Brocade Communications

BRCD : NASDAQ : US$9.35

BUY

Target: US$10.00

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COMPANY STATISTICS:

Market Cap (M):	4,458.9
52-week Range:	2.05 - $9.42
Avg. Daily Vol. (000s):	32,891,340

EARNINGS SUMMARY:

FYE Oct		2008A	2009E	2010E
Revenue:		1,466.9	1,949.5	2,209.8
P/Sales (x):		3.0	2.3	2.0
EV/Sales (x):		3.6	2.7	2.4
EPS:		0.66	0.50	0.60
P/E (x):		14.1	18.7	15.5
Revenue:	Q1	347.8	431.6A	543.2
	Q2	354.9	506.3A	531.4
	Q3	365.7	493.3A	548.4
	Q4	398.5	518.3	586.7
Total		1,466.9	1,949.5	2,209.8
EPS:	Q1	0.16	0.15A	0.15
	Q2	0.15	0.11A	0.13
	Q3	0.16	0.12A	0.15
	Q4	0.19	0.13	0.17
Total		0.66	0.50	0.60

SHARE PRICE PERFORMANCE:

COMPANY SUMMARY:
Brocade's core business has it positioned as the global leader in storage networking equipment. The company's Fibre Channel directors, fabric and embedded switches facilitate any-any communication between the server and storage layer of the IT stack. The company recently introduced host bus adapters, thus rounding out its end-end portfolio. With the acquisition of Foundry Networks, Brocade has expanded its focus into the IP networking market.

All amounts in US$ unless otherwise noted.

Technology -- Infrastructure -- Data Center

FOR SALE GOOD AS SOLD?

Opinion

We agree Brocade boasts strong strategic positioning and that fundamentals warrant a $9-10 share price, but we take issue with the prevailing argument the company is a near-term acquisition target. The independent OEM-centric business model is central to the company's ability to maintain its storage footprint during the pending protocol transitions, while the "anybody but Cisco" story in Ethernet switching has not even begun to ramp. Ownership by a single OEM would hasten the demise of Fibre Channel (60% of revs) while limiting the Ethernet switch TAM expansion story. In our view, a sale today is like punting on second down.

Valuation

At $7.50 as of last week, we believe risk/reward was such that Monday's move to $9 was supportable by fundamentals – whether we agreed with the basis or not. From here, however, it is more important to add context given the changing risk assessment. Note that Brocade purchased Foundry at an EV/sales multiple of 2.6x (later downsized). A similar metric on our BRCD C2010 estimates would be ~$10. At a group mean of 3.0x (BRCD, CSCO, JNPR, QLGC) this would be ~$11.50.

Derivatives

To the degree that there is an appetite to flesh out or build Ethernet switch product lines or gain access to closely held Fibre Channel technology, we view there to be several less expensive candidates. In Ethernet switching, this would include 3Com, Extreme and Force10 (private). In Fibre Channel, we view QLogic as an eager seller of its switching product line – possibly for as little as $300-350 million.

A LONE VOICE OF DISSENTION

Following Monday's assertion from a *Wall Street Journal* blog that Brocade might be seeking an acquirer, the rapidly formed consensus is that this must indeed be a fact. The notion itself is as new as "continental drift"; there was no incremental content provided, and there is a world of separation between seeking a buyer and finding a bid. However, coming on the back of a spate of acquisitions and Cisco's John Chambers calling for increased M&A activity, there appears to be an added level of validity assigned to claim.

We believe Brocade, on fundamental merit, is ultimately a $9-10 stock. At $7.50 as of last Friday, we had no issue with Monday's move given the risk/reward – whether we agreed with the basis or not. However, at $9 and above we believe it becomes incrementally more important to explore the rationale behind the appreciation given the changed risk profile.

While not meant as a hedge, we'd be remiss if we didn't point out that when talking about M&A in Silicon Valley, nothing is completely off the table. However, we for one view there to be material holes in the logic behind this particular transaction that at present are being glossed over. Specifically, we have three primary issues:

1. **Why own when you can rent?** The bulk of Brocade's value is tied up in its OEM-centric approach to SAN switching, coupled with its ramping "Anybody but Cisco" OEM relationships in Ethernet switching – most notably at IBM, Dell and possibly HP. As important, the data center is headed into a period of material upheaval relative to protocol transitions. Brocade dominates Fibre Channel with ~75% share (60% of revenues). Although the slope of the curve is subject to some debate, Fibre Channel will ultimately (2-3 years) yield to alternatives including FCoE, iSCSI, CEE/DCE and 10/40/100GbE. The degree to which Brocade will be successful in this transition is yet to be fully knowable but the TAM expansion opportunity is clearly present (8-10x). The question becomes one of trade-off between TAM expansion and transitioning from a duopoly to a potentially much more crowded market. Given it is Brocade's OEM customers themselves that will to a large degree dictate which direction this debate will take, acquisition by any one becomes an exercise in mutual exclusivity. Moreover, it would most likely hurry the transition away from Fibre Channel. This, in our view, warrants a rental (OEM) versus an ownership approach.
2. **What would a suitor be willing to pay?** Each suitor would arguably have slightly different motives for an acquisition, driven by its unique strategic approach to the market. That said, we would view Brocade's acquisition of Foundry as a primary input relative to any hypothetical take-out. On an EV/sales basis, Brocade initially offered Foundry 2.6x. This was subsequently downsized to ~2.0x given deteriorating market conditions. Assuming the higher of the two, relative to our C2010 estimates which are largely in-line with consensus, this would imply a take-out price of $9.50-$10.00 (~$5 billion), or 6-11% above current levels post the 19% move on Monday.
3. **Less expensive alternatives elsewhere.** Whether the objective is fleshing out an Ethernet switch line or gaining access to Fibre Channel switching technology, we believe there are a number of more economically attractive candidates elsewhere. There is, of course, the installed base consideration. In Ethernet switching, this is a non-issue given Foundry's ~2% of the market. In FC SAN, Brocade owns 75% of the market – making the "footprint" very much an issue, at least on the surface. However, given the common denominator among all the next-gen data center protocols is

moving away from a pure Fibre Channel infrastructure, we view the opportunity for dislocation and/or work-around as a potential threat relative to the historical significance of that installed base. As such, this renders the Fibre Channel debate more tightly aligned to a technology access (intellectual property) discussion. In Ethernet switching, we point to less expensive alternatives at 3Com ($2B cap), Extreme ($220M cap) and Force 10 (private). In Fibre Channel switching, QLogic (QLGC : $17.70 | HOLD) is keen to divest itself of its switch business (~8% market share) – which we value at $300-350 million.

WHO ARE THE "BIDDERS"?

Hewlett Packard

HP is the most aggressive in engaging Cisco in the race to dominance in next generation data center architectures. Just as Cisco is moving into HP's core market (servers), HP has been steadily building via internal development and partner community a portfolio of networking products (ProCurve and ProCurve One, respectively). HP currently owns ~4% of the Ethernet switch market, second (albeit distant) to Cisco's ~75%. Currently concentrated at the low to mid-range of the market, HP is clearly seeking to expand its footprint into bladed architectures and high end chassis. The company currently leverages BLADE Networks in the former, and is thought to be near an OEM relationship with Brocade/Foundry in the latter. HP is also Brocade's top customer in Fibre Channel switching (~20% of sales), followed closely by IBM and EMC (~20% of sales collectively).

As Brocade's single greatest customer, we do believe HP looked closely at a potential acquisition. However, after assessing risk of revenue attrition from other OEMs, its appetite for owning an asset with increasing technology transition risks in the coming year(s), build vs. buy options in Ethernet, and deal economics – the company has opted to pass. While this of course could change, we do not think it does at least until the next calendar year.

Oracle (aka Ora-Sun)

Arguably a dark-horse in the mix, Oracle and Sun have separately mentioned their desires to be involved in the Layer 4-7 space at different times over the last 12-18 months. Ignoring the debate relative to whether or not Oracle keeps the bulk of Sun's hardware business post-close (if not, the discussion is moot), we believe Brocade/Foundry does not fit in the wheelhouse. Specifically, Oracle is embracing an "appliance" approach – which very much appears to end at network access. This, by definition, excludes Brocade from consideration. Although the Foundry business does have exposure to Layer 4-7, it is an immaterial (<5%) component of the business.

Juniper

Juniper is among the more natural fits – if only in the context of Brocade's ability to immediately fill holes in Juniper's Ethernet lineup as well as give the company a one-up on storage access versus archrival Cisco. However, Juniper is currently in the process of rolling out its own next generation architecture – and places performance and ease of manageability at the foremost. A central tenet of this is the company's strict adherence to a single operating system across all product lines. An acquisition of Brocade would have Juniper moving from one OS to three – overnight. Coupled with Juniper's disdain for all protocols other than Ethernet (e.g., InfiniBand, Fibre Channel), we view the company's stated strategy of partnership versus ownership as very much intact. Absent an utter about-face at the highest levels in the company, we do not view Juniper as being in the solution set.

IBM

As with HP, IBM's first due diligence consideration relative to a potential Brocade acquisition would start with an assessment of OEM revenue leakage post-deal. In this we view Brocade's EMC exposure as the greatest risk while HP, preferring to "subsidize" IBM vs. Cisco is a choice of the lesser evils (IBM). However, IBM's trajectory has been very much more aligned to software and services versus hardware. While the IBM/Cisco relationship is certainly frayed post UCS announcement, we the deeply rooted strategic link between the two as too great to risk a full disengagement as a transaction of this nature would lend itself to.

Dell

Fresh on the back of the Perot acquisition, Dell has made clear that it is still in acquisition mode. Relative to any other OEM's hypothetical purchase of Brocade, Dell would be view as the least risky in terms of revenue leakage given HP, IBM and EMC view Dell as a limited to weak competitor. However, our checks have indicated that Dell is not involved in any form of discussion at present and is instead eyeing software and storage system targets.

EMC

EMC spun out McData in 2000, which was subsequently purchased by Brocade in 2005. This alone speaks to EMC's desire to be out of the "pipe" battle. With the blossoming strategic alignment with Cisco carrying the upmost support from the office of the CEO at EMC, we view the likelihood of them buying a direct Cisco competitor as negligible at best. Moreover, we are of the opinion that EMC itself wouldn't shun an offer from Cisco. Owning the Brocade asset would add material complications to any such transaction, in terms of anti-trust considerations.

WHAT WOULD THEY PAY?

Although we do not view an acquisition of BRCD as imminent, we thought it worth entertaining a hypothetical take-out value given our previously discussed risk / reward tolerances. As also previously mentioned, different suitors would arguably have different motivations for a potential acquisition – be that one of fleshing out a product set, access to closely held Fibre Channel technology, or "footprint" acquisition. As such, we view there to be a relatively wide range of vectors by which one might consider valuing the underlying asset. However, from a comp group perspective we can think of no more relevant metric than which Brocade itself used to purchase Foundry.

Brocade made its initial bid for Foundry in July 2008, at the top of this particular technology cycle. The initial consideration called for $18.50/share in cash and 0.09 shares of Brocade stock, or 2.6x on an EV/Sales basis. This was later (October) downsized to ~2.0x given deteriorating demand and credit conditions. Assuming the higher of the two multiples, appropriate given the timing of the current cycle offset by technology transition risk, yields a take-out value of $10 (rounded) based on our C2010 estimates. Should we push to 3.0x, equal to the group mean (BRCD, JNPR, CSCO, QLGC), the hypothetical take-out would be ~$11.50.

Figure 1: Acquisition assumptions

	FY2010	CY2010
Revenue	$2,209.8	$2,277.3
Net Cash	$ (837.7)	
Shout	515.7	525.6
EV/Sales		
2.6x	**$ 9.50**	**$ 9.70**
3.0x	**$ 11.20**	**$ 11.40**
Consensus		
Sales	$2,279.4	
EPS	$0.61	

Source: Company Reports, Thomson One and Canaccord Adams Estimates

Investment risks

Risks that could negatively influence the shares and render our fundamental and stock outlook as overly optimistic include:

The data storage and networking industries appear poised to converge via a series of emerging protocols. Although we believe the company's ownership of closely held Fibre Channel intellectual property is a strategic advantage, there is no guarantee that new competitors will not emerge via partnership, licensing or acquisition.

Brocade recently acquired Foundry Networks, with anticipated revenue and expense synergies representing a core element of our forecast and stock rating. In the year prior to acquisition, a material portion of Foundry's growth was attributable to service provider routing solutions, a market and customer set that Brocade is less familiar with. Should the company fail to maintain this business, our estimates could be materially impacted.

With the company's expansion into Ethernet switching, Brocade is now in competition with business groups within at least one of its major storage OEM customers (HP). Although we view there to be limited opportunity for displacement, should this come to pass our fundamental outlook would be challenged.

In contrast to Brocade's historical position of being the dominant vendor (share and size) in its target market, with the entry into Ethernet, the company is now among the smaller participants. Should the company fail to adapt accordingly, our forecast calling for market penetration may prove aggressive.

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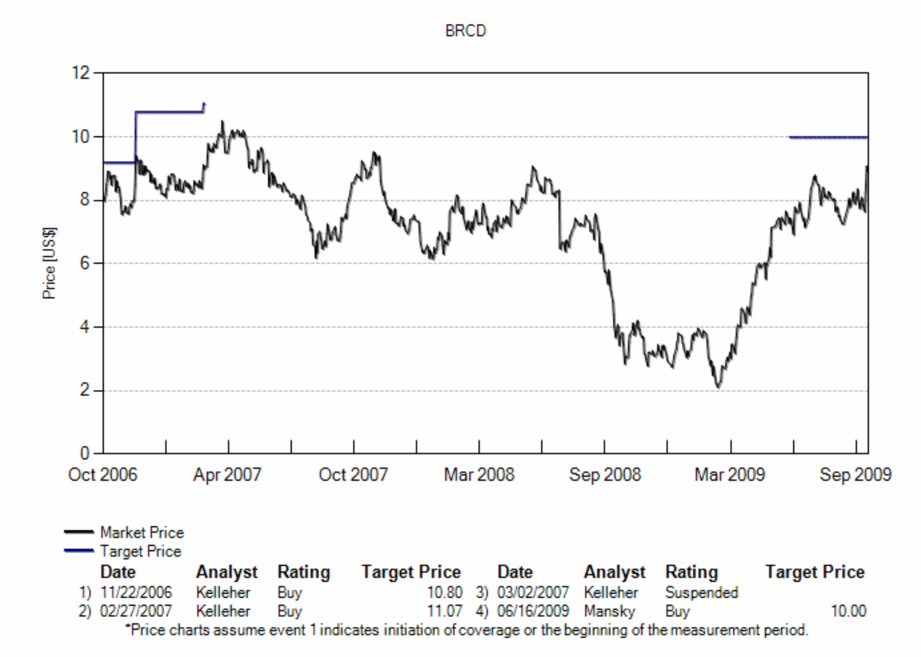

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(as of 1 October 2009)

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Speculative Buy	70	10.7%	45.7%
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	653	100.0%	

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Brocade Communications	5, 7

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