

THE BRASS TACKS VALUE LETTER

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“Economic Pessimism and IPO Market Froth Casts Aside Profitable Companies Providing Bargains for Smart Investors”

-From the Desk of Adam J. Davis, June 2011

Dear Friend and Subscriber,

What a disparity we have in the stock market right now.

As the Dow and NASDAQ plummet to 2011 lows, investment banks are pricing IPO's in social media companies at stratospheric prices.

Judging from the IPO headlines, you might think you hopped into a time machine and landed back in 1999. (Where is Pets.com when you need a short?!)

Alas, the value investor goes to work finding unloved and undervalued companies...which these days is starting to get a bit easier. At least the *unloved* part.

Why? Many businesses are becoming unloved for a reason.

Some market moving investors out there with deep pockets – many in distant foreign lands – are waking up to realize valuations have gotten a little ahead of themselves. The advance of the S&P 500 by more than 100% since the March 2009 lows combined with pessimism on the economy has caused some major pullback..

The good news about the recent corrections is that good businesses can become available for good prices...and sometimes even downright *steals*.

And I think this is the case with one company in particular...a company that once was the most valuable in the world (\$579 billion at its peak). I was as surprised as you will be about the fact that this company came across my desk. It made for interesting and compelling evaluation.

So, without further ado...

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Let's get down to Brass Tacks...

One-time Darling Falls from Grace

It's interesting to see a one-time darling of Wall Street fall so far out of favor.

Cisco Systems (NASDAQ: CSCO) was once the most valuable company in the world, with a market cap of \$579 billion in March of 2000.

Then, the tech bubble burst and valuations came back down to earth (well, maybe close to earth) for many tech darlings.

CSCO has since seen it's stock trade from almost \$90/share at it's peak to the \$25-\$30/share range for most of the past decade.

In the meantime, the company has grown sales at a rate of 13% per year for the past decade. Operating income has grown 23% for the past 10 years.

But What About The Future?

CSCO makes the routers, switches and networking gear found in most of the data centers and information technology "nerve centers" in the world.

CSCO is the dominant player in the corporate and government network equipment sector. They also have a consumer business which is profitable and growing.

If you have a wireless network in your home, there's a high probability you are using a CSCO router or modem. And there's a high probability

your internet service provider is using CSCO equipment to move data to and from your home.

Despite the market beating thrust upon it's stock over the past year (trading down from a 52 week high of \$26) it appears as though CSCO has very good prospects for increasing sales and profits. 23% of product sales and 16% of CSCO's service sales are generated from Asia Pacific and emerging markets, respectively. There is plenty of room for growth as these markets mature.

A great benefit to CSCO is that gross margins from product and service businesses are roughly the same, at 64% of sales, so they can grow in either direction. And margins have remained steady over the past 5 years. It is certain margin pressure will come, but the company has a good moat with which to work from.

As a value investor, it is important to determine if CSCO will be able to at least maintain it's competitive position reasonably well. This speaks to the earning power of the company, which is key in valuation.

Based on my analysis, I think it is likely CSCO will remain very competitive going forward. A lot of bad things would have to happen in order for them to lose substantial market share.

They have a well-entrenched and trusted brand, as well as key relationships with profitable customers. Quality is very important in the evolution taking place right now in virtualization and cloud computing, and very advantageous to CSCO and is not being weighted heavily enough by Wall Street.

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The Value Story

CSCO was trading at a 52 week low when it really came to my attention a few weeks ago. Of course, I knew of them as the high-flying tech stock of the 1990's and of its (insane) valuation in March of 2000.

And, I've used a lot of CSCO gear in my business and home networking. I had seen their numbers a few times, but cursory glances through the years at the price/value relationship didn't do much to excite me.

I got warm to CSCO when I saw them hit 52 week lows recently on economic fears and the whole Greece/Europe/US debt turmoil rocking the markets.

One thing that seemed to tick off Wall Street and lead to big sell-offs in CSCO was missed earnings and sales estimates in recent quarters.

CSCO has also recently shuttering their ill-fated Flip Camera business and announced cost—control restructuring initiatives. For some reason analysts are nervous about this. I am not.

What is the Market Missing?

So, why is CSCO trading at 52-week lows? Why is the company getting so much flak? Are things really *that* bad? You'd think they just announced the worst value-destroying merger in history or an accounting scandal.

Here's what I mean...

CSCO is currently trading at 11x GAAP earnings (P/E). The Dow Jones Industrials average P/E is currently 13. It seems strange to me that the market is pricing a higher earnings multiplier to a basket of stocks that includes companies like Alcoa and AT&T. Now, any company in the Dow might be a fine business upon examination, but the market is overshooting in its pessimism of the CSCO. After all, why is CSCO's outlook *worse* than that of the average Dow component?

Snapshot

Company	Cisco Systems, Inc
Ticker	(NASDAQ: CSCO)
Founded	1984
Business	Networking and IT equipment/services

Share Information

Price	\$15.08
52 Week Range	\$14.92-\$26.00
Market Cap	\$82.9 Billion
Yield (%)	1.60%
5 Year Sales Growth	12.00%

Largest Holders (% Owned)

State Street Corp.	3.85%
Vanguard Group	3.78%
Blackrock Inst.	2.67%

Brass Tacks

CSCO is undervalued due to market pessimism, and disappointing Wall St. guidance. The fundamentals are sound and this business has good earning It is trading for a 33% discount to its estimated intrinsic value.

The bear case for CSCO right now is rampant. One issue is that 20% of its business is derived from public sector spending. With the budget constraints many governments have right now, it is reasonable to assume spending will slow for everything but the most essential services. As cities and state governments bleed red, this is a legitimate argument – for *perhaps a temporary decline* from this segment.

However, information technology expenditures are a necessary component of long-term cost cutting. More software and web-based applications for governments and private sector companies, which reduce fixed costs and employee expenses, will continue into the future. The dominant mindset in our culture now is that we can make everything easier and better by going digital. This bodes well for CSCO –and their industry as a whole

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CSCO - Annual Per Share Data (GAAP) - \$ Billions USD										
Fiscal Year	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Revenue Per Share	\$3.05	\$2.59	\$2.69	\$3.26	\$3.88	\$4.67	\$5.75	\$6.69	\$6.26	\$7.01
EPS	-\$0.14	\$0.26	\$0.51	\$0.65	\$0.90	\$0.91	\$1.21	\$1.36	\$1.06	\$1.36
EBITDA per Share	\$0.15	\$0.50	\$0.75	\$0.97	\$1.20	\$1.21	\$1.50	\$1.68	\$1.36	\$1.69
Book Value	\$3.71	\$3.92	\$3.99	\$3.82	\$3.63	\$3.92	\$5.19	\$5.82	\$6.70	\$7.75
Debt to Equity (%)					26.5	20.4	20.1	26.6	27.5	
ROE (%)	-3.7	6.6	12.8	17	24.8	23.3	23.3	23.4	15.9	17.5
ROA (%)	-14.5	2.4	7.7	11.3	16	10.7	12.9	12.4	8	9.1
Gross Margin (%)	49.7	63.5	70.1	68.6	67.2	65.8	64	64.5	63.9	64
Operating Margin (%)	4.8	19.5	28	29.7	30.9	25.9	26.1	25.1	21.7	24.1
Net Margin (%)	-4.5	10	19	20	23.1	19.6	21	20.4	17	19.4
Shares Outstanding (Millions)	7,319	7,317	7,019	6,761	6,391	6,105	6,071	5,907	5,768	5,711

Another bear argument for CSCO is that rapid changes in data center computing and cloud computing are opening the company up to greater competition and depressed margins. It is argued CSCO won't be able to innovate quickly enough to keep pace with complex and changing consumer demands. It is also believed by many bears that new computing platforms will be less favorable to CSCO's product lines.

Many CSCO detractors are also outspoken critics of present management, particularly CEO John Chambers, who took the post in 1995. While I cannot make an argument for Chambers being a hall of famer, it's hard to say a lot of bad things about a guy who has led the company up and through the technology stock bubble burst of 2000-2001, taking the business from \$1.9 billion in sales to \$42 billion in 16 years at the helm.

Succession planning is a potential issue at CSCO, but the company has a well-established executive development program, much like IBM and GE.

In general, I do not bank on *extraordinary* management in order to bring about the value realization. As long as there is no disturbing trend of constant management shake-ups I feel the company won't do anything really stupid in transitioning where a long-time CEO can handpick a successor.

Valuation

CSCO might be a fine company and they might generate good returns on invested capital. But this doesn't mean much to us if we can't pick up any shares at an appreciable discount to intrinsic value.

So the first thing to do is determine a range of intrinsic values for CSCO. Why a 'range' and not a precise figure?

Because trying to be spot on to the penny with a stock value is what Wall Street analysts do. It's a fruitless exercise for a value investor. If you're on the fence about whether or not a company is worth \$50/share or \$51/share and your investment hangs in the balance, then something has gone awry.

I always try to keep things as simple as possible. Evaluating numbers, disclosures, footnotes and industry data is time consuming. Absolute precision with business value isn't a good use of time.

If you estimate the value of a company at \$50/share-\$55/share and it's trading for \$45, you don't have enough margin of safety to make the purchase. Wait until it's cheaper if fundamentals are unchanged. If it's trading for \$35/share, then you know that your getting a good enough discount. Even if you are "off" in your value estimate. Time to make the purchase.

As I determined my intrinsic value range for CSCO, I thought it was important to define some key concepts in discerning the intrinsic value range.

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CSCO - Selected Value Metrics										
Fiscal Year	<u>2001</u>	<u>2002</u>	<u>2003</u>	<u>2004</u>	<u>2005</u>	<u>2006</u>	<u>2007</u>	<u>2008</u>	<u>2009</u>	<u>2010</u>
Free Cash Flow (\$ Millions)	\$4,108	\$3,847	\$4,497	\$6,404	\$5,794	\$1,728	\$5,169	\$10,423	\$8,466	\$3,886
Free Cash Flow/Share	\$0.56	\$0.53	\$0.64	\$0.95	\$0.91	\$0.28	\$0.85	\$1.76	\$1.47	\$0.68
Total Invested Capital (\$ Millions)	\$20,235	\$16,764	\$20,328	\$18,222	\$17,403	\$14,188	\$17,716	\$18,641	\$19,472	\$22,036
CF Return on Invested Capital	20.30%	22.95%	22.12%	35.14%	33.29%	12.18%	29.18%	55.91%	43.48%	17.63%

10 Year Operating Cash Flow – The average of the past 10 fiscal years cash flow from operations, as documented on 10-K filings.

Multiplier – I used a multiplier of 10 for the low range, which I thought was reasonable for this type of company – given their financial stability and market position. A multiplier of 12 was used for the high range multiple

Margin of Safety – As an investor, you want to get a good deal...and *then* you want to buy at a discount to a good deal. A margin of safety is the most important principle in profitable investing. It is what allows you to be “off” with your approximation of value without getting too badly hurt.

For further discussion on these terms, please read the Valuation Methodology on the next page. (and in case you are wondering, YES, my valuation methodology is ultra conservative. By using a 10 year average operating cash flow figure in obtaining an earning power number, companies with high growth in recent years are handicapped).

One of the most important questions I always ask myself is: “if I had the cash, would I write a check for the whole company?” Would I be happy to have the whole thing? If the answer is no, then I take a step back.

In this instance, we’re looking at a market cap of \$82.5 billion for CSCO. If I was confident in my value estimation and I had \$83 billion in my bank account and could buy all the outstanding shares without moving the price, would I do it?

Let’s dig into the numbers and see...

Averaging 10 years of cash flow from operations for CSCO resulted in \$8.3 billion. Easy enough. There was a pretty steady upward

march in operating cash flow from \$6.3 billion in 2001 to 10.1 billion in 2010.

Normalizing the annual required reinvestment (aka “maintenance capex”) figure for CSCO was a bit more of a challenge. For some businesses, it’s easy to distinguish the amount they put into replacing machinery and equipment and what they spend to expand. For other businesses, this task can be amazingly difficult.

CSCO spends a lot of money to maintain earning power not necessarily on just plant and equipment, but also in acquiring new technologies and investing in product development internally and externally.

Digging into their numbers, I found CSCO amortizes a fair amount of their acquisitions. R&D is already expensed on the income statement. The average annual depreciation & amortization figure for CSCO was \$1.6 billion from 2001-2010. To this figure I added an extra amount for ongoing investments in small companies and technology of \$400 million per year.

With average R&D of \$4.1 billion/year already factored into the 10-year operating cash flow figure, I arrived at annual “maintenance capex” amount of \$2 billion (\$1.6 bil + \$400 mil.).

This \$2 billion is the estimated rough annual spending needed for CSCO to continue generating the same operating cash flow as equates to the average of its past 10 years.

The main question we now have to answer is: “will things continue in the future *pretty much* as they have in the past?” To this question I venture a “yes” by qualifying it with my base earning power figure being 10 year average of the operating cash flow and then deducting mandatory reinvestment.

As the table on page 7 illustrates, I arrived at a low range intrinsic value (using a multiplier of 10) of \$20.04/share for CSCO and a high range value (using a multiplier of 12) of \$22.33/share. Factoring in a 25% margin of safety on the buy price, there's a 33% minimum upside. Given the current market price (close as of publication date) of \$14.84, I think CSCO presents an attractive opportunity to own a great business at a very good price.

What Are The Biggest Risks?

Risk is defined as "likelihood of permanent loss of capital." As Warren Buffett says, rule #1 of investing is "to not lose money..." and rule #2 of investing is "don't forget rule #1!"

The biggest risk to any investment is paying too much. To mitigate this, I have established the case that one can purchase CSCO with a fair margin of safety to its intrinsic value in the \$15-\$16.50 per share trading range.

With our estimate of CSCO being as much as 33% undervalued (25% undervalued at the low-end), what are the risks to value realization?

Standard, though not extraordinary, geopolitical and economic risks face CSCO as face most other global large cap companies. For instance, if the US defaults on its debts and prints money into a hyperinflationary state, CSCO will fair about as well as the average big business (not as good as the mining companies, not as bad as the banks, etc).

The bigger risks to value realization in CSCO are erosion of its competitive advantages (brand, supply chain, product development, customer relationships) resulting in depressed profit margins and stagnant sales growth.

I believe CSCO is able to deal with these threats better than most companies in its industry (and even related industries). CSCO has an established track record of quality and

Valuation Methodology

To arrive at intrinsic value, I use a derived earning power figure and apply an appropriate multiple, then add in book value. The earning figure I use is best defined as "the after-tax profits a private owner could take out of the business after making appropriate re-investment for the maintenance of (at a minimum) the same profit level."

This earning power figure closely resembles Free Cash Flow (operating cash flow less capital expenditures). The key adjustment is to 'normalize' the capital expenditure figure to determine the appropriate annual re-investment amount.

To smooth out the ups and downs of business cycles and fluctuations, we use a 10-year average operating cash flow and then subtract the annual 're-investment' capital required. We then have a close approximation of the earnings a private owner would be able to take out of the business. This estimation will be conservative for company's with fast growing earnings. No model is perfect. I find it better to err on the side of caution versus optimism.

After obtaining the ongoing earning power figure, I then apply a reasonable multiple. Book value is then added to that figure.

For instance, if we'd be willing to pay a multiple of 10, we would have our investment back in 10 years, plus we'd still own a business that was (presumably) still producing cash.

I strive to really keep things as simple as possible. This valuation metric closely approximates a discounted cash flow model, with the book value taking the place of 'terminal value,' but it is faster to calculate and less prone to wild swings based on assumptions of discount rate and earnings growth rate.

performance in its products, which carries a lot of weight with information technology purchasers. This company would have to do a lot wrong and make a lot of mistakes to lose ground. CSCO has also weathered sea change in computing and the application of its products from the very beginning of its existence. So far it has managed.

CSCO is currently subject to some legal challenges related to tax issues in Brazil (it was named as a defendant in the suit as one of their wholly owned subsidiaries was the primary defendant). This law suit could potentially cost the company \$2 billion or so (the amount of the suit), but the likelihood of a settlement not being reached or CSCO being required to pony up this entire amount are remote. The company has not taken a charge or reserved for this to date.

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CSCO - Valuation Breakdown				
10 Yr. Average Operating Cash Flow/Yr (\$ Millions)	\$8,307			
Normalized Maint. Capital Expenditures/Yr (\$ Millions)	\$2,000	=		
Free Cash Frow/Yr (\$ Millions)	\$6,307	x		
Multiplier			Low Range 10	High Range 12
Cash Flow Value (\$ Millions)	=		\$63,070	\$75,684
Shares Out (millions)		/	5,500	5,500
Cash Flow Value/Share	=		\$11.47	\$13.76
Book Value/Share		+	\$8.57	\$8.57
Intrinsic Value/Share	=		\$20.04	\$22.33
Margin of Safety (%)			25%	25%
Max Purchase Price/Share			\$15.03	\$16.75

Another risk to CSCO is the huge cash balance it carries could cause upper management to trigger-happy on acquisitions. A few quarters in a row of missed earnings estimates and some pressing questions from pesky analysts on the conference call could put bigger pressure on management to make an ill-advised acquisition.

Indeed, I feel this is the biggest risk a shareholder in CSCO faces – misallocation of capital for acquisitions and long-term investments. CSCO has a history of being a serial acquirer – albeit of relatively small or even semi-start up stage companies. It appears a large part of their strategy has been to identify disruptive businesses and buy them before they get too big and too disruptive – and also before they get too rich in valuation.

Looking at CSCO's operating history shows many acquisitions over the years. Given these acquisitions, it is unusual (to see a 10-year average cash flow return on invested capital of 29% - as most acquisitions are value-destroying. If this company has been overpaying for their small acquisitions, you'd never know it by looking at their financial performance.

But the prospect of CSCO acquiring its way to future prosperity is a dubious one. This company must find a way to innovate on its own and continue creating products and solutions for its customers.

To this end, the company spends heavily on research and development (R&D), to the tune of 13% of revenues in the most recent fiscal year. I feel that the current R&D expenditures combined with adequate Capex and a provision for other re-investment of capital each year (as discussed earlier) are adequate to *at least* preserve the company's current level of earning power.

Catalysts

A catalyst, in our terms, is an event which brings about the realization of value. For CSCO, value realization will come when the market wakes up and realizes the short-term speed bumps the company has had are not imperiling its long term earning power.

Current cost cutting measures are in place and profit margins are stable. Once the bad news subsides about their missed quarterly earnings estimates and people realize CSCO is not going to meekly shrink off into the dark of night, the share price should begin to reflect intrinsic value.

Additionally, CSCO shareholder value will be returned in the form of dividends (which the company began paying in fiscal year 2010 for the first time). Current yield on CSCO is 1.6%.

Until next month....

THE BRASS TACKS PORTFOLIO

Security	Ticker	Position	Add Date	Add Price	Current Price	Gain/(Loss) %
Cisco Systems	CSCO	Long	6/13/11	\$14.90	\$14.90	0.00%
General Electric	GE	Long	3/10/09	\$8.55	\$18.60	117.54%
LinkedIn	LNKD	Short	5/24/11	\$88.00	67.28	23.55%
Walmart Stores	WMT	Long	6/23/09	\$48.66	53.15	9.23%
BP PLC	BP	Long	6/22/10	\$29.59	\$41.96	41.80%
Eden Bioscience	EDEN	Long	6/19/09	\$1.30	Not traded-	liquidation

Gain/(loss) does not include dividends.

Important Updates

CSCO – Continues to be unloved by Wall Street. Cash flow and revenue growth is positive. No deterioration perceived in value. Fair value range est. \$20-\$23/share.

RJET – Intrinsic value range est. remains \$12-\$13/share. Still a nice upside on this company.

GE – Fair intrinsic value at \$20 per share. Current dividend yield of 3.3%. Will consider selling if fair value price is reached.

LNKD – Plan on covering short position within the next 2 weeks.

WMT – Intrinsic value range of \$62-\$65/share. Will sell when price approaches this range.

BP PLC – Intrinsic value est. \$42-\$45/share. Comfortable dividend yield of 4%.

EDEN – Company is still in liquidation. Expect to make approx. 15% total ROI. This is one I wish I had back.

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