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]
Q3 FY20 Financial Results Conference Call
Wednesday, May 13, 2020

Introduction

Welcome, everyone, to Cisco's Third 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.

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 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 fourth quarter of fiscal 2020. They are subject to the risks and uncertainties, including those related to COVID-19, that we discuss in detail in our documents filed with the SEC, specifically the most recent reports on Forms 10-K and -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.

Chuck, I'll now turn it over to you.

Opening Remarks

Thanks, Marilyn. Before we get started, I want to express my gratitude and appreciation for all the front-line workers who are fighting this pandemic every day to keep so many safe. I also want to express my sympathies for those who have lost their lives and the families that have endeared the deepest pains from the impact of this tragic situation we are in today. This truly is unlike anything any of us have ever experienced.

As you can imagine, we have been focused on helping our employees, customers, partners, and communities. We currently have 95% of our global workforce working from home, which was a seamless transition for us as we already had a flexible work policy and we build the technologies that allow organizations to stay connected, secure and productive. For those 5% who must be in the office to do their roles, we're clearly focused on their health and safety and are taking all of the necessary precautions.

During the crisis, many of customers and partners have been under enormous pressure as they face cash flow challenges. This is why we introduced a variety of free offers and trials for our Webex and security technologies as they dramatically shifted entire workforces to be remote. In addition, we announced $2.5 billion in financing with a new Business Resiliency Program through Cisco Capital to offer financial flexibility and support their business continuity. This will help customers and partners access the technology they need now, invest for recovery, and defer most of the payments until early 2021.

This pandemic is highlighting so many inequities that already existed and is exacerbating these problems. I'm proud to say that Cisco has committed nearly $300 million to date to support both global and local pandemic response efforts, including providing technology and financial support for nonprofits, first responders, and governments. We are also donating personal protective equipment to hospital workers, including N95 masks and face shields 3D-printed by Cisco volunteers around the world.

I'm so proud of our teams who have been relentlessly focused on these efforts and continuing to identify how we can be innovative to help those most in need. I'd particularly like to call out our IT, WebEx, Security, and supply chain teams, along with our partners and suppliers who have been working around the clock to ensure we are doing all that we can to keep organizations around the world up and running and giving back to our communities. Thank you.

Now turning to our third quarter performance. Despite the challenging environment we are all operating in, we delivered a solid quarter and financial performance in the midst of the greatest financial crisis of our lifetime. While we are not immune to the impacts of the global pandemic, we believe our underlying business fundamentals and financial position remain strong.

As we look at the quarter, it very much reflected the journey of the pandemic. In March, we were performing ahead of our expectations as companies focused on building resiliency in their IT environments. Then in April, we began to see a slowdown across the business as countries across the world were locked down. While parts of our portfolio have been more impacted than others, we believe our leadership from a product, innovation, and operational perspective, remain solid.

While there's so much uncertainty now, we believe our role has never been more important and our responsibility has never been greater as much of the world is running on Cisco's technology from networking to collaboration to security to stay connected, secure, and productive.

Organizations more than ever must focus on resiliency and agility, and those who had invested in digital capabilities were able to make this shift more seamlessly. While we cannot predict when it's going to happen, one thing we believe is that the demand for our products and services will be strong when we emerge from this situation.

We believe the transition in our own business model through our shift to more software and subscription-based offerings is paying off. We saw continued strong adoption of our SaaS-based offerings and now have 74% of our software that is subscription versus 65% a year ago.

We also believe we remain well-positioned over the long term so serve our customers and create differentiated value aligned to cloud, 5G, WiFi-6, and 400G. Our business model, diversified portfolio and ability to continue to invest in key growth priorities, gives us a strong foundation to build even stronger customer relationships.

As we prepare for the future, we will closely partner with our customers to modernize their infrastructure, secure their remote workforce and their data through our innovative solutions that will serve as the foundation for their digital organizations.

Next I'll turn to the performance of our business segments starting with Infrastructure Platforms. With the world going online practically overnight, the demand on networks has never been greater with users looking for secure connectivity, reliable performance, and consistent experiences.

This has led to our customers evaluating how to expand their capacity quickly, how best to protect their teams, and how to keep their data secure while keeping their business productive. It is also requiring enterprise IT to rapidly set up, deploy, and provision mobile offices or mobile healthcare clinics. What I've seen IT teams do around the world and what they've made possible is simply astonishing.

Our strategy and value proposition are clear. We are powering the world's ability to stay connected, productive, and secure, while automating many of these capabilities. Our Intent-Based Networking Architecture was built for environments like this. For industries like healthcare, public services, financial services, and service providers

especially, having network infrastructure tightly integrated with security is mission-critical. In Q3, we offered new cloud-based COVID-19 bundles for tele-worker, mobile healthcare, and pop-up branch use cases through our partners and Service Providers.

As customers modernize their network infrastructure, we saw continued strong customer adoption of our subscription-based Catalyst 9K, as customers look to quickly scale remote access capabilities to keep their employees safe and their businesses running.

We continue to execute on our secure cloud scale SD-WAN strategy by investing in innovation and partnerships to help enterprises accelerate their multi-cloud strategies. As an example, we are now integrating with our umbrella secure Internet gateway to give our customers flexibility to use best-of-breed cloud security with our industry-leading SD-WAN solution.

Our partnerships across webscale providers like AWS, Azure, and our most recent announcement with Google Cloud, allow us to offer a truly multi-cloud network fabric. As bandwidth and SaaS application demand increases, we are enabling our customers to securely connect branches and interconnect to different cloud providers to enable consistent application performance and user experience.

Moving on to Security, which is always at the heart of everything we do. In Q3, we saw solid growth reflecting increased demand for our robust solutions to secure the rapid growth in remote workers and their devices.

Being the largest enterprise security company in the world, we are uniquely positioned to safeguard our customers wherever they work. We have the most comprehensive and integrated end-to-end portfolio in the industry across the network, cloud, applications, and endpoints.

As I mentioned earlier, we provided extended free licenses for key security technologies that are designed to protect remote workers, including Cisco Umbrella, zero trust security from Duo, industry-leading secure network access from Cisco AnyConnect, and endpoint protection from our AMP technology.

We're also supporting our customers on their multi-cloud journey by enabling them to secure direct Internet access, cloud application usage, and roaming users. We're only two quarters into our secure Internet gateway transition, and we are already seeing strong adoption from existing and new customers.

Building on the investments we made in innovation partnerships and acquisitions, we also introduced SecureX. This is the industry's broadest cloud-based security platform, connecting the breadth of our portfolio and our customer security infrastructure by providing unified visibility, automation, and simplified security across applications, the network, endpoints, and the cloud.

Turning to Applications. Tele-working and collaboration tools have become a lifeline for businesses and their people to stay connected and productive, with security and privacy being more critical than ever.

Our portfolio's at the center of our customers' strategy for empowering teams and increasing productivity, as 95% of the Fortune 500 use our collaboration portfolio today. We take a security-first approach to remote working and provide highly secure, cloud-based collaboration solutions with integrated end-to-end encryption while protecting our customers' privacy.

Throughout the quarter, we invested in scaling our platform at an unparalleled speed to delivery a highly secure, consistent experience and ensuring business continuity for our customers. We are now running our Webex platform at 3 times the capacity we were running at in February, to manage the dramatic increase in usage growth. We had well over 500 million meeting participants generating 25 billion meeting minutes in April, more than triple the volume in February. We also added many new prospects through free Webex trials that we anticipate converting to revenue in the future.

With applications at the core of every business and the surge in demand for monitoring tools that provide real-time business insights and optimize user experiences in multi-cloud environments, AppDynamics continues to perform well, particularly in this environment.

As I wrap up, I just want to reiterate how grateful I am to have our teams, our resources, and our operational resiliency during this time.

I also want to commend the heroic efforts of IT organizations and teams around the world who have had to digitize their operations and support remote workforces at an unprecedented speed and scale.

This crisis has highlighted the importance of having highly resilient, globally scalable infrastructure technologies to keep the world running, and this is what we build. We are providing innovative solutions that help our customers support business continuity, drive productivity, and ensure a highly secure work environment.

We believe we will emerge from this crisis stronger than before. With our accelerated innovation cycle, refreshed portfolio, and significant progress on our shift to more software and subscriptions, we are in a better position today than in past times of uncertainty. Our confidence is further supported by our strong balance sheet to invest for the future and our proven ability to execute no matter the environment.

I also believe our incredible culture has been amplified during this time, and I'm so proud of what our teams have achieved. I am confident Cisco is resilient and we are built to last, regardless of what the future brings.

Kelly, I'll now turn it over to you.

Financial Overview

Thanks, Chuck. I'll start with a summary of our financial results for the quarter followed by guidance for Q4.

Our overall Q3 results reflect good execution with strong margins and non-GAAP EPS growth in a very challenging environment. COVID-19 did have an impact on our financial results and business operations this quarter, especially in our supply chain where we saw manufacturing challenges and component constraints.

Total revenue was $12 billion, down 8%. Our non-GAAP operating margin rate was 34.9%, up 2.7 points. Non-GAAP net income was $3.4 billion, down 2% year over year, and non-GAAP EPS was $0.79, up 1%.

Let me provide some more detail on our Q3 revenue.

Total product revenue was down 12% to $8.6 billion.

Infrastructure Platforms was down 15%. This is the area that was most impacted by the supply chain challenges. Switching revenue declined in both campus and in data center. We did see strong growth with the continued ramp of the Cat 9K. Routing declined in both Service Provider and in Enterprise. Data center revenue declined, driven by continued market contraction impacting both our servers and HyperFlex offerings. Wireless declined overall, but we did see strength in the ramp of our WiFi-6 products and solid growth in Meraki.

Applications was down 5%, driven by a decline in unified communication and TP endpoints. We did see growth in conferencing as we saw strong uptake with the COVID-19 environment. We also saw strong double-digit growth in AppDynamics and IoT software.

Security was up 6%, with strong performance in unified front management, identity and access, and advanced threat. Our cloud security portfolio performed well, with strong double-digit growth and continued momentum with our Duo and Umbrella offerings.

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

We continue to transform our business, delivering more software offerings and driving more subscriptions. Software subscriptions were 74% of total software revenue, up 9 points year over year.

In terms of orders in Q3, total product orders were down 5%. During the quarter, there was a slowdown in April as we saw the impact of the COVID-19 environment continue.

Looking at our geographies, the Americas was flat, EMEA was down 4%, and APJC was down 22%. Total emerging markets were down 21%, with the BRICS plus Mexico down 29%. In our customer segments, Public Sector was up 1%, while Enterprise was down 4%, Commercial was down 11%, and Service Provider was down 3%.

Remaining performance obligations, or RPO, at the end of Q3, were $25.5 billion, up 11%. The portion related to product was up 25%.

From a non-GAAP profitability perspective, total Q3 gross margin was 66.6%, up 2 points. Product gross margin was 65.8%, up 2.1 points, and service gross margin was 68.9%, up 1.6 points year over year. The increase in product gross margin was driven by productivity with continued memory cost savings and positive mix, partially offset by pricing.

In terms of the bottom line from a GAAP perspective, Q3 net income was $2.8 billion and EPS was $0.65.

We ended Q3 with a total cash, cash equivalents, and investments of $28.6 billion. Operating cash flow was $4.2 billion, down 2% year over year.

We have a very strong balance sheet, healthy free cash flow generation, and the ability to quickly access capital markets. This is a competitive advantage in a challenging environment.

Our commitment to our capital allocation program remains unchanged, and we intend to continue to deliver long-term value to our shareholders through the return of a minimum of 50% of our free cash flow annually. In Q3, we returned $2.5 billion to shareholders during the quarter that was comprised of $1 billion of share repurchases and $1.5 billion for our quarterly dividend.

To summarize, we executed well, with strong margins and non-GAAP EPS growth in a very challenging environment. 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 fourth 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 8.5% to minus 11.5% year-over-year.

We anticipate the non-GAAP gross margin rate to be in the range of 64% to 65%.

The non-GAAP operating margin rate is expected to be in the range of 31.5% to 32.5%. And the non-GAAP tax provision rate is expected to be 20%.

Non-GAAP earnings per share is expected in the range from $0.72 to $0.74.

Summary Comments

Yes. So, let me just close quickly by, first of all, thanking all of you for being with us and just telling you all that we hope that you're safe and your family's safe and you continue to be safe.

I also want to just reiterate our gratitude for the front-line workers. And these are the healthcare workers, the first responders, some of our colleagues locally who are in the homeless camps helping try to stem the tide of this pandemic flowing through those kinds of environments, those people who live paycheck-to-paycheck who are struggling right now, our thoughts and prayers are with everybody and our gratitude is especially with those who are on the front lines.

We look forward to getting to the other side of this and we look forward to doing our part in helping our customers and helping society actually thrive as much as possible during this very difficult time. So, thanks for being with us today on our call.

Closing

Thanks, Chuck. Cisco's next quarterly earnings call, which will reflect our Q4 2020 and annual results, will be on Wednesday, August 12th, 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, feel free to contact the Cisco 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 continued support of our employees, customers, partners and communities, while positioning Cisco for the future, global customer demand to digitize their operations and support remote workforces at a faster speeds and greater scale and our ability to provide the technology and solutions our customers need to accelerate their digital organizations, our ability to continue to build resiliency into our business model, continued growth of revenue from software subscriptions, our ability to drive long-term profitable growth while delivering shareholder value, and future responses to and effects of the COVID-19 pandemic) and

the future financial performance of Cisco (including the guidance for Q4 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: the impact of the COVID-19 pandemic; 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; any other 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 February 18, 2020 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 nine months ended April 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.