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, Incorporated [CSCO]
Q2 FY20 Financial Results Conference Call
Wednesday, February 12, 2020

Introduction

Welcome everyone to Cisco's second quarter FY2020 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.

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 third 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 reports on Form 10-K and 10-Q which identify 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.

With that, I will now turn it over to Chuck.

Opening Remarks

Thanks Marilyn and good afternoon everyone.

As we told you last quarter and still see now, the feedback from our customers is that they remain strongly committed to both our products and services. However, like many in our industry, we are seeing longer decision-making cycles across our customer segments for a variety of reasons including macro uncertainty as well as unique geographical issues. The good news is once this uncertainty passes for our customers we expect to see spending recover as technology continues to be at the heart of all they do.

You'll see in our numbers this quarter that we continue to make progress on several key metrics including our shift to more software and subscriptions with 72% of our software now being sold as a subscription. While we still have a lot more work to do, I firmly believe we have a tremendous opportunity ahead of us. The long-term secular growth trends of 5G, Wi-Fi 6, 400G and the shift to the cloud remain, and we expect to benefit from them.

This is a multi-year transformation and we are managing our business well while staying focused on helping our customers build simpler, more secure and cost-effective networks.

The broad adoption of multi-cloud in modern application environments is changing how the world's largest networks are built, operated and secured, and Cisco is at the center of this transition. We have made significant investments in the development of software, silicon and optics, the building blocks for the Internet of the future. We believe this strategy will change the economics of how the Internet will be built to support 5G, 400G and the demands of the future, while helping our customers innovate and move faster than ever before.

In December, we introduced Cisco Silicon One, a first-ever, single unified silicon architecture, and the Cisco 8000 carrier-class router family built on Silicon One as well as our new IOS XR7 operating system. We also announced new flexible purchasing options that enable customers to consume our technology however they choose.

We also collaborated closely with several of the largest webscale and SP companies throughout the development process. Their participation in our launch demonstrates their strong support of our strategy as well as our commitment to continued innovation. Our goal is to accelerate the deployment of next-generation internet infrastructure by offering our customers choices of components, white box or integrated systems in a flexible consumption model.

Now let me share a brief update of our businesses, starting with Infrastructure Platforms.

As the global leader in networking, we believe we are well positioned with our intent-based networking portfolio, given the strategic investments we've been making. Over the past several quarters, we've made tremendous progress integrating automation, analytics and security across our enterprise networking portfolio, while at the same time shifting to a subscription-based model. A great example of our success is the ongoing strong adoption of our Catalyst 9000 platforms.

We continue to extend our secure SD-WAN solutions as customers move more applications to the cloud. To do this, we are actively engaging with webscale companies to help our customers extend their wide area networks to the cloud and secure their business applications. Recently, we announced integration with Microsoft Azure Virtual WAN and Office 365, along with a deeper partnership with Amazon Web Services to deliver highly secure end-to-end connectivity and better application performance.

Now to Security. We had another solid quarter with strength across our advanced threat and cloud-based solutions, including Duo and Umbrella which are important growth drivers of our business.

We continue to see significant opportunity as we execute on our strategy to deliver an integrated security platform. As the market moves to a multi-cloud environment and the need for visibility grows, we're benefiting from our strong position as our customers' most trusted partner. Our differentiated end-to-end approach across the network, cloud and end point is winning customers, with 100% of the Fortune 100 now using one or more of Cisco's security solutions.

This quarter, we expanded our security portfolio from the cloud to the edge. We brought to market an integrated IoT architecture providing enhanced visibility, insights and threat detection across our customer's entire environment. This architecture includes our new software-based security solutions, Cyber Vision, and our Edge Intelligence data collection tool to enable our customers to make better business decisions.

Finally, Applications. There's no question that customers are undergoing a significant workplace transformation and they are turning to Cisco to help them with this transition. As a global market leader, we believe we are the only company providing a cognitive, highly secure and analytics-driven collaboration platform which is the foundation for their workplace transformation.

This platform is becoming increasingly critical to how enterprises empower their teams by allowing their employees to work more effectively together. To extend our value proposition, we continue to make strategic investments. For example, we recently brought to market several key Webex capabilities which combine context, AI and machine learning to enable our customers and their teams to further enhance their meeting experiences.

We achieved another strong quarter of growth with AppDynamics, demonstrating our ability to deliver unique, real-time AI-powered insights from a single pane of glass providing complete visibility.

Our customers are looking to connect application performance monitoring with infrastructure automation to simplify IT and increase productivity. Two weeks ago, we announced we were bringing together AppDynamics and our Intersight Workload Optimizer to deliver comprehensive visibility of applications and infrastructure both on-prem and in the cloud using machine learning and AI to proactively remediate problems and optimize user experiences.

To summarize, I am pleased with our business transformation with the new innovative platforms

we're bringing to market. While we continue to experience some pause in customer spending related to the uncertainty in the global macro environment, our long-term growth opportunities remain unchanged.

Going forward, we will continue to focus on developing groundbreaking technologies and building a new internet for the 5G era that will help our customers innovate faster than ever before. I remain incredibly confident that our execution against our strategy will drive profitable growth and generate strong shareholder returns for the long term.

I will now 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 Q3.

Our overall Q2 results were consistent with our expectations. We executed well, with strong margins and EPS growth. Total revenue was at $12B, down 4%. Our non-GAAP operating margin rate was 33.7%, up 1.6 points. Non-GAAP net income was $3.3B, flat year over year, and non-GAAP EPS was $0.77, up 5%.

Let me provide some more detail on our Q2 revenue.

Total product revenue was down 6% to $8.7B.

Infrastructure Platforms was down 8%. Switching revenue declined in both campus and data center. We did see growth with the continued ramp of our Cat 9K and strength in the Nexus 9K. Routing declined driven by weakness in Service Provider. Wireless declined overall but we did see strong growth in Meraki and are starting to see the ramp of our WiFi6 products. Data center revenue declined driven by servers offset in part by strong growth in Hyperflex.

Applications was down 8%, driven by a decline in Unified Communications partially offset by double digit growth in AppDynamics.

Security was up 9%, with strong performance in identity and access, advanced threat and unified threat management.

Service revenue was up 5%, driven by software and solutions support.

We continued to transform our business, delivering more software offerings and driving more subscriptions. Software subscriptions were 72% of total software revenue, up 7 points year over year.

In terms of orders in Q2, total product orders were down 6%. Looking at our geographies, the Americas was down 8%, EMEA was down 1% and APJC was down 4%. Total Emerging

Markets were down 7%, with the BRICS + Mexico down 20%. In our customer segments, Public Sector was flat, while Enterprise was down 7%, Commercial was down 4%, and Service Provider was down 11%.

Remaining performance obligations, or RPO, at the end of Q2 were $24.9B up 11%.

From a non-GAAP profitability perspective, total Q2 gross margin was 66.4%, up 2.3 points. Product gross margin was 65.9%, up 3.1 points, and Service gross margin was 67.7%, flat year over year.

In terms of the bottom line from a GAAP perspective, Q2 net income was $2.9 billion and EPS was $0.68.

We ended Q2 with total cash, cash-equivalents, and investments of $27.1B. Operating cash flow was $3.8B, flat year over year.

From a capital allocation perspective, we returned $2.4B to shareholders during the quarter. That was comprised of $0.9B of share repurchases and $1.5B for our quarterly dividend.

Today we announced a $0.01 increase to the quarterly dividend to $0.36 per share, up 3% year over year. This represents a yield of approximately 2.9% based on today's closing price. This dividend increase reinforces our commitment to returning capital to our shareholders and our confidence in the strength and stability of our ongoing cash flows.

We continue to invest organically and inorganically in our innovation pipeline. In early Q3, we closed our acquisition of Exablaze, a designer and manufacturer of advanced network devices aimed at reducing latency and improving network performance.

To summarize, we executed well with strong margins and EPS growth. 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 third quarter of FY20. This guidance includes the type of forward-looking information that Marilyn referred to earlier.

We expect revenue to decline in the range of minus 1.5% to minus 3.5% 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 $0.79 to $0.81.

Our guidance does not reflect any potential disruptions in our global supply chain that could result from the Coronavirus. We will continue to monitor the situation closely.

Summary Comments

All right. Well, let me just thank everyone for joining us today. And I'll just recap by saying that, while we have seen a bit of a pause, we actually feel really good. The conversations I have with our customers, I mean all of the things they're trying to do I believe our technology is at the heart of, whether it's rebuilding their applications, whether securing their data, transforming their infrastructure in this new era or changing their user experience as well as the way they interface with their customers, I think that we're in a very good position to help them do that and we feel good about where we are.

So, thank you all for joining us today and we'll look forward to catching up with you next quarter.

Closing

Thanks, Chuck. Just to wrap the call, Cisco's next quarterly earnings conference call, which will reflect our FY2020 third quarter results, will be on Wednesday, May 13, 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 there are any further questions, feel free to contact Cisco's Investor Relations group. And we thank you very much for joining today's call.

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 continue to drive innovation, our long-term growth opportunities as we help our customers build out the networks for the future, the continued strength of our ongoing cash flows and our ability to continue to return value to our shareholders) and the future financial performance of Cisco (including the guidance for Q3 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 reports on Forms 10-Q and 10-K filed on November 19, 2019 and September 5, 2019, respectively. 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 reports on Forms 10-Q and 10-K as each may be amended from time to time. Cisco's results of operations for the three and six months ended January 25, 2020 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.