

## Update Report

Rating: BUY

AMEX:PKT

Current Price: \$1.54

12-Month Price Target:  
\$4.75

Joseph Noel

jnoel@emerginggrow.com

Emerging Growth Research  
San Francisco, California

925.922-2560

### Analyst Certification

I, Joseph Noel, hereby certify (1) that the views expressed in this research company report accurately reflect my personal views about any or all of the subject securities or issues reflected in this company report, and (2) no part of my compensation was, is, or will be directly or indirectly related to specific recommendations or views expressed in this company report. The analyst does not own shares of this company and is not being compensated for the production of this report.

July 30, 2008

## Procera Networks, Inc. (AMEX:PKT)

Reiterating our Recommendation – Establishing 2009 Estimate of \$46 mm and \$0.19 EPS – But These May Prove Too Conservative – These Shares are Undervalued – Expected FCC Action Positive for PKT

- ◆ We are very excited about the stock price appreciation potential for Procera Networks. In our opinion, revenues will ramp very aggressively over the coming quarters as a result of strong successes in sales of the new multi-gigabit product line. Our confidence level in our June and September quarter estimates of \$2.1 mm and \$4.1 mm, respectively, remains very high. We are currently forecasting revenues of \$6.0 million for the December quarter.
- ◆ We are expecting the anticipated August 1st FCC action against Comcast to be a net positive for Procera as we believe it will force all ISPs to employ much more sophisticated traffic management policies utilizing next generation technologies, such as those produced by Procera Networks.
- ◆ We believe the company is on the verge of receiving several large orders. As a result, we now feel comfortable establishing 2009 estimates, which we have initially set at \$46 mm in revenues and an untaxed \$0.19 EPS, based on 93 million total outstanding shares. Due to the strength of the revenue ramp we are expecting, we believe there is a strong possibility the company could easily surpass these estimates.
- ◆ Should the orders we are expecting come to fruition, we would expect these shares to trade at a 2009 EPS multiple of between 25X to 35X, representing our price target of \$4.75.
- ◆ Should Procera sign the deals on which it is currently bidding, we would expect the shares to immediately double, or more, making the current risk/reward ratio extremely favorable for aggressive small-cap investors. Simply put – We believe these shares are poised for a major move higher. As a result, we are suggesting aggressive accumulation.

### EPS Forecast Probable Case

EPS	2008	2009
Q1	(\$0.05)	
Q2	(\$0.04)	
Q3	(\$0.02)	
Q4	\$0.02	
Year-End	(\$0.09)	\$0.19E
P/E	NA	8X

### Market Data

Market Cap (MM)	\$110
Shares Outstanding (MM)	76
Float	n/a
Dividend Yield	n/a
52-Week Range	\$0.51-\$3.40

### Financial Summary

Revenue FY 09E (MM)	\$46 (E)
Cash end of Last Quarter (MM)	\$3.3
Total Assets (MM)	\$13.7
Long-Term Debt (MM)	none
Shareholders Equity (MM)	\$9.1

Please see important disclosures, including analyst certification

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# PROCERA NETWORKS INC (AMEX:PKT)

## Summary

Over the past few weeks we have been looking into the situation at Procera Networks (AMEX:PKT). Based on what we learned, we are very excited about the Company's near term and longer term prospects. We are raising our expense levels for the rest of 2008 and establishing estimates outlining strong growth and profitability for 2009. We would be aggressive buyers of these shares as we believe a major upward move is imminent. We are expecting these shares to at least double over the next few months. We have established a 12-month price target for the shares of \$4.75.

## The Details

During much of this Spring and Early Summer, Procera has been engaged in numerous trials for its new multi-gigabit platform with some of the largest network operators in the United States and Europe. We see many of these trials now winding down and believe significant purchase orders are imminent. We are expecting the company to receive several area large orders over the near term that, we believe, will propel the price of PKT shares significantly higher.

Our confidence level in our June quarter estimate of \$2.1 million and our September quarter estimate of \$4.1 million remains very high. Based on the expected pipeline of sales, we believe a realistic revenue estimate for the December quarter is for at least \$6.0 million. We are modeling a loss for the June quarter of \$0.04 per share. We are expecting the company to accelerate its investment in its business through the end of the year, which we believe will result in a loss of \$0.02 per share for the September quarter, with a positive \$0.02 per share being realized during the December quarter. Due to the increased spending levels, we are now estimating, full year 2008 to result in an overall EPS loss of \$0.09.

Due to the strong revenue ramp we are now expecting, we believe we are able to estimate revenue and EPS levels for 2009, which we are initially setting at \$46 million in revenues, and a

positive EPS of \$0.19 based on 96 million shares. Based on the strong pipeline of orders that is developing at the company, we believe it is very possible this preliminary revenue estimate will prove to be too conservative with upside revisions being required after additional details of the actual order patterns are learned. Our EPS estimate is based on gross margins of 88% and very robust investment in sales and marketing and R&D. With higher gross margins, which we believe are possible and more conservative spending levels, we believe the EPS could be even higher. Simply put – We are expecting a major ramping of revenues, but overall profitability is difficult to predict. We, however, view our \$0.19 preliminary EPS estimate for full year 2009 as being conservative.

## Seeing Strong Sales Progress

Most of our excitement is related to the introduction of the new gigabit product and the sales progress being seen. There is a race on among competitors in this sub-sector of the networking industry for the development of a multi-gigabit platform that can serve the needs of the largest Internet service and networking providers. Because of the very flexible underlying architecture on which Procera's technology is based, DRDL, it is our opinion that Procera is in a strong leadership position for the delivery of such a product to an industry that is actively seeking solutions to its growing bandwidth related problems.

We believe Procera has been informed by several major service providers, one of which is the largest cable television provider in the United States, to gear up production in order to prepare to deliver significant numbers of units of its new multi-gigabit platform. We also believe there is an additional significant near-term opportunity with a European network provider. We are expecting initial deliveries to occur during the September quarter and follow on orders to continue well into 2009.

We continue to be impressed with the quality of the new sales personnel at Procera. These new sales people were recruited from within the industry and come to Procera on the strength of the product. We believe they will be able to generate substantial

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revenues for themselves and for Procera Networks. We are equally impressed with the recently restructured management team.

## Valuation

Based on the approximately 76 million fully diluted shares, which were outstanding as of the last reported quarter, Procera's total market capitalization at time of publication (\$1.54 per share) is approximately \$117 million, yielding a revenue multiple of 2.5 times our new \$46 million 2009 revenue estimate. If we use a more conservative share count of 93 million, which would include all outstanding options and warrants, the market capitalization of Procera would be approximately \$143 million, which would be approximately 3 times the new \$46 million 2009 revenue estimate. While these multiples are likely to be considered to be in line with hardware-based networking companies, we remind investors that Procera Networks' products are based on innovative software, which is loaded into standard high end computer platforms, which is likely to allow for very strong gross and operating margins; therefore, we believe investors should be careful when making valuation comparisons based on revenue multiples alone.

On a multiple of earnings basis, shares currently trade at only 8X our estimated 2009 EPS, based on our conservative \$0.19 EPS level, which we believe is well below comparable companies. With a very robust top line growth rate and gross margins that could approach the high 80% to low 90% range, we believe a much more realistic earnings multiple is between 25X and 35X, implying a per share valuation of between \$4.75 to \$6.65 should these major orders and our modeled revenue and earnings come to fruition.

## Risks

We believe the biggest risks to the Procera story have recently been removed.

**FCC Action** - It is clear to us that neither the FCC nor other regulatory body will heavily intervene relative to the issue of carrier traffic management, which in our opinion gives the "green light" for all of the carriers to move forward with initiatives to tame the bandwidth beast on their network – which of course is video. We are expecting Comcast to get a "Wrist Slap" from the FCC on August 1<sup>st</sup> for the methodologies it utilized to provide "reasonable network management" and we are expecting the FCC to make it clear to all ISPs that arbitrary interference with Internet users' online access choices is not acceptable.

We believe this FCC action plays into Procera hands. In our opinion, Comcast has utilized a very rudimentary traffic

management scheme and is now being forced to implement a much more sophisticated strategy. We believe Procera provides this network management sophistication that Comcast and the other major ISPs will now desire. The details of this discussion are far too complex for this paper, but we would be happy to discuss them further if investors wish to contact Emerging Growth Research, LLP.

**Competition** - We do not see the major networking equipment vendors as being especially competitive in the traffic management space and therefore do not consider them as near term threats.

**Status of Trials** - Based on the recent positive results of the multi-gigabit product trials, we are now comfortable saying that we believe an additional major risk has been removed from the Procera story. It appears that the initial trials have been highly successful and that the gigabit product does in fact work as advertised. We believe this is a major milestone for Procera and substantially increases our confidence in the long-term viability of the company.

**Management of Growth** - We believe the biggest risk to the Procera story currently relates to management of growth. In our opinion, the company does not currently have sufficient financial resources to fulfill all of the orders that may come its way. We believe it is likely the company will need to raise funds in order to meet this expected demand.

## Overall Opinion

We believe there is currently compelling evidence to suggest that the end of the wait for Procera Networks to produce a meaningful growing revenue stream is over. While we have believed over the past year that Procera possesses superior technology over its competitors, we are now able to point to concrete evidence to back our theory. We believe investors and analysts who follow this sector will be highly impressed over the next few quarters by the revenue growth achieved by Procera Networks. In our opinion, Procera has at least a 12 month lead over the vast majority of its competitors, which will likely yield early market share in what we believe will be a fast growing sub-sector of the networking industry. While we expect the revenue growth numbers to be impressive over the next 12 months, we urge investors to look beyond the simple numbers and evaluate the bigger picture relating to the importance

of this technology and the value it could represent to one of the larger networking players via an acquisition of Procera.

We enthusiastically recommend immediate purchase of the shares. We believe the risk/reward ratio is extremely positive considering a strong possibility of significant orders being realized by the company over the very short term and the meaningful revenue ramp and strong earnings per share that would result.

## Background

The ways that people use the Internet have changed dramatically. Mainstream applications of the past, such as e-mail and Web surfing, consumed only small amounts of bandwidth. Over the past few years, Internet users have begun to use many video-oriented applications that consume significantly higher amounts of bandwidth. The wide scale use of these new applications is creating significant issues for many broadband service providers. The advent and popularity of VoIP applications, along with new government regulatory requirements—such as CALEA—are additional major issues for broadband service providers.

The networking industry has responded to the above issues with a new classification of equipment and software products that enables service providers to identify and effectively manage all of the types of traffic traversing their networks. By understanding traffic flows and the types of applications traversing their networks, broadband network managers are able to establish rules on the network, which are enforced by these bandwidth management devices, to more effectively manage bandwidth hogs; limit access to certain IP addresses; and eliminate viruses, hacker attacks, and other security threats. The management reports generated by these devices allow the manager to develop innovative new services and intelligently plan for network capacity upgrades.

We are excited about Procera Network's prospects in this market. We believe this company has come up with a very innovative design to its products, which differentiates it from its competitors. We think this is especially true within the broadband service provider market, where the company seems to have an edge in features and functions. Based on our conversations with users of this equipment, we also believe the company's DRDL technology enables very robust traffic identification, which is likely ahead of most of the company's competitors. We view the company's DRDL technology to be a major innovation in this product area.

A significant difference between Procera Networks and its competitors is its software orientation. Procera's product is proprietary software loaded into standardized high-end computer platforms. This software approach should enable Procera to enjoy higher gross margins than if a proprietary hardware platform with Application Specific Integrated Circuits (ASIC) were used. While Procera's products are relatively new to the market, the company has already stacked up an impressive array of customers, with hundreds of units currently installed in the field at several hundred customers—including cable television providers, ISPs, major universities, government agencies, and large enterprise organizations. During early 2008, the company continued to increase its customer base, and we believe strong OEM partnership opportunities are currently being explored by the company's management team. We are very impressed with the company's win ratio to date, and have recently observed that most of evaluations have turned into actual purchase orders.

With a distribution strategy centering around OEM relationships, a limited sales force to target high-end broadband carriers, and increasing focus on distributors, we believe Procera's overall cost structure is likely to be very low. We believe this low cost structure will allow Procera Networks to be profitable at only a few million dollars per quarter revenue level and highly profitable as the expected sales ramp materializes during mid and late 2008.

We believe Procera Networks is a highly attractive acquisition candidate for one of the larger networking companies. Because of Procera's software orientation, we think the company's products could easily be integrated into currently installed remote and central site routers, and included in shipments of new products within this category. We also believe Procera's competitors' hardware-oriented platforms pose a significantly more difficult integration issue, and, thus, we consider these companies less attractive acquisitions to the manufacturers of routers and other networking equipment.

## Analyst and Other Important Disclosures

Analyst Certification - I, Joseph Noel, hereby certify (1) that the views expressed in this research company report accurately reflect my personal views about any or all of the subject securities or issuers referred to in this company report and (2) no part of my compensation was, is, or will be directly or indirectly related to the specific recommendations or views expressed in this company report.

### Analyst:

Joseph Noel is a 28-year veteran of the telecommunications and investment industries. Joe was recently a senior analyst at Pacific Growth Equities, LLC, where he tracked the communications equipment/services and advanced industrial sectors. Prior to Pacific Growth, he covered both the telecommunications equipment and services industries at Hambrecht & Quist and was employed by Gartner/Dataquest as a communications industry analyst. Before becoming an analyst, Mr. Noel received solid industry experience at a number of telecommunications carriers, including MCI, where he was responsible for the frame relay product marketing launch; and British Telecom, where he was involved in strategic planning for the company's Internet access service. He was also employed by various Bell Operating Companies in both marketing and technical roles for nearly ten years. Mr. Noel received his MBA in finance from Wake Forest University, and holds a BS in business and economics. A four-time Wall Street Journal All-Star Analyst, Joe specializes in emerging growth companies in the communications, Internet and advanced industrial equipment sectors.

The coverage analyst uses a relative rating system in which stocks are rated as; BUY, SELL, or HOLD.

### Stock Ratings:

**BUY** - the stock is expected to outperform the unweighted expected total return of the sector over a 12-month investment horizon.

**SELL** - the stock is expected to underperform the unweighted expected total return of the sector over a 12-month time horizon

**HOLD** - the stock is expected to perform in line with the unweighted expected total return of the sector over a 12-month investment horizon.

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