Stock Pick of the Week: Cisco Systems (CSCO)

When Old Becomes New Again

You've likely heard of Cisco (CSCO) before. The company makes all sorts of routers, servers, and network infrastructure right? Sort of.

What happens when an established company is faced with a changing market? What happens when that company has planned for the future and begins to reap the profits from its investment? Cisco provides you the opportunity to act upon this kind of shift and see the benefits of a profitable portfolio investment.

This is Not the Same Old Cisco

As the idea of the "Internet of Things" gained traction, investors feared that Cisco's core router and server business would be left behind as revenue growth slowed in these segments. Most of the company's revenues were derived from older technologies such as routing, switching services, and hard top router and server boxes. Cloud data storage, cloud platforms, and growth in interconnected devices threatened Cisco's core revenue stream.

However, Cisco has prepared for this change. The company is creating technology poised to deliver, as Cisco puts it, "The Internet of Everything." Cisco has pointed to its data center, wireless, and security segments as keys to the next phase of its business.

These three segments made up for only 10% of Cisco's revenues in 1Q12. As of the most recent quarter, these three segments make up over 14% of revenues. This increase has offset the sales declines in the routing and collaboration segments. In fact, total revenues have grown 3% since 1Q12 on the back of strong growth in these segments, as well as in Cisco's services segment. Cisco has seamlessly adapted to a changing market and managed to grow its total revenues at the same time.

Can Cisco Continue Adapting?

With a return on invested capital (ROIC) of 14% Cisco's management has shown the ability to effectively invest money into operations that create shareholder value. Add in the fact that the company's free cash flow exceeded $6 billion last year, and it's clear that the company is well positioned to continue adapting its business.

It Pays If We're Wrong…

Cisco's stock price has been an excellent performer this year and is up 23% to date. However, this price increase doesn't even begin to properly value the company.

Even at its current price of ~$27/share, CSCO has a price-to-economic book value (PEBV) ratio of just 1.0. This ratio implies the market expects CSCO to never grow after-tax profit (NOPAT) for as long as the company exists. Over the past decade, Cisco has grown NOPAT by 11% compounded annually. A decade might as well be an eternity in the technology sector, and Cisco has more than proven its ability to adapt and continue growing its business.

Even if we assume that Cisco can only continue to grow NOPAT by 5% compounded annually for the next decade, the stock is worth $33/share today — a 22% upside from today's price. This low growth assumption is well below Cisco's long-term rate of 11% and ever further below the expected 23% and 61% annual growth rate in data center and wireless data usage respectively. Even if the changes Cisco is making don't yield accelerated growth, which seems unlikely, the company is still undervalued.

…But Pays Even More if We're Right

Given the early success Cisco has shown in its transformation efforts, investors have all the reason to be optimistic about this company. If we assume Cisco can grow NOPAT by 10% compounded annually for the next 10 years, the stock is worth $41/share today – a 52% upside. As indicated by its most recent quarterly results, Cisco looks positioned to succeed in adapting and to continue building its business for the future.

Kyle Guske II contributed to this report.
Disclosure: David Trainer and Kyle Guske II receive no compensation to write about any specific stock, style, or theme.

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