# First Cut Stock Study Report

| Company Name: | Cisco Systems | Ticker: | CSCO |
|---|---|---|---|
| Date of Study: | 3/9/2010 (price date 3/1/2010) | Price: | $ 24.60 |
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| Chapter Name (if applicable): | BetterInvesting Home Office | | |

**Discuss why you consider this to be a high quality, growth company that should be investigated further. Please include comments on historical sales and EPS growth, pre-tax profit margin, return on equity, and debt.**

Cisco has achieved fairly consistent revenue growth rates over the last 10 years. They did see some revenue declines in 2002 when the tech sector and capital spending in general declined. They also experienced a difficult year in 2009 as capital spending dried up. Their 3 year CAGR numbers below reflect this dismal year. In my study, I have excluded the oldest 5 years of data and will analyze the company using data from 2005-2009.

Their 5 year Pre-tax profit percentage remains at a healthy 5 year average of 26.9%. While this did decline to 21.5% in 2009, their 2nd quarter %PTP was up at 22.2%. This is healthier than competitors Juniper (15.5% in 2009) and Hewlett-Packard (9.0% in 2009).

While they have taken on debt from 2006 until present, they have used it to fund acquisitions as well as buy back stock. The ratio of debt to capital has been relatively stable in the last 4 years at an average of 18.9%

I believe that the management of the company is strong and they are continuing to position the company for further growth. The Chairman and CEO, John Chambers, has been on the board since 1993, and CEO since 1995. One of Cisco's strengths is their dominant competitive position in the switch and router business. According to the S&P company report 'We view the company's large installed base as a significant competitive advantage over peers, especially in cases of modular switching solutions, where it is very difficult for competitors to displace the large modular chassis equipment.' Cisco allocates approximately 14% of revenue on R&D which is on par with Intel and Microsoft and well above H-P at 3% and IBM at 6%.

Cisco's fiscal year ended in July, 2009. Their 3rd quarter closes April 30, 2010 however the next earnings call is as yet unscheduled. They have a B+ quality rating from S&P.

| Cisco Systems (CSCO) – data from Online SSG | Revenue | Earnings |
|---|---|---|
| 10 Year Compound Annual Growth Rate (CAGR) | 9.0% | 28.9% |
| 5 Year CAGR | 11.4% | 8.0% |
| 3 Year CAGR | 1.7% | -4.8% |
| Recent Quarter Growth (Jan 10 compared to Jan 09) | 8.0% | 23.1% |

**Briefly describe how the company makes money:**

Cisco Systems, which supplies the majority of Internet Protocol (IP) networking gear used for the Internet, is the world's largest supplier of high-performance computer inter-networking systems. The company's sales strategy is primarily based on distribution channel partners, with over 40,000 reseller partner sales representatives around the world.

In 2009, they had $36,177M in revenue segmented into the following product lines:
Switches – 33% of FY09 sales – 70% market share
Routers – 17% of sales – 55% market share
Advanced Technologies – 26% of sales

- Unified Communications (WebEx, contact center, etc.)
- Wireless Technology
- Video, Cable, Content Delivery
- Security, Storage Area Networking

Service Revenue – 19% of sales
Other – 5% of sales

- PureDigital (Flip video)
- Unified Computing (servers, virtualization products)

Cisco Systems has strategic alliances with Accenture Ltd; AT&T Inc.; Cap Gemini S.A.; EMC Corporation; Fujitsu Limited; Intel Corporation; International Business Machines Corporation; Italtel SpA; Johnson Controls Inc.; Microsoft Corporation; Nokia; Nokia Siemens Networks; Oracle Corporation; SAP AG; Sprint Nextel Corporation; Tata Consultancy Services Ltd.; VMware, Inc.; and Wipro Limited. (Strategic alliance source: Yahoo! Finance)

**Projected growth rate for sales**: 13.0**%**
**Why did you select this rate? Discuss from where future growth will come.**
Cisco's growth will come from both organic growth and acquisitions.

They see overall capital spending improving for the 2nd quarter in a row with this spending accelerating and 'balanced across the board in all of our geographies and market segments'.

They continue to develop and innovate their core product lines of switches, routers, security, wireless and networking technology.
On March 9th, they announced the introduction of a line of new high speed routers that will hit the market in the 3rd (calendar) quarter of this year (revenue in FY 2011). This router is currently 12x faster that competitor's routers and helps position the company to supply infrastructure products for high-bandwidth technologies in the future. While this is very good news, the press indicates that its competitor Juniper Networks may have a comparable line of routers by year's end. This is something to keep an eye on.

Cisco has a culture and consistent history of pursuing and closing acquisitions in order to expand their market share or to enter new markets. Recently closed acquisitions include Starent in 2Q FY2010 and ScanSafe in 2Q FY2010. Starent had $254M in yearly revenue in 2008 and ScanSafe had $23M in yearly revenue in 2008. Pending acquisitions at this time include Tandberg (902$M in 2009, 12% rev growth over 2008). Per Cisco's earnings call on 2/3/2010, this acquisition is expected to be completed in the next 3-4 months.

In the 2/3/2010 earning call, Cisco guided revenue growth at 23-26% year over year for Q3 FY 2010. They indicated that over the next 2-3 years revenue would grow in the 12-17% range.
My estimates for growth rates reflect this guidance as well as my optimism about Cisco's market position.

**Projected growth rate for earnings per share**: 13.6**%**

**Why did you select this rate?**

My earnings per share growth rate is based primarily on the Preferred Procedure calculation and taking into account Cisco's guidance on the relevant data in the preferred procedure calculation.

Near term margins will be similar to Q2 (22.2%) so I've adjusted the default form the 5 year average of 26.9% to 22.0%.

Tax rate is expected to be approximately 22%.

Share count is expected to be down 25M shares quarter over quarter so I've modified the default shares outstanding from 5,734M in the most recent quarter to 5,634M.

This calculates out to be 13.6%

| | Defaults | Judgments | Result |
|---|---|---|---|
| Projected 5 Year Sales Growth Rate (Your Forecast): | 13.0% | 13.0 | 66,543.2 |
| Less Expenses (5 Yr Avg % Pre-Tax Profit Margin): | 26.9% | 22.0 | -51,903.7 |
| Less Taxes (Last Yr. Tax Rate): | 19.2% | 22.0 | -3,220.7 |
| Less Preferred Dividends (Current Pref'd Div): | 0.0 | 0.0 | 0.0 |
| Projected 5 Yr Total Earnings: | | | 11,418.8 |
| Divided by Shares Outs. (Current Shares. Outs.(M): | 5,734.0 | 5,634.0 | 2.03 |
| 5 Year Compound Annual EPS Growth Rate: | | | 13.6% |

The Thomson/IBES consensus 5 year estimate was 10.00% (available in the Online SSG) and the analyst 5 year growth estimate in Yahoo Finance is 11.5%.

**Projected High P/E**: 24.0

**Why did you select this value?**

In the last 5 years, the high PE of this stock has remained relatively stable in the 24-26 range. For FY 2009, the high PE dipped down to 23.6 but I consider this to somewhat of an outlier. The current PE as of 3/1/10 was 23.21. While this number approaches the traditional high PE's, I expect there to be some additional PE expansion as capital spending continues in the recovery.

**Projected Low P/E**: 16.35

**Why did you select this value?**

I kept the default average Low PE for the last 5 years.

**Projected Low Price**: $17.49

**Why did you select this value?**

The low PE value of 16.35 multiplied by the last 4 quarter EPS of 1.07 provides a low stock price potential of 17.49.

**At the current price, the stock is a (check one):**

☒**Buy** or ☐**Hold** or ☐**Sell**

**At the current price, the upside-downside ratio is:** 3.22 **to 1**

**Projected compounded rate of return:** 14.31**%** using the forecast high PE to calculate the projected high price. Using the average PE to calculate the projected high price this is reduced to 10.41%. Cisco does not pay a dividend.

**Your final recommendation (check one):**

☐**Buy** or ☒**Hold** or ☐**Sell**

**Explain:**

This is a stock where I've made some pretty aggressive estimates in comparison to the community. In the course of studying this company, I've been impressed with its depth and breadth of product lines and I think the company is well positioned competitively.

My hold recommendation this study reflects the fact that the stock price has continued to rise since I did this study and it is now outside of my buy range. I've put this company on my watch list as I watch 1) the revenue, EPS and %PTP numbers come in for the next quarter, 2) the share price.

I'm inclined to buy this company should the price dip a bit.

As always, before I put investment dollars towards buying this stock or choosing to keep it in my portfolio, I compare it to other stocks in my portfolio and other worthy stocks using the stock comparison guide.

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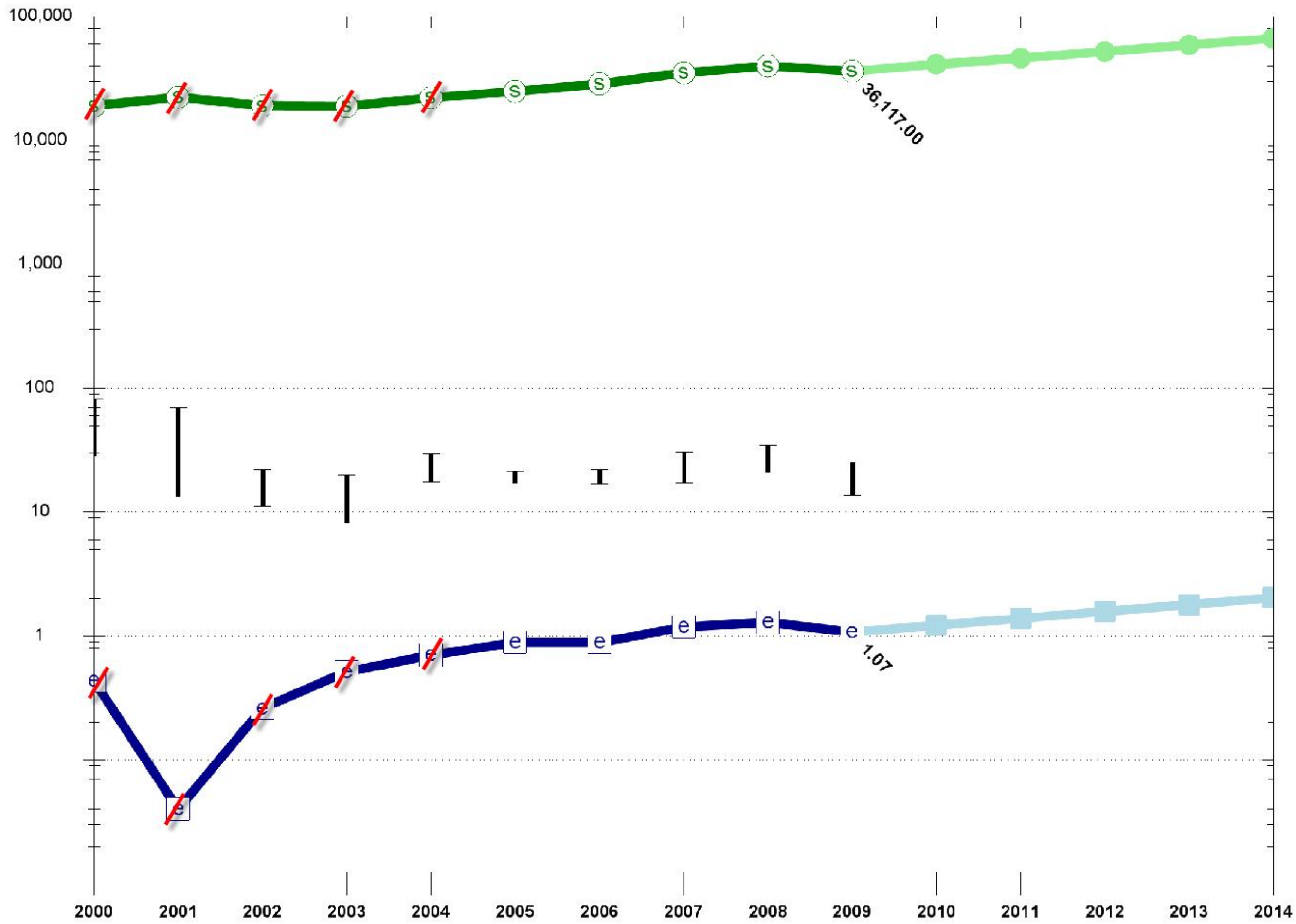
| | | | | | | |
|---|---|---|---|---|---|---|
| Company | Cisco Systems Inc | | | Date | 3/3/2010 | |
| Prepared by | Artzberger | | | Data taken from | S&P Stock Dat | |
| Where traded | NASDAQ | Industry | Other Computer Peripheral Equipm | | | |
| Capitalization --- Outstanding Amounts | | | | Reference | | |
| Preferred ($M) | | | 0.0 | % Insiders | % Institution | |
| Common (M Shares) | | | 5,734.0 | 0.0 | 0.0 | |
| Debt ($M) | 15,194.0 | % to Tot Cap | 26.8 | % Pot Dil | 2.1 | |

# Stock Selection Guide

**Symbol: CSCO**

## 1 VISUAL ANALYSIS of Sales, Earnings, and Price

| **FY2009 QuarterEnding (01/10)** | Sales ($M) | Earnings Per Share |
|---|---|---|
| Latest Quarter | 9,815.0 | 0.32 |
| Year Ago Quarter | 9,089.0 | 0.26 |
| Percentage Change | 7.99% | 23.08% |




| | | | |
|---|---|---|---|
| (1) Historical Sales Growth | 11.4% | (3) Historical Earnings Per Share Growth | 8.0% |
| (2) Estimated Future Sales Growth | 13.00% | (4) Estimated Future Earnings Per Share Growth | 13.60% |

## 2 EVALUATING Management

**Cisco Systems Inc**

| | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | Last 5 Year Avg. |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Pre-tax Profit on Sales (Net Before Taxes/Sales) | 27.39% | 5.16% | 14.67% | 26.79% | 31.73% | 32.51% | 27.12% | 27.32% | 25.94% | 21.47% | 26.87% |
| % Earned on Equity (E/S / Book Value) | 11.58% | 1.08% | 6.63% | 12.73% | 18.25% | 24.04% | 22.30% | 22.87% | 21.96% | 16.02% | 21.44% |

## 3 PRICE-EARNINGS HISTORY as an indicator of the future

This shows how stock prices have fluctuated with earnings and dividends. It is building block for translating earnings into future stock prices.

**PRESENT PRICE** 24.8 **HIGH THIS YEAR** 25.10 **LOW THIS YEAR** 13.61

| | | A | B | C | D | E | F | G | H |
|---|---|---|---|---|---|---|---|---|---|
| | **Year** | **Price** | | **Earnings** | **Price Earnings Ratio** | | **Dividend** | **% Payout** | **% High Yield** |
| | | High | Low | Per Share | High A / C | Low B / C | Per Share | F / C * 100 | F / B * 100 |
| **1** | 2005 | 21.24 | 17.01 | 0.88 | 24.14 | 19.33 | 0.000 | 0.00 | 0.00 |
| **2** | 2006 | 22.00 | 16.83 | 0.88 | 25.00 | 19.13 | 0.000 | 0.00 | 0.00 |
| **3** | 2007 | 30.39 | 17.10 | 1.18 | 25.75 | 14.49 | 0.000 | 0.00 | 0.00 |
| **4** | 2008 | 34.24 | 20.56 | 1.28 | 26.75 | 16.06 | 0.000 | 0.00 | 0.00 |
| **5** | 2009 | 25.25 | 13.61 | 1.07 | 23.60 | 12.72 | 0.000 | 0.00 | 0.00 |
| **6** | TOTAL | | 85.1 | | 125.2 | 81.7 | | 0.0 | |
| **7** | AVERAGE | | 17.0 | | 25.0 | 16.3 | | 0.0 | |
| **8** | AVERAGE PRICE EARNINGS RATIO 20.7 | | | | | 9 CURRENT PRICE EARNINGS RATIO 23.2 | | | |

## 4 EVALUATING RISK and REWARD over the next 5 years

Assuming one recession and one business boom every 5 years, calculations are mode of how high and how low the stock might sell. The upside-downside ratio is the key to evaluating risk and reward.

**A HIGH PRICE - NEXT 5 YEARS**

Avg. High P/E 24.00 X Estimate High Earnings/Share 2.02 = Forecasted High Price $ 48.48

**B LOW PRICE - NEXT 5 YEARS**

(a) Avg. Low P/E 16.35 X Estimate Low Earnings/Share 1.07 = Forecasted Low Price $ 17.49

(b) Avg. Low Price of Last 5 Years 17.02

(c) Recent Market Low Price 13.61

(d) Price Dividend Will Support $\frac{\text{Present Dividend}}{\text{High Yield}} = \frac{0.000}{0.00\%} = 0.00$

Selected Forecasted Low Price 17.49

**C ZONING** using 25%-50%-25%

Forecasted High Price 48.48 Minus Forecasted Low Price 17.49 = 30.99 Range. 25% of Range 7.75

| | | | |
|---|---|---|---|
| Buy Zone | 17.49 | to | 25.24 |
| Hold Zone | 25.24 | to | 40.73 |
| Sell Zone | 40.73 | to | 48.48 |

Present Market Price of 24.84 is in the **Buy** Zone

**D UP-SIDE DOWN-SIDE RATIO (POTENTIAL GAIN VS. RISK OR LOSS)**

$\frac{\text{High Price}}{\text{Present Price}} \frac{48.48}{24.84} \frac{\text{Minus Present Price}}{\text{Minus Low Price}} \frac{24.84}{17.49} = \frac{23.64}{7.35} = 3.22$ To 1

**E PRICE TARGET** **(Note: This shows the potential market price appreciation over the next five years in simple interest terms.)**

$\frac{\text{High Price}}{\text{Present Market Price}} \frac{48.48}{24.84} = 1.95 \times 100 = 195.17 - 100 = 95.17$ % Appreciation

## 5 5-YEAR POTENTIAL

This combines price appreciation with dividend yield to get an estimate of total return. It provides a standard for comparing income and growth stocks.

**A** $\frac{\text{Present Full Year's Dividend \$}}{\text{Present Price of Stock}} \frac{0.000}{24.84} = 0.00 = 0.00\ \%$ Present Yield

**B AVERAGE YIELD - USING FORECAST HIGH P/E**

$\frac{\text{Avg. \% Payout}}{\text{Forecast High PE}} = \frac{0.00\ \%}{24.00} = 0.00\ \%$

**AVERAGE YIELD - USING FORECAST AVERAGE P/E**

$\frac{\text{Avg. \% Payout}}{\text{Forecast Average PE}} = \frac{0.00\ \%}{20.18} = 0.00\ \%$

**C COMPOUND ANNUAL RETURN - USING FORECAST HIGH P/E**

| | |
|---|---|
| Annualized Appreciation | 14.31 % |
| Average Yield | 0.00 % |
| Annualized Rate of Return | 14.31 % |

**COMPOUND ANNUAL RETURN - USING FORECAST AVG P/E**

| | |
|---|---|
| Annualized Appreciation | 10.41 % |
| Average Yield | 0.00 % |
| Annualized Rate of Return | 10.41 % |

## ***Study Notes***

| Subject | Description |
|---|---|
| Revenue Growth Forecasts | Cisco provided guidance at 12-17%<br>Morningstar forecasts 5 year revenue growth at 12%<br>S and P forecasts 10% for FY 2010<br>Also check out the BetterInvesting Member Sentiment data |
| Earnings Growth Forecasts | Cisco provided guidance at 12%<br>MorningStar forecasts 5 year growth at 12%<br>Yahoo Analyst 5 year consensus estimate is 11.5%<br>Preferred procedure = 13.6<br>Look at BetterInvesting Member Sentiment data |