Cisco: Repositioning Success Yields Huge FCF

Price $47.69 **Dividend Holding** **November 21, 2022**

- 3.2% Dividend Yield.
- High cash flow generation with a good cash position. Targeting 50% Free Cash Flow (FCF) return to shareholders.
- Leverage existing customer relationships to grow its subscription and cybersecurity model.
- Fulfillment constraints subsiding as parts shortages decline.
- Earnings per Share (EPS) growth accelerating towards 7%.

Investment Thesis

Cisco (CSCO) is a global communications and technology company. Cisco is focused on both software and hardware networking solutions. The largest segment by revenue is secure networking with 46% of revenue. This is followed by services which make up 26%.

Cisco targets returning 50% of FCF to shareholders. It has $15 billion in authorized repurchases remaining. Dividend is running at an estimated 3.2% yield with a 7% estimated 5-year-CAGR (Compounded Annual Growth Rate).

Cisco has exceeded its Q1 targets despite a constrictive macro environment. 1Q23 was the second highest of volumes ever, following up the record high 1Q22. Cisco delivered the largest quarterly revenue in its history, with Annualized Recurring Revenue (ARR) up 7% year over year and software subscription revenue up 11% year over year. On top of all this, Cisco saw a 16% year over year growth in operating cash flow. These factors combined have led to an increase in full year expectations.

From a valuation perspective, Cisco remains ahead of competitors particularly in dividend safety. The reposition toward focusing on ARR and subscription-based revenue has led to high FCF growth, 48% year over year. While organic growth will be modest, it can leverage an ample cash position to quickly enter new markets. In addition, share repurchasing will drive EPS growth. Over the long-term investment horizon, Cisco is attractive for its market leadership, prodigious FCF, above average dividend yield, and modest growth of both EPS and dividend.

Estimated Fair Value = EFV

EFV = Estimated 2023 EPS times Price to Earnings (PE) ratio

Estimated Fair Value = $3.33 X 16.2 = $54.00 per share

Cisco Systems (CSCO)	E2023	E2024	E2025
Price-to-Sales	3.6	3.5	3.4
Price-to-Earnings	13.5	12.5	11.8

Megatrends: Significant Opportunity in Secure Networks

The largest growing segment for Cisco is their secure networking, growing 12% year over year. This is already the largest segment by percentage of revenue.

The global cybersecurity market is expected to grow to 375 billion by 2029, a CAGR of 13.4%. Network security demand has jumped after several critical systems breaches and the push toward hybrid work. Additionally, Asia could see explosive growth as developing economies like India and China begin to shift toward public and private cloud models.

Over the past 3 years Cisco's revenue has been stagnant. Management is taking on this challenge by attempting to switch its model toward a subscription-heavy model rather than individual products. The secure networking demand exploding over the next decade could provide tailwinds toward growing revenues. Cisco could also see significant economies of scale advantage on this front, offering multiple services and hardware solutions that roughly 30,000 firms already use. Secure networks offer the opportunity to complete the management goal of repositioning towards subscriptions.

Long-Term Case

Cisco is transitioning its model toward that of recurring revenue. Much of this is focused on network security and hybrid workforce efficiency.

Cisco has seen large growth in its subscription software revenue, with recurring subscription software now making up 85% of segment revenues. In the subscription category software has begun to catch up to service subscriptions, growing at 12% year over year. As a total percentage of total revenue, recurring revenues make up 43%. This is stagnant from 1Q22 but up from FY2020 by 12% points.

Cisco has $30.9 billion in contracted revenue. This is made up of $16.4 billion under 1-year, and $14.5 billion over 1-year. While the number of new orders was down by 14%, it is important to note the 1Q23 comparison was against an unusually high 34% year over year growth in 1Q22. Revenues have grown 6% year over year with no notable changes in margins.

Cisco targets a minimum of 50% of free cash being returned to shareholders. 1Q23 was in line with Cisco returning $2 billion out of $4 billion of FCF.

Risk

While margin contracted by approximately 300 basis points, Cisco expects this to be transitory. Primary negatives were component and freight costs.

Cisco derives 42% of its revenue from outside of the Americas. However, the USD is incredibly strong at the moment and Europe is facing a historic recession amidst energy shortages. This could potentially reduce non-USD earnings with strong exchange headwinds and may force European firms to cut their spending on networking architecture.

Peer Comparisons

Estimated Next 12 Months	Dividend Yield	EV-to-EBITDA	Price-to-Sales	Price-to-Earnings
Cisco Systems (CSCO)	3.2%	9.5	3.8	13.5
Motorola Solutions (MSI)	1.3%	19.1	5.1	25.8
Arista Networks (ANET)	0.0%	21.4	10.6	31.0
Nokia (NOK)	1.6%	6.0	1.2	11.2


Cisco Systems (CSCO)
$70.00
$60.00
$50.00
$40.00
$30.00
$20.00
$10.00
$0.00
Nov-21
Dec-21
Jan-22
Feb-22
Mar-22
Apr-22
May-22
Jun-22
Jul-22
Aug-22
Sep-22
Oct-22

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