ANALYST QUICK NOTES

New products, M&A announcements, management shakeups, earnings surprises. Whatever the news, you want to know what Argus thinks. Our Quick Notes fill this need by providing real-time analysis of current news about Argus-covered companies or other market-moving events. Please check back regularly for new Quick Notes. Important disclaimer information is on the last page of this document.

Arista Networks Inc. (NYSE: ANET: BUY)
Target Price: $107
Jim Kelleher, CFA
1/18/2017

Thesis

- Arista again became more of a risk-reward story following the revocation of Arista's ability to import a "work-around" to patent-infringing technology
- We expect that either:
    - Cisco and Arista come to royalty-bearing settlement; or
    - Arista develops a non-infringing "workaround" that can be both imported and sold in US without restrictions.
- Our underlying thesis is intact:
    - As networks become more data-intensive and complex, cloud-based solutions will increasingly displace legacy architectures, and we expect Arista to play a major role in this development.
- We expect Arista to continue taking market share from CSCO and JNPR; the relationship with HPE is smart for both sides.
- The shares are trading below fair value on CSCO litigation risk; buy to $107.

What Happened?

- Cisco initially sought and won an injunction from the U.S. International Trade Commission (ITC) prohibiting importation of Arista products and components because they infringed Cisco patents.
- In November 2016, U.S. Customs and Border Protection (CBP) ruled that a "work-around" crafted by Arista was sufficiently differentiated from Cisco technology to allow importation of Arista products into the U.S.
- On 1/13/17, the ITC ruled that Arista's "workaround" continues to infringe on Cisco's technology and the ITC revoked U.S. Customs ruling allowing Arista to import its "work-around products and components.

What's Next?

- Perhaps anticipating an unfavorable outcome in this patent suit, Arista has also shifted some manufacturing to the U.S., as a way around the original 2016 original ITC import injunction.
- During the 3Q16 call in October, CEO Jayshree Ullal forecast that "more and more" volume would come from the U.S. facility (which may be operated by Flextronics, an existing logistics partner).
- In its 1/15/17 letter on its website, Arista stated it would "lawfully fulfill orders" through its domestic manufacturing sources and with products that contain non-infringing designs.

Arista's Value Proposition

- Arista sees the shift to seamless cloud networking as inevitable, and believes it is well positioned to steer the market away from enterprises data center technology from legacy leaders such as Cisco System.
- Arista's EOS (Extensible Operating System) runs across all Arista devices in virtual machine mode.
    - Within an Arista switch, more than 100 independent regular processes called "agents" manage the ASICs, various routing protocols, simple network management protocol, and other aspects and features of the switch.
    - The switch and its various protocols are centralized in another process called Sysdb, a "file system" that manages network interactions.
    - The tangled inter-process communication ("Spaghetti" architectures) associated with legacy networks require huge scale-up of processing and intense manual intervention.
    - Arista devices provide automated management and self-service provisioning and can administer tens of thousands of virtual servers.
- The trend in server shipments – declining for traditional enterprise networks, surging for cloud enabled data centers – works in Arista's favor.

Largely a US Company

- At present, the cloud transition is further along in US.
- Some 80% of revenue is from the U.S.; the company is largely insulated from turmoil in overseas exposure relate to potential trade restrictions/wars.

Valuation

- ANET is trading at a PEG ratio of 1.41 — well below the average of 2.2 for peer communications-equipment companies.
- The current discount appears excessive given our forecast for above-average growth (20%-plus for ANET versus 15% for peers).
- We reiterate our BUY rating on ANET to a target price of $107, which implies a potential return of 20% from current levels.

DISCLAIMER