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MARKET CALLS

Cisco's Twelve-Step Program for Recovering Techstocks

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Cisco has spoken, and earnings season is officially over now for the major technology companies. And as always, both the substance and the form of Cisco's statements speak volumes about the state of techtopia in the post-boom-and-bust era. With its earnings report last night -- on the surface, a blow-out "beat" with earnings coming in at $0.04 versus a consensus of $0.02 -- Cisco may have set the stage for an important inflection point.

It's done it three times before in just the last three months. With its previous earnings report on August 7, Cisco triggered the most recent leg down in the NASDAQ when it reported in-line earnings -- and its exhausted **CEO John Chambers** finally backed away from the hollow promise of a return to Cisco's trademark 30% to 50% annual revenue growth, replacing it with the hope that business would "stabilize" around customer orders that were, finally, beginning to increase slightly. Two weeks later, Chambers triggered a sharp rally on August 24 after he reported that concrete indications in the new quarter were proving that Cisco's business was indeed stabilizing "in line" with his forecast levels. But the rally fizzled, and the decline intensified when other tech companies reported that conditions were, in fact, worsening.

Then came the terrorist attacks, and even the hope of stabilization was abandoned. But then on October 3, Chambers told a **Goldman Sachs** conference that -- attack or no attack -- Cisco was seeing strong "linearity" in its orders, and was still going to make its quarter. The statement ignited hopes that the attacks wouldn't be the deathblow to the technology industry that had been widely feared -- and it triggered the massive NASDAQ rally that carried the index back up to the levels where it re-opened on September 17 -- and it has pretty much never traded lower since.

Is this another inflection point -- as the sticker on the router says -- "powered by Cisco"? Could be, because with last night's report, Cisco has given us the chance to see the way the market will process some very complex signals. On the one hand, Cisco has delivered what is legitimately a big upside surprise, and the market hasn't had too many of those lately. But at the same time, Cisco has now forced the market to confront the smallness of what we now consider to be an upside surprise, compared to the grand dreams of a little more than a year ago. And when you get into the numbers, Cisco's report is a chance to assess the true cost of the terrorist attacks on the growth prospects of technology companies. And in this, there is as much cause for concern in Cisco's report as there is cause for confidence.

The heart of Cisco's "beat" (as it were) is in the top line. Revenues were $4.4 billion, up 3% sequentially and ahead of the consensus estimate of $4.2. Chambers was quick to point out in his press release that this revenue gain should be interpreted as "market share gains when compared to our industry peers who on average reported sequential revenue decreases in the high teens."

Whether or not this is a correct interpretation, I predict that the market will take it as a positive that Chambers chose to portray it this way. This -- along with several statements in the conference call -- suggests that Chambers has finally woken up to the importance of seizing the opportunity that fate has handed him: to use Cisco's size and strength to emerge from this recession and the chaos of the terrorist attacks in an unassailable competitive position ("Portfolio Secrets of Neutron Jack," October 25, 2001).

But as soon as you look beyond the top line, the world according to Cisco turns out not to be so happy and hopeful a place.

The headline earnings of $332 million, or $0.04 a share, were of course only pro forma. The reality is that they are wiped out almost three times over by a write-off of $858 million representing losses in publicly traded stocks. I suppose that's par for the course these days. But even on a pro-forma basis, $110 million -- one third of net earnings -- came from cost control. And $170 million -- more than half -- came from interest income.

But what is most ominous is what Chambers has indicated for the future. In the conference call he said that some measure of visibility had begun to return to his business before the terrorist attacks -- but now there are enough new uncertainties to make meaningful guidance impossible again. Chambers estimates that the effects of the terrorist attacks cost Cisco about 2% in sequential revenue growth for the quarter -- in other words, growth would have been 5% instead of 3%.

Fair enough. But this would seem to stand in contradiction to his statements of October 3 that Cisco was seeing "linearity" in orders -- having 40% of your revenue growth whacked out of your quarter is pretty non-linear by most people's way of thinking. When questioned on this point by a sell-side analyst in the conference call last night, Chambers redefined "linearity" to suggest a two-step piece-wise process, perturbed downward in the middle by the terrorist attacks.

Now, looking to the next quarter -- while protesting that he lacks visibility again, thanks to the terrorist attacks -- Chambers suggests that revenues will be sequentially flat. And he claims that flat is 5% lower than they would have been *without* the terrorist attacks: in other words, 5% sequential revenue growth is what he'd see if it weren't for all that lack of visibility.

This means that, as always, lack of visibility is what CEOs call it when they don't like what they see. And here's what Chambers sees: underneath this quarter's revenue growth, new orders actually decreased across all Cisco's lines of business. That suggests that *this* quarter Cisco was able to harvest the fruits of the modest order increases *last* quarter -- and it makes me wonder how they're going to deliver even flat revenues *next* quarter.

These elements of substance are important -- they inform the "e" in the "p/e" ratio that investors are going to mentally assign to Cisco now. But the "p" is going to come as much from the psychological cues that came from Chambers last night. And I think that the cues were not especially positive, although it may take several days for the reality of them to set in.

Specifically, in last night's conference call we saw a new John Chambers and a new Cisco. Having already borne the shame of abandoning his 30% to 50% revenue growth dreams in *last* quarter's conference call, Chambers spoke with more self-confidence than we've heard in many quarters now. But this time it wasn't his usual false bravado about "tornado markets" and "breakaway strategies." He did use those expressions from time to time, but the theme he kept coming back to was the more modest one of *recovery*.

So his confidence is not confidence in the sense of belief in a great and glorious future -- it's simply the *relief* of having confessed the worst. It's the confidence of having taken the first step in a [twelve-step program](), starting down the long, painful road to *recovery*.

Now, what investors will have to struggle with is whether *recovery* is worth paying anywhere near the price they used to pay for *growth.* They are *not* the same thing.

Based on overnight trading, it looks like Cisco will open right at about the same price where it was trading on August 24, after Chambers said that his quarter was shaping up "in line." It speaks volumes that last night's big "beat" is only enough to get Cisco back to where it was when earnings were still only shaping up, and shaping up to be only "in line."

That's the difference between real *growth* and mere *recovery*. Recovery is a wonderful thing -- considering the alternative. So while we celebrate the market's miraculous recovery from its September lows, let us not forget that we're still looking for the catalyst that will lead to substantial and sustainable growth.