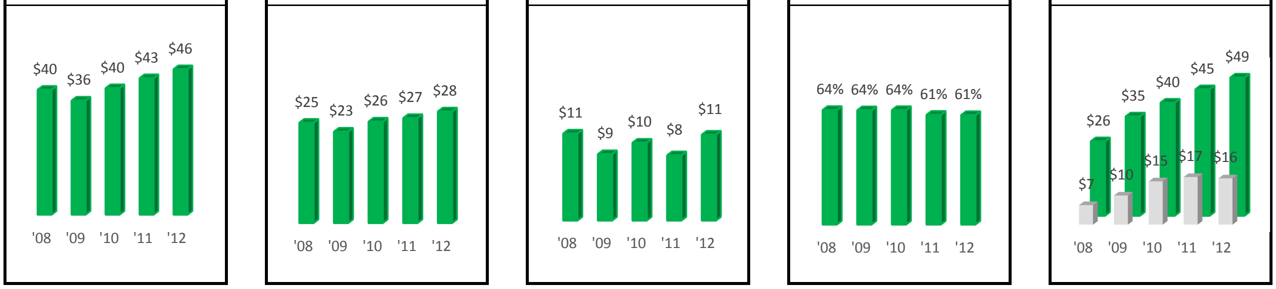
Cisco Systems Inc.
February 28, 2013

General Overview

Cisco Systems, Inc. sells network gear that allows individuals and corporations to access the internet and operate data centers. The company's primary customers are enterprises, commercial businesses, service providers, and various portions of the US government.

Revenue	Gross Profit	Owner Earnings	Profit Margin	Balance Sheet
$46,061,000,000	$28,209,000,000	$11,128,876,200	2012 = 61%	Cash = $48 Billion
5-Year CAGR = 3.9%	5-Year CAGR = 2.7%	5-Year CAGR = -0.3%	2008 = 64%	Debt = $16 Billion



In the last 10 years the company has grown owner earnings from $5.7 billion in 2004 to more than $11 billion in the last twelve months. While the income has almost doubled the earnings per share has increased nearly three-fold during that same timeframe due to a strong share repuchase program. The company has allocated more than $50 billion dollars to repurchasing stock in the last 10 years and reduced the total share count from 7 billion to almost 5 billion today.

Purchase Logic

We purchase Cisco for approximately 12x earnings which represents a 25% discount to the 16x earnings multiple for the average S&P 500 constituent. As a business Cisco faces more challenges and less certainty in future earnings than our typical investment, but we believed the steep discount and outstanding balance sheet justified the purchase. The company has a net cash position of $34 billion and an outstanding competitive position in the global supply chain for networking gear.

Future Expectations

We anticipate modest growth in earnings, between 4% and 6% annually, in the upcoming decade for the company as a whole. However, historically the business has allocated the majority of earnings to share repurchases which should allow EPS to increase significantly faster than the absolute growth of the business. The lower the price multiple the faster EPS will compound into the future. For that reason we view Cisco as a buyback play and intend to hold the company as long as the underlying business fundamentals remain intact and the share price is depressed. In the event the price multiple expands, even modestly, we intend to sell the position for a profit.

Financial Highlights

Historical Growth

Historically the company has compounded earnings at a rate of 9.8% over the last 5 years and EPS at a rate of 12.1%. The disconnect between the two growth rates stems from the strong share repurchase program that has been in place for the last 10 years which has reduced the share count while earnings have grown. In addition to healthy grown in earnings the balance sheet has strengthened considerable increasing cash balances by more than $22 billion while adding approximately $10 billion in debt.

Table 1: Performance Measures

Year	'08	'09	'10	'11	'12
Total Revenue	$ 39,540,000,000	$ 36,117,000,000	$ 40,040,000,000	$ 43,218,000,000	$ 46,061,000,000
Gross Profit	$ 25,346,000,000	$ 23,094,000,000	$ 25,643,000,000	$ 26,536,000,000	$ 28,209,000,000
Profit Margin	64%	64%	64%	61%	61%
Owner Earnings	$11,278,449,000	$8,601,535,800	$10,091,764,800	$8,454,162,600	$11,128,876,200
YOY Earnings Growth	10%	-24%	17%	-16%	32%
Shares Outstanding	6,163,000,000	5,857,000,000	5,848,000,000	5,563,000,000	5,404,000,000
EPS	$1.83	$1.47	$1.73	$1.52	$2.06
Cash	$26,235,000,000	$35,001,000,000	$39,861,000,000	$44,585,000,000	$48,716,000,000
Debt	$6,893,000,000	$10,295,000,000	$15,284,000,000	$16,822,000,000	$16,328,000,000

Products & Services

Cisco sell multiple network services across a myriad of product types including Switching, Next-Generation Network (NGN) Routing, Service Provider Video, Collaboration, Wireless, Data Center, Security, and Other Products.

The products that the company offers are frequently replaced, rapidly obsoleted, and deteriorate in price quickly. Virtualization is having a major impact on the growth of the IT industry. Historically data center resources were segregated across enterprises and there was a significant amount of over capacity per business. The virtualization and the cloud are consolidating the computing power and storage resources into shared locations and virtualizing the applications to be accessed on demand. This consolidation has greatly increases the capacity factor of data center resources globally and reduces the amount of new hardware required due to greater efficiencies. This will create short-term pressure for Cisco's products, but ultimately the global demand for Cisco's hardware will continue to rise.

Customers

Cisco's customers typically operate in four primary markets: enterprise, service provider, commercial, and public sector. Enterprise businesses are large regional, national, or global organizations that employ more than 1,000 employees. Service providers offer data, voice, video, and mobile/wireless services to businesses, governments, utilities, and consumers worldwide. Service providers typically require network design, deployment, and support services. The commercial segment comprises businesses with less than 1,000 employees. The public sector includes federal, state, and local governments and educational customers.

Customers typically select their hardware vendor for data center and network build outs based on total cost of ownership, reliability, service, and brand name. The sheer volume of Cisco certified engineers is a competitive advantage for the company. The reliability of a network is a primary concern for all large institutions and buying Cisco is much safer than going with a smaller company. You can't get fired for buying Cisco.

Distribution

The company has 24,938 sales employees with field sales offices in 94 countries. In addition to these direct sales employees a substantial portion of the company's products and services are sold through channel partners. Cisco's channel partners include systems integrators, service providers, other resellers, and distributors.

Systems integrators sell directly to end users and often provide system installation, technical support, professional services, and other support services. These system integrators are not Cisco employees but have spent time and energy learning how to properly install and trouble shoot Cisco products. There are hundreds of thousands of these "Cisco certified" engineers. The learning curve associated with gaining expertise in Cisco products creates mild switching costs for these "Cisco certified" engineers and functions as a moderate barrier to entry for competing firms.

Revenue Creation

The company generates revenue by selling hardware products like Switches, NGN Routing devices, Service Provider Video, Collaboration, Wireless, Data Center, and Other Products. The products are paid for in cash, or sometimes financed by Cisco and paid for monthly over time with interest. Revenue is inherently hard to predict because it is not recurring. The company is characterized by strong quarters and weak quarters depending on global macroeconomic conditions, but the margins are exceptional and networking gear is absolutely critical to the economy. Over a long period of time substantial resources will be allocated to purchasing these types of products.

Product revenue represents roughly 80% of all revenues generated by the businesses with Service revenue contributing the balance (20%). Product revenue has roughly 60% margins and the service revenue roughly 65% margins. Both of these have been outstanding. In the last 10 years the product gross margins has been slowly in decline (from 68% down to 60%). In the long run I suspect margins will continue to compress, but ROE will should still be in excess of 20%.

Expenses

The company manufactures its products through contractors and maintains no production facilities of its own. This business model reduces the company's need to purchase plant, equipment, machinery, etc. In this respect Cisco is an idea company – they design network equipment and drive sales while third parties do all physically manufacturing. This is identical to Apple's business model and is highly lucrative.

The company has more than 75,000 employees with no collective bargaining agreements or union affiliations.

Real Income

The company's income and actual owner earnings are very close. No significant adjustments were required to reconcile reported earnings to economic reality.

Growth

We believe the market for networking equipment will continue to grow rapidly in emerging markets (despite the most recent quarterly results for Cisco that showed a decline). Network gear will certainly be deployed at an increasing pace through these developing countries while the US and other mature markets will continue to increase on a replacement cycle basis and very small gains in penetration. We are forecasting low growth between 4% and 6% for the next 10 years barring no significant technological breakthroughs that would greatly disrupt the service provider sales. We believe the EPS growth will outpace the overall business growth by a wide margin due to the low share price and strong repurchase program.

Competition

Cisco faces a lot of price-focused competition from competitors in Asia, especially China. Competitors include Alcatel-Lucent; Amazon Web Services LLC; Arista Networks, Inc.; ARRIS Group, Inc.; Aruba Networks, Inc.; Avaya Inc.; Brocade Communications Systems, Inc.; Check Point Software Technologies Ltd.; Citrix Systems, Inc.; Dell Inc.; LM Ericsson; IBM, Juniper Networks, Inc.; Microsoft Corporation; Motorola Solutions, Inc.; Palo Alto Networks, Inc.; Polycom, Inc.; Riverbed Technology, Inc.; Symantec Corporation; and VMware, Inc.; among others.

The primary focus in this competitive market is product performance, price, security, reliability, conformance standards, and market presence. In all of these areas of competition Cisco has a very strong market position - if not the most dominant.

Consolidated Balance Sheet

The company's balance sheet is sensational with $48 billion in cash and $16 billion in debt for a net cash position of $32 billion. Additionally the company has no off balance sheet arrangements that are material. We view Cisco as a debt free company due to the capital structure of the business and believe the $16 billion in financing is an outstanding strategy to minimize taxes without repatriating funds held overseas.

Repatriation – the process of returning a person to their place of origin or citizenship. Typically used to refer to refugees or soldiers to their country of origin after war. In the case of corporate profits *Repatriation* is when you bring money that you made overseas back home. For example, if Cisco sells a router in France for €100 and earns €15 in profit they would not pay taxes on that €15 until they try to bring the money home to America. To avoid taxes they leave the €15 overseas and purchase US treasuries with the money and then *borrow* €15 in the United States. The two interest payments offset and Cisco now has €15 at home they can reinvest or spend however they wish. This is a safe and legal way to avoid paying taxes on overseas profits.

The majority of their investments are in investment-grade securities. More than 75% of their fixed income investments are in U.S. treasuries.

Accounting Quality

Revenue from distributors is recognized on a sell-through method using information provided by each distributor. The company conservatively expenses R&D as incurred. We believe the financial statements are of high quality and external third party auditors have expressed an unqualified opinion.

Legal

Cisco has had a few major legal proceedings in the past which includes the following:

- TiVo sued Cisco for patent infringement and Cisco paid substantial penalties.
- The Brazilian government is suing Cisco for the actions of a subsidiary that center around tax evasion. The government is seeking almost $4 Billion in taxes, interest, and penalties for the evasion. This would have a material adverse effect on our investment thesis, but believe the current price justifies the short-term risk.

Allocation of Capital

Cisco has excelled at capital allocation with opportunistic acquisitions and well-timed share repurchases. In total the capital has been deployed share repurchases (33%), acquisitions (31%), and dividends (33%). Our analysis assumes similar capital allocation practices moving forward.

Moat

The competitive moat for Cisco is relatively narrow, but the industry as a whole is highly lucrative. The primary drivers for Cisco's moat include the importance of the data center and network, a strong brand name, and a competitive offering for TCO. The switching cost (re-education) of hundreds of thousands of Cisco qualified engineers helps widen the moat around the distribution network and would be very difficult for a competitor to replicate. The brand name is very strong and the critical function of the data center makes key decision makers default to Cisco as a vendor of choice.

Works Cited

1) *Cisco Systems Annual Report - SEC Filing 10-K.* EDGAR, 2013.

Disclaimer