Cisco Acquires Splunk for $28bn

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Deal Introduction

DETAILS ABOUT THE DEAL

Late September, it was announced that Cisco (NASDAQ: CSCO) and Splunk (NASDAQ: SPLK) had entered into a definitive agreement, with Cisco's intention to acquire Splunk for $157 per share in cash, representing an approximate $28 billion equity value.

This strategic move is anticipated to have significant financial benefits, as the transaction is expected to be cash flow positive and gross margin accretive in the first fiscal year post-close, with non-GAAP EPS accretion in the second year.

Furthermore, the acquisition is poised to accelerate Cisco's revenue growth and gross margin expansion.

The anticipated timeline for closing this transformative deal is by the end of the third quarter of calendar year 2024, contingent on regulatory approval and customary closing conditions, including the approval of Splunk shareholders.

Industry Overview - Digital Security

WHY IS DIGITAL SECURITY A KEY INDUSTRY AND AN EMERGING MARKET TREND?

The digital security industry is at a critical juncture as it grapples with the rapid growth of cyberattacks fuelled by the development of technology, particularly in the areas of artificial intelligence (AI), machine learning (ML) and quantum computing.

According to McKinsey, the cost of cyberattacks is projected to surge to $10.5 trillion annually by 2025, a fourfold increase since 2015.

This alarming statistic underscores the pressing need for robust digital security solutions, which are becoming a top investment priority for governments and businesses alike.

AI-based cybersecurity products are estimated to grow from $15 billion in 2021 to approximately $135 billion by 2030, as organisations increasingly rely on AI for more accurate attack detection, phishing identification, social engineering simulation, and rapid incident analysis.

OVERVIEW OF ARTIFICIAL INTELLIGENCE, MACHINE LEARNING AND QUANTUM COMPUTING INDUSTRIES

AI is a field which combines computer science and robust datasets to enable problem-solving, allowing machines to produce answers on work it's never been directly trained to work on. It is no secret AI has seen unprecedented growth with an expected 35.2% CAGR of 2021-2030, from a mere £9.32 billion to $140.65 billion in market revenue, almost 16 times the size.

This comes as large language models such as OpenAI's ChatGPT, Microsoft's Bing Chat and Google's Bard AI have taken centre stage, astounding consumers with their unparalleled capabilities. The creativity and autonomy of these softwares have incredible scope for an array of positive and meaningful impact, but have also given opportunity in negative regards such as password cracking, AI assisted hacking, deep fakes and other cyber crime.

Consumer AI Market Revenue (USD Bn)
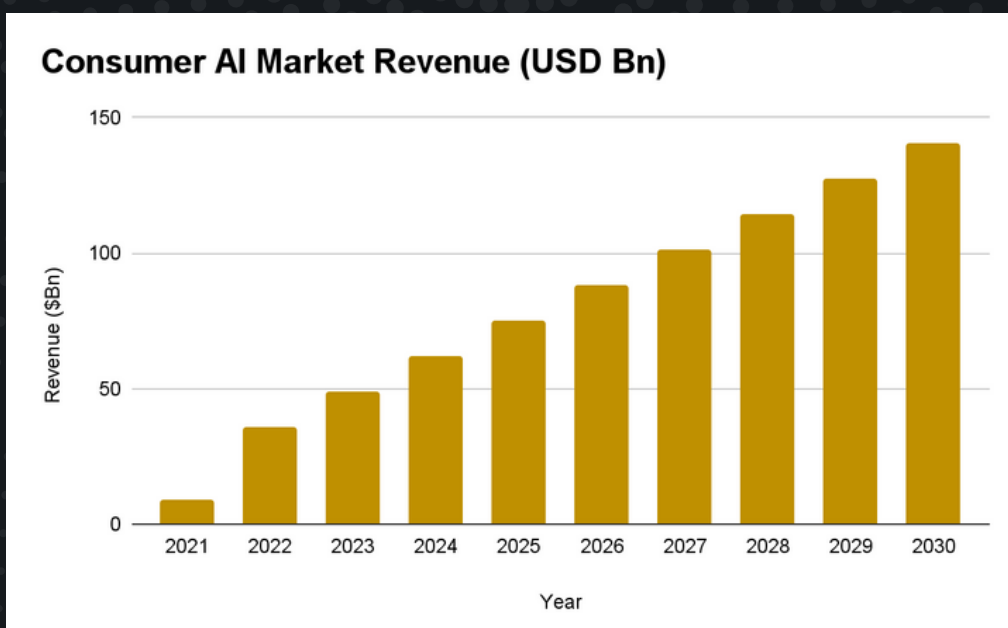
Source: Next Move Stategy Consulting

ML, a subfield of AI focusing on developing algorithms and models that allow computers to learn from data, has seen tremendous growth in market size and is predicted to reach a market size of $144.15bn by 2030.

The reason for this supercharged growth is that ML coupled with real time data, can have incredible results as ML can process the data within milliseconds to produce impactful and insightful strategies for firms to deploy.

For example, ML can use real time market data to conduct trend analysis to execute high-frequency trading strategies to gain a competitive advantage.

Furthermore, optimisation of supply chains may be achieved as real time data allows ML to predict demand and adjust inventory levels appropriately to maximise allocative efficiency.

**Machine Learning Median Market Size (USD Bn)**
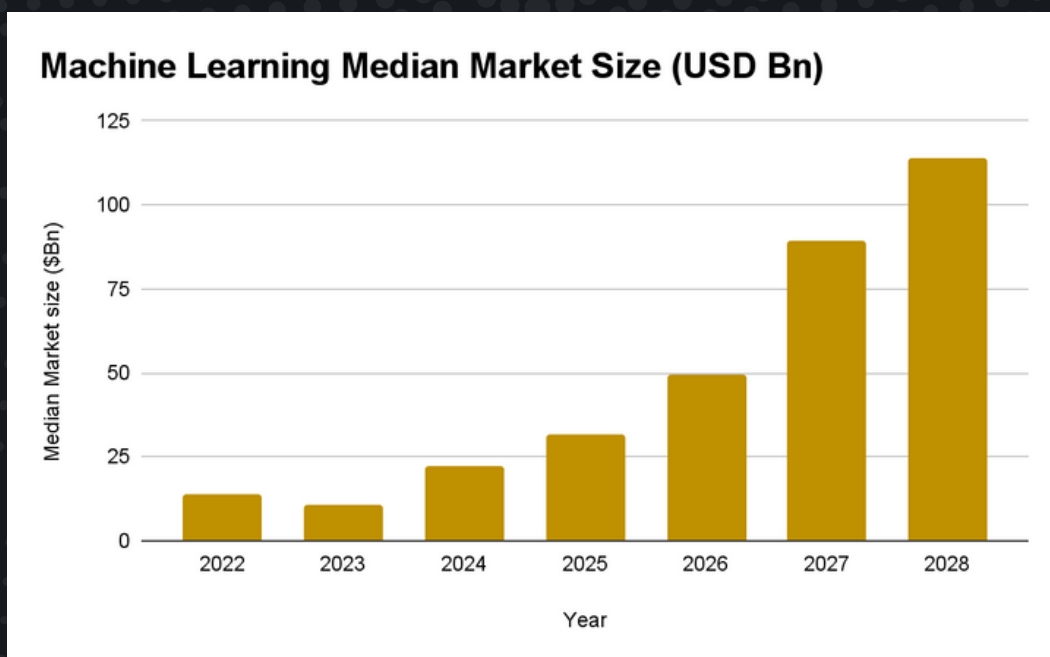
Source: PitchBook

Lastly, quantum computing is a cutting-edge area of computer science and physics that leverages the principles of quantum mechanics to perform and solve very complex statistical problems that today's computers can't.

For example, in 2019 Google announced that its quantum computer solved a problem in 200 seconds that would have taken a classical computer 10,000 years.

Quantum computing has unbounded potential and momentum that Goldman Sachs has identified as one of the next big trends in tech. Quantum computing alone could account for nearly $1.3 trillion in value by 2035 and demonstrates incredible expected growth from a market size of $928.8 million to $6.52 billion (CAGR 32.1%).

Quantum computing has facilitated major breakthroughs in drug discovery and cryptography, but also has the potential of cracking the mathematical padlocks on encrypted data, threatening privacy and security.

Quantum Computing Market Size (USD Bn)

32.1% CAGR

6.53

0.93

2023   2030

Market Size ($Bn)

Year
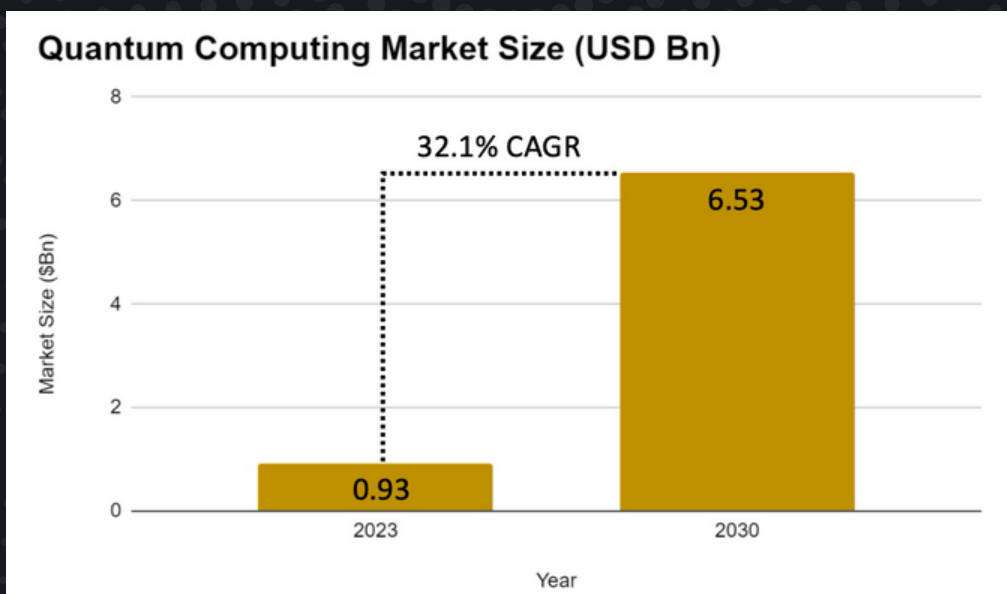
Source: Fortune Business Insights

Acquirer Overview

Cisco is a United States technology company specialising in networking products and services and is widely known for its networking solutions which encompass a broad range of hardware and software. Cisco's networking solutions cater to individual users and small businesses and large industrial scale networks.

KEY FINANCIALS

Monetary values in millions of U.S. Dollar, except per share data, P/E ratio and market cap

Revenue: 56,998 (Jul '23)

EBITDA: 17,256 (Jul '23)

EBIT: 15,530 (Jul '23)

Net income: 12,613 (Jul '23)

Market Cap: 208.8B

P/E Ratio (LTM): 16.8

Share Price: $51.56

BUSINESS MODEL

Cisco operates as a multifaceted technology company with a comprehensive business model that encompasses the design, manufacture, and sale of an extensive range of products and services.

The core focus of Cisco is to support businesses in building and maintaining computer networks. This involves offering a diverse portfolio of products, including routers, switches, wireless access points, and security appliances, which cater to the needs of individual users, small businesses, and large-scale enterprises.

A significant portion of Cisco's revenue is derived from the sale of networking hardware, which are fundamental components for establishing and managing data networks.

Moreover, in response to evolving industry trends, Cisco has been strategically transitioning toward a subscription-based model for certain software and services. This shift aligns with the growing demand for recurring revenue models and provides customers with greater flexibility in how they consume Cisco's offerings.

The company's diversified approach includes various business segments, such as Networking, which encompasses wireless and mobility solutions, Security, focusing on network security products like DDoS protection and firewalls, Collaboration, which supports remote working and administration, and data centres, where Cisco assists clients in building and managing cloud computing networks and infrastructure.

Target Overview

splunk>®

Splunk is a software company focusing on digital resilience and data security through its various APIs, apps and software. They specialise in supporting business navigate complex digital infrastructures operations through its ability in identifying data patterns and handling large volumes of machine-generated data. Splunk has evolved significantly in response to its increasing prominence of digital technology and the growing number of distributions in the digital landscape. This evolution has involved innovation, development and research resulting in a substantial intellectual portfolio with over 1,100 patents.

KEY FINANCIALS

Monetary values in millions of U.S. Dollar, except per share data, P/E ratio and market cap

Revenue: 3,654 (Jan '23)

EBITDA: -168 (Jan '23)

EBIT: -268 (Jan '23)

Net income: -278 (Jan '23)

Market Cap: 24.798B

P/E Ratio (NTM): 34.6

Share Price: $147.14

BUSINESS MODEL

By providing a user-friendly platform, Splunk empowers both IT and business professionals to swiftly analyse machine data into actionable information, optimising business operations through cost reduction, enhanced security risk management, compliance maintenance and more.

The firm's products are designed for large organisations with extensive data needs hence Splunk possesses impressive, large scale capabilities that cater to this.

Customers pay for software licences and the prices are based on the amount of data ingested or the number of users. Splunk offers its software products under various licensing models, and customers purchase licences based on data volume or the number of users accessing the platform (which includes on premises and cloud based offers).

Splunks ecosystem also includes a marketplace where customers can purchase add ons and applications developed by third party developers.

These can extend the functionality of Splunks core products and are often priced separately.

Valuation Analysis

COMPARABLE COMPANY ANALYSIS

Buyout Share Price		$157.00
FY2024 FCF		872
FY2024 EBITDA		953
Implied Market Cap (P/FCF)		34,692
No. of Shares		192
Implied Share Price (P/FCF)	**$**	**180.69**
	Premium	-15.1%
Implied Enteprise Value (EV/EBITDA)		25,947
Net Debt		(1,622)
Implied Equity Value		24,325
No. of Shares		192
Implied Share Price (EV/EBITDA)	**$**	**126.69**
	Premium	19.3%

<u>Please click on the table to access the full model</u>

Given that Splunk's valuation on a P/FCF basis implies a share price of $180.69, the offered buyout price of $157.00 by Cisco showcases a -15.1% premium, indicating a potential undervaluation against market expectations of future cash flows.

Conversely, the EV/EBITDA metric implies a share price of $126.69, with Cisco's offer representing a 19.3% premium. This indicates that Cisco is strategically positioning for the future, anticipating that Splunk's profitability will significantly increase following its integration into the broader Cisco portfolio.

SPLUNK DISCOUNTED CASH FLOW MODEL

Enterprise Value	23,253
(+) Cash	1,715
(-) Debt	(3,138)
Equity Value	21,831
No. of Shares	165
Implied Share Price	132.31
Share Price as per acquisition	157.00
Premium Paid	**19%**

Please click on the table to access the full model

In the base case scenario, assuming a WACC (calculated using CAPM) of 9%, Perpetuity Growth Rate of 3%, moderate volume of sales and margins, we forecast an implied share price of $132.31 for Splunk.

The bull case further assumes higher volume of sales, greater scale economies of distribution and/or margin expansions. This case is modeled through more aggressive Revenue growth rates, larger margins and lower costs, resulting in a $207.79 share price forecast.

In contrast, the bear case assumes lower volume of sales, smaller margins and higher costs, implying a $85.61 share price.

CISCO DISCOUNTED CASH FLOW MODEL

Sensitivity Table					
			Growth Rate		
56.75	1.5%	2.0%	2.5%	3.0%	3.5%
7.85%	60.22	63.61	67.63	72.48	78.44
8.35%	55.68	58.45	61.70	65.55	70.21
8.85%	51.79	54.09	**56.75**	59.87	63.57
9.35%	48.43	50.36	52.56	55.12	58.11
9.85%	45.51	47.14	48.99	51.10	53.55

(WACC label on vertical axis)

Please click on the table to access the full model

Given a 8.8% WACC, calculated using the CAPM, and a 2.5% terminal growth rate as the base case we arrive at an implied share price of $56.75.

Therefore, according to our model, we believe that Cisco is potentially undervalued by the market, with an upside of 18.8%, as it is currently trading at $56.75 as of 17th November 2023.

MERGER MODEL

Post-merger EPS Calculation	
Revenues	67,220
Less: COGS	23,642
Gross Profit	43,578
Less: Operating Expense	17,383
Less: D&A	1,927
EBIT	24,268
Interest Foregone on Cash	1,400
PBT	22,868
Less: Income Tax	4,802
Net Income	18,065
Outstanding Diluted Shares of Combined Compa	4,219
EPS of Combined Company	4.28
EPS of Acquirer Standalone	4.76
Accretive/Dilutive	Dilutive
Accretive/Dilutive	-$0.47
Accretive/Dilutive (%)	-10%

Please click on the table to access the full model

Considering the base case for FY2027, we can infer that the expected integration of Splunk into Cisco's business might not immediately result in accretive value, as suggested by the projected EPS of the combined company being lower than the standalone EPS of the acquirer. This dilution reflects a decrease of $0.47 per share or -10%, indicating that the market may expect some initial challenges post-merger, such as integration costs or operational inefficiencies, which could impact profitability in the short term.

However, it's important to note that the long-term value of the acquisition may still be positive, as the addition of Splunk's cybersecurity and observability capabilities could enhance Cisco's competitive position and lead to potential revenue synergies. The deal is also indicative of Cisco's strategic pivot towards software and services, which could diversify its revenue streams and reduce reliance on hardware sales.

Deal Analysis

STRENGTHS

● **Synergy in Expertise:** Combining Cisco's networking prowess with Splunk's data analytics and cybersecurity capabilities creates a robust synergy, allowing for more comprehensive, data-driven solutions.

● **Market Dominance:** The merger solidifies Cisco's position as a dominant player in the technology industry, enhancing its ability to compete effectively in a rapidly evolving and competitive market.

WEAKNESSES

● **Integration Challenges:** Merging these two complex organisations with distinct corporate cultures, systems, and processes can be a formidable task, potentially leading to operational disruptions.

● **Cost and Resource Allocation:** Successful integration requires substantial financial and human resources, and the commitment to allocate these resources may pose financial challenges in the short term.

Deal Analysis

OPPORTUNITIES

● Innovation: The collaboration opens the door for joint research and development initiatives, allowing both companies to create cutting-edge products and services that address the evolving needs of customers.

● Market Expansion: Access to Splunk's customer base and markets provides Cisco with opportunities for growth and diversification, particularly in the data analytics and cybersecurity sectors.

THREATS

● Competitive Response: Rivals may respond to this merger with their own innovations or strategic partnerships, intensifying competition in the technology and cybersecurity sectors.

● Regulatory Hurdles: Potential regulatory challenges, including antitrust scrutiny, could slow down or disrupt the merger process, impacting its ultimate success.

● Market Fluctuations: Economic downturns or market volatility may affect customer spending, impacting the companies' revenue projections and market expansion plans.

● Integration Delays: Protracted integration could lead to customer dissatisfaction and the potential attrition of key talent, which may hinder the realisation of the expected benefits of the merger.

Conclusion

IMPACT ON CISCO:

The acquisition of Splunk by Cisco, with an equity value of approximately $28 billion, is poised to significantly strengthen Cisco's position in the technology sector.

It enhances Cisco's data analytics and cybersecurity capabilities but also offers a path to accelerate revenue growth and gross margin expansion. Cisco's current annual recurring revenue of $24.3bn is expected to increase by $4bn.

The acquisition aligns with Cisco's strategy to provide comprehensive end-to-end solutions, ensuring it remains at the forefront of innovation and competitiveness in the ever-evolving digital landscape.

Furthermore, the seamless continuation of share buyback and dividend programs ensures Cisco's commitment to delivering value to its shareholders.

IMPACT ON SPLUNK:

For Splunk, this acquisition marks a pivotal moment in its journey as it becomes part of Cisco's extensive technology ecosystem.

The integration into Cisco's operations will open new growth avenues and possibilities, allowing Splunk to tap into a larger customer base and markets.

With Gary Steele, Splunk's President and CEO, joining Cisco's Executive Leadership Team, the collaboration has potential for synergies and a shared vision to address the evolving challenges in the technology and cybersecurity sectors.

Conclusion

IMPACT ON INDUSTRY COMPETITORS

The strategic acquisition of Splunk by Cisco sends ripples across the technology industry, particularly to competitors in the cybersecurity and data analytics domains.

It underscores the increasing importance of comprehensive, end-to-end solutions that seamlessly merge networking, data analytics, and cybersecurity capabilities.

Industry competitors may face intensified competition as Cisco strengthens its position as a dominant player.

The move is expected to trigger further innovation and consolidation in the industry as rivals respond to the evolving landscape, marking a significant shift in the dynamics of the technology sector.

GLOSSARY

CAGR: Compound Annual Growth Rate; the rate at which an investment would grow with reinvested profits at the end of each year.

EPS: Earnings per Share (EPS) is an important ratio used to analyze profitability. It can be calculated by dividing a company's net income after deducting dividends by its weighted average number of shares outstanding.

Non-GAAP: Earnings values that do not follow GAAP (Generally Accepted Accounting Principles) and are not required for external financial reporting

Terminal Growth Rate: Assumption of the rate that a company is expected to grow forever.

WACC: Cost of capital used to represent a firm's after-tax costs from all resources.

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