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The Stock-Option Nightmare

By ALBERT J. MEYER and WAYNE M. FASSLER

EMPLOYEE STOCK options are gradually being recognized as an investor's nightmare. After years of controversy, more people in the market now see that the granting of copious amounts of options to employees in lieu of cash compensation dilutes shareholder ownership. They also have figured out that, to stem dilution, companies often use more cash on stock repurchases than they might have spent on cash compensation.

The debate on expensing stock options, however, has deflected attention from the underlying economic realities in companies that issue a lot of options… The standard construct of free cash flow takes cash from operations and deducts capital expenditures. Management is presumed to be at liberty to apply this free cash to a variety of financing activities, such as paying dividends, repaying debt, making acquisitions or repurchasing stock.

But stock repurchases don't qualify as capital allocation (a financing activity) if they simply mop up shares previously issued to employees. These types of repurchases are quasi-compensation costs. Only the cash that remains after such repurchases is truly free and unfettered.

Occasionally, corporations indicate in SEC filings that the reason for a stock-buyback program is to combat the shareholder dilution brought about by stock-option programs. The rapid rate at which shareholders are diluted makes the buybacks imperative.

It is a not-so-virtuous-circle. The company issues stock to employees at a discount. The employees sell the stock. The company announces a share-repurchase program. Astute investors, fearing dilution, trade their stock for real cash via the buyback program. The whole process, from beginning to end, is unsustainable…

Investors are unconcerned about dilution when a company is growing fast and the stock price keeps going up. Initial investors in a Ponzi scheme enjoy similar euphoria. Stock-option dilution works against investors over time. Allowing corporations to eat up your ownership interest to highly motivate workers is like burning your furniture to stay warm: You cannot do it forever.

Only the insiders benefit from the stock-option game. In effect, executives are legally front-running the shareholders. The executives have timing on their side, whereas time works against the investors. "Buy and hold" becomes "buy and hold the bag." Executives with huge piles of stock options own a lien on the future cash flows of the company.

Stock-option programs allow companies to engage in a stock-watering scheme. Unless that perpetual stock offering is combined with a perpetual buyback (the absurdity of the revolving door), the owners continually lose a portion of their ownership interest.

Boasting of the pervasive employee-option giveaways at Siebel Systems, Tom Siebel recently called the company "a Marxist dream." Most such dreams turn out, of course, to be a shareholder's nightmare.

Instead of citing Marx in describing stock options, it would be more appropriate to borrow from Winston Churchill: Never in the history of financial markets has so much been taken from so many by so few…

ALBERT J. MEYER is the President of Bastiat Capital in Plano, Texas. WAYNE M. FASSLER is a financial writer based in Tyler, Texas.

www.BastiatFunds.com
Direct: 972.731.2666
Main: 972.267.2031
Fax: 806.223.0141

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Extracts from Cisco Report: Cisco Shareholders on a Treadmill to Nowhere

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Abstract Cisco's CPA certified and GAAP-compliant financial statements turn fact into fiction in a manner that would make a magician proud. During the past twelve years, Cisco reported $23.4 billion in net income and generated $36.6 billion in free cash flow. Trust us to rain on this parade by asking the question: What happened to these profits, because throughout this period, shareholders did not receive a penny in dividends? Management spent $27.7 billion buying back stock, which under normal circumstances would qualify as a dividend in kind and offer a satisfactory answer to our inquiry. Unfortunately, during this period under review, the company, with the one hand, issued 1.852 shares to employees in lieu of cash wages and then, with the other hand, repurchased 1.572 billion of the same. It would have cost another $5 billion to repurchase the balance of the shares and thus neutralize the dilutive impact of the company's stock option programs. The sad news for shareholders is that employees still hold 1.435 billion options that could cost the company another 12 years' of profits to buy back. If the company does not repurchase the stock, shareholders will suffer a 22% dilution on exercise. At the beginning of 1993, the company had 4.3 billion shares outstanding. The 1.852 billion shares issued to employees diluted shareholders by 42%. Even despite buyback activity, the share count stands at 6.3 billion, the product of options and acquisition activity. A 10% ownership interest in Cisco back in 1994 has dwindled to 6.7%. The reason why net income trails free cash flow can be attributed to the fact that employee cashed out $24 billion dollars worth of stock option gains during the past twelve years. The IRS generously granted the company a corresponding tax deduction, which saved $8 billion in taxes. Like all other companies that rely heavily on stock-based compensation, Cisco's income statement reports a bogus tax expense to hide the fact that despite the profitable profile, Cisco paid comparatively little in cash taxes. It takes the mind of a skeptic to set aside the CPA certified and GAAP-compliant financial statements in search of economic reality. Stock options are ruining this company. There is no way out. The $138 billion market capitalization is testimony to the mesmerizing power of the company's flawed but sanitized financial statements.

Stock Repurchases Since 2003, Cisco has stepped up stock repurchases, spending $25.3 billion to repurchase 1.372 billion shares. During the past twelve years, the company spent $27.7 billion on buying back 1.572 billion shares. In exercising their stock options, employees contributed $8.3 billion to meet strike price requirements. Net of employee contributions, the company spent $19.4 billion on stock buy-backs during the past 12 years. At the same time, the company reported net income of $23.4 billion, which did not include any recognition of the cost of stock-based compensation. Net income during 2000 to 2005 was $17.3 billion, which was less than the company spent on stock repurchases.

Stock-Buybacks - not accomplishing the intended purpose

Change in Share Count: 1993 to 2005

Years		1	2	3	4	5	6	7	8	9	10	11	12
(million)	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Shares Beginning	4,328	4,453	4,639	5,555	5,844	6,092	6,491	6,821	7,138	7,324	7,303	6,998	6,735
Shares Ending	4,453	4,639	5,555	5,844	6,092	6,491	6,821	7,138	7,324	7,303	6,998	6,735	6,331
- Change $		185	916	289	248	399	330	317	186	(21)	(305)	(263)	(404)
- Change %		4.2%	19.7%	5.2%	4.3%	6.5%	5.1%	4.6%	2.6%	-0.3%	-4.2%	-3.8%	-6.0%

Stock Issues The share count increased 46% since 1993, driven by acquisitions and stock option exercises. During the 12-year period under review, the company issued close to 2 billion shares (42% of total shares outstanding at beginning of 1994) to employees in lieu of cash wages. In addition, there are another 1.435 billion options awaiting exercise, 900 million of which have a strike price below $20. To counteract the dilution caused by stock-based compensation option, Cisco would have had to buyback an additional 280 million shares during this period. It would have cost the company approximately $5 billion to buy the 280 million shares. What purpose does it really serve, considering the avalanche of options coming down the pike? This kind of analysis places a different perspective on stock buybacks. In normal circumstances, stock buybacks reduce the share count and existing shareholder benefits from owning a fractionally larger share of the pie. At Cisco, buybacks conjure up the image of someone desperately balling water to keep a leaking boat afloat.

Stock Issues to Employees and Stock Repurchases 1994 to 2005

Years	1	2	3	4	5	6	7	8	9	10	11	12	
	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	Total
Stock Issues													
- ($ mill)	23	54	117	308	489	947	1,564	1,262	655	578	1,257	1,087	8,341
# Shares (mill)	124	142	172	214	164	300	219	140	76	68	122	112	1,852
Exercise Price	$0.19	$0.38	$0.68	$1.44	$2.98	$3.16	$7.14	$9.01	$8.62	$8.50	$10.30	$9.71	$4.50
Repurchases		70	116	323					1,854	5,984	9,080	10,235	27,661
# shares (mill)		40	14	23	0	0	0	0	124	424	408	540	1,572
Purchase Price		$1.75	$8.40	$14.35					$14.95	$14.11	$22.25	$18.95	$17.59
Net Income	315	456	913	1,051	1,355	2,023	2,668	(1,014)	1,893	3,578	4,401	5,741	23,381

Book Value per Share During the past 12 years, book value per share compounded at 27.7% per annum, most of which was front-end loaded.

Book Value per Share: 1994 to 1998

	1	2	3	4	5	12	
($ million)	1994	1995	1996	1997	1998	2005	12 years
Shareholder Equity	904	1,562	2,820	4,325	7,148	23,174	
– Book Value per Share	$0.19	$0.28	$0.48	$0.71	$1.10	$3.66	27.7%

Acquisitions paid for in stock causes an increase in shareholder equity, which has nothing to do with any changes in retained income. The corresponding debit on the asset side of the balance sheet goes to goodwill and intangibles. Excluding the $5.8 billion added to shareholders' equity by acquisitions during the period 2000 to 2005, shareholder equity compounded at an annual rate of 6.8%. Over the past five years, this statistic went negative, mainly because of all the stock buyback activity.

Changes in Shareholder Equity

($ million)	1994	1999	2005
Shareholder Equity	1,379	11,678	23,174
Contributed by:			
– Goodwill and Intangibles arising from acquisitions	0	0	(5,844)
Shareholder Equity – excluding Goodwill and Intangibles	1,379	11,678	17,330
Cumulative Annual GR from 2000 to 2005			6.8%
Cumulative Annual GR from 2001 to 2005			-0.3%
Cash spent on buying stock issued to employees in lieu of cash wages: 2000 to 2005			27,153
Deduct: Cash from employees: stock option exercises			(6,403)
Net Cash Spent on buying back stock issued to employees: 2000 to 2005			20,750
Net Income reported 2000 to 2005			17,267

Throughout the 12-year period, shareholders did not receive a penny in dividends and the share count at the end of 2005 was up 46% from the beginning of 1993. Some may argue that during the period 2000 to 2005, the share count actually declined by 410 million (not counting the stock issued to pay for a $4.2 billion acquisition funded by a stock issue). This decline in the share count came at a cost. Net income during this period was $17.3 billion, but management spent $20.7 billion (net of employee contributions) on stock buybacks.

Book Value per Share: 1999 to 2005

	6	7	8	9	10	11	12
($ million)	1999	2000	2001	2002	2003	2004	2005
Equity	11,678	26,497	27,120	28,656	28,029	25,826	23,174
– Book Value per Share	$1.71	$3.71	$3.70	$3.92	$4.01	$3.83	$3.66

Net Income in Name Only

Net Income and EPS During the past 12 years, Cisco reported net income and EPS of $23.4 billion and $3.43, respectively.

Net Income and EPS: 1994 to 1999

($ million)	1994	1995	1996	1997	1998	1999	2005	12 years
Revenue	1,243	2,233	4,096	6,452	8,488	11,092	20,853	140,802
Pre-Tax Income	509	738	1,455	1,891	2,311	3,203	8,036	36,332
Taxation	(195)	(281)	(552)	(840)	(956)	(1,180)	(2,295)	(12,390)
- Rate	38%	38%	38%	44%	41%	37%	29%	34%
Net Income	315	456	913	1,051	1,355	2,023	5,741	23,381
- Net Margin	25.3%	20.4%	22.3%	16.3%	16.0%	18.2%	27.5%	16.6%
EPS - diluted	$0.07	$0.08	$0.15	$0.17	$0.21	$0.29	$0.87	$3.43

For the period, 2000 to 2005, net income and EPS amounted to $17.3 billion and $2.46, respectively. These numbers do not include any recognition of the cost of stock based compensation as required by SFAS 123R. Even so, they offer dismal support for the company's $138 billion market capitalization.

Net Income and EPS: 2000 to 2005

($ million)	2000	2001	2002	2003	2004	2005	12 years	2000 to 2005
Revenue	17,002	19,559	15,669	15,565	18,550	20,853	140,802	107,198
Pre-Tax Income	4,343	(874)	2,710	5,013	6,997	8,036	36,332	26,225
Taxation	(1,675)	(140)	(817)	(1,435)	(2,024)	(2,295)	(12,390)	(8,386)
- Rate	39%	16%	30%	29%	29%	29%	34%	32%
Net Income	2,668	(1,014)	1,893	3,578	4,401	5,741	23,381	17,267
- Net Margin	15.7%	-5.2%	12.1%	23.0%	23.7%	27.5%	16.6%	16.1%
EPS - diluted	$0.36	$(0.14)	$0.25	$0.50	$0.62	$0.87	$3.43	$2.46

True Cost of Stock-Based Compensation

During the past 12 years, Cisco employees realized gains of approximately $24.0 billion from exercising stock options, that is, 17.2% of total revenue. This is equal to the amount that the company deducted as stock-based compensation for tax purposes, and what it would have cost the company to buy back the stock issued to employees on an ongoing basis. To put it another way, the $24.0 billion is the true intrinsic or economic cost of issuing stock in lieu of cash wages.

Adjusted Net Income incorporating stock-based compensation as per tax return: 1994 to 1999

($ million)	1994	1995	1996	1997	1998	1999	2005	12 years
Pre-Tax Income	509	738	1,455	1,891	2,311	3,203	8,036	36,332

Employee Gains (tax return)	(350)	(500)	(700)	(900)	(1,300)	(4,400)	(1,000)	(24,050)
– as % of Revenue	28.2%	22.4%	17.1%	13.9%	15.3%	39.7%	4.8%	17.1%
Adjusted Pre-Tax Income	159	238	755	991	1,011	(1,197)	7,036	12,282
Tax @ 25%	(40)	(59)	(189)	(248)	(253)	299	(1,759)	(3,071)
Adjusted Net Income	120	178	566	743	758	(898)	5,277	9,212
– Adjusted Net Margin	9.6%	8.0%	13.8%	11.5%	8.9%	-8.1%	25.3%	6.5%
Adjusted EPS	$0.03	$0.03	$0.10	$0.12	$0.12	$(0.13)	$0.83	$1.50

If we incorporate this $24.0 billion as a stock-based compensation expense in the income statement and use a 25% tax rate, it means the company earned $9.2 billion the past 12-years, or $1.50 in EPS. We use a 25% tax rate because Cisco's GAAP-reported tax rate includes a bogus journal entry that artificially inflates the company tax charge to create the impression that the company pays its fair share of taxes – a topic for another day. However, because the company takes a tax deduction equal to employee gains from option exercises, the company's actual tax rate is much lower than the statutory rate.

Adjusted Net Income incorporating stock-based compensation as per tax return: 2000 to 2005

($ million)	2000	2001	2002	2003	2004	2005	12 Years	2000 to 2005
Pre-Tax Income	4,343	(874)	2,710	5,013	6,997	8,036	36,332	26,225
Employee Gains (tax return)	(8,500)	(4,200)	(550)	(350)	(1,300)	(1,000)	(24,050)	(15,900)
– as % of Revenue	50.0%	21.5%	3.5%	2.2%	7.0%	4.8%	17.1%	14.8%
Adjusted Pre-Tax Income	(4,157)	(5,074)	2,160	4,663	5,697	7,036	12,282	10,325
Tax @ 25%	1,039	1,269	(540)	(1,166)	(1,424)	(1,759)	(3,071)	(2,581)
Adjusted Net Income	(3,118)	(3,806)	1,620	3,497	4,273	5,277	9,212	7,744
– Adjusted Net Margin	-18.3%	-19.5%	10.3%	22.5%	23.0%	25.3%	6.5%	7.2%
Adjusted EPS	$(0.44)	$(0.52)	$0.22	$0.50	$0.63	$0.83	$1.50	$1.23

Dramatic Effect of Option Dilution

Paying a Cash Bonus as an Alternative to Stock-Based Compensation If we ignore 1999 and 2000, two years in which employee options gains were 40% and 50% of revenue, respectively, the average ratio of gains to revenue during the 12-year period was 10%. In the tables below, we assume the company paid employees a cash bonus of 10% of revenue instead of granting options to employees, which leads to an adjusted EPS number, one that more accurately reflects economic reality.

Free Cash Flow In addition, we adjusted free cash flow numbers to account for these cash bonuses. We allocated on average 86% of adjusted free cash flow towards stock repurchases (net of employee contributions) and matched Cisco's history of stock repurchases, that is, buying back stock only in the years that Cisco reported repurchases.

Reported Buybacks vs. Buybacks under Cash Bonus Scenario

	Reported GAAP Numbers	Alternative: Number Used for Analytical Purposes
Cash spent on stock repurchases ($ million)	(27,661)	(27,567)
Cash received from employees ($ million)	8,341	8,341
– Net Cash Outflow ($ million)	(19,326)	(19,226)
Number of Shares Repurchased (million)	1,572	1,569
Average Price	$12.25	$12.25

The tables below illustrate the dramatic effect on the share count when a company shuns stock-based compensation in favor of a generous cash bonus. In this case, share buy backs achieve what they are designed for, namely, to shrink the share count. Under these assumptions, Cisco's share count would have shrunk to 3.9 billion shares by the end of 2005, instead of the actual 6.3 billion shares. Keep in mind that employees own options to another 1.4 billion shares. Shareholders are looking at ownership dilution as far as the eye can see.

Under Cash Bonus Option Share Count Actually Declines: 1993 to 1999

	1993	1994	1995	1996	1997	1998	1999	2005	12 years
Shares – begin	4,328	4,328	4,389	4,893	4,970	4,987	5,223	4,224	
Acquisition	0	61	698	131	57	236	30	24	1,482
Share Repurchases	0	0	(194)	(54)	(40)	0	0	(295)	(1,857)
Shares – end	4,328	4,389	4,893	4,970	4,987	5,223	5,253	3,953	

Under Cash Bonus Option Share Count Actually Declines: 2000 to 2005

(million)	2000	2001	2002	2003	2004	2005	12 years	2000 to 2005
Shares – begin	5,253	5,351	5,397	4,638	4,443	4,224		
Acquisition	98	46	27	51	23	24	1,482	269
Share Repurchases	0	0	(787)	(246)	(242)	(295)	(1,857)	(1,569)
Shares – end	5,351	5,397	4,638	4,443	4,224	3,953		

Enhanced EPS under Cash Bonus Alternative The tables below show adjusted EPS, based on the above assumptions, inclusive of a generous cash bonus and the declining share count. For the 12-year period under review, Cisco would have earned approximately $3.79 instead of the GAAP reported EPS of $3.46. The $3.79 includes a stock-based compensation proxy in the form of the 10% cash bonus, whereas the $3.46 is before recognizing any stock-based compensation expense – perhaps as much as $2.00 per share, but definitely not less than $1.20 per share.

Enhanced EPS under Cash Bonus Alternative: 1994 to 1999

($ million)	1994	1995	1996	1997	1998	1999	2005	12 Years
Pre-Tax Income	509	738	1,455	1,891	2,311	3,203	8,036	36,332
Employee Gains (10% of rev)	(124)	(223)	(410)	(645)	(849)	(1,109)	(2,085)	(14,080)
- as % of Revenue	10.0%	10.0%	10.0%	10.0%	10.0%	10.0%	10.0%	-10.0%
Adjusted Pre-Tax Income	385	515	1,045	1,246	1,462	2,094	5,951	22,252
Tax @ 25%	(96)	(129)	(261)	(311)	(366)	(523)	(1,488)	(5,563)
Adjusted Net Income	289	386	784	934	1,097	1,570	4,463	16,689
- Adjusted Net Margin	23.2%	17.3%	19.1%	14.5%	12.9%	14.2%	21.4%	11.9%
Adjusted EPS	$0.07	$0.09	$0.17	$0.20	$0.24	$0.34	$1.33	$3.79
GAAP EPS	$0.07	$0.08	$0.15	$0.17	$0.21	$0.29	$0.87	$3.46

Enhanced EPS under Cash Bonus Alternative: 2000 to 2005

($ million)	2000	2001	2002	2003	2004	2005	12 years	2000 to 2005
Pre-Tax Income	4,343	(874)	2,710	5,013	6,997	8,036	36,332	26,225
Employee Gains (10% of rev)	(1,700)	(1,956)	(1,567)	(1,557)	(1,855)	(2,085)	(14,080)	(10,720)
- as % of Revenue	10.0%	10.0%	10.0%	10.0%	10.0%	10.0%	-10.0%	10.0%
Adjusted Pre-Tax Income	2,643	(2,830)	1,143	3,457	5,142	5,951	22,252	15,505
Tax @ 25%	(661)	707	(286)	(864)	(1,286)	(1,488)	(5,563)	(3,876)
Adjusted Net Income	1,982	(2,122)	857	2,592	3,857	4,463	16,689	11,629
- Adjusted Net Margin	11.7%	-10.9%	5.5%	16.7%	20.8%	21.4%	11.9%	10.8%
Adjusted EPS	$0.42	$(0.44)	$0.21	$0.67	$1.06	$1.33	$3.79	$3.26
GAAP EPS	$0.36	$(0.14)	$0.25	$0.50	$0.62	$0.87	$3.46	$2.46

On the purely cash compensation basis, during the past six years, Cisco would have earned approximately $3.26 compared to the GAAP reported EPS of $2.46. Again, the $2.46 does not include a stock-based compensation expense.

Free Cash Flow Illusions

Count Stock Buybacks as Compensation Ostensibly, Cisco generated a huge amount of free cash flow - $36.6 billion - but it then turned around and spent $19.4 billion ($27.7 billion less $8.3 billion employee contributions) to buy back some, but not all of the stock it issued to employees in lieu of cash wages. As noted, if it had spent an additional $5 billion, it could have bought another 280 million shares (at an average price of $17.59), which would have neutralized the dilutive impact of its stock option program. Factor this into the equation and that leaves a paltry $12 billion of free cash flow over a 12-year period. The cost of buying back all the shares to employees would have been close to the $24.0 billion that employees realized in option gains, which is also the amount the company claimed as stock-based compensation on its tax return.

Under the current stock-based compensation scenario, stock buybacks amounted to nothing more than employee compensation in disguise, hidden in the dark recesses of the financial statements.

Shareholders have little to show for the $141 billion that the company generated in revenue during the 12-year period under review.

GAAP-based Free Cash Flow: 1994 to 1999

($ million)	1994	1995	1996	1997	1998	1999	2005	12 years
Operating Cash Flow	318	443	1,063	1,448	2,890	4,325	7,568	49,455
Capital Expenditures	(60)	(152)	(283)	(332)	(417)	(602)	(692)	(9,865)
Net Change in Receivables						(310)		71
Technology Purchases						(95)		(543)
Purchase of Minority Investments						(119)	(205)	(2,579)
Lease Deposit								
Free Cash Flow - GAAP	258	291	780	1,116	2,473	3,199	6,671	36,599

GAAP-based Free Cash Flow: 2000 to 2005

($ million)	2000	2001	2002	2003	2004	2005	12 Years	2000 to 2005
Operating Cash Flow	6,141	6,392	6,587	5,319	6,962	7,568	49,455	38,969
Capital Expenditures	(1,086)	(2,271)	(2,641)	(717)	(613)	(692)	(9,865)	(8,020)
Net Change in Receivables	(535)	457	380	79			71	381
Technology Purchases	(444)	(4)					(543)	(448)
Purchase of Minority Investments	(130)	(1,526)	(173)	(282)	(84)	(205)	(2,579)	(2,400)
Lease Deposit		(320)	320					
Free Cash Flow - GAAP	3,946	2,728	4,473	4,399	6,265	6,671	36,599	28,482

If the company had paid a cash bonus of 10% instead of using stock options, it would have generated $22.5 billion in free cash flow. We adjust free cash flow for stock repurchases that follow the historic pattern in Cisco’s financial statements.

Adjusted Free Cash Flow – incorporating cash bonus and stock buybacks: 1994 to 1999

($ million)	1994	1995	1996	1997	1998	1999	2005	12 Years
Free Cash Flow – GAAP	258	291	780	1,116	2,473	3,199	6,671	36,599
Deduct: Employee Cash Bonus*	(124)	(223)	(410)	(645)	(849)	(1,109)	(2,085)	(14,080)
Adjusted Free Cash Flow	134	68	370	471	1,624	2,090	4,586	22,519
* Assume 10% of Revenue								
Stock Repurchases (122% of FCF)	0	(340)	(452)	(574)	0	0	(5,595)	(27,567)
Employee Contributions	23	54	117	308	489	947	1,087	8,341
Adjusted Free Cash Flow	157	(218)	35	204	2,113	3,037	78	3,292
122% of Cash Flow	(163)	(83)	(452)	(574)	(1,982)	(2,550)	(5,595)	(27,569)
Employee Contributions	23	54	117	308	489	947	1,087	8,341
– Net Available for Stock Repurchases	(140)	(29)	(335)	(266)	(1,493)	(1,603)	(4,508)	(19,226)
– as % of Free Cash Flow	104%	43%	91%	57%	92%	77%	98%	86%

Adjusted Free Cash Flow – incorporating cash bonus and stock buybacks: 2000 to 2005

($ million)	2000	2001	2002	2003	2004	2005	12 years	2000 to 2005
Free Cash Flow – GAAP	3,946	2,728	4,473	4,399	6,265	6,671	36,599	28,482
Employee Cash Bonus	(1,700)	(1,956)	(1,567)	(1,557)	(1,855)	(2,085)	(14,080)	(10,720)
Adjusted Free Cash Flow	2,246	772	2,906	2,843	4,410	4,586	22,519	17,762
Stock Repurchases (122% of FCF)	0	0	(11,758)	(3,468)	(5,380)	(5,595)	(27,567)	(26,201)
Employee Contributions	1,564	1,262	655	578	1,257	1,087	8,341	6,403
Adjusted Free Cash Flow	3,810	2,034	(8,197)	(47)	287	78	3,292	(2,036)
122% of Cash Flow	(2,740)	(942)	(3,545)	(3,468)	(5,380)	(5,595)	(27,569)	
Employee Contributions	1,564	1,262	655	578	1,257	1,087	8,341	
– Net Available for Stock Repurchases	(1,176)	320	(2,890)	(2,890)	(4,123)	(4,508)	(19,226)	
– as % of Free Cash Flow	52%	-41%	99%	102%	93%	98%	86%	

Shareholders taken for a Ride down Dilution Lane

Cisco currently trades at a P/E of 25 – hard to believe. Under the cash wages only assumption, the company could have earned approximately $1.13, which translates into a price of $28.23. The last time Cisco's stock traded above $29 was in the 3rd quarter of 1999. This compares to the current price of $21.75.

Under the cash wages only scenario, a person owning 10% of Cisco in 1993, would now own 11.3%. Stock repurchases accomplished their intended purchase.

Under the current stock-based compensation regime, a 10% ownership in 1993, declined to 6.7% despite management's stock-buy back activity. We believe a calculation similar to the above led Bill Gates to conclude that he regretted offering stock options to employees as part of his company's compensation package (MSNBC, May 5, 2005). It is a formula to riches for insiders, but one of misery for shareholders. As Microsoft's largest shareholder and an executive who declined option grants, Bill Gates was contemplating a miserable outcome.

Cash Only Wages vs. Cash and Stock Options

	1993	Ownership Interest	2005	Ownership Interest
Stock Price using a 25 P/E based on Adjusted EPS			$28.23	
Stock Price using a 25 P/E based on reported EPS			$21.75	
10% owner of Cisco - adj. EPS (million shares)	445.35	10.0%	445.35	11.3%
- market capitalization ($ million)	966.4		12,570.7	
10% owner of Cisco - GAAP EPS (million shares)	445.35	10.0%	445.35	6.7%
- market capitalization ($ million)	966.4		9,686.3	

No End to Dilution

Stock Option Analysis: 1994 to 2005

(million)	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	Total
Share Count	4,763	5,706	6,000	6,256	6,491	6,821	7,138	7,324	7,303	6,998	6,735	6,331	
Options Granted	74	311	297	342	214	223	258	222	200	142	143	179	2,605
- as % of Count	1.55%	5.45%	4.95%	5.47%	3.30%	3.27%	3.61%	3.03%	2.74%	2.03%	2.12%	2.83%	
Options Exercised	117	128	160	157	152	210	176	133	54	45	96	93	
- as % of Count	2.46%	2.24%	2.67%	2.52%	2.34%	3.08%	2.47%	1.82%	0.74%	0.64%	1.43%	1.47%	
Options Outstanding	342	485	622	808	870	889	971	1,060	1,206	1,303	1,350	1,435	
- as % of Count	7.2%	8.5%	10.4%	12.9%	13.4%	13.0%	13.6%	14.5%	16.5%	18.6%	20.0%	22.7%	

Stock Option Analysis During the past 12 years, the company granted employees 2.6 billion options. The current option overhang is 22.7%. If the above discussion has not convinced shareholders of the wealth destroying power of option dilution, perhaps the prospect of another 22% dilution in ownership would get the message through that shareholders are holding the short-end of the stick. This stock should not be in any responsible investor's portfolio.
