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]
Q2FY22 Earnings Results Conference Call
Wednesday, February 16, 2022

Introduction

Welcome, everyone, to Cisco's Second 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.

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 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 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.

I will now turn it over to Chuck.

Opening Remarks

Thanks, Marilyn. I hope you all are remaining safe and healthy.

After the solid results we delivered last year, 2022 is proving to be an even stronger year fueled by exceptional demand for our solutions and the continued success of our transformation.

In Q2, I'm thrilled to say that we delivered another great quarter with double-digit ARR growth and robust product orders, which fueled an all-time high backlog and a strong pipeline. These results underscore the increasing relevance and criticality of Cisco's innovation in the era of digital transformation and cloud and reinforces my confidence in our ability to deliver growth.

We are focused on staying ahead of our customers' most pressing needs as they navigate a dynamic world. Our customers are moving faster than ever, driven by the move to hybrid work and hybrid cloud. This requires modernized infrastructure, new security architectures and accelerated digital transformation.

The breadth of our innovative solutions and services at a global scale, combined with our increasing ability to deliver more flexible consumption offerings, is driving even deeper partnerships with our customers across our entire portfolio.

Now I'd like to spend a few minutes covering our results in more detail and what we are seeing in the market.

We delivered solid top line growth combined with margins and earnings that exceeded the high ends of our guidance despite operating in a supply constrained and inflationary environment. The robust demand we saw in Q1 continued into Q2 with product order growth of 33%, our third consecutive quarter of order growth of 30% or higher, with momentum once again across all geographic regions and customer markets. For example, in our Enterprise business, we delivered 37% order growth, the highest in over 12 years, as large customers prioritize investments to modernize their networks and enable new digital capabilities and resiliency.

As more and more becomes digitized, we expect our momentum to continue. We believe the need for highly secure seamless connectivity, hybrid cloud and hybrid work solutions, along with edge computing will drive growth for Cisco. The opportunity ahead of us is clear as demonstrated by our growing pipeline and record backlog, which more than doubled from a year ago and will convert into revenue in the coming quarters.

In our webscale business, we delivered another incredible quarter. Our order growth was up more than 70% year-over-year, which is over 100% growth on a trailing four-quarter basis. We continued to see exceptional performance driven by the rapid pace of adoption of our 400G solutions and our routed optical networking portfolio, which grew over 50% fueled by the Cisco 8000 product line, Acacia and Silicon One.

We're also seeing tremendous traction with ZR optics as part of the Routed Optical Network strategy. Our optical systems and Acacia businesses both saw significant double-digit growth driven by our webscale customers.

The innovations we've invested in over the last several years have positioned us well as the largest players in this space adopt next generation technologies. Our customers are making strategic decisions on their future roadmap and recognize Cisco's unparalleled portfolio as critical to their strategies. We believe they are still in the early phases of their next generation platform buying decisions and expect our momentum to continue.

From a product revenue perspective, we delivered another strong and balanced quarter with 9% growth, with broad-based demand across the majority of our product portfolio. This was led by increased customer spending to modernize their networks, securely connect their hybrid workforce and build out their 5G networks, all with the strong uptake of our subscription offerings.

We continue to prioritize investments that will drive our long-term performance and capitalize on the mega trends in large growing markets, including Cloud, Full-Stack Observability, 5G, 400G, Wi-Fi 6 and Security. Our expertise in these areas, along with the deep integration of hardware, software and silicon across our portfolio differentiates us and sets us up to win.

Our team continues to innovate at a speed and scale like never before. To help our customers build and deliver the best hybrid work experience, we recently introduced new breakthrough networking innovations, including Catalyst 9000X switches built on Silicon One, the industry's first high-end Wi-Fi 6E access points, and an as-a-service Private 5G offering for the enterprise, enabling Communications Service Providers to deliver cloud-based services to their customers.

We are committed to also lead in a more sustainable way. An example of this is our Silicon One Catalyst 9000X switches I just mentioned, which are approximately 40% more power-efficient compared to prior versions. Building technologies in this way is key toward our goal to reduce our Scope 3 emissions to net zero by 2040.

I'm also proud of the progress of our business transformation to more software and subscription-based recurring revenue as we transition more of our business to the cloud. Annualized recurring revenue, or ARR, of $21.9 billion was up 11%, with product ARR increasing by 20%. Product remaining performance obligations, or RPO, which is largely software revenue that is committed but not yet recognized, was up 16%.

We remain one of the largest software companies in the world. In Q2, our software revenue grew by 6% to $3.8 billion. Total subscription revenue accelerated to $5.5 billion, up 7% year-over-year. It's important to note that both of these metrics continue to be negatively impacted by subscription software and service that is attached to hardware where the shipments are delayed due to the component situation.

The strength in our software, RPO and ARR clearly demonstrate the value we are creating through our transformation and provides us a greater degree of visibility and predictability into our future growth.

From a macro perspective, the component shortage continues to remain challenging. Our

incredibly strong demand continues to outpace supply, expanding our backlog of products, software and services.

Our supply chain team continues to take aggressive action through strong inventory positions, deepening supplier relationships, qualifying alternative components and increased use of expedited freight. There are still significant constraints with semiconductors, preventing us from completing manufacturing of some of our products, and that remains a headwind to revenue growth despite very strong demand. In addition, the constrained environment continues to drive up supply chain costs, which we have successfully passed through to help offset these increases.

In summary, we continue to work through the impact of the pandemic and component shortages, and we've never felt better about the company, our position and our outlook for growth.

Our Q2 results reflect healthy momentum, a clear vision and outstanding execution by our teams. Our innovation engine and pipeline have never been stronger, and we are rapidly transforming our business by accelerating our transition to more software and subscription offerings.

I'm so proud of our teams and what they've accomplished during these very dynamic times. We are bringing industry-leading innovation to market and further enhancing our differentiated position across the portfolio by delivering flexible consumption models for our customers.

I remain confident and optimistic about our future. Cisco is at the epicenter of massive shifts toward hybrid cloud, hybrid work and digital transformation, which we believe creates momentum for our business and positions us well to capture the significant opportunities ahead.

I'll now turn it over to Scott.

Financial Overview

Thanks, Chuck. Q2 was a strong quarter across the business. We executed well delivering our third consecutive quarter of more than 30% product order growth driven by strength across our portfolio, including continued robust demand for our products and services, along with disciplined spend and supply chain management.

Total revenue increased by $760 million to $12.7 billion, up 6% year-over-year, in line with our guidance range for the quarter. We saw strength in a number of product areas and across all of our geographies. Our business performed well in this highly dynamic and supply constrained environment, which, as Chuck said, continues to hinder our ability to convert the significant demand we have into revenue.

Overall profitability in Q2 was strong, with non-GAAP operating margin of 34.3%, non-GAAP net income of $3.5 billion and non-GAAP earnings per share of $0.84, with non-GAAP earnings per share coming in above the high end of our guidance range.

Looking at our Q2 revenue in more detail:

Total product revenue was $9.4 billion, up 9%.

Service revenue was $3.4 billion, down 1%, driven by delays in hardware support contracts related to the supply constraints.

Within product revenue, Secure, Agile Networks performed well, with revenues up 7%. Switching had solid growth, driven by a double-digit increase in data center switching, driven by our Nexus 9000 products. Campus switching had solid growth, led by our Catalyst 9000 and Meraki switching offerings. Wireless had very strong double-digit increase, driven by our Wi-Fi 6 products and our Meraki wireless offerings. We also saw double-digit growth in compute revenue driven by servers. Enterprise routing declined, primarily driven by access, slightly offset by strength in SD-WAN.

Hybrid Work, which is where we report just our collaboration portfolio, was down 9%, driven by declines in our collaboration devices and meetings offerings, partially offset by the continued ramp of our Communication-Platform-as-a-Service. Beginning next quarter, the name of this category will change from Hybrid Work to Collaboration. There will not be any changes to the components within this category.

End-to-End Security grew 7%, with broad strength across most of the portfolio. Our Zero Trust portfolio performed well, with double-digit growth driven by strong performance in our Duo offerings. Our subscription portfolio continued to perform well, driven by Cloud Security and Zero Trust.

Internet for the Future was up 42%, driven in large part by the strength of our Webscale customers. We saw broad strength in the portfolio, with growth in Edge, driven by double-digit growth from our ASR 9000 offerings and Core with strength in Cisco 8000 and Optical. We also saw continued strong contribution from Acacia, our optical networking offerings.

Optimized Application Experiences was up 12%, driven by double-digit growth in both ThousandEyes and Intersight. SaaS revenue for AppDynamics grew mid-single digits with the continued shift to its cloud-delivered platform.

We continue to make progress on our transformation metrics as we shift our business to more software and subscriptions:

Software revenue was $3.8 billion, an increase of 6%, with the product portion up 9%. 80% of software revenue was subscription-based, which was up 4 percentage points year-over-year.

Total subscription revenue was $5.5 billion, an increase of 7%. Total subscription revenue represented 44% of Cisco's total revenue.

Annualized recurring revenue, or ARR, was $21.9 billion, an increase of 11%, with strong product ARR growth of 20%.

And remaining performance obligations, or RPO, was $30.5 billion, up 8%. Product RPO

increased 16%, service RPO increased 3% and the total short-term RPO grew 8% to $16.3 billion. As a reminder, the short-term portion will convert to revenue over the next 12 months.

Relative to acquisitions, there was an approximate 200 basis point year-over-year positive impact on Q2 revenue growth and no material impact on our non-GAAP EPS, which is in line with our expectations.

We continued to have exceptionally strong order momentum in Q2. Total product orders grew 33%, with strength across the business. Looking at our geographic segments, the Americas was up 36%, and EMEA and APJC were both up 30%. Total Emerging Markets were up 39%, with the BRICS plus Mexico up 48%. In our customer markets, Service Provider was up 42%, Enterprise was up 37%, Commercial was up 34% and Public Sector was up 20%. As you can see, it was broad strength across our geographies and customer markets.

From a non-GAAP perspective, total gross margin came in at 65.5%, down 140 basis points year-over-year. Product gross margin was 64.3%, down 230 basis points, and Service gross margin was 68.8%, up 90 basis points. The decrease in product gross margin was primarily driven by ongoing higher component costs related to supply constraints, as well as higher freight and logistics costs.

As we've been discussing for several quarters, 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 supply costs. The situation remains challenging. We continue to partner 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 our fiscal 2022.

As I mentioned, the component supply constraints also slow the conversion of our strong demand into revenue. This has resulted in a substantial increase and continued build in our backlog levels well beyond our normal historical levels. Additionally, the ongoing supply constraints have not only impacted our ability to ship hardware, but also impacts our delivery of software, such as subscriptions the customers order with the hardware. That undelivered software is also included in backlog until the hardware ships, which is when we begin to recognize the revenue. Of course, this impacts our software revenue growth and other related metrics. To give you a sense of scale of our backlog, our Q2 ending product backlog was more than $14 billion, an increase of more than 150% year-on-year. Within that amount, software backlog almost doubled to more than $2 billion; keeping in mind that backlog is not included as part of our $38.5 billion in remaining performance obligations.

We ended Q2 with total cash, cash equivalents and investments of $21.1 billion. Operating cash flow for the quarter was $2.5 billion, down 17% year-over-year, primarily driven by advance payments to secure future supply. These advance payments had a negative 17% year-over-year impact on operating cash flow. Additionally, we made a tax payment of approximately $100 million this quarter, which had been deferred as a result of the CARES Act. This payment had an additional negative 4% year-over-year impact on our operating cash flow.

In terms of capital allocation, we returned $6.4 billion to shareholders during the quarter. It was comprised of $4.8 billion of share repurchases and $1.5 billion for our quarterly cash dividend.

Given the confidence we have in our business today and into the future, our Board has authorized an additional $15 billion for share repurchases, bringing the total to approximately $18 billion. We are also raising our dividend by $0.01 to $0.38 per quarter, which represents our 12th increase.

The combination of our dividend increase, additional share repurchase authorization and higher share repurchases during the quarter demonstrates our commitment to returning excess capital to our shareholders and our confidence in the stability of our ongoing cash flows.

We continue to invest organically and inorganically in our innovation pipeline. We closed the acquisition of Replex in Q2 and Opsani in early Q3 to enhance our Full Stack Observability offerings. These investments are consistent with our strategy of complementing our internal innovation in 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 another good quarter with robust product demand and solid execution in a complex, supply-constrained environment. We continued to make great progress on our business model shift and are making the investments in innovation to capitalize on our significant growth opportunities in expanding addressable markets. 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 Q3. As a reminder, the third quarter of last year included an extra week, which was a benefit to total revenue of approximately three points of growth. The total impact on our cost of sales and operating expenses was approximately $150 million, and this translated into a $0.04 benefit to earnings per share in our Q3 of last year.

For next quarter, we expect revenue growth to be in the range of 3% to 5%.

We anticipate non-GAAP gross margins 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%.

Non-GAAP earnings per share is expected to range from $0.85 to $0.87.

For the full year fiscal '22, we're tightening the range as follows:

We expect revenue growth to be in the range of 5.5% to 6.5% year-on-year.

Non-GAAP earnings per share is increasing to $3.41 to $3.46, up 5.9% to 7.5% year-on-year.

In both our Q3 and full year guidance, we're assuming a non-GAAP effective tax rate of 19%.

Summary Comments

Thank you. First of all, I'm proud of what we were able to accomplish in Q2 despite the ongoing component demands, or component dynamics. The product order growth, the revenue of EPS, the ARR growth, the RPO growth, the balanced growth across the world. Really pleased with our continued success in Webscale. And just happy that our customers are choosing our technology as they continue down this digital transformation path. And I think it speaks to the relevance and criticality of what we're building and what our teams have built.

And I want to just take a minute to thank all the Cisco employees, because it's been an incredibly difficult couple of years. I think the team has showed a great deal of resiliency, delivered breakthrough innovation, and really done everything we can to take care of our customers.

So thanks for spending time with us today, 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 third quarter results, will be on Wednesday, May 18, 2022, at 1:30 p.m. Pacific Time, 4:30 p.m. Eastern Time.

This now concludes today's call. If you have any further questions, please feel free to reach out to 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 our ability to deliver growth through our investments in innovation; the strength of our strategy; the continued momentum in our business; our growing pipeline and record backlog which we believe will convert into revenue in the coming quarters; our on-going transformation to accelerate our shift to more software and subscription-based recurring revenue; our significant growth opportunities and expanding addressable markets; and our commitment to returning excess capital to our shareholders and confidence in our ongoing cash flows) and the future financial performance of Cisco (including the guidance for Q3 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; significant supply constraints; 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 reports on Forms 10-Q and 10-K filed on November 23, 2021 and September 9, 2021, 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 29, 2022 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.