RBC Capital Markets

RBC Capital Markets, LLC
Mark Sue (Analyst)
(212) 428-6491
mark.sue@rbccm.com

Ameet Prabhu (Associate)
(212) 618-3330
ameet.prabhu@rbccm.com

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Arista Networks Inc.

Sue did your homework: Expect beat and raise

Our view: Arista is set to beat and raise, and strong customer growth points to further potential as the de-facto standard in datacenter networking. Share gains are from Cisco, Juniper, and others and Arista's U.S. win rate may soon be replicated overseas as datacenter builds expand with Asian web giants. Look for expanding deals with increasingly friendly partner VMware. Post lock-up may provide better entry point.

Key points:

- **Earnings on Thursday, 11/6.** Web 2.0 and enterprise customer demand for cloud services are driving datacenter spend. Arista customer Microsoft reported +128% YoY growth in F1Q15 commercial cloud revenues, the fifth consecutive quarter of triple-digit YoY growth with investments in datacenter capacity and locations. Juniper's recent switching results (-22% QoQ, +5% YoY) point to what we think is share-loss to Arista. RBC/consensus revenues: $146M/$148M (+45% YoY); our non-GAAP EPS is $0.26 vs. Street's $0.28 on slight spending variance. For 4Q14, we expect book-to-bill >1.0 and Arista's outlook to surpass RBC's $152M/$0.21, moving toward or above the $161M/$0.29 consensus (implies +40% YoY). Dial-in for 4:30PM ET call: 877-201-0168; ID 2361-0535.
- **Key metrics.** Investors seek evidence that Arista continues taking share, as investment in Arista is primarily about the top line. Increased customers, design wins, and evidence that partnerships with VMware for SDN, F5 for application delivery, and Palo Alto Networks for security are all important indicators. Expect little change to GMs in mid-60% range (67.9% last Q).
- **Look yonder.** The focus has been on NA datacenter build-outs, but investors may start focusing on potential build-outs in regions like Asia, more specifically China, as Arista's differentiation may be placing it above other switch vendors. International expansion is heavily dependent on channel partner/distribution relationships, so commentary surrounding channel expansion builds confidence. International revenues comprised 25% of total in 2Q, with EMEA +125% YoY and APAC at +230% YoY.
- **Why are investors long?** Arista's growing almost twice as quickly as Juniper while Cisco actually showed negative YoY switching growth the past three quarters. Investors believe that given the competitive dynamics, Arista's price/performance is providing differentiation in the high-growth data-center market. With only 25% of revenues abroad, investors see a large addressable greenfield opportunity.
- **Why are some investors short?** Even in a best-case scenario, CY16E EPS may be $3.00 (vs. consensus of $1.83), implying shares are already fairy valued, then some. Arista's ability to displace a Cisco means someone else can come from behind and subsequently displace Arista (particularly in a fluid SDN environment). If GMs decline below 60%, it would imply that Cisco can win back share. Lastly, consider upcoming December 3rd lock-up expiration.

Outperform

NYSE: ANET; USD 81.25

Price Target USD 90.00

WHAT'S INSIDE	
☐ Rating/Risk Change	☐ Price Target Change
☐ In-Depth Report	☐ Est. Change
☑ Preview	☐ News Analysis

Scenario Analysis*

Downside Scenario	Current Price	Price Target	Upside Scenario
60.00	81.25	90.00	100.00
↓ 26%		↑ 11%	↑ 23%

*Implied Total Returns

Key Statistics

Shares O/S (MM):	67.5	Market Cap (MM):	5,484
Dividend:	0.00	Yield:	0.0%
		Avg. Daily Volume:	502,917

RBC Estimates

FY Dec	2013A	2014E	2015E	2016E
Revenue	361.2	553.1	744.0	965.0
EPS, Ops Diluted	0.97	1.10	1.05	1.75
EBITDA, Adj	81.4	127.5	136.6	226.8
P/E	NM	73.9x	77.4x	46.4x

Revenue	Q1	Q2	Q3	Q4
2013	61.3A	83.5A	101.6A	114.8A
2014	117.2A	137.9A	146.0E	152.0E
2015	152.0E	180.0E	198.0E	214.0E
EPS, Ops Diluted				
2013	0.16A	0.23A	0.27A	0.31A
2014	0.28A	0.35A	0.26E	0.21E
2015	0.17E	0.22E	0.29E	0.36E

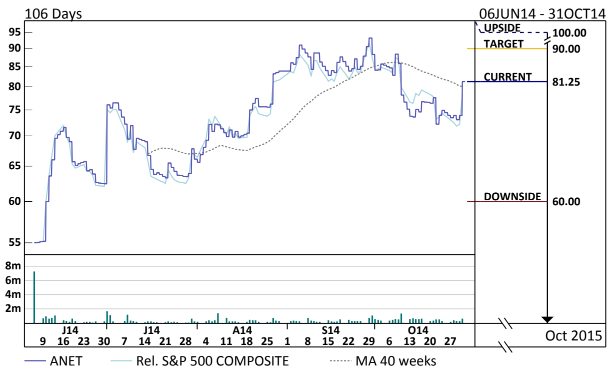
Revenues in $, M
All values in USD unless otherwise noted.

Priced as of prior trading day's market close, EST (unless otherwise noted).

For Required Conflicts Disclosures, see Page 5.

Target/Upside/Downside Scenarios

Exhibit 1: Arista Networks Inc.



Source: Bloomberg and RBC Capital Markets estimates for Upside/Downside/Target

Target price/ base case

For our base case, we primarily consider new product launches and demand for cloud infrastructure, accelerating top-line growth trends, with market share gains in Ethernet switching and further penetration at existing customers.

Our base case scenario target is $90 or 8.5x EV/sales CY15E revenue of $744M, growing +35% YoY with OMs of 16.2% and EPS of $1.05. In CY16, we estimate revenues to grow +30% YoY to $965M with OMs of 21.7% and EPS of $1.75, implying EV/sales of 6.8x.

Upside scenario

Our upside scenario assumes higher than expected demand, market share gains, and faster customer growth and increased capex spending from web 2.0 and cloud service providers. New products and software could enhance margins as customers recognize capex and opex savings.

Our upside scenario is $100 or EV/sales of 8.7x, we expect CY15 revenues growing +37% YoY to $814M, OMs of 18.5% and EPS of $1.43. In CY16, we estimate revenues grow +29% YoY to $1.07B, OMs of 24.7%, and EPS of $2.57, implying EV/sales of 6.9x.

Downside scenario

Our downside scenario assumes a weaker-than-expected data-center build-out environment, weaker enterprise IT spending, and slower uptake of new products and transition toward cloud-based infrastructure, driving meaningful, albeit weaker-than expected revenue growth and margin trends.

For our downside scenario of $60, we expect CY15 revenues to grow +30% YoY to $702M with OMs of 14.3% and EPS of $0.84, implying an EV/sales ratio of 5.7x. In CY16, we estimate revenues to grow +26% YoY to $883M with operating margins of 19.6% and EPS of $1.40, implying an EV/sales of 4.7x.

Investment summary

We rate Arista Networks Outperform rating with a price target of $90. We believe Arista Networks is one of the most important new data networking companies in recent years. Its rate and breadth of new customer wins give us added confidence that the top-line growth rate may be sustainable beyond just the near term. The strong top-line growth, leading differentiated technology, and Ethernet switching market share gains warrant a premium valuation, in our view.

The top-line growth is driven by secular trends in data-center build-outs by web 2.0, cloud service provider, and enterprise customers. Driving these growth trends is the transition of traditional IT infrastructure to cloud-based environments. We expect the cloud data-center segment to grow from $6–7B currently to about $9–10B by 2018.

Our $90 price target is based on an EV/sales multiple of 8.5x our CY15E revenue of $744M (+35% YoY) and 6.8x our CY16E revenue estimate of $965M (+30% YoY), which is supported by our DCF analysis, utilizing a long-term growth rate of 3.5% and a discount rate of 8.0%. Investors are assigning a high valuation multiple to the stock, as indicated by the run-up in the stock price since it went public. We believe the valuation metrics are justified given Arista's strong multi-year top-line growth trends, secular trends in cloud data-center infrastructure, technology differentiation, rapid customer growth, margins and profitability metrics, coupled with the market share gains opportunity and Arista's experienced management team.

Risks and price target impediments

There are many moving parts in Arista's growth story: a large and growing end market, growth in cloud infrastructure build-out, a differentiated technology platform, diverse customer base, profitability and cash flow generation, and a seasoned management team. The following factors may impede achievement of our price target:

- Competition and rapid technology changes
- Litigation involving co-founder, former board member
- Margin pressure and impact of product bundling
- High customer and channel concentration
- Limited uptake of cloud-based solutions
- Weakness in enterprise IT spending

Valuation

We believe early-stage growth companies in tech warrant multiple approaches to valuation accounting for factors such as the TAM opportunity, competitive dynamics, opportunities for market share growth, long-term strategy, top-line growth rates, margin profiles, and capital investment considerations. As such, we use a blended approach to establish a valuation range that may include multiples of sales, earnings and EBITDA.

Arista currently trades at 8.1x our CY15 revenue estimate and 6.5x our CY16 revenue estimate. The valuation multiple is consistent with some of the high-growth names such as F5 Networks (4.4x CY15E), Palo Alto Networks (7.9x CY15 consensus estimates), and Fortinet (4.6x CY15 consensus estimates). Our 12-month price target of $90 implies 8.5x our CY15 revenue estimate, 46x our CY15 EBITDA estimate, and a P/E of 86x. Our implied valuation multiples are a premium to the selected comparable peer companies but not outside the bounds of companies with large addressable markets and disruptive products.

Price target impediments

There are many moving parts in Arista's growth story: a large and growing end market, growth in cloud infrastructure build-out, a differentiated technology platform, diverse customer base, profitability and cash flow generation, and a seasoned management team. The following factors may impede achievement of our price target:

- **Competition and rapid technology changes.** Competition in Ethernet switching can be intense. Cisco is the large incumbent player in the market, while there are other small and large players, coupled with some white-box players.
- **Litigation.** Co-founder and prior board member David Cheriton's company OptumSoft has filed a lawsuit against Arista, claiming ownership of certain components of its EOS network operating system, which may impact EOS-related IP and include potential damages.
- **Changing end-market demands.** Dynamic customer requirements, competitive solutions and emergence of SDN mean the Ethernet switching market is evolving rapidly.
- **High customer concentration.** Arista has a high customer concentration and generates a significant portion of revenues from a few large customers, especially web 2.0 companies.
- **Weakness in enterprise IT spending, limited uptake of cloud-based solutions.** Slowdown in enterprise IT spending or limited traction for cloud-based solutions may weigh on demand trends for Arista's platform.

Company description

Founded in 2004 and headquartered in Santa Clara, CA, Arista Networks is a provider of data-center Ethernet switching solutions. Arista provides 10G/40G Ethernet switches to large data centers. Arista has a strong position in low latency, web 2.0 and cloud networks. The company has a customer base of >2,500 customers and >750 employees. The Linux-based Extensible Operating System (EOS) is the foundation of its switching platform and product portfolio.

Mark Sue (212) 428-6491; mark.sue@rbccm.com

Period Ending ($, 000s except EPS and ratios)	Mar-13 1Q	Jun-13 2Q	Sep-13 3Q	Dec-13 4Q	Mar-14 1Q	Jun-14 2Q	Sep-14 3QE	Dec-14 4QE	Mar-15 1QE	Jun-15 2QE	Sep-15 3QE	Dec-15 4QE	Dec-13 CY	Dec-14 CYE	Dec-15 CYE	Dec-16 CYE
Non-GAAP Income statement																
Total revenues	**61,348**	**83,485**	**101,625**	**114,767**	**117,207**	**137,947**	**146,000**	**152,000**	**152,000**	**180,000**	**198,000**	**214,000**	**361,225**	**553,154**	**744,000**	**965,000**
Product revenues	56,440	76,806	93,495	105,585	107,830	126,911	135,000	140,500	138,000	163,000	178,000	191,000	332,327	510,242	670,000	853,000
Services and other revenues	4,908	6,679	8,130	9,181	9,377	11,036	11,000	11,500	14,000	17,000	20,000	23,000	28,898	42,912	74,000	112,000
YoY growth	*NA*	*NA*	*NA*	*NA*	*91%*	*65%*	*44%*	*32%*	*30%*	*30%*	*36%*	*41%*	*87%*	*53%*	*35%*	30%
QoQ growth	*NA*	*36%*	*22%*	*13%*	*2%*	*18%*	*6%*	*4%*	*0%*	*18%*	*10%*	*8%*	*NA*	*NA*	*NA*	NA
Cost of sales	19,153	29,501	36,482	37,142	35,682	44,266	51,100	53,702	54,002	63,968	70,726	76,467	122,278	184,750	265,163	355,439
Product cost of sales	17,621	27,141	33,564	34,171	32,827	40,725	47,250	49,597	48,990	57,865	63,546	68,187	112,496	170,399	238,588	313,831
Services cost of sales	1,532	2,360	2,919	2,971	2,855	3,541	3,850	4,106	5,012	6,103	7,180	8,280	9,782	14,351	26,575	41,608
Gross profit	**42,195**	**53,984**	**65,143**	**77,624**	**81,525**	**93,681**	**94,900**	**98,298**	**97,998**	**116,032**	**127,274**	**137,533**	**238,946**	**368,404**	**478,837**	**609,561**
Sales & marketing	9,653	12,432	13,759	16,286	17,227	18,780	22,630	23,560	24,776	28,440	30,294	31,030	52,130	82,197	114,540	143,129
R&D	18,518	19,972	25,296	29,337	30,979	31,361	36,500	40,280	41,800	48,600	49,500	50,290	93,123	139,120	190,190	200,855
G&A	3,539	3,242	4,869	5,736	6,555	6,180	7,592	10,640	11,856	13,320	14,058	14,552	17,386	30,967	53,786	56,626
Other operating expenses	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Total operating expenses	31,710	35,646	43,924	51,359	54,761	56,321	66,722	74,480	78,432	90,360	93,852	95,872	162,639	252,284	358,516	400,610
Operating income	**10,485**	**18,338**	**21,219**	**26,265**	**26,764**	**37,360**	**28,178**	**23,818**	**19,566**	**25,672**	**33,422**	**41,661**	**76,307**	**116,120**	**120,321**	**208,951**
Interest & other expense	(1,850)	(1,773)	(1,820)	(2,430)	(2,535)	(5,435)	(750)	(750)	(750)	(750)	(750)	(750)	(7,873)	(9,470)	(3,000)	(2,000)
Other income	0	0	0	0	0	2,472	0	0	0	0	0	0	0	2,472	0	0
Income before inc. taxes	**8,635**	**16,565**	**19,399**	**23,835**	**24,229**	**34,397**	**27,428**	**23,068**	**18,816**	**24,922**	**32,672**	**40,911**	**68,434**	**109,122**	**117,321**	**206,951**
Provision for income taxes	282	4,240	4,961	6,332	7,824	10,674	8,777	7,382	6,021	7,975	10,455	13,092	15,815	34,657	37,543	66,224
Net Earnings	**8,353**	**12,325**	**14,438**	**17,503**	**16,405**	**23,723**	**18,651**	**15,686**	**12,795**	**16,947**	**22,217**	**27,819**	**52,619**	**74,465**	**79,778**	**140,727**
Earnings per share	**$0.16**	**$0.23**	**$0.27**	**$0.31**	**$0.28**	**$0.35**	**$0.26**	**$0.21**	**$0.17**	**$0.22**	**$0.29**	**$0.36**	**$0.97**	**$1.10**	**$1.05**	**$1.75**
EPS YoY Growth													*83%*	*13%*	*-5%*	*67%*
Shares Outstanding, diluted	52,044	53,252	54,412	56,470	57,816	67,470	71,289	73,436	74,541	75,642	76,723	77,820	54,051	67,503	76,182	80,612
Percent of Sales:																
Gross Margins	68.8%	64.7%	64.1%	67.6%	69.6%	67.9%	65.0%	64.7%	64.5%	64.5%	64.3%	64.3%	66.1%	66.6%	64.4%	63.2%
Product gross margins	68.8%	64.7%	64.1%	67.6%	69.6%	67.9%	65.0%	64.7%	64.5%	64.5%	64.3%	64.3%	66.1%	66.6%	64.4%	63.2%
Services gross margins	68.8%	64.7%	64.1%	67.6%	69.6%	67.9%	65.0%	64.3%	64.2%	64.1%	64.1%	64.0%	66.1%	66.6%	64.1%	62.9%
Operating income	17.1%	22.0%	20.9%	22.9%	22.8%	27.1%	19.3%	15.7%	12.9%	14.3%	16.9%	19.5%	21.1%	21.0%	16.2%	21.7%
Pre-Tax income	14.1%	19.8%	19.1%	20.8%	20.7%	24.9%	18.8%	15.2%	12.4%	13.8%	16.5%	19.1%	18.9%	19.7%	15.8%	21.4%
Net income	13.6%	14.8%	14.2%	15.3%	14.0%	17.2%	12.8%	10.3%	8.4%	9.4%	11.2%	13.0%	14.6%	13.5%	10.7%	14.6%
Sales & marketing	15.7%	14.9%	13.5%	14.2%	14.7%	13.6%	15.5%	15.5%	16.3%	15.8%	15.3%	14.5%	14.4%	14.9%	15.4%	14.8%
R&D	30.2%	23.9%	24.9%	25.6%	26.4%	22.7%	25.0%	26.5%	27.5%	27.0%	25.0%	23.5%	25.8%	25.2%	25.6%	20.8%
G&A	5.8%	3.9%	4.8%	5.0%	5.6%	4.5%	5.2%	7.0%	7.8%	7.4%	7.1%	6.8%	4.8%	5.6%	7.2%	5.9%
Tax rate, net	3.3%	25.6%	25.6%	26.6%	32.3%	31.0%	32.0%	32.0%	32.0%	32.0%	32.0%	32.0%	23.1%	31.8%	32.0%	32.0%

Source: Company data, RBC Capital Markets estimates

Mark Sue (212) 428-6491; mark.sue@rbccm.com

Required disclosures

Conflicts disclosures

The analyst(s) responsible for preparing this research report received compensation that is based upon various factors, including total revenues of the member companies of RBC Capital Markets and its affiliates, a portion of which are or have been generated by investment banking activities of the member companies of RBC Capital Markets and its affiliates.

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Ratings

Top Pick (TP): Represents analyst's best idea in the sector; expected to provide significant absolute total return over 12 months with a favorable risk-reward ratio.

Outperform (O): Expected to materially outperform sector average over 12 months.

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Distribution of ratings
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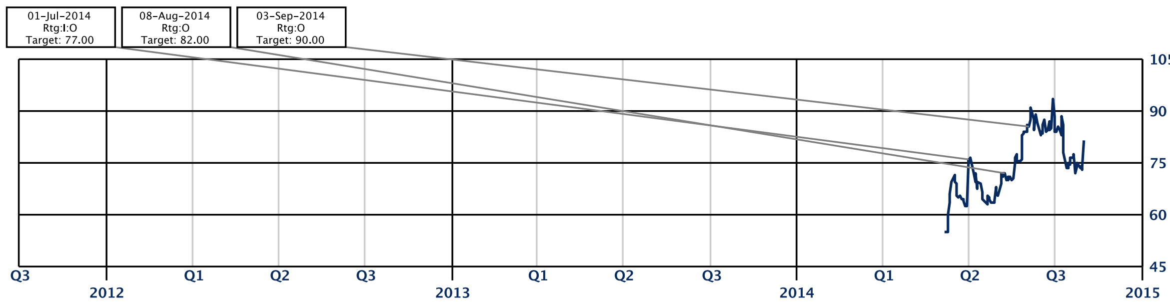
As of 30-Sep-2014

			Investment Banking Serv./Past 12 Mos.	
Rating	**Count**	**Percent**	**Count**	**Percent**
BUY [Top Pick & Outperform]	**858**	**52.35**	**308**	**35.90**
HOLD [Sector Perform]	**683**	**41.67**	**151**	**22.11**
SELL [Underperform]	**98**	**5.98**	**8**	**8.16**

Rating and price target history for: Arista Networks Inc. as of 31-Oct-2014 (in USD)



Legend:
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References to a Recommended List in the recommendation history chart may include one or more recommended lists or model portfolios maintained by RBC Wealth Management or one of its affiliates. RBC Wealth Management recommended lists include a former list called the Prime Opportunity List (RL 3), the Guided Portfolio: Prime Income (RL 6), the Guided Portfolio: Large Cap (RL 7), the Guided Portfolio: Dividend Growth (RL 8), the Guided Portfolio: Midcap 111 (RL 9), the Guided Portfolio: ADR (RL 10), and the Guided Portfolio: Global Equity (U.S.) (RL 11). RBC Capital Markets recommended lists include the Strategy Focus List and the Fundamental Equity Weightings (FEW) portfolios. The abbreviation 'RL On' means the date a security was placed on a Recommended List. The abbreviation 'RL Off' means the date a security was removed from a Recommended List.

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Mark Sue (212) 428-6491; mark.sue@rbccm.com