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]
Q1FY22 Earnings Results Conference Call
Wednesday, November 17, 2021

Introduction

Welcome, everyone, to Cisco's First Quarter Fiscal 2022 Quarterly Earnings Conference Call. This is Marilyn Mora, Head of Investor Relations, and I'm joined by Chuck Robbins, our Chair and CEO; and 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.

As a reminder, effective in Q1, we began reporting our revenue in the following categories: Secure Agile Networks, Hybrid Work, End-to-End Security, Internet for the Future, Optimized Application Experiences, Other Products and Services. As discussed during our Investor Day and in our October 20th press release, this change better aligns our product categories with our strategic priorities. This change only impacts how we report revenue by product category, as our reportable segments will continue to be based on geographies, which consist of the Americas, EMEA and APJC. We included quarterly reclassified revenue amounts for the last three fiscal years on our website. Click on the Financial Information section of the website to access these documents.

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 done 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 and full year of fiscal 2022. 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 report on Form 10-K, 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.

I will now turn it over to Chuck.

Opening Remarks

Thanks, Marilyn, and good afternoon, everyone. We look forward to spending time with you today.

First, I would like to thank those of you who joined us for our Investor Day in September, where we showcased the strong foundation we've built for helping to generate long-term profitable growth. We're striving to maximize value creation through our focus on higher concentrations of software and subscription-based revenue streams. This gives us and you greater visibility and predictability into our future growth. We also highlighted our unique portfolio of market-leading franchises, which are well positioned to drive growth in highly attractive existing and expansion markets. Lastly, we showcased the depth of our leadership team and outlined the next phase of our strategy.

Moving into fiscal year '22, we are off to a great start with robust order growth of 33% and continued strong demand across our portfolio. Our teams are executing well, our ARR grew double digits and our momentum is accelerating, driven by digital transformation and cloud. Even with the ongoing supply constrained environment, we are solidly on track to deliver against our long-term financial targets by investing for growth while delivering breakthrough innovation.

The past 18 to 24 months have no doubt accelerated the digital revolution we are all experiencing, as technology is permanently changing nearly every aspect of our lives. The technology we build is powering the modern secure infrastructure that sits at the heart of this revolution, and Cisco is well positioned to capture the opportunities ahead.

Our customers want digital and cloud-enabled solutions that allow them to move with greater speed, agility and efficiency. We're already seeing the positive impact of our investments to drive accelerated innovation across high-growth areas, including hybrid cloud, Webscale, cloud security, 5G, WiFi6, 400G and Full-Stack Observability.

A key trend in front of us is enabling employees to work from anywhere, and this is much broader than meetings. It's about the holistic capabilities to support a highly distributed workforce that require new infrastructure architectures, observability and security. Many companies are in the process of defining their hybrid work strategy, which will be based on the technology we build across our networking, security and collaboration portfolios. We are also leading the way with new innovation, including our recently expanded Webex portfolio, purpose-built for inclusive experiences across hybrid work, workspaces and events.

Now I'd like to discuss our Q1 performance. Building on the momentum from last quarter, I'm proud to say we achieved another strong quarter inline with our expectations despite supply constraints, which I will discuss shortly.

We delivered balanced revenue and non-GAAP EPS growth with healthy margins driven by a continued economic recovery, strong execution and exceptional demand for our products. We also generated a strong quarter of double-digit growth in ARR and RPO, reflecting the ongoing success of our transformation.

We have continued to operate successfully in a very dynamic environment, staying nimble in order to navigate the evolving conditions related to the Delta variant and global component shortages.

Now let me discuss the performance of our customer market segments. Q1 marks the third consecutive quarter of accelerating order momentum with broad-based strength across our business. Every geographic region and three of the four customer markets grew product orders at 30% or higher. We again experienced the strongest demand in over a decade as our customers increased their investments in digital transformation.

In our Enterprise and Commercial businesses, we achieved our fourth consecutive quarter of accelerating order growth. We also saw solid growth in Public Sector. Our Service Provider segment delivered its highest level of order growth in over five years, with 66% growth, as these customers address their growing bandwidth requirements.

In our webscale business, our robust momentum continues. Our performance was once again a record, with order growth of over 200%. That's 120% growth on a trailing four-quarter basis. We are very pleased with the early traction of our 400G solutions, Cisco 8000 platform, Silicon One portfolio and rapid growth in our Acacia portfolio of optical networking products. It's clear we are expanding our footprint as our cloud growth rate is outpacing our peers. We continue to invest in webscale innovations, with differentiated customer value. Launching this quarter, the latest member of the Silicon One family, the 19.2-terabit P100 routing device, the 11th chip in the Silicon One family. In addition, Acacia marked a major milestone by unveiling the industry's first pluggable module capable of delivering 1.2-terabit capacity on a single wavelength.

Our product revenue was up nearly $1 billion year-over-year, demonstrating the competitive advantages of our scale and reach, as well as our ongoing momentum. We saw broad-based demand across the majority of our product portfolio.

In addition, we continue to see steady progress in our business model transition. Our focus on subscriptions allows us to deliver innovation faster to our customers while providing more predictability and visibility, leading to a more durable growth business over the long term.

We delivered software revenue of $3.7 billion, with 80% sold as a subscription. Subscription revenue increased by 4% to nearly $5.5 billion, while ARR increased by 10% year-over-year to $21.6 billion. We saw strong product ARR growth of 21% and product RPO grew 18%, reflecting our rapid transformation to a software-led business model.

While our revenue growth was solid, it was impacted by the supply constraints, which are affecting our technology peers and nearly every other industry. Our product orders were extremely strong and balanced across our markets, but we are constrained in what we can build and ship to our customers.
We have a world-class supply chain team that works to deliver an incredibly high volume of products given our scale and reach. They continue to execute well in this highly fluid and complex environment. We have been taking multiple steps to mitigate the supply shortages and deliver products to our customers, including working closely with our key suppliers and contract manufacturers, paying significantly higher logistics costs to get the components where they're most needed, working on modifying our designs to utilize alternative suppliers where possible, and constantly optimizing our build and delivery plans.

We are doing this at a breadth and scale that is significantly greater than most in our industry. Of course, all these steps, while necessary to maximize our production and delivery to customers, add to our cost structure. When combined with cost increases we are seeing from many of our suppliers, these factors are putting pressure on our gross margins. While we've thoughtfully raised prices to offset this impact, the benefits are not immediate and will be recognized over the coming quarters. Our focus remains on our customers to ensure we provide them with the products they need as quickly as possible.

Now I'd like to share the progress we're making on our ESG initiatives. In September, we committed to being net zero greenhouse gas emissions for Scope 1 and 2 by 2025 and net zero for all emissions, including Scope 3, by 2040. We believe we will do this by focusing on four areas: building more efficient products, accelerating the use of renewable energy, embracing hybrid work and investing in innovative carbon removal solutions. We believe we have a deep responsibility to use our industry leadership position and our innovation to make the world a better place and look forward to continuing to do our part.

In summary, I am very pleased with the start to our fiscal year. Our teams are executing on our strategy while navigating a challenging operating environment, and this is reflected in our Q1 results. Demand remains strong, and with the momentum in our business transformation, we have set the stage for another year of accelerated growth in fiscal 2022.

Our performance is a testament to the power of our differentiated innovation, the strength of our end markets and our team's commitment to excellence.

As our customers accelerate their digital transformation and their adoption of hybrid cloud and hybrid work strategies, we believe we are uniquely positioned to capture the opportunities ahead. We will continue to strategically invest across our portfolio to drive growth and innovation, strengthen our competitive advantage and position Cisco for success, and I continue to have great confidence in our future.

I'll now turn it over to Scott.

Financial Overview

Thanks, Chuck. We started the fiscal year with a strong Q1 performance. We executed well, resulting in another quarter of more than 30% product order growth, driven by strength across our portfolio and demonstrating continued, robust demand for our products and services. We also had strong results across revenue, net income and earnings per share.

Total revenue increased to $12.9 billion, up 8% year-over-year, coming in line with our guidance range for the quarter. We saw strength in a number of product areas and across all geographies. Our business continues to execute well in this highly dynamic environment, but ongoing component supply constraints are impacting our ability to convert historically high demand into revenue as quickly as we'd like.

Non-GAAP operating margin was 33.3%, up 60 basis points. Non-GAAP net income was $3.5 billion and non-GAAP earnings per share was $0.82, both up 8% year-over-year, with non-GAAP EPS coming in above the high end of our guidance range.

Looking at our Q1 revenue in more detail:

Total product revenue was $9.5 billion, up 11%.

Service revenue was $3.4 billion, up 1%.

Secure Agile Networks performed very well with revenues up 10%. Switching had strong growth, driven by a double-digit increase in Campus Switching, led by our Catalyst 9000, and Meraki switching offers. The Enterprise routing portfolio had high-single-digit growth driven by Edge and SD-WAN. Wireless had very strong double-digit increase, driven by our WiFi6 products and Meraki wireless offerings. We had growth in data center switching, and compute revenue declined slightly.

Hybrid Work was down 7% overall, driven by revenue decreases in our perpetual calling, meetings and contact center offerings. These were partially offset by the ramp of Communication-Platform-as-a-Service and growth in our Collaboration Devices. Within Hybrid Work, our SaaS revenue continues to show growth of high single digits, driven by cloud calling and contact center.

End-to-End Security was up 4%, driven by growth in our cloud-based solutions, also offset by declines in our perpetual and hardware offerings. Our Zero Trust portfolio performed well, with double-digit growth, as we had continued momentum in our Duo offerings. We also saw good growth in Unified Threat management. Here again, our subscription portfolio performed well, growing 15%, driven by our cloud security and Zero Trust platforms.

Internet for the Future was up 46%, driven in large part by the strength of our Webscale customers. We saw broad strength in the portfolio with growth in cloud, growth in core with strength in both Cisco 8000 and NCS 5500, and growth in Edge with the ASR 9000. We also saw benefits from our acquisition of Acacia.

Optimized Application Experiences was up 18%, driven by both ThousandEyes, which grew triple digits, and Intersight, which grew in the strong double digits. SaaS revenue for AppDynamics grew double digits, as its revenue shifted to a greater proportion from its cloud delivered platform.

Our transformation metrics we covered at Investor Day were solid, as we continue to shift our business to more software and subscriptions.

Software revenue was $3.7 billion, an increase of 1%, with the product portion up 3%. 80% of software revenue was subscription-based, which was up 2 percentage points year-over-year.

Total subscription revenue was $5.5 billion, an increase of 4%, with the product portion increasing at 7%. Total subscription revenue represented 43% of Cisco's total revenue.

ARR, or annualized recurring revenue, was $21.6 billion, an increase of 10%, with strong product ARR growth of 21%.

And remaining performance obligations, or RPO, was $30.1 billion, up 10%. Product RPO increased 18% and short-term RPO grew 9% to $15.9 billion.

As you can see, we continue to make significant progress on the transformation to increase software and subscriptions.

We continued to have exceptionally strong order momentum in Q1 with total product orders up 33%, as Chuck mentioned earlier, with strength across the business. Looking at our geographic segments, the Americas was up 31%, EMEA was up 36% and APJC was up 39%. Total emerging markets were up 37%, with the BRICS plus Mexico up 47%. In our customer markets, Service Provider was up 66%, Commercial was up 46%, Enterprise was up 30% and Public Sector was up 10%. As you can see, it was broad strength across the business.

From a non-GAAP perspective, total gross margins came in at 64.5%, down 130 basis points year-over-year. Product gross margin was 63.8%, down 150 basis points, and service gross margin was 66.5%, down 60 basis points. The decrease in product gross margin was primarily driven by higher costs from freight, expedite and increased component costs related to the supply constraints. Pricing impact was relatively moderate and consistent with prior quarters, partially offset by positive product mix.

We continue to manage through the supply constraints seen industry-wide by us and our peers due to component shortages, which have resulted in extended lead times and higher costs for many of these components. We are partnering closely with our key suppliers, leveraging our volume purchasing and extended supply commitments, as we address the supply challenges and cost impacts which we expect will continue into the second half of fiscal 2022. Our supply chain team continues to perform well with this very complex situation.

We believe we're taking the right strategic actions with our suppliers and contract manufacturers to ensure we meet customer demand despite the potential risk associated with increasing our inventory and purchase commitments.

When we look at the impact of acquisitions on our Q1 results, there was an approximate 250-basis-point positive impact on revenue and no material impact on our non-GAAP EPS, which is in line with our expectations.

Operating cash flow for the quarter was $3.4 billion, down 16% year-over-year, driven by higher supply-related payments and timing of other payments and collections. We ended Q1 with total cash, cash equivalents and investments of $23.3 billion, down approximately $1.2 billion sequentially, primarily driven by $2 billion in scheduled repayments of our long-term debt.

In terms of capital allocation, we returned $1.8 billion to shareholders during the quarter. It was comprised of $1.6 billion for our quarterly cash dividend and $256 million of share repurchases.

We continue to invest organically and inorganically in our innovation pipeline. During Q1 we closed the acquisition of Epsagon and announced our intent to acquire replex. 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 in our key growth areas.

To summarize, we had a strong Q1 in a complex, supply-constrained environment. We executed well, with strong top line revenue and earnings per share as we delivered balanced, profitable growth. We continue to make great progress on our business model shift and are continuing to make the investments in innovation to capitalize on our significant growth opportunities. We're seeing progress as we drive the continued shift to more software and subscription revenue, delivering growth and driving shareholder value.

Guidance

Now let me provide our financial guidance for Q2, which is as follows:

We expect revenue growth to be in the range of 4.5% to 6.5% year-on-year.

We anticipate non-GAAP gross margin to be in the range of 63.5% to 64.5%, reflecting the continuing increase in supply chain costs we're incurring as we protect shipments to our customers.

Our non-GAAP operating margin is expected to be in the range from 32.5% to 33.5% and non-GAAP earnings per share is expected to range from $0.80 to $0.82.

There's no change to our full year fiscal '22 guidance.

We expect revenue growth to be in the range of 5% to 7% year-on-year.

Non-GAAP earnings per share is expected to range from $3.38 to $3.45, also up 5% to 7% year-over-year.

In both our Q2 and full year guidance, we're assuming a non-GAAP effective tax rate of 19%.

Summary Comments

All right, let me just wrap up by thanking all of you for spending time with us today, and just saying, I'm really proud of what the teams have accomplished. It's an incredibly complex environment. When you look at -- we delivered 8% revenue growth, 8% non-GAAP EPS, all three geographies, product bookings over 30%, ARR growing to $21.6 billion, double digits, RPO at $30.1 billion, double digits, I really am just pleased with what the teams have done. It was truly a great quarter in a very complicated time.

Largest backlog in our history; it will ship, and combine that with our RPO, and we feel good about where we're headed. We'll continue to plan and work hard on navigating these component issues and our supply chain team continues to work night and day to do that. We feel good, still, about our annual guidance, and I have a lot of confidence about where we are with our innovation and with the company in general.

So thanks for spending time with us, and we'll talk to you next time.

Closing

Great, thanks, Chuck. Cisco's next quarterly earnings conference call, which will reflect our fiscal 2022 second quarter results, will be on Wednesday, February 16, 2022, at 1:30 p.m. Pacific Time, 4:30 p.m. Eastern Time.

This concludes today's call. If you have any further questions, please feel free to contact the Cisco Investor Relations group. And we thank you very much for joining 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 innovate, the demand for our technology, the continued success of our business transformation, the growth of our business, and the continued progress in our business model transformation to more recurring revenue) and the future financial performance of Cisco (including the guidance for Q2 FY 2022 and full year FY 2022) 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 and related public health measures; 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 Secure, Agile Networks 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, other intellectual property, antitrust, stockholder and other matters, and governmental investigations; our ability to achieve the benefits of restructurings and possible changes in the size and timing of related charges; cyber-attacks, data breaches or malware; vulnerabilities and critical security defects; terrorism; natural catastrophic events (including as a result of global climate change); 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 report on Form 10-K filed on September 9, 2021. 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 30, 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.