A Network to Rely Upon

While economists warn of the possibility of an impending recession, investors should focus on putting their money in the stocks of companies with enduring business models that generate significant free cash flow and offer an attractive yield. Cisco Systems, Inc. (CSCO: $52/share) fits the bill and is this week's Long Idea.

Cisco's stock presents quality risk/reward given the:

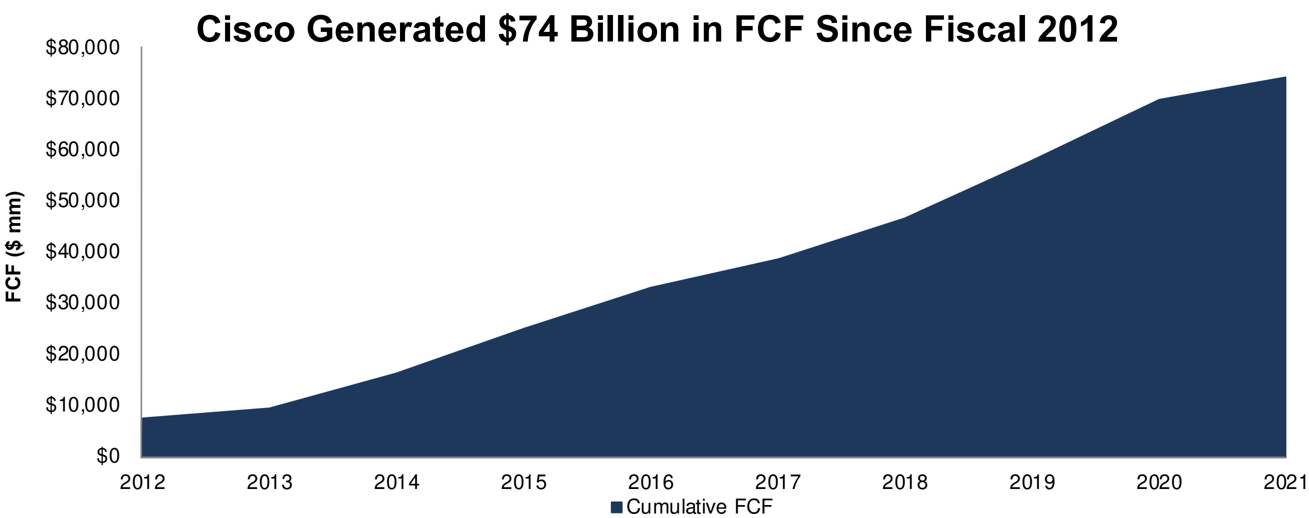
- company's large customer network
- long-term demand for networking products and services
- company's leading networking product market share
- company's backlog for products and services is at all-time highs
- stock price implies the company's profits will not significantly improve above TTM levels

Focus on Free Cash Flow in a Stormy Market

While money moves away from profitless growth stories, investors can find safety and value with companies, such as Cisco, that generate strong, consistent free cash flow (FCF). Companies that generate healthy amounts of FCF are better equipped than others to navigate challenging macro environments.

Cisco generated $40.8 billion (19% of market cap) in cumulative FCF over the past five years, and $74.0 billion (35% of market cap) in cumulative FCF over the past ten years, per Figure 1.

Figure 1: Cisco's Cumulative Free Cash Flow: Fiscal 2012 – 2021



Sources: New Constructs, LLC and company filings

Dividends and Buybacks Provide 6.0% Yield

Cisco's ability to generate significant amounts of FCF, and its $20.1 billion (9% of current market cap) in excess cash, means it can return a large amount of capital to investors in the form of dividends and share buybacks. Since fiscal 2017, Cisco has paid $29.6 billion (14% of current market cap) in cumulative dividends. Over the trailing twelve months (TTM), the company has paid $6.2 billion in dividends. The company's current dividend, when annualized, provides a 3.0% yield.

Cisco also returns capital to shareholders through share repurchases. From fiscal 2017 to 2021, the company repurchased $47.5 billion (22% of current market cap) worth of stock. Over the TTM, Cisco has repurchased $6.4 billion worth of stock, and the company has $18 billion remaining on its current share repurchase authorization. Should the company continue to repurchase stock at TTM levels, shareholders would realize a combined yield from dividends and buybacks of 6.0% of Cisco's current market cap.

Cisco Is a Market Leader in Physical Equipment

Cisco provides the physical infrastructure that powers the internet across the globe. The company estimates that 85% of the world's web traffic travels across Cisco connections. According to International Data Corporation (IDC), Cisco has the largest market share of routers and ethernet switches worldwide, per Figure 2.

By being the largest provider of networking equipment, Cisco is an established reliable partner with a global reach and offers customers extensive maintenance and support. Additionally, the company's widespread certification program means customers can more easily find employees with the skills to work with Cisco products and services.

Figure 2: Cisco Vs. Competitors: Routers and Ethernet Switches Market Share – 2021

Company	Share of Enterprise & Service Provider Routers	Share of Ethernet Switches
Cisco Systems	35%	45%
Huawei Technologies	31%	10%
Arista Networks	n/a	8%
New H3C Technologies	2%	6%
Hewlett Packard Enterprise	n/a	6%

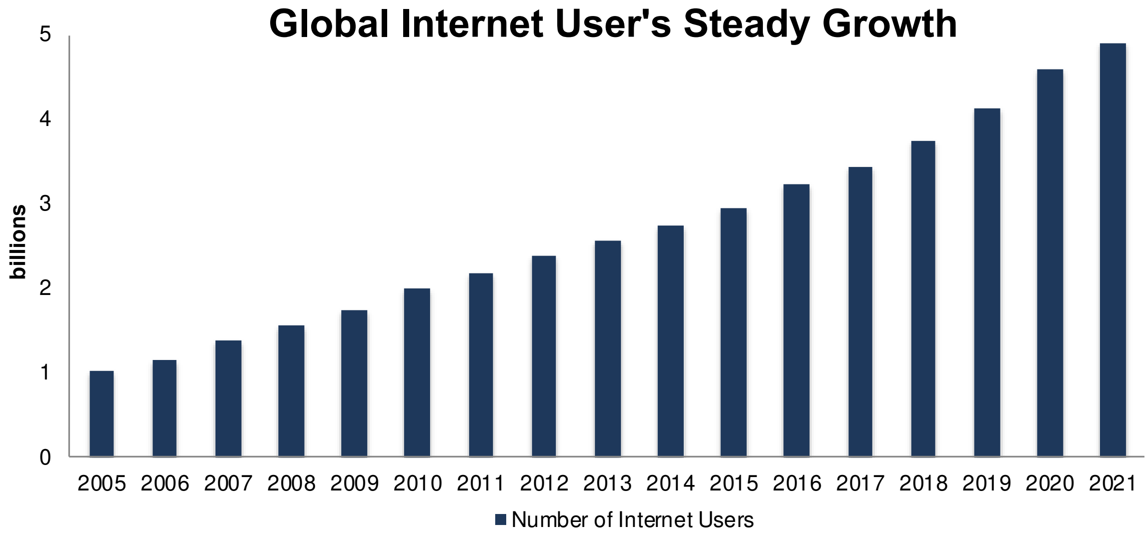
Sources: New Constructs and IDC

The Internet Is Still Growing

Per Figure 3, the number of global internet users has increased year-over-year (YoY) in each of the past 16 years and rose from 1.0 billion users in 2005 to 4.9 billion in 2021.

Not only is the number of internet users increasing, but the number of devices and connections per person has grown from 2.3 in 2016 to 3.5 in 2021, while the average monthly traffic per person rose from 12.9 GB to 35.5 GB over the same time. The steady expansion of internet use creates very meaningful long-term demand for providers of the internet's infrastructure, such as Cisco.

Figure 3: Global Internet Users: 2005 – 2021



Sources: New Constructs and Statista

Cisco Is Also a Growing Software Company

A key component of Cisco's future growth strategy is serving customer needs beyond physical equipment. Cisco operates in 115 countries and leverages the customer relationships it has established with its widespread equipment business to grow its software business.

The company's investment in developing its software business is paying off since the company began its transition to more software subscription revenue in fiscal 2017. Software subscription revenue in fiscal 2021 reached ~$12 billion (24% of fiscal 2021 total revenue), or 3.5x higher than the $3.4 billion of software subscription revenue it generated in fiscal 2015.

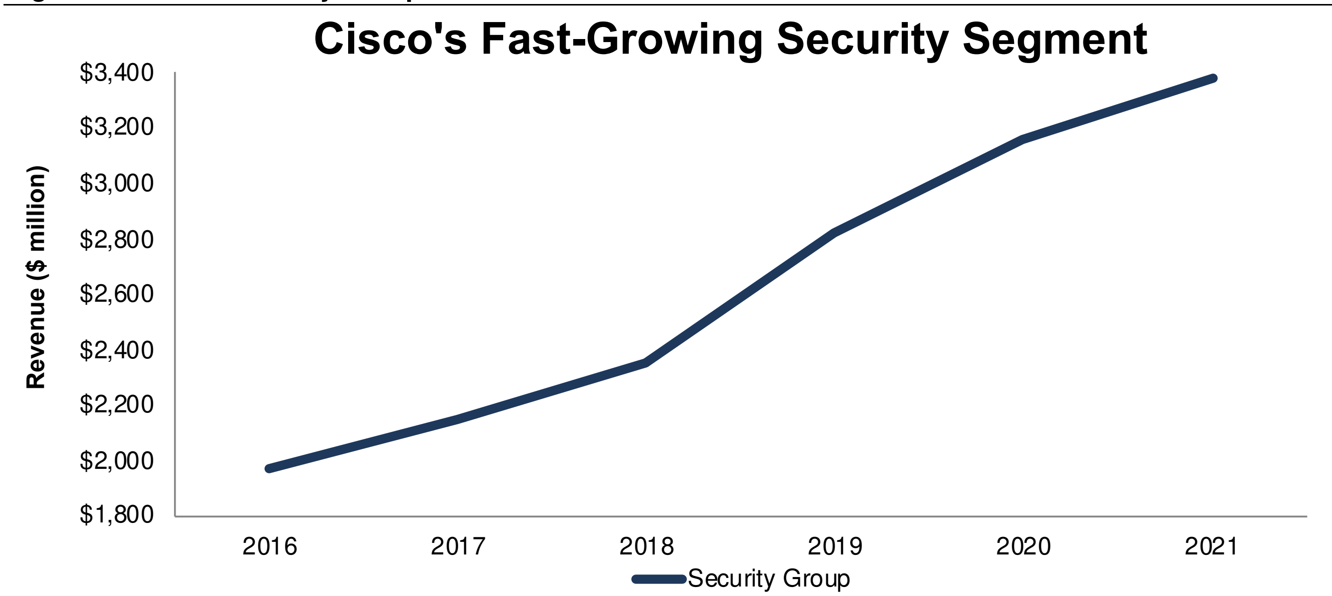
Security Concerns Drive Additional Demand

According to Identity Theft Resource Center, the number of data breaches in 2021 rose 68% YoY and 23% higher than the previous record set in 2017. Companies need to continually invest in network security to protect themselves from the an increasingly hazardous digital environment.

Perhaps not surprisingly – given the backdrop – Cisco's security segment is the company's fastest growing by revenue. Revenue from Cisco's security segment grew 20% from fiscal 2019 to 2021. Figure 4 shows Cisco's revenue from its security group rose from $2.0 billion in fiscal 2016 to $3.4 billion in fiscal 2021, or 11% compounded annually.

While competitors are also growing their security businesses, Cisco is growing fast enough to take market share. Cisco's share of the calendar 4Q21 worldwide security appliance vendor market rose from 14.6% in calendar 4Q20 to 15.3% in calendar 4Q21. This improvement displaced Palo Alto Networks (PANW) (15.2% share in calendar 4Q21) for the market's top spot.

Figure 4: Cisco's Security Group Revenue: Fiscal 2016 – 2021



Sources: New Constructs, LLC and company filings

China's Loss Is Cisco's Gain

Concerns over security not only boost Cisco's security segment but will likely drive more demand for its trusted physical networking equipment. While Chinese competitors Huawei and New H3C Technologies may offer lower-cost products, rising global tensions with China make companies and entire countries reluctant to use products and services from Chinese companies to handle sensitive information. Given China's history of exploiting Huawei's equipment to collect intelligence, concerns over using equipment made by Chinese firms are likely to grow in the current political environment.

U.S.-based Cisco is positioned to benefit from these increased concerns as the company offers a more credible commitment to security than its Chinese competitors. The Chinese system of production has just as much trouble as the Soviet system when forced to compete directly with the West and is ultimately incapable of meeting customer needs of various complexity.

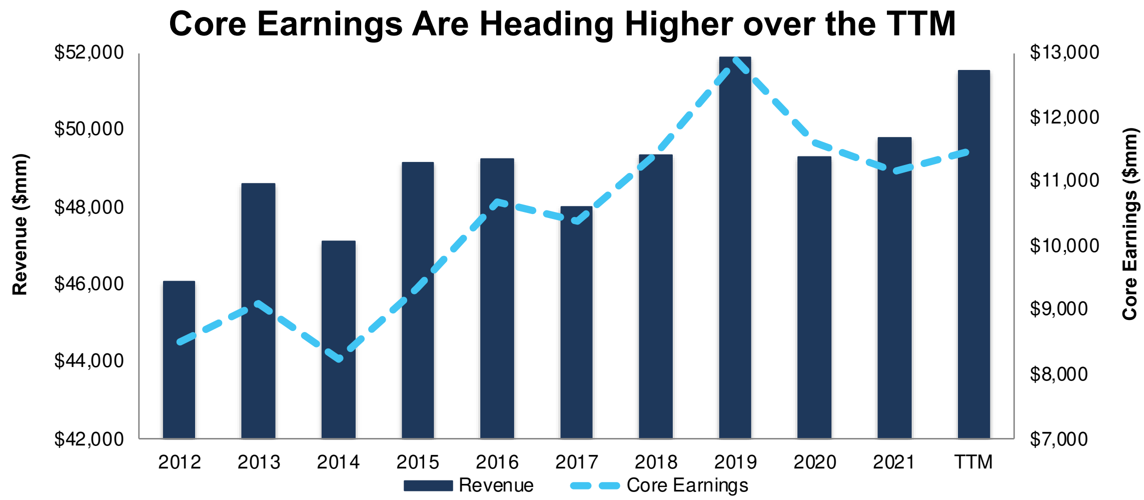
Should tensions between U.S.-friendly and China-friendly countries give rise to two separate internets, Cisco would likely gain more than it would lose as it did in fiscal 2021. While the company doesn't disclose country-specific revenue, its Asia Pacific, Japan, and China (APJC) region reveals the strength of the company's business outside of China. Though revenue declined 4% YoY in China in fiscal 2021, revenue in the APJC region rose 4% YoY as growth in the rest of the region more than offset the decline from China.

Core Earnings Are Moving Higher

Cisco's strong equipment business and growing software segment generate consistent profits. Cisco has generated positive Core Earnings in each of the past twenty years. More recently, Cisco's Core Earnings rose from $8.5 billion in fiscal 2012 to $11.5 billion over the TTM, per Figure 5.

Cisco still faces supply challenges which have affected its business since the COVID-19 pandemic began. These challenges have resulted in lower revenue and Core Earnings. However, the company's Core Earnings are back on an upward trend. Cisco's fiscal 2Q22 TTM Core Earnings were up 2% YoY.

Figure 5: Cisco's Revenue & Core Earnings Since Fiscal 2012



Sources: New Constructs, LLC and company filings

Cisco Delivers Profitable Scale

Though Cisco's return on invested capital (ROIC) fell from 18% in fiscal 2019 to 15% over the TTM as it faced pandemic-related challenges, the company's economic earnings have trended higher over the past five years. Economic earnings improved from $6.4 billion in fiscal 2017 to $7.3 billion TTM.

Cisco's economic earnings are superior to the economic earnings of 20 out of 22 peers[1] which include the publicly traded competitors listed in the company's fiscal 2022 10-K. Only Microsoft and Amazon, which are among the largest companies in the world, have higher economic earnings over the TTM.

[1] Microsoft Corporation (MSFT), Amazon (AMZN), Broadcom Inc (AVGO)., Dell Technologies Inc (DELL)., VMware Inc (VMW), Nokia Corporation (NOK), Arista Networks Inc (ANET), Check Point Software Technologies, Ltd. (CHKP), Fortinet Inc. (FTNT), Ubiquiti Inc. (UI), F5 Networks Inc (FFIV), Hewlett Packard Enterprise Co (HPE), Juniper Networks Inc (JNPR), Dynatrace Inc. (DT), CrowdStrike Holdings, Inc. (CRWD), CommScope Holding Co Inc (COMM), New Relic, Inc. (NEWR), Zscaler Inc. (ZS), Ringcentral Inc (RNG), Mandiant Inc. (MNDT), Palo Alto Networks Inc (PANW), and Nutanix Inc (NTNX).

Figure 6: Cisco's Economic Earnings Vs. Peers: TTM

Company	Ticker	TTM Economic Earnings
Microsoft Corporation	MSFT	$58,834
Amazon.com	AMZN	$15,089
Cisco Systems	**CSCO**	**$7,330**
Broadcom Inc.	AVGO	$5,932
Dell Technologies	DELL	$2,054
VMware	VMW	$1,671
Nokia Corporation	NOK	$1,024
Arista Networks	ANET	$794
Check Point Software Technologies	CHKP	$771
Fortinet	FTNT	$600
All others combined		($1,877)

Sources: New Constructs, LLC and company filings

Historically High Backlog Will Deliver the Goods

The decline in Cisco's revenue during the pandemic doesn't mean demand for the company's products and services has declined. As the company continues to navigate supply constraints, its backlog of orders has been growing. Cisco ended fiscal 2Q22 with an all-time high backlog valued at more than $14 billion (27% of TTM revenue).

As supply constraints unwind, Cisco will likely realize a large boost to its top and bottom lines from the orders in its inflated backlog. Of course, the risk is that the global economy suffers a sharp decline before the backlog is worked off and orders are cancelled. Nevertheless, given the essential nature of internet usage for so many people and companies, demand for Cisco's products will likely hold up better than most in a downturn.

Large Customer Network, Research and Development, and Cash Keep Cisco Relevant

Some bears may believe that Cisco's established, mundane business of selling physical networking equipment exposes the company to industry disruption. However, the company's cash-generating equipment business fuels its large research and development (R&D) spending, which reduces risk of losing market share to disruptive competitors.

The company spent $6.5 billion in R&D in fiscal 2021 alone. The company's ability to invest in nascent technology keeps it up to date. Additionally, Cisco's large amount of excess cash and strong FCF means it can acquire technologies needed to complement those it develops internally.

Furthermore, Cisco's large customer network also creates a large moat that is difficult to replicate and is protected by switching costs companies incur when choosing a new vendor. Cisco's customer network gives the company the ability to quickly distribute new technologies, as well as get feedback from what clients need next.

Supply Constraints Are a Near-Term Headwind

Cisco is feeling the effects of the shortage of semiconductors, which are obviously critical components in networking equipment. Cisco doesn't expect this challenge will go away anytime soon, either. Management expects to face chip shortages through the rest of fiscal 2022. In the future, the company anticipates a gradual easing of constrained supply playing out over several quarters.

Regardless of the challenges, Cisco's management noted in its 2Q22 earnings call that the company is, "leveraging our volume purchasing and extended supply commitments as we address the supply challenges and cost impacts" associated with supply constraints.

Importantly, these challenges are not Cisco specific, and with the competitive advantages noted above, Cisco is well-suited to navigate these turbulent times.

Looking Beyond the Rating

Our Robo-Analyst technology drives our Stock Ratings, which are proven to outperform ratings from human analysts, and we encourage all investors to include them in their investment processes. Our Stock Ratings evaluate the quality of a company's earnings and the valuation of its stock.

Though Cisco's GAAP earnings have risen from $10.6 billion in fiscal 2021 to $11.8 billion over the TTM, its economic earnings have fallen from $7.5 billion to $7.3 billion over the same time. The company's recent decline in economic earnings largely contribute to the stock's overall Neutral rating, per Figure 7.

However, our human analysts' view is that the stock holds better risk/reward than its current Robo-Analyst rating suggests. Looking forward, we expect the company's economic earnings to rebound as Cisco's large backlog and growing service business translates to improved profitability. Should the company's performance follow our expectation, its stock rating will improve, unless, of course, the stock rises rapidly and its valuation gets expensive.

Figure 7: Cisco's Risk/Reward Rating

Risk/Reward Rating	Quality of Earnings: Economic vs Reported EPS	Quality of Earnings: ROIC	Valuation: FCF Yield	Valuation: Price to EBV	Valuation: Market-Implied GAP
Very Unattractive	Misleading Trend	Bottom Quintile	< -5%	> 3.5 or -1 < 0	> 50
Unattractive	False Positive	4th Quintile	-5% < -1%	2.4 < 3.5 or < -1	20 < 50
Neutral	Neutral EE	3rd Quintile	-1% < 3%	1.6 < 2.4	10 < 20
Attractive	Positive EE	2nd Quintile	3% < 10%	1.1 < 1.6	3 < 10
Very Attractive	Rising EE	Top Quintile	> 10%	0 < 1.1	0 < 3
Actual Values					
CSCO	**$1.74 vs. $2.80**	**15%**	**2%**	**1.0**	**< 1 yr**
Benchmarks					
Sector ETF (QQQ)	Positive EE	51%	1%	2.4	33 yrs
S&P 500 ETF (SPY)	Positive EE	33%	2%	2.3	27 yrs
Small Cap ETF (IWM)	Positive EE	7%	-1%	3.0	33 yrs

Sources: New Constructs, LLC and company filings

CSCO Has 29%+ Upside If Consensus Is Correct

Cisco's price-to-economic book value (PEBV) ratio of 1.0 means the stock is priced for profits to never meaningfully grow from TTM levels. Such an assumption seems overly pessimistic, given the company's large market share, substantial backlog of orders, and growing software business.

Below we use our reverse discounted cash flow (DCF) model to analyze three future cash flow scenarios and highlight the upside potential in Cisco's current stock price.

DCF Scenario 1: to Justify the Current Stock Price of $52/share.

If we assume Cisco:

- maintains TTM NOPAT margins of 22% (compared to three-year average of 23%) in fiscal 2022 – 2031 and
- grows revenue by 1% (vs. fiscal 2022 – 2024 consensus estimate CAGR of +5%) compounded annually from fiscal 2022 – 2031, then

the stock is worth $52/share today – equal to the current stock price. In this scenario, Cisco earns $12.5 billion in NOPAT in fiscal 2031, nearly equal to its pre-pandemic NOPAT in fiscal 2019.

DCF Scenario 2: Shares Are Worth $67+

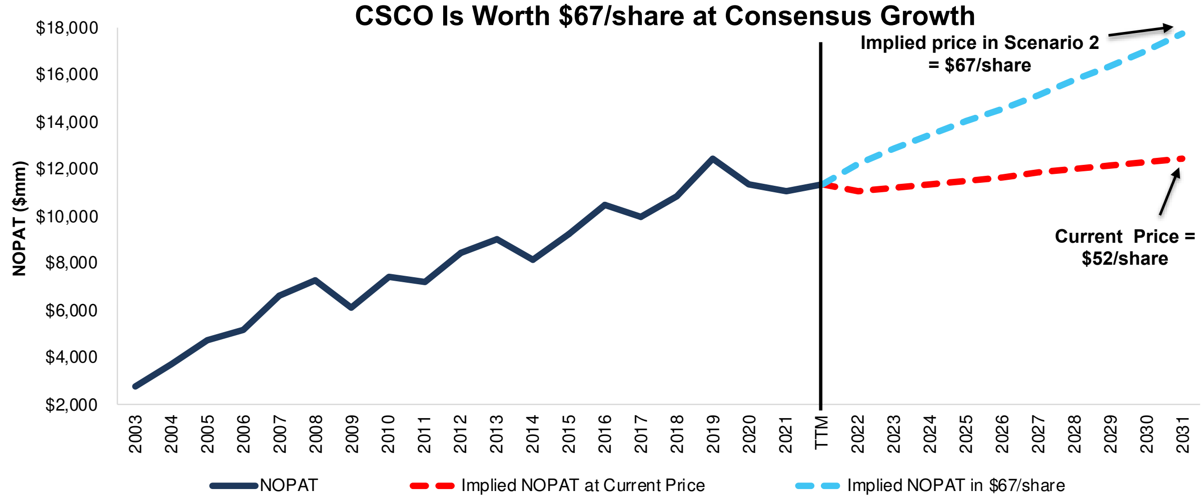
If we assume Cisco:

- improves NOPAT margins to 23% (equal to three-year average) from fiscal 2022 – 2031,
- grows revenue at consensus estimate CAGR of 5% from fiscal 2022 – 2024, and
- grows revenue at a 4% CAGR from fiscal 2024 – 2031 (half its revenue CAGR since fiscal 1998)

the stock is worth $67/share today – a 29% upside to the current price. In this scenario, Cisco's NOPAT grows just 5% compounded annually for the next decade. For reference, Cisco grew NOPAT at a 7% CAGR from fiscal 2009 – 2019 before the COVID-19 pandemic. Should Cisco's NOPAT grow in line with pre-pandemic growth rates, then the stock has even more upside.

Figure 8 compares Cisco's historical NOPAT to its implied NOPAT in each of the above DCF scenarios.

Figure 8: Cisco's Historical and Implied NOPAT: DCF Valuation Scenarios



Sources: New Constructs, LLC and company filings

Sustainable Competitive Advantages Will Drive Shareholder Value Creation

We think the moat around Cisco's business will enable it to continue generating higher NOPAT than the current market valuation implies. Factors contributing to Cisco's moat include:

- market leadership makes Cisco a natural choice for companies wanting reliability, ease of use, and a robust workforce familiar with its products and services
- extensive customer network provides distribution for new products and services
- large physical product offering that drives service growth
- significant R&D expenditures that enable the company to quickly adapt

What Noise Traders Miss With Cisco

These days, fewer investors focus on finding quality capital allocators with shareholder friendly corporate governance. Instead, due to the proliferation of noise traders, the focus is on short-term technical trading trends while more reliable fundamental research is overlooked. Here's a quick summary of what noise traders miss:

- growing software business
- large backlog that will translate into future revenue
- stable cash flows and 6% yield make the stock a relative "safe haven" pick in a tumultuous market
- valuation implies 29% upside if the company grows at consensus estimates

Earnings Beat Could or Market Rotation Could Send Shares Higher

At its current PEBV ratio of 1.0, expectations for future cash flows are overly pessimistic, and should Cisco beat earnings estimates, shares could go higher. For reference, Cisco beat earnings estimates in each of the past twelve quarters.

If fears of a larger downturn in the market grow, Cisco's stable cash-flow generating business is likely to command more attention as investors grow increasingly concerned about fundamentals and profitability. A rotation of money away from high-flying tech names to Cisco could send shares on a steady upward climb.

Should Cisco's supply chain challenges subside, the company could see a large boost in revenue and profits as it works through its backlog of orders, which could also send the stock higher.

Executive Compensation Plan Could Be Improved

No matter the macro environment, investors should look for companies with executive compensation plans that directly align executives' interests with shareholders' interests. Quality corporate governance holds executives accountable to shareholders by incentivizing them to allocate capital prudently.

Cisco compensates executives with salaries, cash bonuses, and long-term equity awards. Cash bonuses were tied to revenue and operating income performance targets in fiscal 2021. The company linked executives' performance restricted stock units (PSRUs) to operating cash flow, earnings per share (EPS), and total shareholder return (TSR) targets. While tying a portion of its compensation to profitability metrics is a positive sign, Cisco could improve its executive compensation.

Instead of revenue, TSR, or GAAP metrics, we recommend tying executive compensation to ROIC, which evaluates the company's returns on the total amount of capital invested in the company. Linking ROIC to executive compensation ensures that executives' interests are aligned with shareholders' interests as there is a strong correlation between improving ROIC and increasing shareholder value.

Though there is room for improvement, Cisco's focus on cash flows and earnings has helped it grow economic earnings. The company's economic earnings have grown from $4.6 billion in fiscal 2011 to $7.3 billion TTM.

Insider Trading and Short Interest Trends

Over the past 12 months, insiders have purchased 1.1 million shares and sold 822 thousand shares for a net effect of ~246 thousand shares purchased. These purchases represent less than 1% of shares outstanding.

There are currently 13.4 million shares sold short, which equates to less than 1% of shares outstanding and under two days to cover. Short interest decreased 18% from the prior month.

Critical Details Found in Financial Filings by Our Robo-Analyst Technology

Fact: we provide more reliable fundamental data and earnings models – unrivaled in the world.
Proof: Core Earnings: New Data & Evidence, forthcoming in The Journal of Financial Economics.

Below are specifics on the adjustments we make based on Robo-Analyst findings in Cisco's 10-K and 10-Qs:

Income Statement: we made $2.5 billion of adjustments, with a net effect of removing $468 million in non-operating expenses (1% of revenue). Clients can see all adjustments made to Cisco's income statement on the GAAP Reconciliation tab on the Ratings page on our website.

Balance Sheet: we made $63.1 billion of adjustments to calculate invested capital with a net increase of $7.2 billion. One of the largest adjustments was $19.1 billion related to goodwill. This adjustment represented 27% of reported net assets. Clients can see all adjustments made to Cisco's balance sheet on the GAAP Reconciliation tab on the Ratings page on our website.

Valuation: we made $35.1 billion of adjustments to shareholder value for a net effect of increasing shareholder value by $5.1 billion. One of the most notable adjustments to shareholder value was $20.1 billion in excess cash. This adjustment represents 9% of Cisco's market cap. Clients can see all adjustments to Cisco's valuation on the GAAP Reconciliation tab on the Ratings page on our website.

Attractive Funds That Hold CSCO

The following funds receive our Attractive rating and allocate significantly to CSCO:

1. Formidable Fortress ETF (KONG) – 5.4% allocation
2. Matrix Advisors Dividend Fund (MADFX) – 4.8% allocation
3. Edgar Lomax Value Fund (LOMAX) – 4.5% allocation
4. Schwab U.S. Dividend Equity ETF (SCHD) – 4.0% allocation
5. Invesco Dow Jones Industrial Average Dividend ETF (DJD) – 3.6% allocation
6. Brown Advisory Equity Income Fund (BADAX, BAFDX, BIADX) – 3.5% allocation

This article originally published on April 20, 2022.

Disclosure: David Trainer, Kyle Guske II, and Matt Shuler receive no compensation to write about any specific stock, style, or theme.

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It's Official: We Offer the Best Fundamental Data in the World

Many firms claim their research is superior, but none of them can prove it with independent studies from highly-respected institutions as we can. Three different papers from both the public and private sectors show:

1. Legacy fundamental datasets suffer from significant inaccuracies, omissions and biases.
2. Only our "novel database" enables investors to overcome these flaws and apply reliable fundamental data in their research.
3. Our proprietary measures of Core Earnings and Earnings Distortion materially improve stock picking and forecasting of profits.

Best Fundamental Data in the World

Forthcoming in The Journal of Financial Economics, a top peer-reviewed journal, Core Earnings: New Data & Evidence proves our Robo-Analyst technology overcomes material shortcomings in legacy firms' data collection processes to provide superior fundamental data, earnings models, and research. More details.

Key quotes from the paper:

- "[New Constructs'] *Total Adjustments* differs significantly from the items identified and excluded from Compustat's adjusted earnings measures. For example… 50% to 70% of the variation in *Total Adjustments* is not explained by *S&P Global's (SPGI) Adjustments* individually." – pp. 14, 1st para.
- "A final source of differences [between New Constructs' and S&P Global's data] is due to data collection oversights…we identified cases where Compustat did not collect information relating to firms' income that is useful in assessing core earnings." – pp. 16, 2nd para.

Superior Models

A top accounting firm features the superiority of our ROIC, NOPAT and Invested Capital research to Capital IQ & Bloomberg's in Getting ROIC Right. See the Appendix for direct comparison details.

Key quotes from the paper:

- "…an accurate calculation of ROIC requires more diligence than often occurs in some of the common, off-the-shelf ROIC calculations. Only by scouring the footnotes and the MD&A [as New Constructs does] can investors get an accurate calculation of ROIC." – pp. 8, 5th para.
- "The majority of the difference…comes from New Constructs' machine learning approach, which leverages technology to calculate ROIC by applying accounting adjustments that may be buried deeply in the footnotes across thousands of companies." – pp. 4, 2nd para.

Superior Stock Ratings

Robo-Analysts' stock ratings outperform those from human analysts as shown in this paper from Indiana's Kelley School of Business. Bloomberg features the paper here.

Key quotes from the paper:

- "the portfolios formed following the buy recommendations of Robo-Analysts earn abnormal returns that are statistically and economically significant." – pp. 6, 3rd para.
- "Our results ultimately suggest that Robo-Analysts are a valuable, alternative information intermediary to traditional sell-side analysts." – pp. 20, 3rd para.

Our mission is to provide the best fundamental analysis of public and private businesses in the world and make it affordable for all investors, not just Wall Street insiders.

We believe every investor deserves to know the whole truth about the profitability and valuation of any company they consider for investment. More details on our cutting-edge technology and how we use it are here.

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