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BJORKLUND FUND

October, 18, 2017

Arista Networks (ANET)

Marco Kloster

ARISTA

Sector: Cloud Network Solutions
Industry: Communications Equipment
Current Price: $189.61
Target Price: $214.80

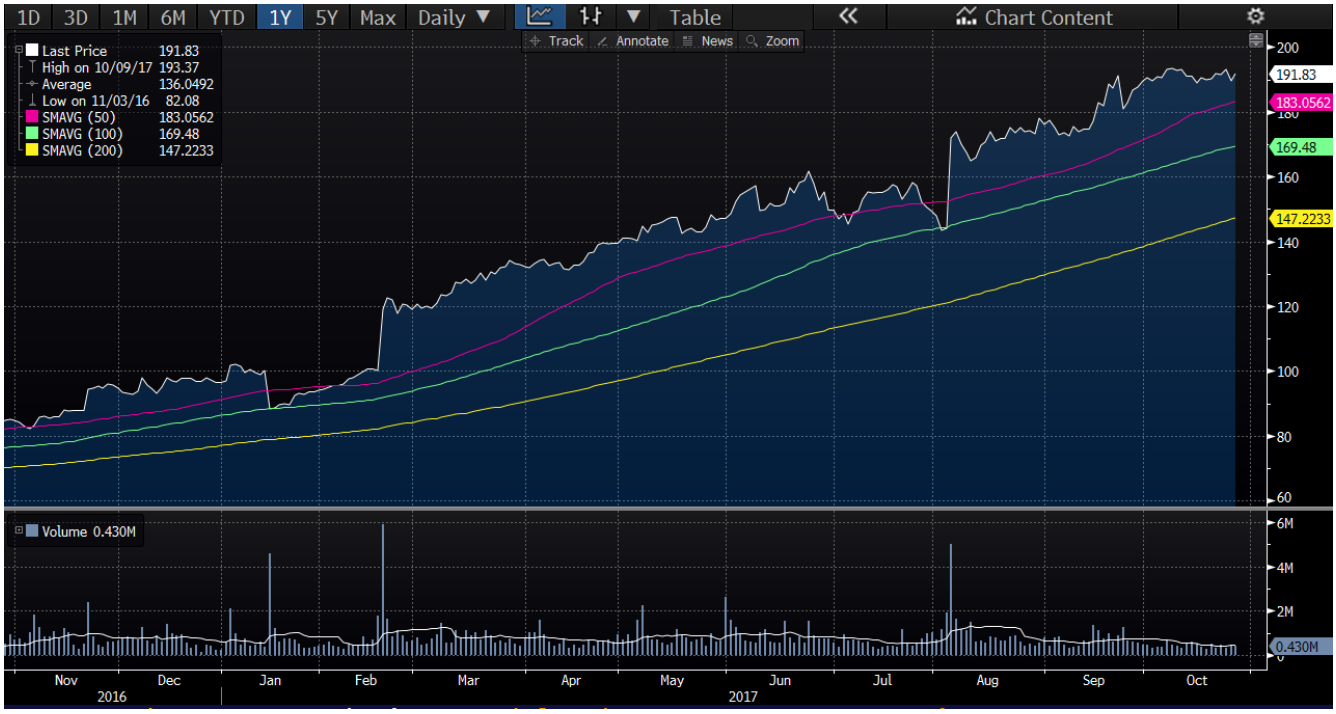
Arista Networks Inc. provides cloud-networking solutions for data-centers and computer environments. The Company offers Ethernet switches, pass-through cards, transceivers, cards, and enhanced operating systems. Arista also provides host adapter solutions and networking services and markets its products globally.

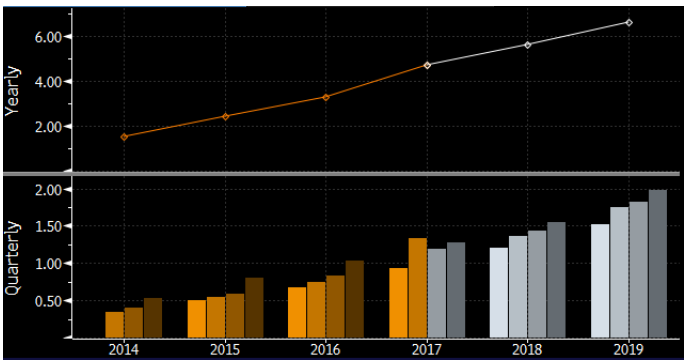
BUY

Current Price:	$189.61
Target Price:	$214.80
Market Cap:	14.97B
Beta:	1.134
Gross Margin (LTM)	64.1%
Gross Profit	39.4%
EBITDA Margin	25.8%
D/E	2.8%
Operating margin	36.3%

Catalysts:

- Short Term(within the year): Arista's software development gives it a sustained market advantage that has led to additional share gains in 100G sales.
- Mid Term(1-2 years): Worldwide spending on public cloud services and infrastructure will reach $122.5 billion in 2017, an increase of 24.4% over 2016, promising profitable revenues going forward.
- Long Term(3+): End markets show strong growth, Big Data, Social Media, Video on Demand, Service Provider Network Function Virtualization, and importantly as a Service and Software as a Service. Demand for Arista's products will increase consequently.





Thesis: Despite high trading multiples, Arista Networks continue to show strong sales momentum and increase customer base expansion as well as organic growth. In my opinion, Arista is currently undervalued and due to their growing industry, and their ability to meet customer's needs compared to the competition. Arista will capture around 20% of the data center switching market by 2020, and continue growing. Arista's advanced technology in their Ultra-high-speed Ethernet switches will guarantee Arista's success in their market. Arista's constant revenue growth and the inevitable demand for could solutions in the current market will enable Arista to continue beating earnings expectations and to become more dominant in their industry.

Earnings Performance

Arista Networks, Inc. reported their Second Quarter 2017 Financial Results by beating the expected earnings compared to analyst's estimates, once again. On August 3, ANET presented a Revenue of $405.2 million, an increase of 20.8% compared to the first quarter of 2017, and an increase of 50.8% from the second quarter of 2016. Additionally, Arista had a Non-GAAP gross margin of 64.4%, compared to a gross margin of 64.2% in the first quarter of 2017 and 64.1% in the second quarter of 2016.

Non-GAAP net income of $105.5 million, or $1.34 per diluted share, compared to net income of $53.7 million, or $0.74 per diluted share, in the second quarter of 2016.

Arista Networks beat the Earnings per Share (EPS) by 42.1%, with a $1.35 EPS compared to the analysts' estimated $0.95 EPS. Current Earnings per Share is a 45.2% increase compared to the previous quarter.

Company Overview

Arista Networks, Inc., launched on December 2, 2011, is a supplier of cloud networking solutions that use software innovations to address the needs of Internet companies, cloud service providers and data centers for enterprise support. The Company develops markets and sells cloud-networking solutions, which consist of its Gigabit Ethernet switches and related software.

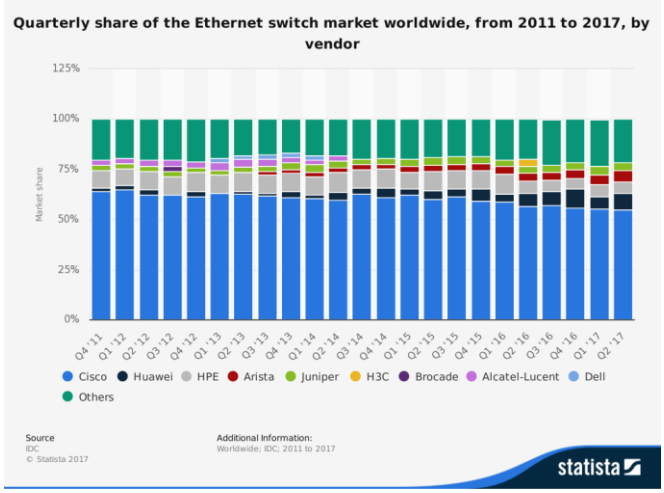
The Business's cloud networking solutions consist of its Extensible Operating System (EOS), a set of network applications and its Ethernet switching and routing platforms. The programmability of EOS has allowed the Company to create a set of software applications that address the requirements of cloud networking, including workflow automation, network visibility and analytics, and has also allowed it to integrate with a range of third-party applications for virtualization, management, automation, orchestration and network services.

EOS supports cloud and virtualization solutions, including VMware NSX, Microsoft System Center, OpenStack and other cloud management frameworks.

Industry Outlook:

The market for data center networking, including the market for cloud networking, is intensely competitive, and this competition is expected increase in the future from established competitors and new market entrants. This competition could result in increased pricing pressure, reduced profit margins, increased sales and marketing expenses. A continuous increase of revenues is crucial to Arista's business and their success in the future.

Arista intense competition, especially from larger, well-established companies, and their lack of sufficient financial shows that Arista market share acquisition may take longer due to their competitive position. Certain large competitors encourage end customers of their other products and services to adopt their data networking solutions through discounted bundled product packages, which it pressures ANET's ability to compete with their prices. However, due to its Cloud Networking Platforms and their multiple silicon architectures switches and routers enabled ANET to differentiate themselves from the rest of the industry. A differentiated product has allowed resulting in an increase of revenue growth year over year of 50.78%. The second best performer in the data center industry has only increased by 7.17%



The chart called "Quarterly share of the Ethernet switch market worldwide, from 2011 to 2017, by vendor" shows the market share by vendor around the globe. Cisco Systems, Inc. has a noticeable dominance in the market over the years. However, their average market share has declined quarter after quarter. Arista Networks have consistently increased their revenue and consequently their share in the Ethernet switch market. Huawei have also increased their market share similarly to ANET's performance, which could be worrisome due to their performance as a provider of router and switches segment.

Products and Segments:

Arista provides two distinctive products in high-speed networking market:

Series 7000 switches: This line of product has a higher efficiency compared to its competitors and at the same time offers significantly high cost savings. Based on company reports, total cost of ownership for a 100GbE port from Arista Networks is just about $3,000 compared to $100,000 in competing products. The new series of switches is a big deal and enhances the differentiation that this company can offer. The new cards are designed to provide existing customers with investment protection so they can take advantage of the new capabilities without changing out their switches. Overall, the new capabilities allow an Arista network to handle 3X the Internet routing table, 10X the number of ACL' s that can be processed and 100X what is called the sFlow rate of previous generations.

EOS (Extensible Operating Systems): Arista developed a customized operating system to be used in high-speed Ethernet switches, which is device independent. That means a user may buy any type of product, install EOS and benefit from the efficiency of ANET. Before development of EOS, users where bonded to the solution that each vendor provide. This new software allows customers to better analyze and autotomize their work, independently of the data center of their choice. Additionally, Arista EOS CloudVision simplifies tasks in a simple software solution designed to help customers move to a more automated, cloud-like infrastructure. This solution has allowed ANET to simplify the integration of the private and public cloud solutions to the customers' physical data centers. Another factor that is helping growth rates has been the advent of this company's router solutions, which have grown to be 20% of revenues in a very short space of time and helped to diversify the company's total revenue.

These are features that that are tailored to the customers that Arista targets, public cloud providers, service providers and large enterprises that need the ability to scale up and to provide a workflow automation for their customers. This ability to tailor to their customers' need is what had made Arista continue to increase revenues quarter after quarter.

Profitability:

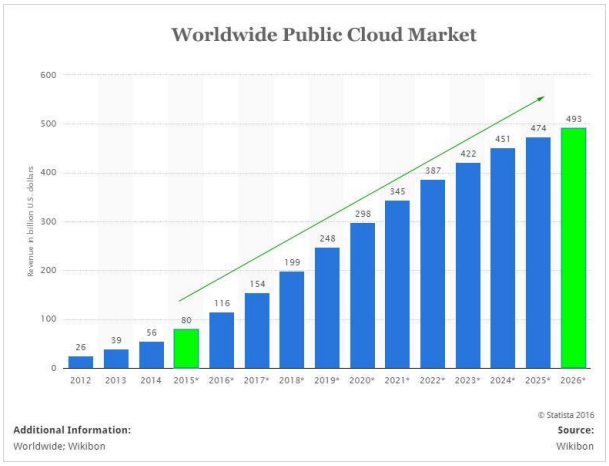
Arista's high trading multiples can be explained by their healthy financials. Arista has routinely increased their revenue and diluted EPS over the past. Their margins have been constant while new products are released with the newest technology demanded by the customers. Arista is a top-class company in their industry in terms of efficiency. Additionally, increasing sales growth quarter after quarter represent their ability to allocate their capital towards products and services that best s satisfy their customers' needs. ANET's ability to operate efficiently will guarantee their progress and success in this growing industry.

Overview | Comp Sheets | Markets | EPS Preview | Ownership | Credit | Custom

Equity Valuation | CDS Spreads | Op Stats | Profitability | Balance Sheet | ESG

	Name (BI Peers)	Sales Growth (%)	Gross Profit Growth (%)	Operating Income Growth (%)	Net Income Growth (%)	Free Cash Flow/Share Growth (%)	Return on Equity	Return on Assets (%)	Return on Invested Capital (%)
	Median	2.72%	4.75	39.28%	46.27%	14.12%	11.77%	6.52%	8.99%
100)	ARISTA NETWORKS INC	34.81%	33.03	46.41%	43.51%	13.13%	23.78%	15.52%	24.02%
101)	JUNIPER NETWORKS INC	2.72%	0.93	0.54%	-2.50%	-15.05%	13.81%	7.27%	10.17%
102)	F5 NETWORKS INC	4.76%	4.75	3.50%	9.64%	15.12%	33.84%	17.07%	32.79%
103)	NETGEAR INC	2.12%	12.10	32.45%	54.38%	--	9.47%	6.52%	8.99%
104)	A10 NETWORKS INC	15.61%	16.58	53.01%	49.27%	--	-19.25%	-7.83%	-17.66%
105)	D-LINK CORP	-13.87%	-6.47	46.11%	49.03%	--	-6.08%	-3.07%	-4.02%
106)	CISCO SYSTEMS INC	-2.52%	-2.29	0.54%	1.37%	7.63%	16.23%	8.37%	11.10%
107)	EXTREME NETWORKS INC	13.20%	19.83	97.13%	73.29%	30.59%	11.77%	2.70%	8.12%
108)	RADWARE LTD	-9.23%	-9.80	--	--	81.40%	-3.12%	-2.17%	-3.82%

Arista's Cloud Networking Opportunity:

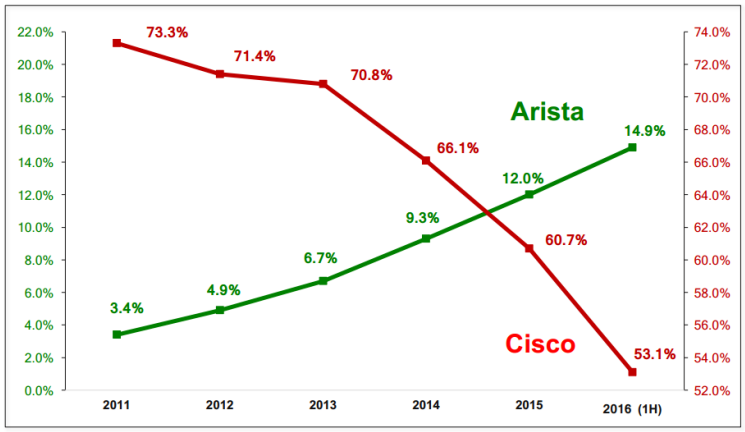


Arista Networks cloud networking solutions deliver industry-leading performance, scalability, availability, programmability, automation and visibility. The programmability of EOS has allowed the company to create and not only compete at Ethernet switches, but they are also able to integrate data centers with cloud solutions that many companies currently have. Mainly, EOS is a set of software applications that addresses the requirements of cloud networking, including workflow automation, network visibility and analytics, and has also allowed them to rapidly integrate with a wide range of third-party applications for virtualization, management, automation,

orchestration and network services. EOS is a tool that facilitates the workflow automation of cloud networking. EOS is not competing with the Cloud Titans, but facilitating their customers to optimize the usage of those services.

The demand for cloud networking is expanding rapidly and competition forces all providers to look for cheaper yet more efficient solutions. Based on estimates provided by IDC, worldwide spending on public cloud services and infrastructure will reach $122.5 billion in 2017, an increase of 24.4% over 2016. According to the their own reports, Arista is expected to deliver 20% plus growth in the Enterprise arena due to their diversification in their products ranging from the data centers, Ethernet switches and cloud networking solutions. According to the expected increase for cloud-networking solutions will ensure the upside potential from datacenter routing and software-based tech advantage, which should lead the increase Arista Networks' growth year over and year and increase of their market share.

Growth Potential:



Arista's software development has become to a market advantage that has led to additional share gains in 100G sales. Arista has tailored its solution set to the needs of the largest and most demanding users which include Cloud Titans, what it calls Cloud Specialty & Hosting Providers, the largest Service providers and the largest Financial Services vendors. Arista has a market share overall of just 5%, it has a market share of 28% in the 100GB market segment. The graph above shows the contrast between Arista and their main competitor Cisco from 2011 and 2016. The trend is still valid in this quarter. Even though Cisco still has the majority of the high-speed data center market share, they have losing their dominance year after year. The opposite has happened to Arista Networks. ANET have been gaining market share due to their product differentiation and high efficiency.

While the 100 GB segment is new, it is showing dramatic increases. That is why Arista's market share is rising. Put another way, Arista has a dramatically disproportionate share of the 100 GB market and the 100 GB market is exploding as it becomes necessary to support the performance requirements for the Cloud Titans and other larger users. ANET's growth is tied to the growth of the only part of the switching market that is growing rapidly and that seems likely to persist into the future. Following the trend, Arista Networks expects meaningful contribution from 400G products in 2019 as the Cloud Titans will continue to look for new technologies. Arista Networks have already invested in this type of technology and they will see an increase of demand for this technology in 2019.

Another area for growth is via product line extensions. Currently Arista focuses on datacenter networking, with no products addressing the markets for campus networking and wide-area networking (WAN). The cloud-based approach to IT networking is not just limited to datacenters, and Arista can further accelerate its growth by developing cloud-first products for those use cases as well.

With the financial flexibility afforded by its $1.1 billion of cash and barely no debt compared to their total equity, Arista certainly has the means to pursue capital-intensive growth strategies. Most technology hardware companies lean heavily on debt financing (Cisco has $33.7 billion of debt on its balance sheet, or a

leverage ratio of approximately 2.4x debt/EBITDA). Arista's large net cash position actually makes its enterprise value cheaper than its current market cap of $13 billion, and the clean balance sheet also gives it future flexibility for debt financing if it chooses to pursue further growth opportunities.

Ownership Summary:

Ownership Type	10/22/17	Curr↓	Change
11) Investment Advisor	60.49	60.31	-0.18
12) Individual	23.34	23.45	+0.11
13) Trust	8.65	8.69	+0.04
14) Hedge Fund Manager	4.23	4.25	+0.02
15) Pension Fund	1.18	1.18	0.00
16) Bank	0.70	0.70	0.00
17) Sovereign Wealth Fund	0.44	0.44	0.00
18) Government	0.38	0.38	0.00
19) Other	0.20	0.22	+0.02
20) Insurance Company	0.22	0.21	-0.01
21) Brokerage	0.14	0.13	-0.01

This table shows the owners of the Arista Networks. The ownership of ANET primarily consists of Investment Advisors, and Individual investors. Respectively, these two groups make up 60.49% and 23.34% of the ownership of Arista Networks. There has been an increasing position in shares outstanding by individuals, Trust and Hedge Fund Managers and a decreasing position by investment advisors. Hedge fund only represents 4.23% of the owners of the company. The hedge fun ownership increased by 0.02%. It is a sign of an increase of hedge fund interest on the company.

Conclusion:

The eminent growth in cloud data centers, as well as the expansion into the routing market should help Arista to keep growing at a similar pace into the next couple of years. Due to historical revenue growth, Arista Networks will be able to scale their operations and lead to a better operating margins and EPS. Arista has shown healthy financials compared to their competitors, which has signifies an increase of market share in each segment they operate. I value ANET as a buy since they continues to outperform their peers in a growing industry.

I have set a 1-year price target to $214.80, a 13% increase from the current price. Additionally, the following chart shows two possible scenarios that deviate from my assumption. The Bearish scenario assumes that if future revenue values are 2% less than what I expected and a 1% increase in operating expenses, there would be a 7.48% downside compared to the current share price. On the other side, the Bullish scenario represents the possibility of a 2% positive deviation in revenue compared to my prediction and a 1% decrease in operating costs compared to what I expected. The Bullish scenario (which is not far realistic since I was very conservative in my assumptions) would result in an increase of 34.27% compared to the current price. Even with high trading multiples, I believe that this stock will continue to gain value as Arista Networks gain market share and scale their operations in a growing industry.

Scenario	1-year price target	% Change
Bearish	$ 175.42	-7.48%
Realistic	$ 214.80	13.29%
Bullish	$ 254.59	34.27%

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Arista Networks, Inc. (ANET)

CENTER FOR GLOBAL FINANCIAL STUDIES

NEUTRAL

Analysis by MARCO KLOSTER

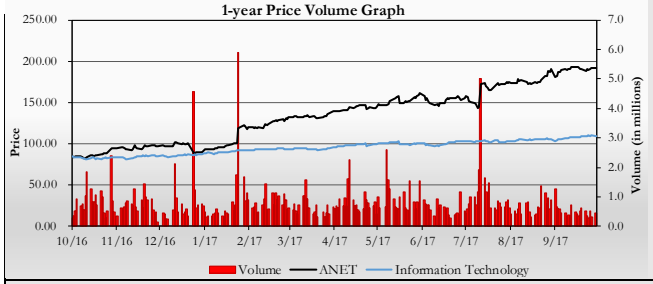
10/27/2017

Current Price:	$189.61	Intrinsic Value	$187.62
Divident Yield:	0.0%	Target Price	$214.80

Target 1 year Return: 13.28%

Probability of Price Increase: 93.67%

1-year Price Volume Graph



Description

Arista Networks, Inc. supplies cloud networking solutions in the Americas, Europe, the Middle East, Africa, and the Asia-Pacific.

General Information

Sector	Information Technology
Industry	Communications Equipment
Last Guidance	November 3, 2015
Next earnings date	November 2, 2017
Estimated Country Risk Premium	6.25%
Effective Tax rate	23%
Effective Operating Tax rate	23%

Market Data

Market Capitalization	$13,752.41
Daily volume (mil)	0.46
Shares outstanding (mil)	72.53
Diluted shares outstanding (mil)	76.04
% shares held by institutions	71%
% shares held by investments Managers	49%
% shares held by hedge funds	4%
% shares held by insiders	34.37%
Short interest	4.24%
Days to cover short interest	4.03
52 week high	$196.27
52-week low	$79.05
Volatility	0.00%

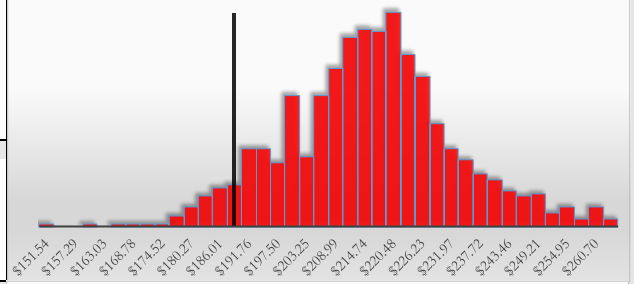
Past Earning Surprises

Quarter ending	Revenue	EBITDA
6/30/2016	2.27%	-21.96%
9/30/2016	2.57%	-13.76%
12/31/2016	3.56%	-10.78%
3/31/2017	2.64%	-17.38%
6/30/2017	12.31%	10.94%
Mean	4.67%	-10.59%
Standard error	1.9%	5.7%

Peers

NETGEAR, Inc.
Juniper Networks, Inc.
F5 Networks, Inc.
Brocade Communications Systems, Inc.
Fortinet, Inc.
Palo Alto Networks, Inc.
Cisco Systems, Inc.
Finisar Corporation

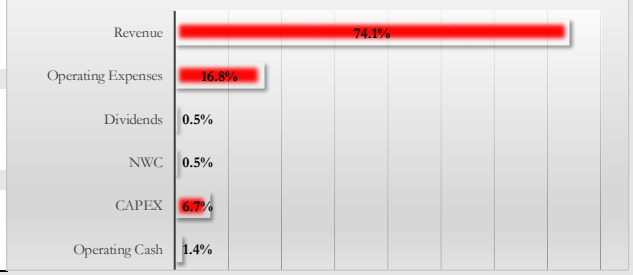
Intrinsic Value Distribution--Probability



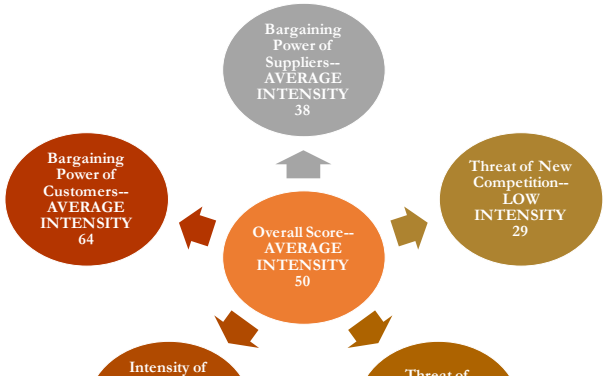
Management	Position	Total compensations growth	Total return to shareholders
Bechtolsheim, Andreas	Co-Founder, Chairman & Chief	-51.78% per annum over 2y	26.2% per annum over 2y
Ullal, Jayshree	President, CEO & Director	112.37% per annum over 3y	N/M
Brennan, Ita	CFO & Senior Vice President	-82.84% per annum over 1y	24.32% per annum over 1y
Taxay, Marc	Senior VP & General Counsel	N/M	0% per annum over 0y
Sadana, Anshul	Chief Customer Officer	-20.88% per annum over 2y	26.2% per annum over 2y
Duda, Kenneth	Co-Founder, CTO & Senior VP	-100% per annum over 2y	26.2% per annum over 2y

Profitability	ANET (LTM)	ANET (5 years historical average)	Peers' Median (LTM)
Return on Capital (GAAP)	68.6%	186.74%	34.55%
Operating Margin	22%	17.67%	13.42%
Revenue/Capital (GAAP)	3.17	10.57	2.57
ROE (GAAP)	25.9%	25.9%	9.6%
Net margin	25.1%	23.2%	10.5%
Revenue/Book Value (GAAP)	1.03	1.12	0.91
Invested Funds	**ANET (LTM)**	**ANET (5 years historical average)**	**Peers' Median (LTM)**
Cash/Capital	64.9%	80.2%	45.5%
NWC/Capital	13.3%	34.4%	-3.7%
Operating Assets/Capital	21.8%	-8.7%	41.8%
Goodwill/Capital	0.0%	0.0%	16.4%
Capital Structure	**ANET (LTM)**	**ANET (5 years historical average)**	**Peers' Median (LTM)**
Total Debt/Market Capitalization	0.04	0.16	0.20
Cost of Existing Debt	7.6%	6.9%	5.1%
CGFS Rating (F-score, Z-score, and default Probability)	BB	BB	A
WACC	13.7%	13.5%	10.6%

Sensitivity Attribution Analysis



Porter's 5 forces (scores are out of 100)



Valuation

Period	Revenue Growth Forecast	NOPAT Margin Forecast	Revenue to Capital Forecast
Base Year	40%	31.0%	1.06
6/30/2018	35%	36.4%	1.21
6/30/2019	30%	34.6%	1.23
6/30/2020	30%	34.2%	1.27
6/30/2021	20%	32.1%	1.21
6/30/2022	15%	32.6%	1.17
6/30/2023	15%	31.2%	1.17
6/30/2024	15%	31.6%	1.20
6/30/2025	15%	31.1%	1.23
6/30/2026	10%	31.1%	1.22
6/30/2027	8%	34.2%	1.22
Continuing Period	3%	33.3%	1.19

Period	Return on Invested Capital Forecast	WACC Forecast	Price per share Forecast
Base Year	32.8%	13.7%	$181.41
6/30/2018	44.2%	12.6%	$206.19
6/30/2019	42.5%	12.1%	$232.66
6/30/2020	43.2%	12.3%	$262.40
6/30/2021	38.8%	11.9%	$293.78
6/30/2022	37.9%	12.1%	$327.64