

**EXTREME NETWORKS
 (NASDAQ: EXTR)**

**Cloud-driven networking delivers
 a significant advantage**

10/19/ 2020
 John Roy, Ph.D.
 IT Hardware & Comm Equipment
john@watertowerresearch.com
 +1 (973) 666 2172

KEY POINTS

- Extreme Networks is widely viewed as being well positioned for the growth of Government and Education, and to exploit its cloud-based systems.
- We see cloud-based management solutions continuing to take market share in both hardware and networking markets. The centralized data allows for better predictions and operations, and the cloud makes it cost effective.
- Global internet penetration has grown from 25% in 2010 to 62% in 2020 (by Internet World Stats) and is projected to grow to 90% by 2030 (by Cybersecurity Ventures). However, consensus projections are for a 1% growth in industry revenues the next three years, down from a +5% CAGR the last decade.
- Networking market share changes tend to take time as multi-vendor customers are rare. Taking share from Cisco, Arista, and Juniper will be difficult, thus Extreme’s strategy to focus on cloud-driven differentiation in markets where it has a significant presence is the best approach in management’s opinion.
- The company has nearly completed its hardware refresh (36 of 40 target refreshes are done, out of a total of 57 products). The next step is a universal product platform approach. The progress of the universal platform and the growth in subscription customers are milestones to expanding gross margin above 60% in 2HFY21 by company estimates.
- Consensus expectations for Extreme are for both sales and EPS growth over the next year. The company has said it is “guarded” with its view of the rebound, which it expects will move slowly. F1Q21 earnings are expected to be released on 28-Oct-2020, after a positive pre-announcement.

KEY STATISTICS

Price:	\$4.41
52 Week Range:	\$1.43 - \$8.00
Avg. Daily Vol. (30 day)	1,006,403
Shares Out (MM):	187
Market Cap (MM):	\$547
Institutional Ownerships	86%
Short Int. (MM) / % of float:	4.8 / 4.2%
Debt to Equity:	76
Revenue TTM (MM):	\$948

Source: YCharts, *As of October 16, 2020



COMPANY OVERVIEW

Headquartered in San Jose with 2,800 employees, Extreme Networks provides software-driven networking services for enterprise customers. Its products include wired and wireless network infrastructure equipment and software for network management, policy, analytics, and access controls. It offers high-density Wi-Fi, centralized management, cloud-based network management, and application analytics capabilities. The company serves a number of end-markets including Government & Education (>35% of sales), Healthcare (>10%), Manufacturing (~10%), Retail Logistics / Transportation (~10%), Telco / Service Provider (<10%), and Sports / Entertainment & Hospitality (<5%). Roughly half of the firm’s revenue is generated in the Americas, with the rest coming from Europe, the Middle East, Africa, and Asia-Pacific.

WTR CATALYST MONITOR

- ✓ Tracking growth in the subscription model should provide some support for the company's view that it can expand gross margin above 60% in 2HF21. Extreme's gross margin has rarely been over 60%, and over the last three years it has stayed in the 57-60% range. Sequentially, in F2Q20, 28% of revenue came from subscriptions, 34% in F3Q20, and 34% in F4Q20.
- ✓ Extreme is seeing more interest from larger clients due to its cloud-driven approach allowing more data to be collected by clients. Tracking the large client sales should show if these discussions are bearing fruit. In FY20, the number of large deals (> \$1mn) have been flat, with 22 in 2FQ20, 24 in 3FQ20, and 23 in 4FQ20. This should increase if Extreme is making progress with large clients.
- ✓ The product line refresh is nearly complete, and the company's next phase is for a universal product platform. A universal product platform is a key element of the company's plan to expand its gross margin. Tracking reviews of the refreshed products and updates on the universal platform should help investors understand if these important changes are on schedule, and if they are having a significant impact.
- ✓ Some smaller deals (< \$75,000) were pushed out in F3Q20 and F4Q20, however, the company said that F1Q21 has seen some increase in this run-rate business. Active Customer Accounts (86k/92k/98k in 2Q/3Q/4Q of F20) and Managed Devices (1.01mn/1.05mn/1.14mn in 2Q/3Q/4Q of F20) are good indicators of the run-rate business which is critical to Extreme.

OUR INSIGHT

The Opportunities

With COVID-19 changing nearly every business, Extreme Networks has new opportunities that could change its trajectory.

Cloud-driven management more impactful due to COVID

Remote and socially distanced employees are pushing more wireless LAN usage and causing companies to spend less on core and more on distributed access. Extreme's acquisition of Aerohive allows for full network administration and security from remote network employees – the management from the cloud being a key differentiator.

With nearly all prospects being remote, cloud-driven brings another advantage; the way prospects can easily try out Extreme's products without leaving their homes. Sales are typically 20% from new customers, 80% from existing, however, there is an opportunity with marketing improving as remote is levelling the playing field.

New universal product platform makes software better and lowers manufacturing costs.

Extreme is finishing up a complete product line refresh. With 36 of 40 products refreshed, out of a total of 57, the company has new equipment in the marketplace. The next step is one of its key opportunities – moving the products to a universal platform. This platform will serve from core to edge.

We expect one universal platform is possible because technology is moving so line-speeds can be maintained with more general hardware – it will be the software that makes the difference. If Extreme can move to a universal platform, its manufacturing lines are expected to be simplified, possibly driving gross margin expansion. Additionally, their software can be run on all its products, reportedly making software development easier and more useful.

New EVP and Head of Sales named in June 2020.

Executive management changes are catalysts for change. Particularly, CEOs and heads of sales. Joe Vitalone joined the company as the new Chief Revenue Officer in June. Previously, Joe was at Mitel, ShoreTel, Arrow Systems Integration, and Jemez Technology. We could see new sales and marketing approaches favorably impacting sales, but it could take a few quarters to play out.

The Obstacles

Although there are numerous favorable tailwinds, there are also headwinds that must be navigated and overcome. The company has a long operating history but has only been profitable in four individual quarters since 2014. There are a variety of externalities and issues that have been problematic, but nonetheless that is the reality. Some of the highlighted obstacles include the following:

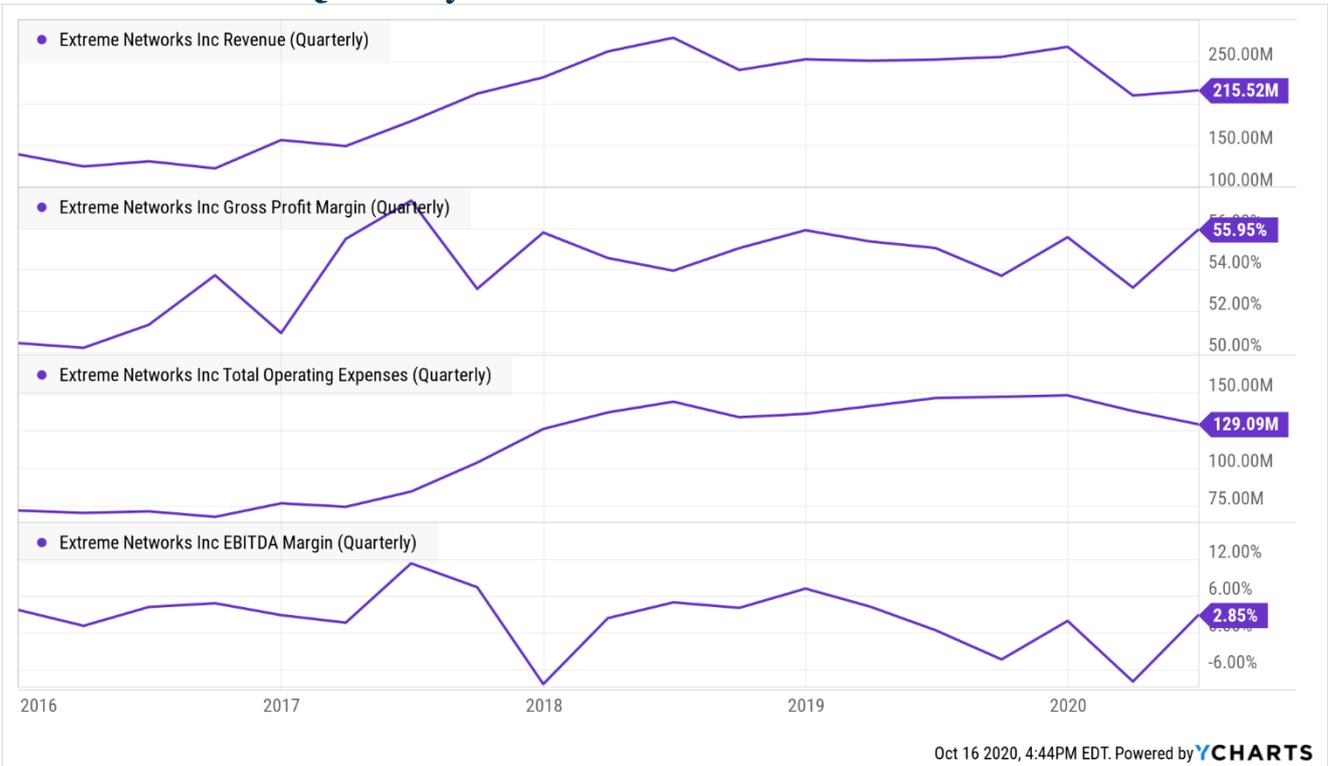
- It is obvious, but external economic factors, elections, geopolitical issues, pandemics, etc. can all negatively impact demand for any product or service and Extreme is no different. Despite the variety of factors helping to sell networking, customers are still sensitive to the global economic conditions, which makes the product sales of the company somewhat cyclical. This is being offset to some degree with the roughly 1/3 of sales that is subscription, but the company needs both product sales and subscriptions to grow to be successful.
- A complete product refresh could boost sales growth, however, new products can have teething issues. The next few quarters should provide some evidence on whether or not the new products are working. The new universal product platform also introduces risk – will it work, will it cause customers to slow purchases while they wait, will it be delayed significantly.
- The new Head of Sales started in June of 2020 and aims to continue making changes - whether those changes have positive or negative impacts is unclear. Consensus expectations are for sequential revenue growth of 5% and 4% the next two quarters, and for YoY revenue growth to return in 2HFY21(+8% in 3FQ21 and+12% in 4FQ21).

WATER TOWER RESEARCH CHART TOPPERS

3 Year Earnings Overview



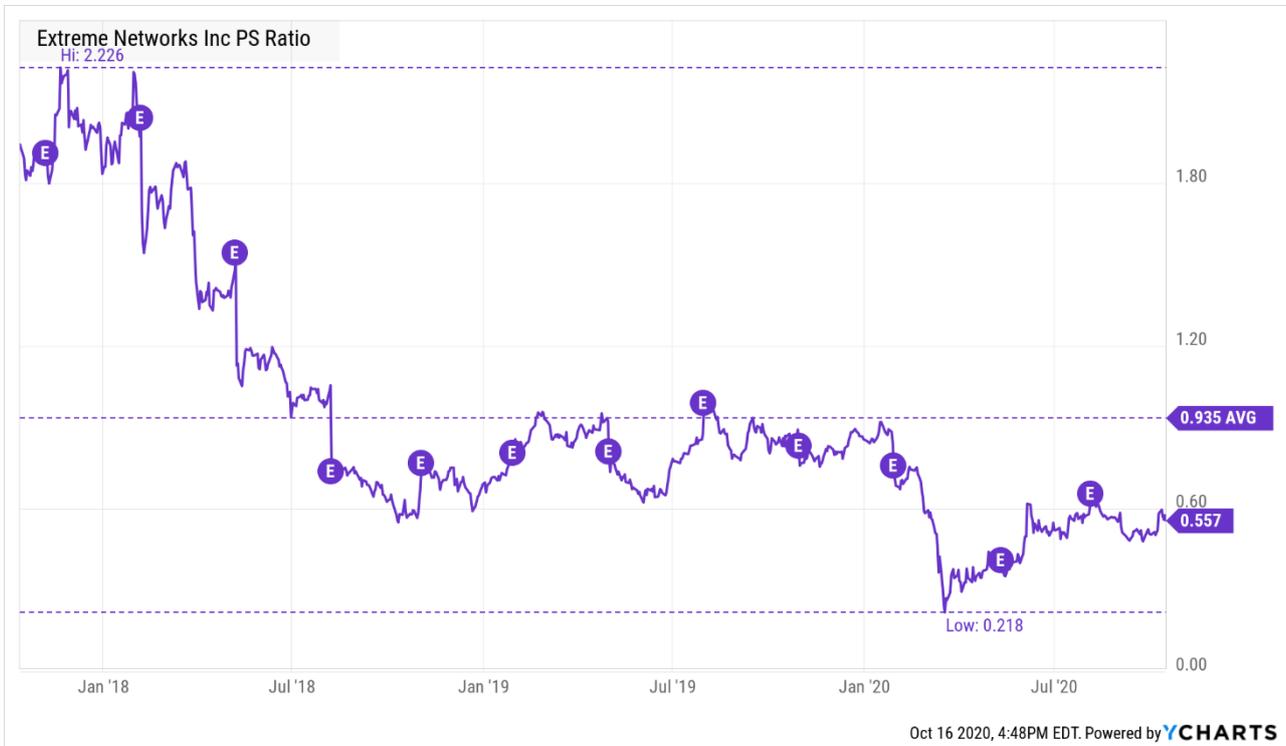
Selected Historical Quarterly Financial Results



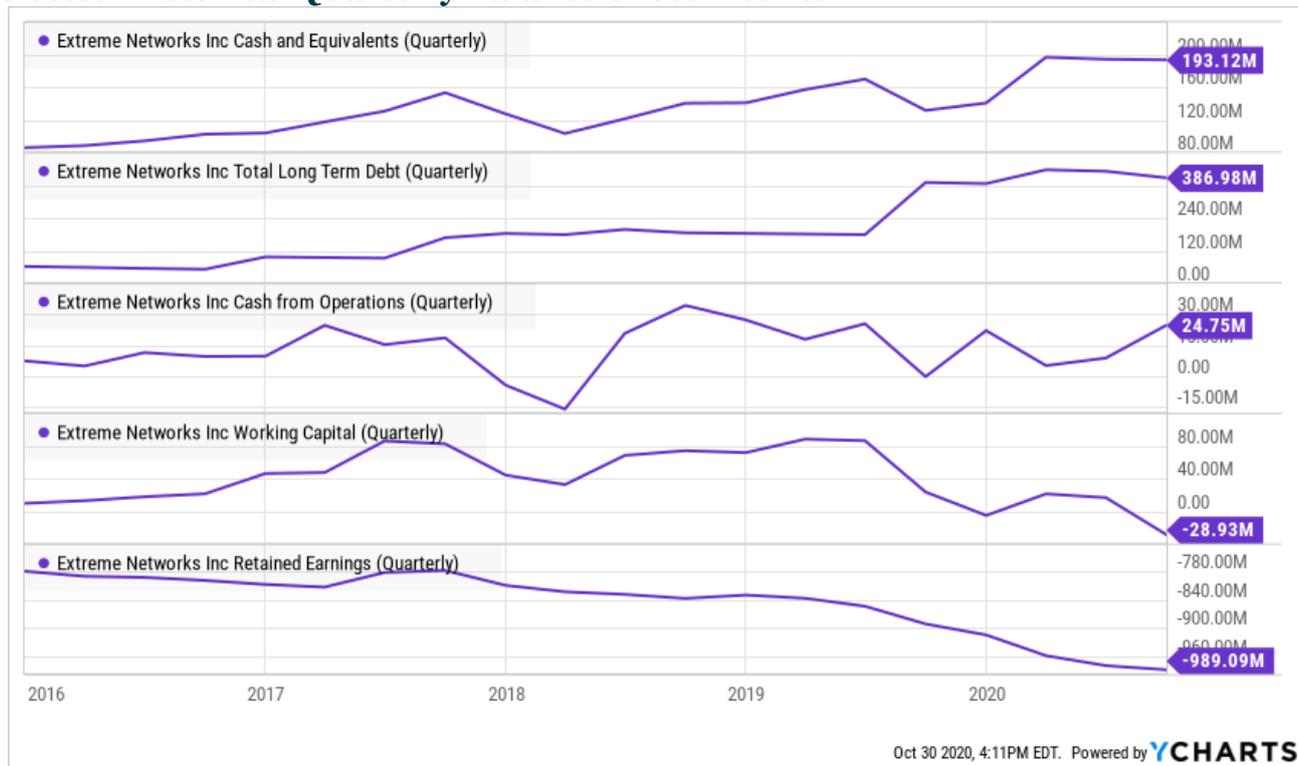
Technical Stock Chart



Price-to-Sales



Selected Historical Quarterly Balance Sheet Metrics



ABOUT THE ANALYST

John Roy, Ph.D. – Managing Director
IT Hardware & Communications Equipment Research

In his role at Water Tower Research, Dr. Roy provides cutting-edge equity research coverage of IT hardware companies supplying hardware to both commercial and individual users, and communications equipment companies which power the connected world.

Prior to Water Tower Research, Dr. Roy worked as lead analyst at UBS covering IT Hardware, Communications Equipment, and IT Services. During his 20 years covering technology stocks on the sell-side, Dr. Roy was also a lead analyst covering Alternative Energy, Advanced Materials, and Nanotechnology at Merrill Lynch, W.R. Hambrecht, and Janney Montgomery Scott. Before his sell-side equity research career, Dr. Roy was a lead software architect at J.P. Morgan, an AI sales engineer at Neuron Data, and a systems engineer and AI researcher at Hughes Aircraft.

Dr. Roy holds a Ph.D. degree in Computer Science from the University of California, Irvine, a MSEE degree from the University of Southern California, and a BSEE degree from the University of California, San Diego where he was a Regents Scholar.

DISCLOSURES

Water Tower Research ("WTR") is a publisher of professional investment research reports on public companies and, to a lesser extent, private firms ("the Companies"). WTR provides investor-focused content and digital distribution strategies designed to help companies communicate with investors.

WTR is not a registered investment adviser or a broker/dealer nor does WTR provide investment banking services. WTR operates as an exempt investment adviser under the so called "publisher's exemption." WTR does not provide investment ratings / recommendations, price targets or earnings estimates on the companies it reports on. Readers are advised that the research reports are published and provided solely for informational purposes and should not be construed as an offer to sell or the solicitation of an offer to buy securities or the rendering of investment advice. All users and readers of WTR's reports are cautioned to consult their own independent financial, tax and legal advisors prior to purchasing or selling securities.

John Roy, who is the writer of this report, covers three different companies for us in the Communications Equipment industry. Dr. Roy and his family have no relationships with the covered company.

Unless otherwise indicated, WTR intends to provide continuing coverage of the covered companies. WTR will notify its readers through website postings or other appropriate means if WTR determines to terminate coverage of any of the companies covered.

In certain instances, including this report, WTR will write research covering non-clients. Readers should assume that WTR will seek to turn these non-paying companies into paying clients. Likewise, WTR will seek to transform these non-clients into paying clients of its affiliate, Water Tower Strategies, LLC, which provides ancillary services such as presenting at sponsored investor conferences, distributing press releases, advising on investor relations and broader communication strategies as well as performing certain other ancillary services. The companies that WTR covers in our research are not required to purchase or use non research products or services our affiliate provides to clients.

The manner of WTR's research compensation and affiliate services to covered companies raise actual and perceived conflicts of interest. WTR is committed to manage those conflicts to protect its reputation and the independence of employees/analysts by adhering to strictly written compliance guidelines.

The views and analyses included in our research reports are based on sources believed to be reliable, but no representation or warranty, expressed or implied, is made as to their accuracy, completeness, timeliness, or correctness. Neither we nor our analysts, directors, officers, employees, representatives independent contractors or agents shall be liable for any omissions, errors or inaccuracies, regardless of cause, foreseeability or the lack of timeliness of, or any delay or interruptions in the transmission of our reports to content users. This lack of liability extends to direct, indirect, incidental, exemplary, compensatory, punitive, special or consequential damages, costs, expenses, legal fees, losses, lost income, lost profit or opportunity costs.

All investment information contained herein should be independently verified by the reader or user of this report.

All readers of this report are encouraged to review Water Tower Research's Research Principles which may be found on WTR's website www.watertowerresearch.com