our company, and any new securities we issue could have rights, preferences and privileges senior to those of holders of our common stock. If we are unable to obtain adequate financing or financing on terms satisfactory to us, if and when we require it, our ability to grow or support our business and to respond to business challenges could be significantly limited.

Our business is subject to the risks of earthquakes, fire, floods and other natural catastrophic events, and to interruption by manmade problems such as computer viruses or terrorism.

Our corporate headquarters are located in the San Francisco Bay Area, a region known for seismic activity. A significant natural disaster, such as an earthquake, fire or a flood, could have a material adverse impact on our business, operating results and financial condition. In addition, our servers are vulnerable to computer viruses, break-ins and similar disruptions from unauthorized tampering with our computer systems. In addition, acts of terrorism or war could cause disruptions in our or our customers' business or the economy as a whole. To the extent that such disruptions result in delays or cancellations of customer orders, or the deployment of our products, our business, operating results and financial condition would be adversely affected.

Risks Related to Ownership of Our Common Stock

The trading price of our common stock has been volatile and is likely to be volatile in the future.

The trading prices of the securities of technology companies have been highly volatile. Further, our common stock has a limited trading history. Since our initial public offering in September 2006 through October 23, 2007, our stock price has fluctuated from a low of \$13.60 to a high of \$52.81. Factors that could affect the trading price of our common stock include, but are not limited to:

- variations in our operating results;
- announcements of technological innovations, new services or service enhancements, strategic alliances or significant agreements by us or by our competitors;
- the gain or loss of significant customers;
- recruitment or departure of key personnel;
- changes in the estimates of our operating results or changes in recommendations by any securities analysts who follow our common stock;
- significant sales, or announcement of significant sales, of our common stock by us or our stockholders, including our directors and executive officers;
- announcements by or about us regarding events or news adverse to our business;
- market conditions in our industry, the industries of our customers and the economy as a whole; and
- adoption or modification of regulations, policies, procedures or programs applicable to our business.

If the market for technology stocks or the stock market in general experiences loss of investor confidence, the trading price of our common stock could decline for reasons unrelated to our business, operating results or financial condition. The trading price of our common stock might also decline in reaction to events that affect other companies in our industry even if these events do not directly affect us. Each of these factors, among others, could have a material adverse effect on an investment in our common stock. Some companies that have had volatile market prices for their securities have had securities class actions filed against them. If a suit were filed against us, regardless of its merits or outcome, it could result in substantial costs and divert management's attention and resources. This could have a material adverse effect on our business, operating results and financial condition.

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If securities or industry analysts do not publish research or publish inaccurate or unfavorable research about our business, our stock price and trading volume could decline.

The trading market for our common stock will continue to depend in part on the research and reports that securities or industry analysts publish about us or our business. If we do not continue to maintain adequate research coverage or if one or more of the analysts who covers us downgrades our stock or publishes inaccurate or unfavorable research about our business, our stock price would likely decline. If one or more of these analysts ceases coverage of our company or fails to publish reports on us regularly, demand for our stock could decrease, which could cause our stock price and trading volume to decline.

Insiders have substantial control over us and will be able to influence corporate matters.

As of September 30, 2007, our directors and executive officers and their affiliates beneficially owned, in the aggregate, approximately 28.8% of our outstanding common stock. As a result, these stockholders will be able to exercise significant influence over all matters requiring stockholder approval, including the election of directors and approval of significant corporate transactions, such as a merger or other sale of our company or its assets. This concentration of ownership could limit your ability to influence corporate matters and may have the effect of delaying or preventing a third party from acquiring control over us.

Anti-takeover provisions in our charter documents and Delaware law could discourage, delay or prevent a change in control of our company and may affect the trading price of our common stock.

We are a Delaware corporation and the anti-takeover provisions of the Delaware General Corporation Law may discourage, delay or prevent a change in control by prohibiting us from engaging in a business combination with an interested stockholder for a period of three years after the person becomes an interested stockholder, even if a change in control would be beneficial to our existing stockholders. In addition, our restated certificate of incorporation and amended and restated bylaws may discourage, delay or prevent a change in our management or control over us that stockholders may consider favorable.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds.

(a) Sales of Unregistered Securities

None.

(b) Use of Proceeds from Public Offering of Common Stock

In September 2006, we completed our IPO pursuant to a registration statement on Form S-1 (Registration No. 333-133437) which the U.S. Securities and Exchange Commission declared effective on September 20, 2006. Under the registration statement, we registered the offering and sale of an aggregate of 9,990,321 shares of our common stock, and another 100,000 shares of our common stock sold by a certain selling stockholder. The offering did not terminate until after the sale of all of the shares registered on the registration statement. All of the shares of common stock issued pursuant to the registration statement, including the shares sold by the selling stockholder, were sold at a price to the public of \$9.75 per share. The managing underwriters were Goldman, Sachs & Co., Citigroup Global Markets Inc., Deutsche Bank Securities Inc., and Thomas Weisel Partners LLC.

As a result of the IPO, we raised a total of \$87.4 million in net proceeds after deducting underwriting discounts and commissions of \$6.8 million and offering expenses of \$3.1 million. On October 2, 2006 we used \$1.5 million of our proceeds to pay off our credit facility.

In February 2007, we completed our follow-on public offering pursuant to a registration statement on Form S-1 (Registration No. 333-140544) which the U.S. Securities and Exchange Commission declared effective on February 22, 2007. Under this registration statement, we registered the offering and sale of 2,854,671 shares of our common stock (including 250,000 shares sold by us pursuant to the underwriters' exercise of their over-allotment option) and another 2,645,329 shares of our common stock sold by certain selling stockholders. The offering did not terminate until after the sale of all of the shares registered on the registration statement. All of the shares of common stock issued pursuant to the registration statement, including the shares sold by the selling stockholders, were sold at a price to the public of \$32.50 per share. The managing underwriters were Goldman, Sachs & Co., Deutsche Bank Securities Inc., Citigroup Global Markets Inc., and Thomas Weisel Partners LLC.

As a result of the follow-on public offering, we raised a total of \$87.7 million in net proceeds after deducting underwriting discounts and commissions of \$4.2 million and other offering costs of \$0.9 million. No payments for such expenses were made directly or indirectly to (i) any of our officers or directors or their associates, (ii) any persons owning

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10% or more of any class of our equity securities, or (iii) any of our affiliates. We did not receive any proceeds from the sale of shares in the follow-on public offering by the selling stockholders.

We anticipate that we will use the remaining net proceeds from the IPO and the follow-on public offering for general corporate purposes, which may include expansion of our domestic and international sales and marketing organizations, investments in our infrastructure to support our anticipated growth, further development and expansion of our service offerings and possible acquisitions of complementary businesses, technologies or other assets. We have no current agreements or commitments with respect to any material acquisitions. Pending such uses, we plan to invest the net proceeds in short-term, interest-bearing, investment grade securities. There has been no material change in the planned use of proceeds from the IPO and the follow-on public offering as described in the final prospectuses filed with respect to such public offerings with the Securities and Exchange Commission pursuant to Rule 424(b).

(c) Purchases of Equity Securities by the Issuer and Affiliated Purchasers

None.

Item 3. Defaults Upon Senior Securities.

None.

Item 4. Submission of Matters to a Vote of Security Holders.

None.

Item 5. Other Information.

None.

Item 6. INDEX TO EXHIBITS

Exhibit No.	Description
3.2	Restated Certificate of Incorporation. (1)
3.4	Amended and Restated Bylaws. (1)
4.2	Form of Common Stock Certificate. (1)
10.45	Form of 2006 Director Option Plan Notice of Stock Option Grant and Stock Option Agreement
31.1	Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification of Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

The certification attached as Exhibit 32.1 that accompanies this Quarterly Report on Form 10-Q is not deemed filed with the Securities and Exchange Commission and is not to be incorporated by reference into any filing of Riverbed Technology, Inc. under the Securities Act of 1933 or the Securities Exchange Act of 1934, whether made before or after the date of this Quarterly Report on Form 10-Q, irrespective of any general incorporation language contained in such filing.

-
- (1) Incorporated by reference to exhibit of same number filed with the Registrant's Registration Statement on Form S-1 (No. 333-133437) on April 20, 2006, as amended.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

Dated: October 25, 2007

RIVERBED TECHNOLOGY, INC.

By: /s/ Jerry M. Kennelly
Jerry M. Kennelly
President and Chief Executive Officer

Dated: October 25, 2007

RIVERBED TECHNOLOGY, INC.

By: /s/ Randy S. Gottfried
Randy S. Gottfried
Chief Financial Officer

EXHIBIT INDEX

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-
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RIVERBED TECHNOLOGY, INC. 2006 DIRECTOR OPTION PLAN
NOTICE OF STOCK OPTION GRANT

You have been granted the following option to purchase shares of the Common Stock of Riverbed Technology, Inc. (the “Company”):

Name of Optionee:	«Name»
Total Number of Shares:	_____
Type of Option:	Nonstatutory Stock Option
Exercise Price per Share:	\$«PricePerShare»
Date of Grant:	«DateGrant»
Vesting Schedule:	This option becomes exercisable with respect to 1/48 th of the Shares subject to this option when you complete each month of continuous “Service” (as defined in the Plan) after the Date of Grant.
Expiration Date:	«ExpDate». This option expires earlier if your Service terminates earlier, as described in the Stock Option Agreement.

You and the Company agree that this option is granted under and governed by the terms and conditions of the 2006 Director Option Plan (the “Plan”) and of the Stock Option Agreement, which is attached to and made a part of this document.

You further agree that the Company may deliver by email all documents relating to the Plan or this option (including, without limitation, prospectuses required by the Securities and Exchange Commission) and all other documents that the Company is required to deliver to its security holders (including, without limitation, annual reports and proxy statements). You also agree that the Company may deliver these documents by posting them on a web site maintained by the Company or by a third party under contract with the Company. If the Company posts these documents on a web site, it will notify you by email.

OPTIONEE:

RIVERBED TECHNOLOGY, INC.

By: _____
 Title: _____

**RIVERBED TECHNOLOGY, INC. 2006 DIRECTOR OPTION PLAN
STOCK OPTION AGREEMENT**

Tax Treatment	This option is intended to be a nonstatutory stock option.
Vesting	This option becomes exercisable in installments, as shown in the Notice of Stock Option Grant. In addition, this option will become exercisable in full if the Company is subject to a Change in Control before your Service terminates. This option will in no event become exercisable for additional shares after your Service has terminated for any reason.
Term	This option expires in any event at the close of business at Company headquarters on the day before the 10 th anniversary of the Date of Grant, as shown in the Notice of Stock Option Grant. (It will expire earlier if your Service terminates, as described below.)
Termination of Service	If your Service terminates for any reason, then this option will expire at the close of business at Company headquarters on the date twelve months after your termination date. The Company determines when your Service terminates for this purpose.
Restrictions on Exercise	The Company will not permit you to exercise this option if the issuance of shares at that time would violate any law or regulation.
Notice of Exercise	When you wish to exercise this option, you must notify the Company by filing the proper "Notice of Exercise" form at the address given on the form. Your notice must specify how many shares you wish to purchase. Your notice must also specify how your shares should be registered. The notice will be effective when the Company receives it. If someone else wants to exercise this option after your death, that person must prove to the Company's satisfaction that he or she is entitled to do so.
Form of Payment	When you submit your notice of exercise, you must include payment of the option exercise price for the shares that you are purchasing. To the extent permitted by applicable law, payment may be made in one (or a combination of two or more) of the following forms: <ul style="list-style-type: none">• Your personal check, a cashier's check or a money order.

- Certificates for shares of Company stock that you own, along with any forms needed to effect a transfer of those shares to the Company. The value of the shares, determined as of the effective date of the option exercise, will be applied to the option exercise price. Instead of surrendering shares of Company stock, you may attest to the ownership of those shares on a form provided by the Company and have the same number of shares subtracted from the option shares issued to you.
- Irrevocable directions to a securities broker approved by the Company to sell all or part of your option shares and to deliver to the Company from the sale proceeds an amount sufficient to pay the option exercise price and any withholding taxes. (The balance of the sale proceeds, if any, will be delivered to you.) The directions must be given by signing a special "Notice of Exercise" form provided by the Company.

**Withholding
Taxes and Stock
Withholding**

You will not be allowed to exercise this option unless you make arrangements acceptable to the Company to pay any withholding taxes that may be due as a result of the option exercise. With the Company's consent, these arrangements may include withholding shares of Company stock that otherwise would be issued to you when you exercise this option. The value of these shares, determined as of the effective date of the option exercise, will be applied to the withholding taxes.

**Restrictions on
Resale**

You agree not to sell any option shares at a time when applicable laws, Company policies or an agreement between the Company and its underwriters prohibit a sale. This restriction will apply as long as your Service continues and for such period of time after the termination of your Service as the Company may specify.

**Transfer of
Option**

Prior to your death, only you may exercise this option. You cannot transfer or assign this option. For instance, you may not sell this option or use it as security for a loan. If you attempt to do any of these things, this option will immediately become invalid. You may, however, dispose of this option in your will or a beneficiary designation. Regardless of any marital property settlement agreement, the Company is not obligated to honor a notice of exercise from your former spouse, nor is the Company obligated to recognize your former spouse's interest in your option in any other way.

Retention Rights

Your option or this Agreement does not give you the right to be retained by the Company or a subsidiary of the Company in any capacity. This Agreement shall not in any way be construed or interpreted so as to affect adversely or otherwise impair the right of the Company or the stockholders to remove you from the Board of Directors at any time in accordance with the provisions of applicable law.

Stockholder Rights	You, or your estate or heirs, have no rights as a stockholder of the Company until you have exercised this option by giving the required notice to the Company and paying the exercise price. No adjustments are made for dividends or other rights if the applicable record date occurs before you exercise this option, except as described in the Plan.
Adjustments	In the event of a stock split, a stock dividend or a similar change in Company stock, the number of shares covered by this option and the exercise price per share may be adjusted pursuant to the Plan.
Applicable Law	This Agreement will be interpreted and enforced under the laws of the State of Delaware (without regard to their choice-of-law provisions).
The Plan and Other Agreements	<p>The text of the Plan is incorporated in this Agreement by reference. Capitalized terms not otherwise defined in this Agreement shall be defined as set forth in the Plan.</p> <p>This Agreement and the Plan constitute the entire understanding between you and the Company regarding this option. Any prior agreements, commitments or negotiations concerning this option are superseded. This Agreement may be amended only by another written agreement between the parties.</p>

**BY SIGNING THE COVER SHEET OF THIS AGREEMENT, YOU AGREE TO ALL OF THE
TERMS AND CONDITIONS DESCRIBED ABOVE AND IN THE PLAN.**

**CERTIFICATION OF PRINCIPAL EXECUTIVE OFFICER
PURSUANT TO SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002**

I, Jerry M. Kennelly, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Riverbed Technology, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:
 - a. Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - b. [Paragraph omitted in accordance with SEC Release 34-47986]
 - c. Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - d. Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - a. All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - b. Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: October 25, 2007

/s/ Jerry M. Kennelly

Jerry M. Kennelly
President and Chief Executive Officer
(Principal Executive Officer)

**CERTIFICATION OF PRINCIPAL FINANCIAL OFFICER
PURSUANT TO SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002**

I, Randy S. Gottfried, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Riverbed Technology, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:
 - a. Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - b. [Paragraph omitted in accordance with SEC Release 34-47986]
 - c. Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - d. Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - a. All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - b. Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: October 25, 2007

/s/ Randy S. Gottfried

Randy S. Gottfried
Chief Financial Officer
(Principal Financial Officer)

Certification of Chief Executive Officer and Chief Financial Officer**Pursuant to 18 U.S.C. Section 1350,
as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002**

I, Jerry M. Kennelly, certify pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that the Quarterly Report of Riverbed Technology, Inc. on Form 10-Q for the quarterly period ended September 30, 2007 fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934 and the information contained in such Form 10-Q fairly presents, in all material respects, the financial condition and results of operations of Riverbed Technology, Inc.

Date: October 25, 2007

/s/ Jerry M. Kennelly
Jerry M. Kennelly
President and Chief Executive Officer
(Principal Executive Officer)

I, Randy S. Gottfried, certify pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that the Quarterly Report of Riverbed Technology, Inc. on Form 10-Q for the quarterly period ended September 30, 2007 fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934 and the information contained in such Form 10-Q fairly presents, in all material respects, the financial condition and results of operations of Riverbed Technology, Inc.

Date: October 25, 2007

/s/ Randy S. Gottfried
Randy S. Gottfried
Chief Financial Officer
(Principal Financial and Accounting Officer)

A signed original of this written statement required by Section 906 of the Sarbanes-Oxley Act of 2002 has been provided to Riverbed Technology, Inc. and will be retained by Riverbed Technology, Inc. and furnished to the Securities and Exchange Commission or its staff upon request. This certification “accompanies” the Form 10-Q to which it relates, is not deemed filed with the Securities and Exchange Commission and is not to be incorporated by reference into any filing of the Company under the Securities Act of 1933, as amended, or the Securities Exchange Act of 1934, as amended (whether made before or after the date of the Form 10-Q), irrespective of any general incorporation language contained in such filing.

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