Riding Through Turbulence

Buying into a company's stock after the market has punished it for what are likely to be temporary reasons is a tried and true value-investor strategy. Is Cisco providing just such an opportunity today?

In a third quarter in which SuperInvestors sent divergent messages on high-profile technology leaders like Apple and Microsoft – both of which made the quarter's most frequently bought *and* most frequently sold lists – the message concerning Cisco Systems was far less equivocal. Of seven investors owning Cisco shares, six increased their positions, including brand-new purchases by Ivory Investment, Glenview Capital, Appaloosa Management and Omega Advisors. In total, the collective ownership of the information-technology networking giant rose more than 160%.

All of which makes the behavior of Cisco's shares since the end of the quarter much more interesting. On November 10, the company reported solid revenues and profits for its closed fiscal first quarter, but warned that sales growth in the current quarter was surprisingly weak and was expected to come in up only 3-5%, off markedly from the 13% increase expected by Wall Street and well below the company's long-term growth target in the mid-teens. "We've got a couple pockets here we have to fly through that surprised us, quite candidly," said Cisco CEO John Chambers.

Wall Street collectively reached for the air-sickness bags, sending Cisco shares down 16% the following day – their steepest decline since July 1994 – to close at $20.50. The stock has weakened further since, closing yesterday at $19.20, bringing the total loss in the company's market value over two weeks to a cool $30 billion.

The question for investors is whether Cisco's air pockets signal a fundamental change in its future prospects that justifies a dramatic step-down in its market cap, or whether the issues are cyclical and temporary and shouldn't impact intrinsic value. If so many smart investors thought Cisco shares were cheap before they fell more than 20%, are they an even more compelling bargain today?

In its ill-fated earnings call the company took great pains to affirm the health of its core business selling the routers and switches that companies and telecommunications firms use to connect computers to the Internet and to each other. The problems, it said, came from a sharp slowdown in government sales, general weakness in Europe, and a decline in set-top-box purchases by cable television providers. Taken at face value – which they're willing to do given Cisco's general history of transparency – James Roumell and Richard Sherman of Roumell Asset Management (*Value Investor Insight*, April 30, 2009) consider

INVESTMENT SNAPSHOT

Cisco Systems
(Nasdaq: CSCO)

Business: Global provider of data-networking equipment and software. Among newer markets entered: home networking, security devices, servers and storage.

Share Information
(@11/23/10):

Price	**19.20**
52-Week Range	19.18 – 27.74
Dividend Yield	0.0%
Market Cap	$107.42 billion

Financials (TTM):

Revenue	$41.77 billion
Operating Profit Margin	22.5%
Net Profit Margin	18.9%

Valuation Metrics
(@11/23/10):

	CSCO	Nasdaq
Trailing P/E	14.1	12.2
Forward P/E Est.	11.9	16.2

Largest Institutional Owners
(@9/30/10):

Company	% Owned
Vanguard Group	3.8%
State Street Corp	3.7%
BlackRock	2.7%
Fidelity Mgmt & Research	2.5%
Wellington Mgmt	2.0%

Short Interest (@10/29/10):

Shares Short/Float	0.8%

CSCO PRICE HISTORY

THE BOTTOM LINE

The market's overreaction to the company's latest near-term forecast obscures how well it is positioned to benefit from a long-lived secular shift toward centrally managed computer content and power, says Richard Sherman. At a more reasonable 8% free cash flow yield on his fiscal 2012 estimates, the shares would trade at around $28.

Sources: Company reports, other publicly available information such shortfalls more likely indicative of an uneven and choppy economic recovery than evidence that Cisco is losing competitiveness. "Nothing there signals permanent impairment of the business to us," says Sherman.

Far more important to the analysis of Cisco, says Sherman, is how well the company is positioned to benefit from what he expects to be a profound and long-lived secular shift away from PC-centric computing power to a world in which end-user devices connect to more powerful and centrally managed computer hardware, software, data and video – colloquially dubbed "cloud" computing. In such a world, there will be an even greater premium on fast, stable and secure networks to manage the resulting dramatic increase in the flow of information. Cisco's expanding product portfolio of connectivity hardware, software and services, its deep existing relationships with customers, and its reputation for quality and reliability put it "front and center" in the cloud's development, he says.

If Sherman is right that Cisco's problems are transitory bumps on a road paved largely with gold, what are the shares worth? He believes the company can earn around $8.7 billion in free cash flow for the 2011 fiscal year ending next July, so at $19.20, the shares trade at a 10x multiple of free cash flow on an enterprise value basis (after net cash) – the low end of its range over the past five years. Were the company to earn the $9.5 billion he estimates for fiscal 2012 and its multiple to expand to 12.5x – still a historically high 8% free cash flow yield – the shares would trade around $28.

ON CISCO'S VALUATION:

An 8% free cash flow yield is pretty good for a company with this profile. Getting in at 10% is that much better.

The key ongoing risk for a market leader like Cisco is that aggressive and/or innovative competitors erode its dominant positions. Hewlett-Packard is stepping up competition in switching equipment after purchasing 3Com earlier this year. Small competitors such as Riverbed Technology and F5 Networks have made inroads in certain networking niches. Chinese rivals such as Huawei Technologies have been slow to crack the U.S. market, but have had some successes competing with Cisco on price in Asia and Europe. "Not to minimize any of the threats," says Sherman, "but Cisco has faced strong competition for a long time and has proven it's more than capable of holding its own."

"You could buy Cisco last quarter at probably an 8% free cash flow yield, which is pretty good for a company with its growth profile and nearly 20% net margins," says Jim Roumell. "If you think the probability is high the growth is still there, getting in at a 10% free cash flow yield is that much better." SII

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