

Communication Equipment

Alert: Live From ONUG – New SDN Use Cases Emerging, White Box Switching Option Becoming More Appealing

- **Last week we attended the Open Networking Users Group (ONUG) in NYC.** ONUG was started by IT users within the financial services industry as a forum to exchange ideas, share implementation challenges, and influence vendor direction around open networking technologies. Our takeaways are summarized in this note.
- **Software-defined (SD) WAN is emerging as a leading use case for SDN,** replacing the ~\$3B enterprise edge routing market where Cisco holds ~85% share with commodity-based routers and a centralized controller. The new architecture enables central management of branch routers and programmability and prioritization of flows by traffic type. This could provide enterprise customers more flexibility in managing WAN bandwidth in pools, reducing dependence on expensive MPLS connections by leveraging lower cost broadband connections. Companies focused on this market include vIPtela, Cloud Genix, and Glue Networks.
- **We are not convinced SD-WAN is a significant threat to Cisco's edge router business, however.** While SD-WAN functionality appears compelling, we would expect Cisco to develop a competitive solution to defend its share. Glue Networks' cloud orchestration overlay provides similar functionality for existing Cisco routers.
- **Virtual network overlays and network services virtualization were also voted by ONUG participants as leading use cases for SDN, behind SD-WAN.** Virtual overlays – such as VMWare's NSX or Alcatel-Lucent's Nuage – enable seamless mobility of virtual workloads across the data center, while network service virtualization is similar to the carriers' network functions virtualization or NFV, moving L4-7 services like server load balancing and security into software.
- **White box switching also appears to be becoming a more appealing option for mainstream IT users** as it aligns with the white box server model. Vendors are enabling users to purchase a fully functioning switch + support from a single supplier, rather than shifting integration to a user to purchase a bare metal switch from one vendor, the OS from another, and integrate the OS themselves, which we believe initially limited the white box option to hyper-scale users. Dell, after announcing a reseller agreement with Cumulus in Jan (see [Cisco Systems, Inc. \(CSCO\) - Dell/Cumulus Tie-Up Magnifies Switching Risk for CSCO; Reiterate Sell](#)), announced a similar agreement to sell BigSwitch's SwitchLight OS and SDN Controllers, while Pica8 is also delivering customers a switch pre-loaded with its software. **We continue to view white box switching as a threat to Cisco's data center switching share and gross margin longer term.**
- **We heard more interest in adopting scale-out commodity based storage arrays over IP/Ethernet networks,** and away from conventional Fibre Channel SANs, again negative for SAN switch vendor Brocade in our view. Storian and CleverSafe are two of the private companies focused on this space who attended ONUG.

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Cisco Systems, Inc.

(CSCO.O; US\$23.02; 3)

Valuation

Our \$18 target price equates to 9x our CY 2014 EPS estimate of \$1.97, below the Street at \$2.02, while a projected 3% dividend yield and ~8% free cash flow yield are minor offsets to the price depreciation we forecast. We expect Cisco to grow revenue 3-5% longer term, with modest declines from what we view as peak operating margins, leaving share repurchases the only lever to grow earnings faster than revenue. We believe a discount to peers is warranted given our forecast for revenue to decline 4.6% in FY14 and uncertainty around Cisco's competitive position in data center switching.

Risks

Upside risks to our target price include 1) Share gains in data center, resulting in better revenue growth and gross margins; 2) Stable free cash flow and a growing dividend attracting more value investors and limiting multiple compression; 3) An improving macro environment, lifting revenue growth above our estimates; and 4) limited impact to Cisco's core routing share from competitor Alcatel entering the market.

Brocade Communications Systems, Inc.

(BRCD.O; US\$8.12; 3)

Valuation

Our \$8.00 target price is 10x our CY14 EPS estimate of \$0.77, a discount to networking peers, justified given slower earnings growth of -2% through FY16. Our target price is equal to the company's 5-year average NTM P/E of 10.2x.

Risks

Risks that could result in material upside to our target price include: 1) Better than anticipated fiber channel demand; 2) Increasing traction in the data center market; 3) Announcement of a dividend; and 3) Operating margin expansion.

Appendix A-1

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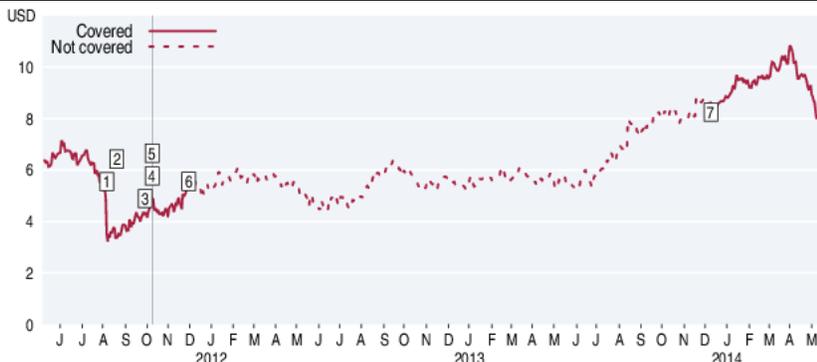
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Ratings and Target Price History

Fundamental Research

Analyst: Kimberly Watkins, CFA
Covered since December 10 2013



	Date	Rating	Target Price	Closing Price
1	5-Aug-11	1S	*6.00	3.52
2	19-Aug-11	1S	*5.25	3.42
3	29-Sep-11	1S	*5.75	4.33

* Indicates change

	Date	Rating	Target Price	Closing Price
4	8-Oct-11	Stock rating system changed		
5	8-Oct-11	*1H	5.75	4.75
6	30-Nov-11	Coverage terminated		

	Date	Rating	Target Price	Closing Price
7	10-Dec-13	*3	*8.00	8.62

Rating/target price changes above reflect Eastern Standard Time

Brocade Communications Systems, Inc. (BRCD)

Ratings and Target Price History

Best Ideas Research

Relative Call (3 Month)

Analyst: Kimberly Watkins, CFA
Covered since December 10 2013



* Indicates change

Rating/target price changes above reflect Eastern Standard Time

Cisco Systems, Inc. (CSCO)
Ratings and Target Price History
Fundamental Research

Analyst: Ehud Gelblum, Ph.D.
Covered since December 10 2013



	Date	Rating	Target Price	Closing Price
1	4-Aug-11	2M	*17.50	14.82
2	8-Oct-11	Stock rating system changed		
3	8-Oct-11	*2	17.50	16.66
4	6-Nov-11	2	*19.00	18.03
5	10-Nov-11	*1	*22.00	18.61

* Indicates change

	Date	Rating	Target Price	Closing Price
6	30-Nov-11	Coverage terminated		
7	8-Jun-12	1	*19.00	16.73
8	16-Aug-12	1	*21.00	19.02
9	9-Nov-12	1	*20.00	16.82
10	14-Nov-12	1	*21.00	17.66

	Date	Rating	Target Price	Closing Price
11	8-Feb-13	1	*24.00	21.16
12	16-May-13	1	*26.00	23.89
13	27-Aug-13	Coverage terminated		
14	10-Dec-13	*3	*18.00	21.21

Rating/target price changes above reflect Eastern Standard Time

Cisco Systems, Inc. (CSCO)
Ratings and Target Price History
Best Ideas Research
Relative Call (3 Month)

Analyst: Ehud Gelblum, Ph.D.
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* Indicates change

Rating/target price changes above reflect Eastern Standard Time

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