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 FY21 Earnings Results Conference Call
Tuesday, February 9, 2021

Introduction

Welcome, everyone, to Cisco's Second Quarter Fiscal 2021 Quarterly Earnings Conference Call. This is Marilyn Mora, Head of Investor Relations, and I'm joined by Chuck Robbins, our Chairman and CEO; and I'm very pleased to welcome Scott Herren, 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 third quarter of fiscal 2021. They are subject to the risks and uncertainties, including COVID-19, that we discuss in detail in our documents filed with the SEC, specifically the most recent reports on forms 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'll now turn it over to Chuck.

Opening Remarks

Thanks, Marilyn. First of all, I hope that all of you and your families are safe and healthy. This year is full of promise, as vaccines give us a path to healing and recovery. We are optimistic about the future and look forward to what lies ahead.

This past quarter, our team delivered strong performance with revenues coming in at the top of our guidance range and non-GAAP EPS landing above the high end of our expectations, all supported by margin expansion and a further strengthening of our balance sheet. More importantly, we are seeing encouraging signs of strength across our business as the recovery takes shape, with all customer segments showing improvement in year over year growth rates.

Our employees and partners have done a remarkable job executing and innovating throughout the pandemic to help our customers connect, secure and automate to accelerate their digital agility in a cloud-first world.

We are partnering with them on core issues that are essential to their success: business resiliency, modernizing their IT environments, and embracing secure hybrid work. Over the past year, our customers have relied on our innovation to accelerate their digital and cloud capabilities while protecting them from an expanding threat environment.

In my numerous conversations with customers, it is clear that our technology will be a powerful engine for their recovery and growth as their technology needs continue to evolve at a rapid pace.

Building on the strength of our broad portfolio, we are focused on six strategic pillars that will deliver highly secure next-generation architectures with unprecedented insights, automation and visibility.

First, we're building networking solutions with built-in simplicity, security, agility and automation that can be consumed as-a-service.

Second, we're optimizing our customers' application experiences, enabling greater speed, agility and scale of cloud-native applications and DevOps that deliver the best end-user experience.

Third, with the future of work being hybrid, we're delivering highly secure access, a safer workplace and the best collaboration experiences, no matter whether workers are at home or in an office.

Fourth, with our customers and partners, we're building the internet for the future by transforming connectivity and efficiently meeting the ever-growing demand for low-latency and higher speeds.

Fifth, with security and privacy a top priority, we are building integrated, high-efficacy, end-to-end security solutions that are delivered on-prem or in the cloud.

Lastly, as apps and workloads move closer to users and devices, we're developing new-edge capabilities for a distributed world while enhancing the developer experience and extending enterprise and carrier networks.

I am confident that this is the right strategy to deliver the innovation and integrated network solutions that our customers need, no matter what the future holds.

Now moving to our performance this quarter. We continued to see signs of gradual improvement led by order growth in our Commercial, Public Sector and Service Provider businesses, which together account for nearly three quarters of product orders. The Enterprise market remains soft, driven by some elongated sales cycles and a continued pause in spending among some customers brought on by the pandemic. From a product revenue perspective, we saw strength in our Catalyst 9K, Data Center Switching, Security, Wireless and Webex portfolios.

The transformation of our business to more software and subscriptions continues to show great progress as we achieved $3.6 billion in software revenue with 76% of our software revenue sold as a subscription. We also saw our sixth consecutive quarter of double-digit growth in our deferred product revenue.

We continued to accelerate our pace of innovation, delivering unique solutions and digital capabilities as we invest in flexible consumption models. I am confident in our ability to capture the long-term opportunities ahead in areas such as cloud, 400G, 5G, security, hybrid work and next generation applications.

Looking ahead, we are cautiously optimistic, as recent surveys of IT spending indicate year-over-year IT budget growth for calendar 2021, and Cisco remains well positioned among CIOs' top forward-looking spending priorities, including network infrastructure, cybersecurity software, as well as cloud migration and cloud infrastructure. We are also mindful and vigilant about the uncertainty of the pandemic and its influence in the market, which is not fully behind us yet.

Now let me touch on infrastructure platforms. To manage the highly distributed and complex nature of modern IT environments, our customers must fundamentally change how their networks are architected.

To help them achieve this, we are building a unified cloud-native platform suite to deliver secure agile networking. A good example of this is our subscription-based, intent-based networking portfolio and is reflected in the momentum of our Catalyst 9K family which saw another quarter of double-digit revenue growth.

We are also delivering full stack observability from the application to the infrastructure to give our customers greater insights for faster, better decision-making. We are doing this through key elements of our portfolio, like Intersight, ThousandEyes and AppDynamics, as well as our leading security innovations.

As a global leader in transport network infrastructure, we are playing an important role in helping customers build their networks for the future. We continue to invest heavily to capture 5G, 400G and Wi-Fi 6 transitions to enable Open RAN and edge services. This is reflected in our SD-WAN portfolio, routing, 5G mobile core platforms, optics and automation capabilities.

In our webscale business, we delivered our fifth consecutive quarter of very rapid order growth, increasing to triple digits, and on a trailing-12-month basis, our orders grew over 60% as we

focused on delivering routing, data center switching and optical platforms built on Cisco Silicon One, which has a better efficiency over other silicon on the market. While we could see our performance vary quarter to quarter due to the timing of large deals, we are incredibly confident in our ability to further strengthen our position. By building a network on Silicon One, our customers can also save up to 30% of network switching power, resulting in a meaningful reduction in their environmental footprint as well as significant energy cost savings.

Our agreement to acquire Acacia will enable us to deliver leading edge optical technology to meet both the bandwidth requirements and the economics of next-generation networks, which is critical to providing high speed connectivity. This is just another reason why I'm so confident we will continue to win in the webscale space.

As I've mentioned, we plan to transition the majority of our portfolio to be cloud-driven, cloud-managed and delivered as-a-service. If we can deliver it from the cloud, we will. For example, we are looking at offering SD-WAN plus cloud security as a service, along with creating other new solutions. We will also provide simplified end-to-end networking with security, reliability, control and automation, plus seamless on-ramp capabilities to the cloud that no one else can deliver.

Moving to security. We delivered another strong quarter of revenue growth driven by increasing adoption of our next generation cloud-based architectures, which can enable fast, secure access to applications and data from anywhere.

With the rapid growth in modern applications and more distributed work environments, our customers are adopting new security architectures as identity and data privacy are increasingly critical. The recent SolarWinds breach only highlights the urgent need for advanced threat defense.

Our comprehensive security portfolio offers simplified protection for any workload on any cloud while minimizing the attack surface and automating security policies across an organization's hybrid cloud footprint. This extends to our Secure Access Service Edge (SASE) framework and zero-trust architecture, where we have developed a best-in-class cloud-delivered stack across Umbrella, Secure Internet Gateway, Meraki SD-WAN and Viptela.

We are also delivering leading unified detection and response capabilities built on Cisco SecureX, our cloud-native platform. Over 5,400 customers are already seeing the benefits of this platform since it became generally available last June.

We remain committed to delivering simple, integrated and highly effective end-to-end security solutions delivered on-prem and in the cloud.

Turning to Applications, which includes our collaboration portfolio. We are focused on building solutions that will enable an engaged, productive workforce and an intelligent workplace built with secure collaboration, automation and insights. Our aim is to deliver the best collaboration experience for our customers no matter where they are.

Our strong momentum with Webex continued, resulting in double-digit revenue growth. I am so proud of the work the Webex team has done to ensure our nearly 600 million quarterly average users are able to stay connected and productive. In addition, we are connecting over 6 billion calls every month for our customers around the world.

We are bringing incredible innovation to the collaboration market at an unprecedented pace. Our goal is to deliver a 10x-better experience than just in-person interactions. At our recent Webex One event, we introduced more than 50 new product and feature innovations integrating security and privacy to deliver inclusive experiences. Some of the new powerful capabilities we announced include noise cancellation, real-time language translation and our Webex Desk Pro Series platforms.

Our recently announced intent to acquire cloud-based IMImobile and Slido furthers our vision of building a Webex suite of applications as we combine these technologies with our Webex Contact Center to improve customer interactions.

In summary, our strategy is clear and our business remains strong. We are executing and innovating with speed and delivered solid results with our Q2 revenue coming in at the high end and earnings coming in above our stated guidance. As we move into the gradual recovery phase, we believe our customers will continue to turn to Cisco as their partner of choice.

I am so proud of what our teams have achieved. The incredible innovation and trusted partnerships we are building will serve us well in the years ahead. While the past year has highlighted far too many inequities in our society, we believe in the power of technology to drive more inclusivity and opportunity to underserved populations and communities around the world, which is why we are committed to powering an inclusive future for all.

With our ongoing disciplined approach to investment and innovation, we expect to be in an even stronger position postpandemic as our customers look to deploy their next-generation networks at the heart of their organizations. I firmly believe Cisco is well positioned to capture the long-term growth opportunities ahead and win for years to come.

I'll now turn it over to Scott, our new CFO, to walk through our financial results. As you know, Scott has strong experience in software and a proven track record of leading successful business model transitions from perpetual licenses to SaaS and recurring subscriptions. Scott is proving to be a powerful addition to our team, and I look forward to partnering with him as we plan the next phase of Cisco's continued transformation.

Scott, over to you.

Financial Overview

Thanks, Chuck. Let me start by saying how excited I am to join the Cisco team at such a pivotal time in the company's transformation.

Before turning to our performance in the quarter, I thought I'd share my initial observations and key priorities. I'm impressed by the team here at Cisco and the progress the company has made on its transformation, achieving the goals laid out three years ago of driving 50% of our revenue from software and services. It's also clear that the leadership team is unified and focused and that the strategies Chuck laid out earlier in the call will drive our growth over the next several years. It's an exciting time to be joining the company in this role.

In terms of my key priorities, they include the following: 1) driving profitable growth, 2)a continued disciplined focus on financial management and operating efficiency, 3)setting a long-term plan to maximize value creation through strategic transformation, and 4) examining investments, both organic and inorganic. I'm also committed to providing you the insight and metrics needed to understand and properly value our business longer term.

Now let's turn to our results. I'll start with a summary of our financial results for the quarter, followed by the guidance for Q3.

Our overall Q2 results reflect very good execution, with strong margins and growth in non-GAAP net income and earnings per share in a continuing challenging environment.

Total revenue of $12.0 billion came in at the top of our guidance range, flat year over year, as we see gradual recovery in several key product areas and sequential growth rate improvement in two out of three of our geographies. Our non-GAAP operating margin was 34.4%, up 70 basis points. Non-GAAP net income was $3.4 billion, up 2%. And non-GAAP earnings per share was $0.79, coming in above the high end of our guidance range and up 3% year-over-year.

Now let me provide some more detail on our Q2 revenue.

Total product revenue was $8.6 billion, down 1%.

Infrastructure Platforms was down 3%. As a reminder, this is the product area most impacted by the Covid environment. Switching revenue was flat overall. We saw solid growth in data center switching with strong growth of the Nexus 9K. We also saw continued strong momentum of the Cat 9K products within campus switching. Routing declined, driven by weakness in service provider. Wireless had solid growth, driven by the continued ramp of our WiFi 6 products and strength in Meraki. Data center revenue declined, driven primarily by servers as we experienced continued market contraction.

Applications was flat overall. We continued to see strong double-digit growth in Webex driven by our continuing product innovations and the criticality of remote working. This was offset by declines in Unified Communications and TP endpoints.

Security was up 10%, with growth across the portfolio. Our cloud security portfolio performed well, with strong double-digit growth and continued momentum of our Duo and Umbrella offerings.

Service revenue was up 2%, driven by growth in our maintenance business as well as solutions support.

And we continued to transform our business, delivering more software offerings and driving more subscriptions. Software subscriptions were 76% of total software revenue, up 4 points year-over-year, as Chuck mentioned earlier.

Remaining performance obligations, or RPO, at the end of Q2 were $28.2 billion, up 13%. RPO per product was up 17% and for service was up 10%. The continued growth in RPO demonstrates the strength of our portfolio of software and services and is another indicator of the broad recovery we see happening.

In terms of orders in Q2, total product orders were up 1%, a significant improvement from Q1. Looking at our geographies, the Americas was down 1%, EMEA was up 7% and APJC was down 5%. Total emerging markets were down 14%, with the BRICS plus Mexico down 11%. In our customer segments, Public Sector was up 10%, Service Provider was up 5% and Commercial was up 1%, and Enterprise down 9%.

Non-GAAP total gross margin was 66.9%, up 50 basis points. Product gross margins were 66.6%, up 70 basis points. And Service gross margin was 67.9%, up 20 basis points year-over-year. The growth in product gross margin was driven by positive product mix, including some software benefit and productivity improvements, partially offset by pricing.

In terms of the bottom line from a GAAP perspective, Q2 net income was $2.5 billion and earnings per share was $0.60.

We ended Q2 with total cash, cash equivalents and investments of $30.6 billion, up $600 million sequentially. Operating cash flow was $3 billion, down 22% as expected, driven by a lower beginning receivables balance for the quarter, timing of payments and the restructuring payments. We expect operating cash flow growth to normalize over the course of the fiscal year.

From a capital allocation perspective, we returned $2.3 billion to shareholders during the quarter. That was comprised of $1.5 billion for our quarterly dividend and $800 million of share repurchases. Year-to-date, we've returned $4.6 billion to shareholders, which represents 69% of our free cash flow.

And today we announced a $0.01 increase to the quarterly dividend to $0.37 per share, up 3% year-over-year. This dividend increase reflects the 10th consecutive year of increasing our dividend and 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. During Q2 we announced an amendment to the definitive merger agreement under which we'd previously agreed to acquire Acacia Communications. We expect to complete the Acacia acquisition in our fiscal Q3, subject to closing conditions, including Acacia stockholder approval. In addition, we announced our intent to acquire IMImobile, a cloud communications, software and services

company, and Slido, a provider of SaaS-based solutions, to enhance our Webex platform and our new cloud-native Contact Center offerings. These investments are consistent with our strategy of complementing our internal innovation and R&D with targeted M&A to allow us to further strengthen and differentiate our market position and our focused growth areas.

To summarize, we executed well, with strong margins and growth in non-GAAP net income and earnings per share growth. We're seeing returns on the investments we're making in innovation and driving the continued shift to more software in subscriptions, delivering long-term growth and shareholder value.

Guidance

Now let me reiterate our guidance for the third quarter of fiscal '21. This guidance is subject to the disclaimer regarding forward-looking information that Marilyn referred to earlier. Q3 does include an extra week, which occurs every five to six years. We've factored this extra week into our guidance for both revenue and expenses. Although it's difficult to forecast the impact of the extra week, we have assumed roughly 2% to 3% year-over-year impact on total revenue growth, along with approximately $185 million of incremental cost of sales and operating expenses.

The guidance for Q3 is as follows:

We expect revenue to be in the range of 3.5% to 5.5% growth year-over-year.

We anticipate the non-GAAP gross margin to be in the range of 65% to 66%.

The non-GAAP operating margin is expected to be in the range of 33% to 34% and the non-GAAP tax provision rate is expected to be 19%.

Non-GAAP earnings per share is expected to range from $0.80 to $0.82.

Summary Comments

All right, just to wrap up, I want to thank everybody for spending time with us today, and again, just hope that everybody stays safe as we work through what we're all hopeful is the beginning of the recovery, and I think that from a business perspective, we continue to feel like that is definitely the case, that we are in the midst of a recovery, which gives us a lot of optimism.

I'm proud of what our teams have done. I'm proud of the innovation that we have built during this complicated time. We have Cisco Live coming up at the end of March where there'll be a lot of innovation that we'll be announcing, and based on that and some of the performance that we see and the continued improvement in our business, I remain fairly optimistic about where we are right now as we come through this pandemic. So we'll look forward to talking to all of you on the next call, and Marilyn, I'll turn it back over to you.

Closing

Thanks, Chuck. Cisco's next quarterly earnings conference call, which will reflect our fiscal 2021 third quarter results, will be on Wednesday, May 19, 2021, at 1:30 p.m. Pacific Time, 4:30 p.m. Eastern Time.

As a reminder, we will be presenting and hosting meetings at several investor conferences over the next few weeks, including the Goldman Sachs Technology & Internet Conference tomorrow.

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 investor relations team. Have a great day.

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 encouraging signs of strength across our business showing how our technology will be a powerful engine for recovery and growth, our customers continuing to partner with us to accelerate their digital transformation and drive secure, remote work, and our continued growth of deferred revenue through the shift to more software and subscriptions) and the future financial performance of Cisco (including the guidance for Q3 FY 2021) 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 November 17, 2020 and September 3, 2020, 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 23, 2021 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.