These prepared remarks should be viewed solely in conjunction with the related quarter's conference call webcast and press release, which can be found here. The webcast includes the prepared remarks as well as a question and answer session.

Please click here for complete GAAP reconciliation information between our GAAP financial results and our non-GAAP financial results.

Cisco Systems, Inc. [CSCO]
Q1FY20 Financial Results Conference Call
Wednesday, November 13, 2019

Introduction

Welcome, everyone, to Cisco's First Quarter Fiscal 2020 Quarterly Earnings Conference Call. This is Marilyn Mora, Head of Investor Relations, and I'm joined by Chuck Robbins, our Chairman and CEO, and Kelly Kramer, our CFO.

By now you should have seen our earnings press release. A corresponding webcast with slides, including supplemental information, will be made available on our website in the Investor Relations section following the call.

As is customary in Q1, we have made certain reclassifications to prior period amounts to conform to the current period's presentation. Income statements, full GAAP to non-GAAP reconciliation information, balance sheets, cash flow statements, and other financial information can also be found in the Financial Information section of our Investor Relations website.

Throughout this conference call, we will be referencing both GAAP and non-GAAP financial results and will discuss product results in terms of revenue and geographic and customer results in terms of product orders, unless stated otherwise. All comparisons made throughout this call will be made on a year over year basis.

The matters we will be discussing today include forward-looking statements, including the guidance we will be providing for the second quarter of fiscal 2020. They are subject to the risks and uncertainties that we discuss in detail in our documents filed with the SEC, specifically the most recent report on Form 10-K, which identifies important risk factors that could cause actual results to differ materially from those contained in the forward-looking statements. With respect to guidance, please also see the slides and press release that accompany this call, for further details. Cisco will not comment on its

financial guidance during the quarter unless it is done through an explicit public disclosure.

In Q2 of fiscal 2019, we completed the sale of our SPVSS business, and, accordingly, had no revenue or expense from that business in Q1 fiscal 2020. As such, all of the revenue, non-GAAP, and product orders information we will be discussing is normalized to exclude the SPVSS business from our historical results. We have provided historical financial information for the SPVSS business in the slides that accompany this call and on our website, to help to understand these impacts. The guidance we provided during our Q4 earnings call had been normalized in the same way.

I will now turn it over to Chuck.

Opening Remarks

Thanks, Marilyn. We delivered a solid quarter against a challenging macro environment. While we're pleased with this performance, we're most focused on the environment as we move forward. We'll discuss this more in a moment.

What's happening inside Cisco, regardless of the macro, is an unrelenting focus on driving innovation, transforming our business, and exceeding our customers' expectations.

In Q1, as you've seen, we had revenue growth of 2% and double-digit non-GAAP earnings per share growth. We also delivered strong non-GAAP gross margins and non-GAAP operating margins along with solid operating cash flow. We continued to invest in innovation and expand our market opportunities, while maintaining our commitment to maximizing shareholder return.

Over the last year, many of you have heard me talk about the resilience of the global macro environment. However, on our last earnings call, we indicated that we had begun to see some weakness, and that weakness continued throughout Q1 and was more broad-based.

While the main challenges continue to be Service Provider and Emerging Markets, this quarter we also saw relative weakness in Enterprise and Commercial. Despite these headwinds and because of key decisions we made four years ago to change our business model, we remain well positioned to capitalize on the tremendous opportunities across cloud, automation, 5G, Security, and Collaboration.

Our transition to software continues to progress, and we are on track with where we said we would be at the end of fiscal year 2020. This transition to software not only aligns to how our customers want to consume our technology, but we also believe it will lessen the impact of macroeconomic shifts in the future.

Despite the current uncertainty, our innovation pipeline remains strong. At our annual

Partner Summit last week, we announced several exciting additions to our portfolio, including network automation and analytics, cloud-based networking, collaboration, as well as new security capabilities. Over the next couple of months, you will see us deliver even more innovation to help our customers achieve their business objectives.

Now I'd like to share some recent highlights across the business.

Our enterprise networking portfolio continued to grow as customers increasingly adopt our intent-based networking portfolio spanning our Catalyst 9000 family of switches, Meraki cloud-based platforms, and next-generation data center solutions.

Our customers today are running applications across multiple cloud environments, and this shift requires a fundamental change in how they build their networks and their security architectures. To help them achieve this, we are automating connectivity across any cloud. A good example of this is our recently announced partnership with Microsoft to help our customers improve network connectivity with the highest level of security from branch offices to cloud-based applications by integrating Cisco's SD-WAN solution with Azure's virtual WAN.

To further extend our enterprise networking leadership, we continue to expand our cloud-managed network and security offerings. Last week we also announced an expansion of our Meraki portfolio, including continued integration between Meraki's dashboard and Cisco's switching portfolio, as well as innovative new LTE-based WAN connectivity solutions.

We believe our planned acquisition of Acacia will also play a critical role in building upon the strength of our switching, routing, and optical networking portfolio. By utilizing our innovations across silicon, software, and optics, we are enabling our customers to transform their networks.

Now let's turn to Security, which is always at the heart of everything we do. It's deeply integrated into the fabric of our entire portfolio to help secure our customers' data and address their modern application and multi-cloud environments.

Cybersecurity continues to be a top concern for our customers as they evolve their enterprise architectures to address the challenges of an ever-changing threat environment. We have the most comprehensive integrated cybersecurity platform in the market, designed to enable our customers to securely connect any application running on any cloud and delivered to any device.

We have been building an expansive zero trust framework for securing access across the workforce, the workplace, and the workload. As the leader in zero trust, our customers are increasingly turning to us to help them extend simple and trusted access to their users in hybrid and multi-cloud environments. This is leading to strong uptake of Duo, our identity access management solution, which provides continuous authentication ensuring the right people are able to access the right applications.

To further reduce complexity in our customers' environments, we recently announced new enhanced capabilities in our firewall, breach defense, endpoint protection, and Talos Incident Response solutions. These innovations are designed to provide greater threat protection and enhance the benefits of our platform.

We also continue to leverage AI and ML capabilities through our industry-leading threat intelligence platform, Talos, along with Stealth Watch and Umbrella, to bring our customers simplicity, visibility, and insight that no other company can deliver.

Moving to Applications. We are rapidly becoming the center of our customer strategy for empowering teams and increasing productivity, as 95% of the Fortune 500 use our collaboration portfolio. This is leading to the solid performance in our business as a growing number of customers adopt our unique solutions.

During the quarter, we expanded our offerings to empower our customers for the modern workplace, protecting data from ever-increasing cyber threats and delivering highly secure productivity and collaboration solutions. A good example of this is our next-generation Webex, our cloud-based, team collaboration platform enabling better teamwork while helping users stay secure with integrated end-to-end encryption.

We also launched single platform Advantage, delivering all collaboration workloads, including calling, messaging, meeting, and contact center, from a single platform. In addition, we announced our new Cisco Webex Edge for Devices as well as hardware as a service options for phones, desk, and room-based video systems.

We are raising the bar for the industry by continuing to drive innovation in our expanding family of cognitive collaboration offers with AI and ML integrated capabilities. During the quarter, we acquired Cloud Cherry, a market-leading customer experience management solution, to augment our contact center portfolio, with cloud analytics and AI to increase productivity and enhance user experiences.

We also achieved a strong quarter in our AppDynamics business with yet another quarter of double-digit growth. Our investments in AppDynamics have made Cisco the leader in application monitoring and analytics. We are helping our customers transform their digital businesses through our comprehensive portfolio of solutions that turns data into actionable, real-time insights by linking application performance to business outcomes.

To summarize, while we remain in a challenging macroeconomic environment, I'm proud of our progress both in our own continued transformation and in how we are empowering customers to drive their own transformation and shift to the cloud. We have a clear vision and strategy, and are executing well against it to capture the many opportunities ahead.

I feel great about our portfolio and I believe fully in our customers' commitment to our technology solutions. We will also continue to invest in organic and inorganic innovation

to position Cisco for the long term.

We also remain committed to managing our business to ensure we drive the greatest long-term value for our customers, employees, partners, and shareholders.

Now let me turn it over to Kelly.

Financial Overview

Thanks, Chuck. I'll start with a summary of our financial results for the quarter followed by the guidance for Q2.

Our overall Q1 results were solid. We executed well with revenue growth and strong margins, net income and EPS. Total revenue was $13.2 billion, up 2%. Our non-GAAP operating margin rate was 33.6%, up 1.3 points. Non-GAAP net income was $3.6 billion, up 5%, and non-GAAP EPS was $0.84, up 12%.

Let me provide some more detail on our Q1 revenue.

Total product revenue was up 1% to $9.9 billion.

Infrastructure platforms was down 1%. All of the businesses were up, except for routing. Switching had growth in both campus and data center, with the continued ramp of the Cat 9K and strength of the Nexus 9K. Wireless grew, driven by Meraki. Data center had solid growth, led by HyperFlex. Routing declined due to weakness in Service Provider.

Applications was up 6%, with growth across all the businesses, including double-digit growth in AppDynamics.

Security was up 22%, with strong performance in identity and access, advanced threat, unified threat, and web security.

Service revenue was up 4%, driven by software and solution support.

And we continued to transform our business, delivering more software offerings and driving more subscriptions. Software subscriptions were 71% of total software revenue, up 12 points year over year.

When we look at the impact of acquisitions on our Q1 results year-over-year, there was a 50 basis point positive impact on revenue.

In terms of orders in Q1, total product orders were down 4%. Looking at the geographies, Americas and EMEA were each down 3%, and APJC was down 5%. Total emerging markets were down 13%, with the BRICS + Mexico down 26%. In our customer segments, Public Sector was up 6%, Enterprise and Commercial were each down 5%, and Service Provider was down 13%.

Remaining performance obligations, or RPO, at the end of Q1, were $24.9 billion, up 11%. RPO is our total deferred revenue plus unbilled deferred, and represents total committed non-cancelable future revenue.

From a non-GAAP profitability perspective, total Q1 gross margin was 65.9%, up 1.7 points. Product gross margin was 66.1%, up 2.5 points, and Service gross margin was 65.4%, down 0.4 points.

In terms of the bottom line from a GAAP perspective, Q1 net income was $2.9 billion and EPS was $0.68.

We ended Q1 with total cash, cash equivalents, and investments of $28 billion. Operating cash flow was $3.6 billion, down 5%. Normalized for the $400 million legal settlement we received from Arista in Q1 of fiscal 2019, operating cash flow was up 7%.

From a capital allocation perspective, we returned $2.3 billion to shareholders during the quarter that was comprised of $0.8 billion of share repurchases and $1.5 billion for our quarterly dividend.

We continue to invest organically and inorganically in our innovation pipeline. During Q1, we closed four acquisitions, all in the applications area. These moves are consistent with our strategy of increasing investment in innovation and R&D for our growth areas.

To summarize, we had a solid Q1. We executed well, with top line growth and strong profitability. We're seeing the returns on the investments we're making in innovation and driving the shift to more software and subscriptions, delivering long-term growth and shareholder value.

Guidance

Let me reiterate our guidance for the second quarter of fiscal 2020. This guidance includes the type of forward-looking information that Marilyn referred to earlier.

We expect revenue to decline in the range of minus 3% to minus 5% year-over-year.

We anticipate the non-GAAP gross margin rate to be in the range of 64.5% to 65.5%.

The non-GAAP operating margin rate is expected to be in the range of 32.5% to 33.5% and the non-GAAP tax provision rate is expected to be 20%.

Non-GAAP earnings per share is expected to range from $0.75 to $0.77.

Summary Comments

So let me just wrap up and say that obviously it's a complicated world right now, and we

certainly felt the continuing impact that we talked about at the end of our last quarter. That being said, I have great confidence in where we are with the portfolio. We shared some metrics today on the software transition that I think is going incredibly well. And notwithstanding the short-term challenges, we feel really good about the future.

And so thank you all for being with us today. And I'll kick it back to you, Marilyn.

Closing

Thanks, Chuck. Cisco's next quarterly earnings conference call, which will reflect our fiscal 2020 second quarter results, will be on Wednesday, February 12th, 2020, at 1:30 PM Pacific time, 4:30 PM Eastern time.

Again I'd like to remind the audience that in light of regulation FD, Cisco's policy is not to comment on its financial guidance during the quarter unless it is done through an explicit public disclosure.

We now plan to close the call. If you have any further questions, please feel free to contact the Cisco Investor Relations Department, and we thank you very much for joining the call today.

The prepared remarks set forth above and the related conference call may be deemed to contain forward-looking statements, which are subject to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. These forward-looking statements include, among other things, statements regarding future events (such as our ability to drive innovation, transform our business and exceed our customers' expectations, our continued progress in transforming our business model with software subscriptions, and our investment in our innovation pipeline to generate long-term profitable growth and deliver value for shareholders) and the future financial performance of Cisco (including the guidance for Q2 FY 2020) that involve risks and uncertainties. Readers are cautioned that these forward-looking statements are only predictions and may differ materially from actual future events or results due to a variety of factors, including: business and economic conditions and growth trends in the networking industry, our customer markets and various geographic regions; global economic conditions and uncertainties in the geopolitical environment; overall information technology spending; the growth and evolution of the Internet and levels of capital spending on Internet-based systems; variations in customer demand for products and services, including sales to the service provider market and other customer markets; the return on our investments in certain priorities, key growth areas, and in certain geographical locations, as well as maintaining leadership in routing, switching and services; the timing of orders and manufacturing and customer lead times; changes in customer order patterns or customer mix; insufficient, excess or obsolete inventory; variability of component costs; variations in sales channels, product costs or mix of products sold; our ability to successfully acquire businesses and technologies and to successfully integrate and operate these acquired businesses and technologies; our ability to achieve expected benefits of our partnerships; increased

competition in our product and service markets, including the data center market; dependence on the introduction and market acceptance of new product offerings and standards; rapid technological and market change; manufacturing and sourcing risks; product defects and returns; litigation involving patents, intellectual property, antitrust, shareholder and other matters, and governmental investigations; our ability to achieve the benefits of the announced restructuring and possible changes in the size and timing of the related charges; cyber-attacks, data breaches or malware; vulnerabilities and critical security defects; terrorism; natural catastrophic events; a pandemic or epidemic; our ability to achieve the benefits anticipated from our investments in sales, engineering, service, marketing and manufacturing activities; our ability to recruit and retain key personnel; our ability to manage financial risk, and to manage expenses during economic downturns; risks related to the global nature of our operations, including our operations in emerging markets; currency fluctuations and other international factors; changes in provision for income taxes, including changes in tax laws and regulations or adverse outcomes resulting from examinations of our income tax returns; potential volatility in operating results; and other factors listed in Cisco's most recent report on Form 10-K filed on September 5, 2019. The financial information contained in the prepared remarks and the related conference call should be read in conjunction with the consolidated financial statements and notes thereto included in Cisco's most recent report on Form 10-K as it may be amended from time to time. Cisco's results of operations for the three months ended October 26, 2019 are not necessarily indicative of Cisco's operating results for any future periods. Any projections in the prepared remarks and the related conference call are based on limited information currently available to Cisco, which is subject to change. Although any such projections and the factors influencing them will likely change, Cisco will not necessarily update the information, since Cisco will only provide guidance at certain points during the year. Such information speaks only as of the date of the prepared remarks and the related conference call.