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UBNT -- \$32.30

- Too early to short – wait until lockup expires
- Distributor convicted of smuggling
- European distributor was selling to Iran illegally
- European VAR says margins are down and saturation is up
- Possibly Catalyst: ~82M shares coming off lockup in early April
- Teaser for next report: 1 on one interview w/head of sales at Flytec

Market Cap.	\$3.0 b
Shares Out.	91.9 m
Short Interest	4.9
Days short	15
Avg. Daily Vol.	318k
St. eps est. 2012	\$1.14
St. eps est. 2013	\$1.33
Px/book	41x
Px/sales	10x
Px/ EBITDA	-

Source: Bloomberg

Sales that look a little too good to be true

UBNT has a colorful past, to put it lightly. Putting it not so lightly, this company could be engaging in illegal behavior. Given their growth, the track record of selling products illegally to Iran, regulatory trouble from the US Treasury Department, and the company's affiliation with a known smuggler in South America, it is not too hard to conclude that UBNT could be headed for serious trouble. We have reason to believe there are layers of distributors designed to hide end-users and concentration risk. For the short to work, we have to be certain there is nefarious activity occurring and that it will slow sales. Given the sales growth, being wrong would be very painful, which is why we recommend waiting at a minimum until shares come off lockup in a few weeks.

	Three Months Ended December 31,				Six Months Ended December 31,			
	2011		2010		2011		2010	
North America(1)	\$ 21,440	24%	\$ 13,887	31%	\$ 46,381	28%	\$ 24,081	30%
South America	24,250	28%	9,012	20%	44,085	26%	18,835	24%
Europe, the Middle East, and Africa	30,356	35%	19,093	42%	55,139	33%	29,296	37%
Asia Pacific	11,771	13%	3,095	7%	21,379	13%	6,957	9%
Total revenues	\$ 87,817	100%	\$ 45,087	100%	\$ 166,984	100%	\$ 79,169	100%

(1) Revenue for the United States was \$20.7 million and \$13.6 million for the three months ended December 31, 2011, and 2010, respectively. Revenue for the United States was \$45.1 million and \$23.4 million for the six months ended December 31, 2011, and 2010, respectively.

UBNT produces wireless network equipment. South American sales in fiscal 2010 and 2011 were 10% and 26% of revenue respectively, or \$13M and \$51M. Flytec is a Florida-based distributor representing 17% and 20% of UBNT revenue in fiscal 2010 and 2011, respectively. Osni Arruda founded Flytec Computers. Arruda was arrested in Brazil in 2006 for “alleged crimes of embezzlement, forgery of private documents, misrepresentation, use of false documents and conspiracy.”

“In January 2011, the OEE [BIS's Office of Export Enforcement] contacted us [UBNT] to request that we provide information related to our relationship with a logistics company in the UAE and with a company in Iran... We believe our products have been sold to Iran by third parties.”

“In May 2011, the Company filed a self-disclosure with the BIS and Security's Office of Export Enforcement OEE and in June 2011, filed one with U.S. Department of the Treasury's Office of Foreign Asset Control

("OFAC") regarding the compliance issues noted above....OFAC is still in the early stages of reviewing the Company's voluntary disclosure." "Our review also found that while we had obtained required Commodity Classification Rulings for our products in June 2010 and November 2010, we did not advise our shipping personnel to change the export authorizations used on our shipping documents until February 2011." (We spoke to former CEO Robert Fitzgerald, who left in 2010, to question him about the company's practices; however, was uncooperative). "...we now believe that Distributor 1 continued to sell our products into Iran after February 2010 and that we overlooked emails from Distributor 1 that included information about Distributor 1's possible activities related to shipping our products to Iran."

"...another Distributor, Distributor 2, was selling our products to a company in Iran. Distributor 2, a distributor in Europe, received orders from an Iranian entity, placed those orders with us and instructed us to ship the products to a third party in the UAE."

FlyTec's President and Founder, Osni Arruda: Here's what FlyTec's President and Founder, Osni Arruda, writes about himself: "A native of Brazil, Osni Arruda founded Flytec Computers S.A. in South America more than 15 years ago and established its U.S. office in 2007. Located in Doral, Florida, Flytec Computers, Inc., serves as a distributor of fixed wireless services. Founder and president Osni Arruda focuses his energy on pricing strategies aimed at increasing global market penetration." "...Osni Arruda started his second company, a wireless and IT technologies firm called Flytec Computers S.A. Headquartered in Paraguay's second largest city, Ciudad del Este, the company serves clients throughout the Mercosur, or Common Southern Market nations of Brazil, Argentina, Uruguay, and Paraguay."

Osni Arruda Arrested for Smuggling, Embezzlement: Brazilian electronics contraband king falls - March 23, 2006 – "The 'Urutau' operation launched yesterday by the Federal Police and the Federal Revenue Service in the states of Paraná and Santa Catarina led to ten arrests. The operation's purpose was to dismantle a gang specializing in the contraband of data processing material and tax evasion. The gang sold products from Paraguay on the internet countrywide." "...the operation aimed at finding and arresting 13 people and executing 20 search-and-seize warrants in homes and businesses. Ten of the 13 people were arrested: Osni Muccellin Arruda...."

"According to the Federal Police, the merchandise was brought from Paraguay by 'mules,' who hide it amidst the cargo of different trucks..the operation seized data processing items, US\$2,924, R\$33,746, two pistols, a .12 rifle, a .32 gun, a .38 ammunition box, computers, accounting notebooks and ledgers, four motorcycles, three cars, and a large amount of invoices of the involved enterprises."

- "It appears from the record that the patient [Osni Arruda] was reported by alleged crimes of embezzlement, forgery of private documents, misrepresentation, use of false documents and conspiracy..."

- In what is either a filing by the government or a court order, responsive to the habeas corpus motion, we found the following, which gives greater detail about some of the shell corporations and structures established by Arruda in furtherance of the 2006 smuggling ring, as well as his own tax evasion: "...there was robust evidence that pointed to...[Osni Arruda] and his...wife Rosani Hack Arruda composed directly or indirectly (through the possible use the front men...) the corporate structure of several companies, which....use cross-Tax ID names and companies that are inactive before the IRS on Internet ...including the business Valley Federal International Corp., based in the BVI (which has Osni Mucellin as president and representative in Brazil Rosani Hack Arruda) and its subsidiary in Brazil, Brazil's Federal Valley Ltd...all of which, as noted in the information made by the Federal Treasury, are closely linked to the Criminal Organization created to smuggling in the country and subsequent marketing electronics and informatics from Paraguay..."

The Basics (SEC filings): "Products bridge the digital divide by fundamentally changing the economics of deploying high-performance wireless networking solutions in underserved and underpenetrated markets globally. These markets include emerging markets and other areas where individual users and small and medium-sized enterprises do not have access to the benefits of carrier-class broadband networking." "Revenues were \$22.4 million, \$63.1 million, \$137.0 million and \$130.3 million in the fiscal years ended June 30, 2008,

2009 and 2010 and the nine months ended March 31, 2011, respectively.” “Upon completion of this offering, we will have 89,740,183 outstanding shares...no shares will be eligible for sale immediately upon completion of this offering, and 82,768,202 shares will be eligible for sale upon the expiration of lock-up...[t]he lock-up agreements expires 180 days after the date of this prospectus.” This comes from page 33 of the final prospectus, dated October 13th, implying a lock-up expiration of ~April 13th.

“According to Gartner, Inc., an independent market research firm, aggregate end-user spending on wireless networking equipment for enterprise local area network, or WLAN, wireless broadband access, and Long Term Evolution, or LTE, solutions are expected to grow from \$5.2 billion in 2010 to \$22.5 billion in 2015, representing a compound annual growth rate, or CAGR, of 34%.” “Although we have a large number of distributors who sell our products, we sell a substantial majority of our products through a limited number of these distributors. In fiscal 2009, fiscal 2010 and fiscal 2011, Streakwave Wireless Inc. represented 12%, 13% and 15% of our revenues, respectively.”

Federal Investigation into UBNT Products Being Sold into Iran: “Sale of certain of our products into Iran, Cuba, Syria, the Sudan and North Korea is restricted or prohibited under U.S. export control and economic sanctions laws. Also, certain of our products incorporate encryption components and may be exported from and outside the United States only with the required authorization or eligibility for a license exception. Until early 2010, we lacked sufficient familiarity with the export control and sanctions laws and their applicability to our products. Our lack of sufficient familiarity was largely due to our lean corporate infrastructure...” “In January 2011, the OEE [BIS’s Office of Export Enforcement] contacted us to request that we provide information related to our relationship with a logistics company in the UAE and with a company in Iran, as well as information on the export classification of our products. As a result of this inquiry we, assisted by outside counsel, conducted a review of our export transactions from 2008 through March 2011 to not only gather information responsive to the OEE’s request but also to review our overall compliance with export control and sanctions laws. We believe our products have been sold to Iran by third parties.”

“In February 2011, our Audit Committee retained outside counsel to conduct a review of our export control compliance and possible sales of our products by third persons to embargoed countries...[i]n August 2011, we received a warning letter from the OEE indicating that the OEE had completed its investigation of us, was closing out the matter without issuing a penalty, had not referred the matters described below for criminal or administrative prosecution of us and closed the investigation of us. In June 2011, we also filed a voluntary self-disclosure with OFAC [US Department of the Treasury’s Office of Foreign Asset Control], which disclosure is still pending.”

As of the filing of the most recent 10-Q on February 1st, 2012, “OFAC is still in the early stages of reviewing our voluntary disclosure. In our submission, we have provided OFAC with an explanation of the activities that led to the sales of our products in Iran and the failure to comply with the EAR and OFAC sanctions. Although our OFAC and OEE voluntary disclosures covered similar sets of facts that led the OEE to resolve the case with the issuance of a warning letter, OFAC may conclude that our actions resulted in violations of U.S. export control and economic sanctions laws and warranted the imposition of penalties that could include fines, termination of our ability to export our products, and/or referral for criminal prosecution.” “Our review also found that while we had obtained required Commodity Classification Rulings for our products in June 2010 and November 2010, we did not advise our shipping personnel to change the export authorizations used on our shipping documents until February 2011. During our export control review, we also determined that we had failed to maintain adequate records for the five year period required by the EAR and the sanctions regulations due to our lack of infrastructure and because it was before our transition to our system of record, NetSuite.”

Feb. 2012 10-Q: “While we have now taken actions to ensure that export classification information is distributed to the appropriate personnel in a timely manner and have adopted policies and procedures to promote our compliance with these laws and regulations, we have not yet obtained written distribution agreements with all our distributors that contain covenants requiring compliance with U.S. export control and

economic sanctions law; we have notified all of our distributors of their obligations and have obtained updated distribution agreements from distributors that account for about 80% of our revenue in fiscal 2010. ”

More on UBNT History with Distributors Selling into Iran: “Although we do not believe that we directly sold, exported or shipped our products into Iran or any other country subject to a U.S. embargo, we believe our products have been sold to Iran by third parties. However, until early 2010, we did not prohibit our distributors from selling our products into Iran or any other country subject to a U.S. embargo.” “From 2008 to early 2010, we had a distribution arrangement with a distributor, or Distributor 1, in the United Arab Emirates, or UAE, that gave this distributor exclusive jurisdiction over eleven countries in the Middle East, including Iran, as well as authorization to sell worldwide. Sales to Distributor 1 represented 7%, 6% and 4% of our revenues in fiscal 2009, fiscal 2010 and fiscal 2011, respectively. We cannot determine which of our products Distributor 1 sold directly or indirectly to persons in Iran.”

“In early 2010, we began implementing policies prohibiting sales of our products into the countries subject to the U.S. embargo....[w]e also entered into a new distribution agreement with Distributor 1 that excluded Iran as one of its territories and contained explicit covenants that Distributor 1 would comply with U.S. export control and economic sanction laws, including a covenant not to sell our products to Iran.” “From March 2010 until February 2011, we continued doing business with Distributor 1....we now believe that Distributor 1 continued to sell our products into Iran after February 2010 and that we overlooked emails from Distributor 1 that included information about Distributor 1’s possible activities related to shipping our products to Iran. In February 2011, we suspended sales of our products to Distributor 1 due to the information learned during our export control review that indicated Distributor 1 may still be selling products into Iran.” “Also, during the export review we recently conducted, we learned that from December 2009 through February 2011, another distributor, Distributor 2, was selling our products to a company in Iran. At the time of these transactions, we did not have a distribution agreement with Distributor 2, and we had not specifically instructed Distributor 2 that our products could not be sold into Iran. Distributor 2, a distributor in Europe, received orders from an Iranian entity, placed those orders with us and instructed us to ship the products to a third party in the UAE.”

“In March 2011, upon learning that it was receiving orders from a company in Iran, we notified Distributor 2 that the end customer was in Iran and of our prohibition on sales to Iran and also entered into a distribution agreement with Distributor 2. The agreement contains clear language requiring compliance with the export control and economic sanctions laws. We continue to sell products to Distributor 2, as we believe this issue has been resolved...” “In January 2011, OEE contacted us to request that we provide information related to our relationship with a logistics company in the UAE and with a company in Iran, as well as information on the export classification of our products, neither of which are Distributor 1 or Distributor 2.” “However, the findings also indicate that both Distributor 1 or Distributor 2 continued to sell, directly or indirectly, our products into Iran during the period from February 2010 through March 2011 and that we received various email communications from them indicating that they were continuing to do so.” We suspect that the YoY sales growth rate could collapse in 2012 vs. 2011, as the company may have been more likely to clean up its act in 2h11.

UBNT’s user forum/board (Jan 12, 2012):[Quoting a 12/28/2011 Forbes article on UBNT’s CEO/President, Robert Pera]: “Another concern: keeping Ubiquiti’s equipment from finding its way to countries like Cuba, Iran and North Korea where Pera can’t export to without U.S. government approval. One distributor in Dubai shipped goods to Iran, flouting the rules of its contract. (Pera quickly dropped him.) The U.S. Department of Commerce issued Ubiquiti a warning letter asking the company to upgrade its systems so it can better track where shipments are going. ‘We didn’t have the controls in place that we should,’ admits Pera. ‘It can’t happen again. If it does, I’ll be in a lot of trouble.’”

[Response to the above, from UBNT user forum member]: “For those Americans who haven’t been to Dubai, the above paragraph might make sense. Robert is saying what he needs to say to satisfy the current US regulators. However, I can guarantee you that ubnt devices are still being sold into places that are technically under US embargo, and there’s very little that can be done to stop it. The scale of the warehousing and

distribution operations that go on in the UAE (and Qatar) is quite large. The UAE has become the electronics distribution hub for pretty much all of East Africa, for Pakistan, for Iran, Afghanistan and other places. It's impossible to stop somebody from buying a 20' cargo container full of HP PCs in Dubai and shipping it to Iran." "The UAE has no embargo on the trade of non-sensitive, non-military goods with Iran. Once something has been shipped to the UAE, there's no way to control it, though US manufacturers need to pay lip service to the US' laws."

Q/A with UBNT VARs: We found a list of 67 value added resellers in Europe on the company's website. We sent out a short questionnaire regarding UBNT's product popular. We started with soft questions, followed up by harder questions. For what it's worth, we thought it prudent to show the bull story as describe from a VAR. This particular VAR is in Belgrade. We found several VARs in countries that could easily be selling into Iran (for example, Turkey, as well as several others in Eastern Europe). After that, we sent similar emails to all of the company's VARs in South America and a few in Asia. One Asia distributor in Taiwan said the company sells products to Iran via Dubai. Unfortunately, when pressed, source backed away. He commented that "I know the guy, but don't know he will give the information or not. I will try and let you know." Obviously, it would be helpful to find out products are being shipped directly from Taiwan to the Middle East and potentially from Iran.

European VAR—Resells UBNT Abroad (email conversation):

Q: What do you think will slow the sales of network equipment?

A: our income (as distributor or producer of some products) is not decreasing, but profit from this business are the worst they have been in 2-3 years. The main reason that market is much more saturated. "And we reexport lot of products outside middle Europe, where demand is better." We queried source to elaborate, but he went cagey on us: "It's in Europe, outside EU. Outside Europe we sell rarely. Details are my trade secret."

We pressed source further. He then went on to say that it is easy to get around an embargo, at least for network equipment. He wouldn't elaborate further. The source continued: We have been selling wireless network equipment for 12 years. I think this market has seen its best years already in Europe. Internet connections exist in most homes already. Maybe fiber is starting a long-term up cycle, but it will never be as fast as easy to install wireless. Few people in this part of the world have access to enough capital to buy UBNT in quantity. Mr. Pera (CEO) has good ideas and designs, but we have no capital. UBNT has better chips in quantity going into their systems, better software at lower prices, where he can take market share. Some discussion about Cisco and Motorola product here, not clear.

The Bull Case Q/A with a European VAR:

Q: Do you think the network equipment market is growing, if so, how much?

A: "Yes, average ~ 30%."

Q: Are the economic factors in the news affected equipment investments?

A: "Well...not really, all pending projects are still according to plan."

Q: Is the market for network equipment beginning a long-term cycle of greater investment?

A: "Yes, for sure I think...at least it is my opinion."

Q: I noticed you sell Ubiquiti. Their growth rate in Europe has been extremely strong. Do you think this is because the company products are being well received by customers or are the entire industry growing at a similar pace?

A: "They are offering a whole range of ISP/Client equipment with excellent quality and affordable price. Regarding big mess in ether on 2.4GHz they announced in good time [right timing?] 5.8GHz equipment. Great quality, good prices, great support, engineers affected their growth. Of course, they are doing other bands as 3.5, 900, 2.4, ten etc."

Q: How long have you been a reseller for them?

A: "Few Years."

Q: What do you think will slow the sales of network equipment? Does currency fluctuation affect the industry?

A: "Currency fluctuations indeed affect ISP business because subscribers have same prices in local currency for a long time. ISP are buying goods and paying internet link per fluctuating exchange rate which is in the constant rise. Even have to give more equipment to keep existing customers with a small rise in an amount per month."

Q: Is there a brand that is most popular?

A: "For Wireless UBNT for sure, other TP-Link, Planet, D-link, etc. in Soho /SMB Segment...than adsl,vdsl...Planet has great solutions for SMB also IP Surveillance (miners in Chile was communicating with Planet equipment during 30 days.. extremely conditions...OF course Cisco etc.."

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