

Cisco Systems (CSCO) Investment Report

Cisco Systems, Inc. (CSCO) is kicking off a fresh upgrade cycle powered by AI. Rising orders from the big cloud providers and a push to bring networking gear closer to the enterprise edge should make next year's revenue picture clearer. Software now accounts for a larger slice of the pie thanks to Splunk, so margins could widen once today's cloud-hosting costs settle down. Cisco also generates hefty free cash flow (FCF)—that's more free cash flow than Starbucks earns in a year—giving management extra breathing room. Still, uneven AI demand, a growing pile of high-end silicon inventory, and tougher competition could put pressure on earnings and pricing power.

i Key Takeaways

- AI infrastructure orders reached \$1.3 billion in 1Q26; management targets ~\$3 billion hyperscaler AI revenue for FY26.
- Software mix is rising with Splunk; near-term cloud cost of goods sold (COGS) pressures margins despite long-term mix benefits.
- Inventory and purchase commitments increased by ~\$1 billion quarter-over-quarter and +38% year-over-year, elevating margin risk.
- FY26 guidance of \$60.2–\$61.0 billion revenue anchors the base case; discounted cash flow (DCF) central tendency sits in the high \$80s to low \$90s per share.
- Key risks include hyperscaler demand volatility and Silicon One obligations; strong free cash flow (FCF) and buybacks provide a cushion.

Company Description

Cisco designs, builds, and supports the networking gear, security platforms, and software that keep data moving across the Americas, EMEA, and the Asia-Pacific region (APJC). Together, these territories account for more than 95% of sales, with no single country contributing even 40%.

Management groups the portfolio into four families—Networking, Security, Collaboration, and Observability—plus a services arm that supports customers throughout a product’s life. Hardware still provides the lion’s share of revenue (about 72% in fiscal 2025), while software and SaaS supply the remaining 28%. Cisco aims to flip that split to roughly half software by fiscal 2027. Two recent moves help accelerate the shift: the Unified Edge appliance, introduced in November 2025 to bring AI inferencing closer to where data is created (Verizon was first in line), and the March 2024 acquisition of Splunk, a \$28 billion deal that deepens Cisco’s security and observability toolkit.

Fiscal 2025 revenue reached \$56.7 billion. Networking delivered \$28.3 billion, Security \$8.1 billion, and Observability \$1.06 billion, while recurring subscriptions and services already make up about 40% of the total—evidence that steadier, software-style cash flows are gaining ground.

Cisco sells through a direct sales force and more than 50,000 channel partners worldwide, backing them with financing, technical support, and advisory services. The company employs roughly 86,200 people—that’s roughly the population of a small city—including 25,600 quota-carrying and technical sales staff. CEO Chuck Robbins, now a decade into the role, recently promoted former Chief Strategy Officer Scott Patterson to CFO.

Table of contents

Investment Thesis	4
Bull Case	5
Bear Case	6
Industry Overview and Review – Networking Equipment	8
Industry-Wide Trends and Disruptors	10
Company-Specific Business Model and Operations	12
Company-Specific Industry Opportunities and Threats	13
Catalysts	14
Valuation	14
Concluding Thoughts	16
Glossary	19

Investment Thesis

Cisco kicked off FY26 with an 8 % revenue bump to \$14.88 billion, while product orders climbed 13 % on the back of \$1.3 billion in AI-focused networking gear that is already on the books. Management thinks roughly \$3 billion of that AI backlog will turn into revenue this fiscal year, giving investors a clearer line of sight than usual. The company also introduced its Unified Edge platform—essentially moving AI smarts closer to where data is created—with Verizon as an early tester. Non-GAAP gross margin slipped about 170 basis points year over year as a heavier mix of hardware offset higher-margin software gains. Inventory plus purchase commitments—advance orders Cisco has promised to buy from suppliers—now total about \$3 billion, a build-up meant to ensure parts are on hand for the AI wave.

1Q26 Highlights	Value	YoY
Revenue	\$14.88 B	+8 %
Product orders	—	+13 %
AI infrastructure orders	\$1.3 B	—

Table: Select operating and order metrics for 1Q26 (company disclosures).

Hyperscaler Momentum Fuels Refresh Cycle

The \$1.3 billion of first-quarter AI orders from cloud giants shows that spending is moving from “talk” to “truck deliveries.” Cisco’s Silicon One roadmap and new 51.2 Tbps P200 router aim to handle the east-west traffic surges created by large language-model training. A revamped partner program now steers resellers toward AI networking, security bundles, and premium services—all designed to deepen wallet share.

Risk isn’t absent: a larger parts pile means more chance of write-downs if AI demand cools, and any slowdown may temporarily pinch margins.

Splunk Drag Tempers Margin Optics

Buying Splunk boosts Cisco’s software mix but brings higher cloud hosting costs. Non-GAAP gross margin fell 120 basis points to 68.1 % and Security revenue dipped 2 %—early

signs of dilution from the subscription-style cloud billing model. Management believes this headwind fades within a year as recurring revenue scales, but elevated hosting prices could stretch that timeline.

Bull Case



Figure 1: CSCO: Earnings, FCF, and Dividend Yields Over Time

Hyperscaler AI Ramp Accelerates Orders

In 1Q26, overall product orders jumped 13% year-over-year and networking revenue climbed 15%, powered by \$1.3 billion in hyperscaler AI infrastructure purchases that signal spending is rotating back toward high-capacity platforms. Unified Edge rollouts could facilitate incremental AI hardware demand at the enterprise edge if early pilots scale.

Backlog Converts to FY26 Revenue

Management anticipates approximately \$3 billion in hyperscaler AI infrastructure revenue for FY26, supported by a pipeline exceeding \$2 billion across sovereign, neocloud, and enterprise customers. This locked-in volume tightens forecasting ranges and reinforces the raised FY26 topline outlook of \$60.2–\$61.0 billion. With pricing largely established, supply constraints rather than demand are likely to be the primary execution variables.

Software Mix Expansion Lifts Margins

The Splunk integration resulted in a 12% YoY rise in operating expenses during FY24; however, non-GAAP gross margin improved to 67.9%, reflecting early advantages from a stronger software and subscription mix. Management forecasts an interim 0.8 percentage-point margin decline from Splunk cloud COGS, which could improve as cost synergies and higher-margin security analytics scale. Management's discussion and analysis indicates software accounts for approximately 39% of revenue compared with about 28% in the Software-as-a-Service (SaaS) view—despite definition differences, both signal a growing focus on software.

Cash and RPO Underpin Downside Protection

FY25 operating cash flow reached \$14.2 billion, enabling \$12.4 billion in capital returns while net leverage remained modest. Cisco initiated an additional \$3.6 billion in dividends and buybacks in 1Q26 and retains \$12.2 billion of remaining repurchase authorization. Liquidity and a contracted AI backlog may mitigate downside risk even in a macro slowdown.

Keep an eye on the next two earnings calls—if Cisco keeps this momentum rolling, the upside story could gather even more steam.

Bear Case

Hyperscaler Demand Volatility

Cisco still lives and dies by the big cloud providers' spending cycles. AI gear orders hit \$1.3 billion in 1Q26—enough to lift total product orders 13% year over year—but management

says visibility is limited and “lumpiness could persist.” If hyperscalers tap the brakes, quarterly revenue could swing outside Wall Street’s forecasts. In prior cycles, sales have moved between –4 % and +6 % quarter to quarter; management’s own stress test suggests a deep slowdown could trim FY26 earnings per share (EPS) by 7–10%.

Security Mix Compresses Margins

Security revenue slipped 2% in 1Q26 as older hardware products faded and new, subscription-based services took longer to bill. That mix shift shaved about 170 basis points from non-GAAP gross margin according to Cisco’s call (third-party estimates put it closer to 120 bp). Until cloud-security growth catches up, the extra hosting costs could keep a lid on profitability.

Silicon One Liability Overhang

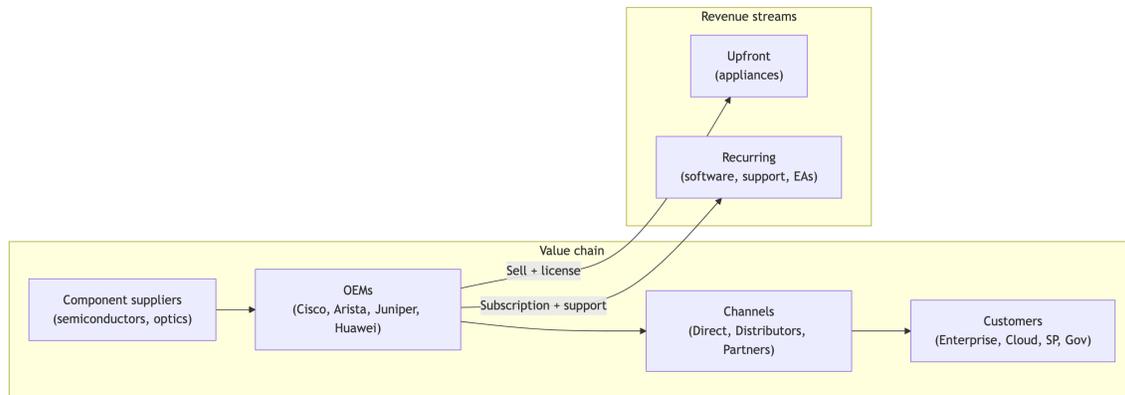
Purchase commitments for Silicon One chips climbed from \$7.6 billion at FY25 year-end to \$8.3 billion by October 2025. If demand cools, Cisco may be stuck with parts it doesn’t need, forcing a write-down—having to admit those parts are worth less than the company paid. Each inventory cleanup of roughly one percentage point (100 basis points) in gross margin would cost about four cents of EPS, and the rising obligation limits Cisco’s wiggle room on pricing should AI orders slow.

Splunk Integration Drag

Buying Splunk pushed operating expenses up 12% year over year to \$6.2 billion in 4Q24, and management now expects the higher cloud infrastructure bill to trim non-GAAP margins by roughly 80 basis points. Analysts still model 150–200 basis points of margin improvement starting in FY26; if cost synergies arrive more slowly, EBIT could stay below those optimistic targets.

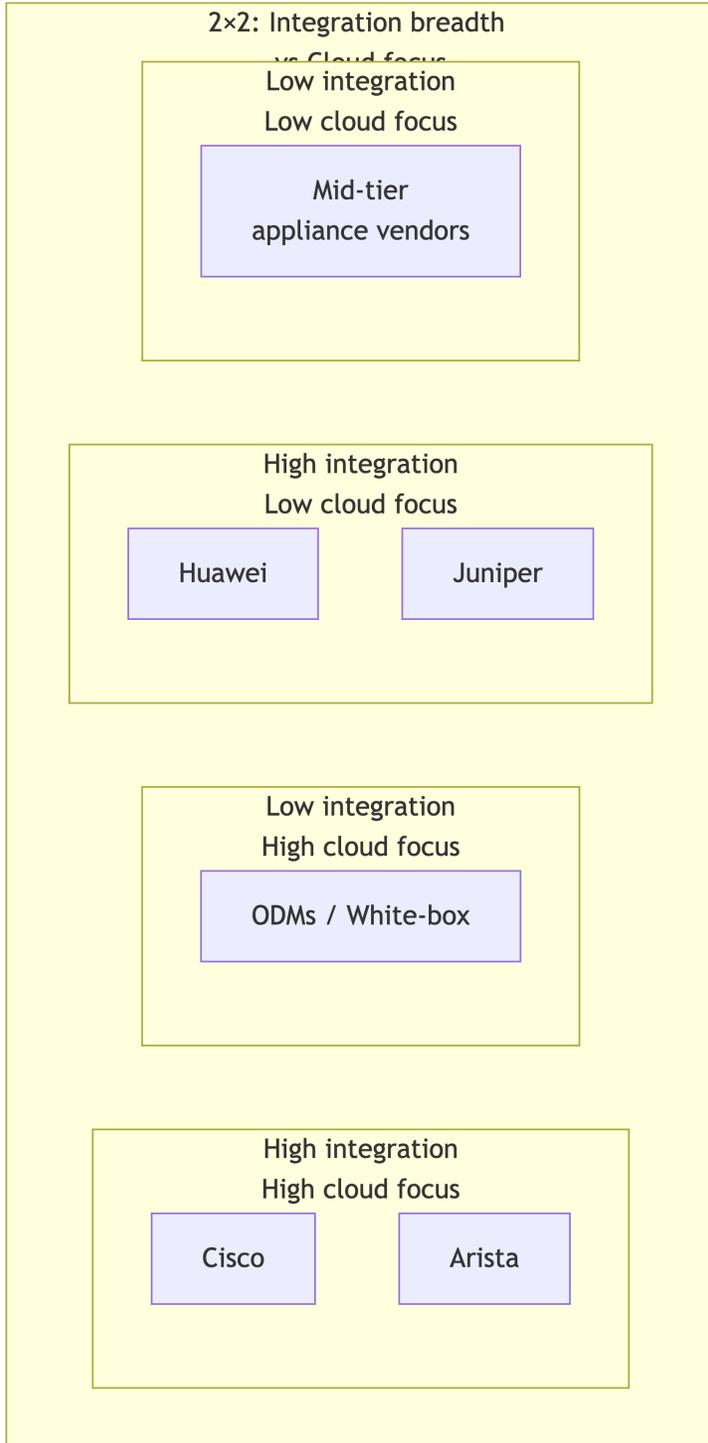
- A November 2025 AP report revived headlines around an older China-related lawsuit, posing additional reputation risk.

Industry Overview and Review – Networking Equipment



Networking equipment value chain and revenue streams

The networking equipment industry provides switches, routers, optical links, and related software for enterprise campuses, cloud data centers, and service-provider backbones. Component manufacturers (semiconductors, optics) supply original-equipment manufacturers (OEMs) such as Cisco, Arista, and Juniper, which sell hardware directly or via distributors. Revenue comprises upfront appliance sales, recurring software licenses, and multi-year support contracts, underpinning an ~8.2% CAGR through 2026; Cisco and Arista are identified as scale leaders.



Competitive positioning across

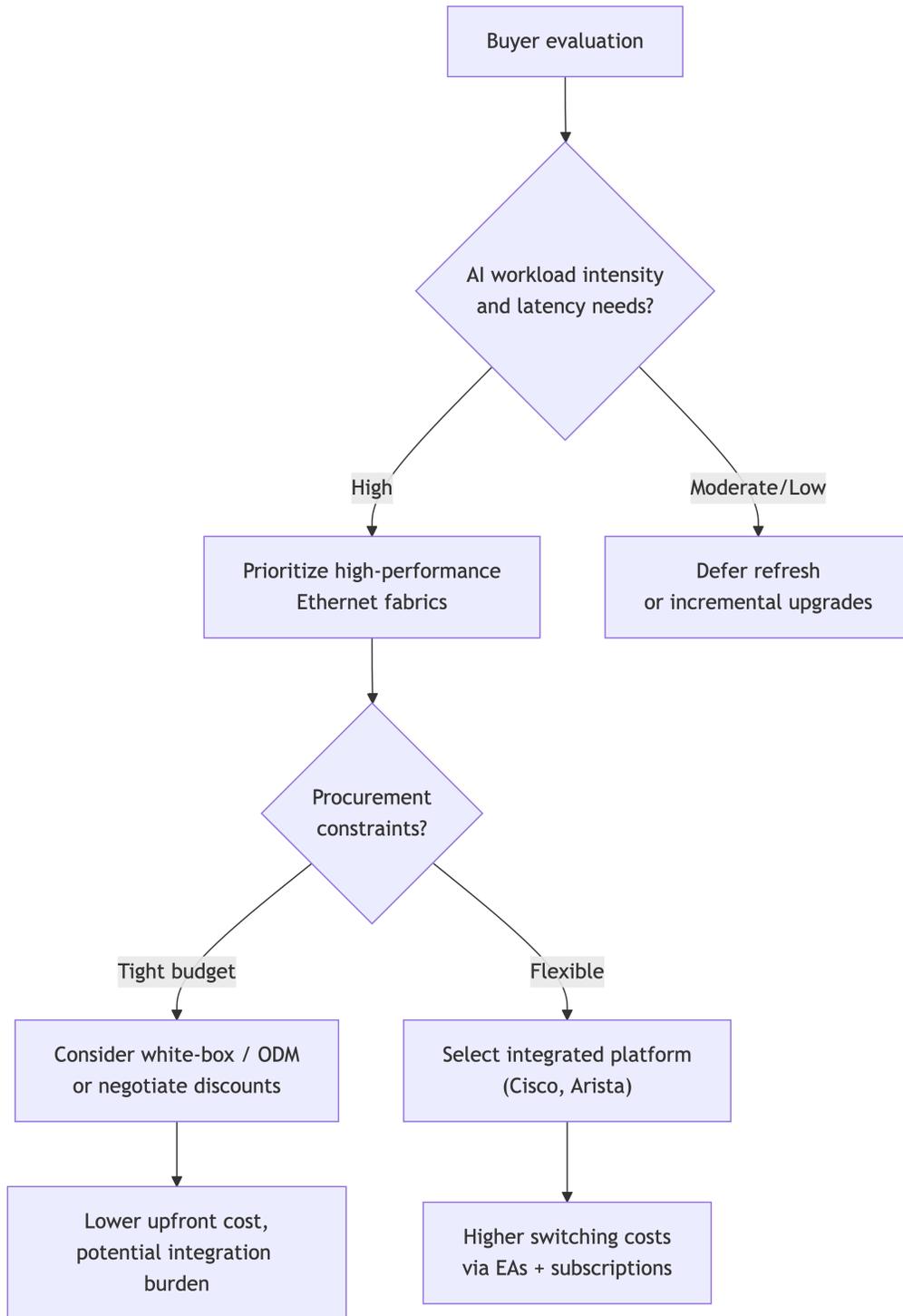
integration and cloud focus

Demand is influenced by AI workloads and cloud architectures, directing capital toward high-performance Ethernet fabrics and Software-Defined Networking platforms. Unified Edge positions Cisco for on-premises AI workloads in verticals such as retail and manufacturing. Competition is polarized: Arista leads in cloud leaf-spine deployments; Juniper focuses on telecom routing; Huawei is a global competitor despite export controls. Cisco projects approximately \$3 billion in AI infrastructure revenue for FY26, highlighting scale advantage. Arista's AI-optimized switching intensifies rivalry in high-bandwidth Ethernet fabrics for GPU clusters. Long qualification cycles, adherence to open standards (e.g., Ethernet, IP), and usage-based EAs create high switching costs and moderate price inflation.

Cisco's core business spans Networking, Security, Collaboration, and Observability, plus lifecycle services. Hardware contributes ~72% of FY25 revenue; software/SaaS accounts for 28%, with a 50% software mix targeted by FY27. FY25 sales totaled \$56.7 billion, led by \$28.3 billion from Networking and \$8.1 billion from Security, with about 40% of total revenue recurring. In 1Q26, revenue rose 8% YoY and product orders grew 13%, driven by \$1.3 billion hyperscaler AI bookings, supporting 15% Networking growth. Management anticipates approximately \$3 billion of recognized hyperscaler AI revenue in FY26 and a further >\$2 billion pipeline across sovereign and enterprise customers.

Industry-Wide Trends and Disruptors

Investor dollars are flocking to companies that can build AI-ready networks and cloud-first services, putting heavyweight vendors in the driver's seat while bargain brands without an AI angle fall behind. Firms that bundle high-speed chips, optical links, and orchestration software now sit closest to the budget hose; mid-tier appliance makers without these bells and whistles are already feeling the pinch as buyers narrow their supplier lists.



Buyer

decision paths in AI-driven refresh cycles

For everyday investors, here's the punch line: when the world jumps to a faster standard—AI-driven computing today and 6G wireless tomorrow—enterprises rip out old gear and sign new purchase orders, creating an earnings windfall for the suppliers that keep up.

- Early 6G field tests, expected around 2028, could reward research leaders; stragglers risk seeing their product road maps tossed aside.
- Long-shot bets like quantum networking (IBM and Cisco aim for a demo by 2030) promise big upside but almost no near-term revenue.

Big-picture economics matter too. Moderate global growth supports planned network upgrades, but sticky inflation can push part costs higher and delay discretionary projects—an edge for vertically integrated giants with stronger purchasing clout.

On the policy front, a recent U.S. court ruling trimmed the authority of the nation's communications regulator, the Federal Communications Commission (the FCC). With looser traffic-management rules, carriers may spend more on smart edge analytics. Meanwhile, the European Union's forthcoming AI rulebook could add new compliance steps for data-handling gear—costs deep-pocketed platform owners can absorb far more easily than up-and-comers.

Bottom line: whoever controls advanced silicon, offers sticky software subscriptions, and can clear the next wave of rulebooks stands the best chance of emerging as tomorrow's winner.

Company-Specific Business Model and Operations

Cisco reported \$59.3 billion in FY25 revenue, with 44% derived from software and subscription contracts. However, Annual Recurring Revenue (ARR) constitutes only 27% of the total, reflecting an ongoing transition from one-time hardware sales to recurring revenue models. Multi-year Enterprise Agreements (EAs) cover 82% of the Fortune 500. While these agreements provide usage flexibility, they restrict renewal price increases to Consumer Price Index (CPI) plus 1%, potentially capping margin growth during inflation. The top 10 customers account for 18% of sales, underscoring sensitivity to hyperscaler spending cycles. A consolidated partner program and long-duration customer financing (12–60 months) facilitate AI rollouts and can reduce customers' weighted average cost of capital (WACC) compared to peers.

The primary revenue driver remains campus and data center networking equipment, but management is prioritizing AI fabrics and high-bandwidth silicon to enhance mix. In 1Q26, Cisco achieved \$14.88 billion in revenue and secured \$1.3 billion in AI infrastructure orders, marking a 13% YoY increase in product orders. Cisco has already captured over \$2 billion in AI orders for FY25 and anticipates approximately \$3 billion in AI infrastructure revenue from hyperscalers in FY26, supporting Silicon One switches, optics, and software licenses. The \$23.4 billion product backlog recorded at fiscal year-end may help manage the anticipated demand surge and expand ARR as deployments transition to subscription-based observability and security.

These dynamics may benefit Cisco as AI workloads strain networks. Risks include concentrated hyperscaler exposure, CPI-linked EA renewals, and an unwinding backlog that could diminish pricing power as supply chains normalize.

Company-Specific Industry Opportunities and Threats

Arista's cloud-centric switches continue to impact Cisco's data center share, Juniper targets telco routing niches, and Huawei remains competitive outside the U.S. Cisco retains approximately 46% of campus switching and 38% of data center switching, with both declining by roughly 130–200 basis points over the past year. Networking equipment demand tied to AI workloads and cloud migration is estimated to grow at ~8% compound annual growth rate (CAGR) through 2026, positioning Cisco and Arista as leaders. Cisco's Silicon One portfolio and ~\$3 billion FY26 hyperscaler AI revenue expectations imply scale advantages. Management cites a pipeline of over \$2 billion in sovereign and neo-cloud projects, with NVIDIA Spectrum-X-based N9100 availability anticipated in 2026.

Cisco's advantage lies in a broad offering—campus to cloud hardware, integrated security, and observability—plus multi-year EAs and ~27,000 patents that mitigate substitution risk. Bundling AI-ready fabrics, optics, and software subscriptions reinforces switching costs as enterprises reduce suppliers.

Threats remain: Arista and white-box original design manufacturers (ODMs) may erode high-margin data center ports; hyperscalers are bringing optics in-house; the EU AI Act could add compliance costs. Arista's R4 Series elevates competition in high-performance fabrics. If open networking and disaggregated models gain favor, a vertically integrated strategy could face pricing pressure amid regulatory scrutiny. IBM–Cisco quantum networking collaboration is long-term and unlikely to deliver near-term revenue.

Catalysts

Think of these upcoming events as Cisco's next "show-me" moments: * Watch for fresh analyst upgrades after Cisco's first-quarter beat—sales climbed 8 % to \$14.88 billion and adjusted earnings per share rose 10 %; management now guides full-year sales of \$60.2–\$61.0 billion. * Look out for the AI order surge turning into real revenue—mega-cloud customers have already inked \$1.3 billion in deals, and Cisco is chasing roughly \$3 billion for the year, a tailwind that can power results for several quarters. * Watch for early wins from the new Unified Edge platform, which moves AI crunching closer to where the data is born (think store aisles or factory floors) and could widen Cisco's hardware footprint. * Keep an eye on Cisco's quantum-networking partnership with IBM—an open-source project aiming for a 2030 demo that, while distant, could add sparkle to the long-term story. * Watch progress on the AMD–Cisco–Humain 100-megawatt AI data-center venture in the Middle East, scheduled to go live in 2026, potentially boosting demand for Cisco optics and routers without tying up much capital. * Look out for momentum from the streamlined channel program and Unified Edge pilot deployments, both designed to speed up deal flow. * Watch for additional price-target bumps (recently around \$86–\$90) that can keep sentiment leaning bullish.

Valuation

Cisco's price tag hangs on three things: how long the AI-networking boom lasts, how quickly software takes over the sales mix, and how smoothly Splunk is folded in—all without crimping capital spending or buybacks. Today the company throws off roughly \$13.3 billion in free cash flow (a 23.5 % margin) and returns more than 90 % of it to shareholders, so even small tweaks to growth or margin forecasts move the equity dial. Wall Street still treats Cisco like a hardware outfit and pencils in sub-4 % revenue growth with flat margins, even though software is already about 40 % of sales and the AI order book plus Remaining Performance Obligations (RPO) hint at sturdier demand. This disconnect shows up in our discounted-cash-flow (DCF) spread between bear and bull cases.

Our valuation work brackets fair value between \$85 and \$145 per share. The model's "central tendency" clusters in the high \$80s to low \$90s (mean \$90.5; median \$87.5). With the stock at \$76.46, that median points to high-single-digit upside, while the mean suggests low-teens potential. Breaking \$100 a share is plausible if the \$3 billion AI backlog converts on schedule, the \$2 billion-plus pipeline lands, Security/Observability keeps growing

at high-teens to 20 %, and Splunk-related costs taper, revealing cleaner EBIT and FCF margins.

Discounted-Cash-Flow Scenarios

Scenario	Value/Share	Upside (%)	Notes
Bear	~70.9	-7	AI orders slow, software mix stalls, margins hug current GAAP levels
Base	~87.5	+14	AI backlog converts, software mix deepens, operating margin trends toward mid-20s
Bull	~120.8	+58	AI revenue and pipeline exceed plan, ARR mix nears two-thirds, margins move into high-20s

Sensitivity Levers

Lever	Low	Base	High	Comment
AI infrastructure revenue FY26-27	Below \$3 B	~\$3 B	Above \$3 B plus faster pipeline	Drives early-cycle growth and Silicon One utilization

Lever	Low	Base	High	Comment
Soft-ware/ARR mix by FY30	<60 %	~65 %	>70 %	Higher mix structurally lifts margins and trims cap-ex

– Scenario Notes • Bear: Irregular hyperscaler demand, modest networking rebound, and tepid security/observability growth keep Cisco looking like a slow-growth hardware vendor deserving a mid-teens multiple. • Base: Management hits FY26 targets—\$60.2-\$61.0 billion revenue and ~\$3 billion AI sales—while software mix improves and Splunk synergies surface, supporting healthier free-cash-flow growth. • Bull: AI networking, optics, Unified Edge, and sovereign-cloud wins push recurring revenue toward two-thirds of total sales and justify a premium multiple akin to faster-growing infrastructure peers.

At roughly 14× EV/EBITDA (FactSet consensus, December 2025) Cisco already trades below the ~20× average for leading network-infrastructure names, suggesting room for multiple expansion if management delivers on these AI and software catalysts. Elevated R&D, Splunk integration costs, and sizeable Silicon One purchase commitments remain the main execution risks; proof that earnings and free cash flow can grow despite them should narrow the current valuation gap.

Concluding Thoughts

1Q26 results showed an 8% revenue increase and a 13% rise in product orders, driven by \$1.3 billion in hyperscaler AI infrastructure demand—evidence of a shift from legacy routing to AI-ready fabrics. Management’s ~\$3 billion FY26 hyperscaler AI revenue target improves visibility into an historically unpredictable order book. Together, these factors suggest AI networking can offset maturation in core hardware and support a higher growth trajectory than consensus implies.

Upside Drivers

Service provider and cloud orders surged 45% during the quarter, with several hyperscalers reporting triple-digit growth. Converting orders into the projected ~\$3 billion FY26 revenue could restore sustained double-digit Networking growth and substantiate the Silicon One strategy. Effective execution may also accelerate campus and data center refresh cycles, improving mix and margins.

Bearish Offsets

Silicon One purchase commitments of ~\$7–\$8 billion introduce inventory write-down risk if AI demand slows, constraining pricing flexibility. A 100 basis point gross-margin decline from excess inventory would reduce EPS by approximately \$0.04; Splunk adds substantial cloud COGS and over \$1 billion in operating expenses, weighing on margins by ~80 basis points before synergies. Memory and optics shortages are accounted for in FY26 margin guidance, partially mitigating component inflation risk.

Financial Cushion and Returns

In FY25, Cisco generated \$13.29 billion in FCF—234% of GAAP net income—and returned 93% to shareholders while keeping net leverage below 1× EBITDA. The company ended FY25 with \$7.6 billion in purchase commitments tied to AI projects and \$43.53 billion in RPO (roughly half realizable within 12 months), providing visibility and flexibility to manage cycles.

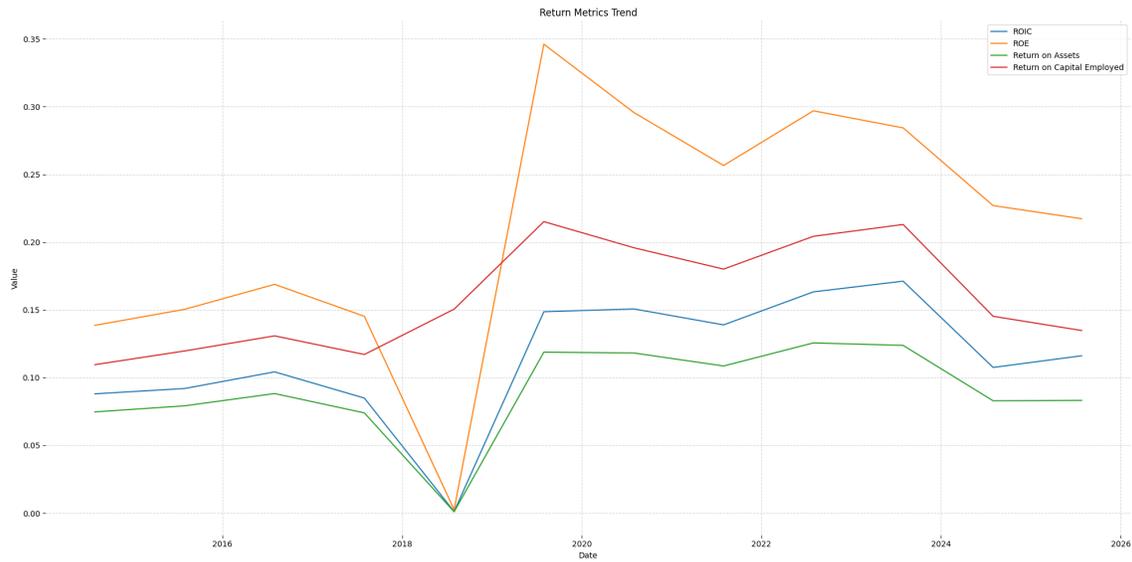


Figure 2: Return Metrics Trend

Catalyst Path

Recognition of ~\$3 billion hyperscaler AI revenue and sustained order momentum could prompt a re-rating toward a software-weighted peer multiple. Quarterly confirmation that AI backlog is converting to revenue—and that product orders exceed historical averages—would reinforce the bullish case. Insider selling near \$78 and late-November valuation pressures highlight the need for clear milestones on AI and Splunk execution.

Glossary

- AI — Artificial Intelligence — Smart software that learns and makes decisions on its own.
- APJC — Asia Pacific, Japan, and China
- ARR — Annual Recurring Revenue — Subscription income that rolls in year after year.
- CAGR — Compound Annual Growth Rate
- COGS — Cost of Goods Sold
- CPI — Consumer Price Index
- DCF — Discounted Cash Flow
- EA — Enterprise Agreement
- EBITDA — Earnings Before Interest, Taxes, Depreciation, and Amortization
- EMEA — Europe, Middle East, and Africa
- EPS — Earnings Per Share
- EU — European Union
- FCC — Federal Communications Commission
- FCF — Free Cash Flow — Cash left after expenses—the fuel for dividends and buybacks.
- FY — Fiscal Year
- GAAP — Generally Accepted Accounting Principles
- GDP — Gross Domestic Product
- JV — Joint Venture
- OEM — Original-Equipment Manufacturer
- ODM — Original Design Manufacturer
- P/E — Price-to-Earnings ratio
- QoQ — Quarter-over-Quarter
- R&D — Research and Development
- RPO — Remaining Performance Obligations
- SaaS — Software-as-a-Service
- WACC — Weighted Average Cost of Capital
- YoY — Year-over-Year