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]
Q3FY23 Earnings Results Conference Call
Wednesday, May 17, 2023

Introduction

Welcome, everyone, to Cisco's Third Quarter Fiscal 2023 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 sheet, cash flow statements and other financial information can be found in the Financial Information section of the Investor Relations website.

Throughout this conference call, we will be referencing both GAAP and non-GAAP financial results, and we'll 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 fourth quarter and full year of fiscal 2023. They are subject to the risks and uncertainties that we discuss in detail in our documents filed with the SEC, specifically the most recent reports on forms 10-K and 10-Q, which identify important risk factors that could cause the actual results to differ materially from those contained in the forward-looking statements. With respect to guidance, please also see the slides and press release that accompany this call for further details. Cisco will not comment on its financial guidance during the quarter unless it is done through an explicit public disclosure.

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

Opening Remarks

Thank you, Marilyn, and hope you all are doing well. This was another strong quarter for us, and I'm proud of what our teams have achieved. In Q3, we delivered our strongest ever revenue, non-GAAP income, non-GAAP EPS, and operating cash flow. We also continued to successfully

execute on our strategy, driving solid growth in ARR to nearly $24 billion and posting double-digit growth in subscription and software revenues.

Based on our strong Q3 performance, we are once again raising our fiscal 2023 outlook for revenue and earnings per share, which Scott will cover shortly. As we look ahead to fiscal year '24, we expect to see modest revenue growth even with the tough compare of double-digit growth in fiscal year '23.

Now, before I go through our Q3 performance, I would like to discuss three key areas that will help drive our long-term growth.

First, we are pleased with continued success in our movement toward more subscriptions and recurring revenue. In Q3, we delivered 18% growth in software revenues. We also have $32 billion in Remaining Performance Obligations (RPO), and we expect to see this momentum accelerate.

Second, Security continues to be an enormous opportunity for us. As you've heard me say, we've revamped our strategy, put a world-class team in place, and made this a top priority for the company. Over the coming quarters, you will see new innovations in this space building on our strong Cisco Security Cloud strategy, including at Cisco Live next month. Based on the rapid progress we are making, we are optimistic about our opportunity in this fast-growing market.

And third, Generative AI and cloud. At Cisco, we already use predictive AI extensively across our portfolio. In addition, our core networking technology is already powering some of the leading AI models run by hyperscalers around the world. We have also moved rapidly to leverage generative AI capabilities in our own products, which you'll hear more about in the next few weeks and beyond, starting at Cisco Live.

Now let me discuss our quarterly performance. As I mentioned, in Q3, we delivered our highest ever quarterly revenue in non-GAAP earnings per share, exceeding the high end of our guidance range. We saw healthy margins and record non-GAAP net income, which reflect our strong operating discipline. All of this contributed to record operating cash flow in Q3.

As we expected, the actions we took to mitigate supply constraints have continued to pay off. Price realization as a result of the actions we put in place last year helped offset inflationary pressures. Our disciplined cost management enabled us to continue to expand gross margins, as well as prioritize our strategic investments to drive long-term growth.

As it relates to customer demand, it is being shaped by a few factors that we believe are impacting the entire industry.

First, our increase in product shipments is often leading customers and partners to absorb these shipments prior to placing new orders. Second, the significant reduction in product lead times reduces the need for extensive advanced ordering by our customers. And third, macroeconomic conditions.

With this said, in our discussions with customers, such as the ones we had at our most recent Global Customer Advisory Board event earlier this month, they continue to invest in key technologies that are core to their overall strategies.

As we previously shared, given the unprecedented demand for our technology during the pandemic, we believe sequential order rates are far more informative than year-over-year rates. Just like the prior two quarters, our sequentials in Q3 were in general alignment with historical ranges, coming in one point below the historical range.

In addition, our order cancelation rates also remain well below historical levels, indicating the strength of our backlog and portfolio. In terms of our backlog, we continue to expect that we will end the fiscal year with roughly double our normal product backlog.

Now let me share a bit more detail about some of our newest innovations. Regarding our web scale customers, they are currently consuming and implementing their prior significant technology investments. There remains a huge growth opportunity across all these customers, enabled by our portfolio of hardware, software, silicon, and systems. We already see early design wins in AI infrastructure and continue to see other wins in competitive displacements, leading to continued share gain in this space.

In our Networking business, we remain focused on building solutions that drive a higher return on investment and sustainability. In March, we introduced 800G capability to our Cisco 8000 platform with the industry's first 28.8-terabit line card, powered by Cisco's Silicon One ASICs and pluggable optics. This new platform can deliver up to 68% power savings and 83% space savings compared to 400G solutions, helping to reduce operational cost and carbon emissions, as well as enabling the densification of networks to support use cases such as AI/ML and IoT. This continues to drive positive customer feedback, and we're excited about this opportunity.

To complement our own innovations, in Q3, we closed the acquisition of Valtix, which is aligned to our Security Cloud vision for providing protection across multicloud environments with a seamless experience. We also announced our intent to acquire two companies that further extend our capabilities in cloud, security, and full stack observability.

Before I close, I also want to share once again how incredibly proud I am that for the third in a row we were ranked #1 in the U.S. on Fortune magazine's 100 Best Companies to Work For, and in 14 other countries around the world, we were also ranked as the #1 Great Place to Work, reflecting Cisco's position as a premiere destination for top talent worldwide.

To summarize, our ability to navigate uncertainty was demonstrated by our record results. Our performance remains solid and reflects the strength of our strategy and the benefits from the investments we've made over the last several years. Our operational discipline and excellence in execution are driving record earnings, cash flow and shareholder value.

As we look toward Q4 and fiscal year '24, I would like to share a few observations. As I mentioned earlier, as of now, we see modest revenue growth in fiscal year '24 on top of our strong performance in fiscal year '23. You can also expect us to grow earnings per share at a

higher rate than revenue in Q4 fiscal year '23 and full year fiscal year '24, reflecting improving gross margins and strong expense management. Lastly, we expect to continue our stock buybacks at the higher levels you've seen over the last two quarters.

I'd like to thank our teams for their focus and execution, and our customers and partners for the trust they've placed in us. As cloud, AI and security continue to scale, Cisco's long-established leadership in networking and the breadth of our portfolio give me the confidence in our ability to capture the many opportunities ahead.

I'll now turn it over to Scott.

Financial Overview

Thanks, Chuck. We delivered a record quarter that exceeded both our top and bottom-line expectations, driven by focused execution, continued business transformation and the actions we've taken over the last several quarters to mitigate supply issues. We reported our strongest ever revenue, non-GAAP income, non-GAAP earnings per share and operating cash flow for the quarter. Total revenue was $14.6 billion, up 14% year-on-year. Non-GAAP net income was $4.1 billion and non-GAAP earnings per share was $1.00, up 15%.

Looking at our Q3 revenue in more detail:

Total product revenue was $11.1 billion, up 17%, and Service revenue was $3.5 billion, up 3%.

Within product revenue, Secure, Agile Networks, our largest business, was very strong, up 29%. Switching revenue had strong double-digit growth with strength in both campus and data center switching, driven by our Catalyst 9000, Meraki and Nexus 9000 offerings. Enterprise routing growth was driven primarily by strength in our Catalyst 8000 series routers, SD-WAN and IoT routing, and wireless also had very strong double-digit growth with strength driven by our WiFi 6 products and Meraki wireless offerings.

Internet for the Future was up 5%, driven by growth in our core routing products, including very strong growth in our Cisco 8000 offering. We also saw double-digit growth in Webscale.

Collaboration was down 13%, driven by declines in Collaboration Devices and Meetings, offset slightly by growth in Calling and Contact Center.

End-to-End Security was up 2%, driven by our Unified Threat Management and Zero Trust offerings.

And Optimized Application Experiences was up 12%, driven by growth across the portfolio, including double-digit growth in ThousandEyes.

We continue to make progress on our transformation metrics as we shift our business to more recurring-revenue-based offerings, driven by higher levels of software and subscriptions.

We saw solid performance of our ARR of $23.8 billion, which increased 6%, with product ARR growth of 10%.

Total software revenue was $4.3 billion, an increase of 18%, with software subscription revenue up 17%. 82% of software revenues were subscription based. We continue to have an elevated level of software orders in our product backlog.

Total subscription revenue was $6.1 billion, an increase of 11%.

RPO was $32.1 billion, up 6%, with product RPO increasing 9% and Service RPO increasing 4%. And total short-term RPO grew to $16.9 billion.

Total product orders were down 23%, driven by the three factors Chuck pointed out earlier. The aging of our backlog has improved significantly, and we continue to have very low cancelation rates, reflecting the quality of our past orders and critical nature of our product portfolio.

Total non-GAAP gross margin came in at 65.2%, exceeding the high end of our guidance range, and down 10 basis points year-over-year. Product gross margin was 64.5%, up 240 basis points sequentially and up 40 basis points year-over-year. The year-over-year increase was primarily driven by positive pricing and favorable product mix. This was partially offset by higher component and other costs. Services gross margin was 67.3%, down 160 basis points year-over-year.

Non-GAAP operating margin was at the high end of our guidance range at 33.9%, down 80 basis points year-over-year, and up 140 basis points sequentially.

Backlog for both our hardware and software products continues to significantly exceed historical levels. Due to an improving supply situation and our focused execution, we were able to accelerate shipments of our aged backlog to meet customer needs, which resulted in a decline in backlog levels sequentially and year-over-year. We continue to expect to exit the year with roughly double our normal product backlog. And just a reminder, backlog is not included as part of our $32 billion in remaining performance obligations. Combined, our significant product backlog and RPO continue to provide great visibility to our top line as we approach fiscal year '24.

Shifting to the balance sheet, we ended Q3 with total cash, cash equivalents and investments of $23.3 billion. We had record operating cash flow for the quarter of $5.2 billion, up 43% year-over-year, driven primarily by strong collections and the deferral of our Q3 federal tax payment due to the IRS tax relief related to the California floods earlier this year. The federal tax payment deferral had a positive impact of approximately 20 points of growth year-over-year on Q3 operating cash flow. This recent IRS relief postponed our remaining current year federal income tax payment deadlines until Q1 of our fiscal '24.

In line with our disciplined capital allocation strategy and commitment to return capital, we returned $2.9 billion to shareholders during the quarter, which was comprised of $1.6 billion for our quarterly cash dividend and $1.3 billion of share repurchases. We ended the quarter with

$12.2 billion in remaining stock purchase authorization. Year-to-date, we've returned a total of $7.7 billion via cash dividends and share repurchases. This reinforces our confidence in the strength and stability of our ongoing cash flows.

We continue to invest organically and inorganically on our innovation pipeline. During Q3 we announced and closed the acquisition of Valtix, which further strengthens our security portfolio. This investment is consistent with our strategy of complementing our internal innovation and R&D with targeted strategic M&A.

To summarize, we had a strong quarter delivering record top line growth, non-GAAP profitability and cash flow. We continue to make progress on our business model shift to more recurring revenue while making strategic investments in innovation to capitalize on our significant growth opportunities.

Guidance

Turning now to our guidance. For fiscal Q4, our guidance is:

We expect revenue growth to be in the range of 14% to 16%.

We anticipate the non-GAAP gross margin to be in the range of 64.5% to 65.5%

Our non-GAAP operating margin is expected to be in the range of 34% to 35%.

Non-GAAP earnings per share is expected to range from $1.05 to $1.07.

As Chuck mentioned, we are yet again raising our fiscal year guidance for fiscal '23, which is as follows:

We expect revenue growth to be in the range of 10% to 10.5% year-on-year.

Non-GAAP earnings per share is expected to range from $3.80 to $3.82.

In both our Q4 and full year guidance, we're assuming a non-GAAP effective tax rate of 19%.

Our guidance ranges reflect significant visibility driven by healthy backlog, ARR, RPO and improving availability of supply.

As Chuck mentioned earlier, as of now, we see modest revenue growth in fiscal '24 on top of our strong performance in fiscal '23. You can also expect us to deliver earnings per share at a higher growth rate than revenue in Q4 and in fiscal '24, reflecting improving gross margins and strong expense management. And lastly, we expect to continue our stock buybacks at the higher level you've seen over the last two quarters.

Summary Comments

Hey, in closing, I want to thank everybody for spending time with us today, first of all. I'm super proud of our results. I think our teams are executing very well. I'm proud of the record results that we had this quarter. I'm also really proud that we're seeing what we also said, which is the market share gains come through that we had talked about. We've been asked on several calls about market share, and in the reports that we expect to be coming out very soon, we have meaningful share gains that I think you'll see in campus switching, SD-branch routing, wireless LAN, SP routing, some of our absolute biggest markets, I think which reflect the relevance of our technology to our customers right now.

I'm really proud that looking at FY '24 we still see growth on a strong double-digit-growth year, and also growing earnings per share faster than we are revenue, and our teams are committed to delivering on our commitments, and we look forward to spending time with you 90 days from now. So thanks for being with us.

Closing

All right, thanks, Chuck. And to close us out, Cisco's next quarterly earnings conference call, which will reflect our fiscal year 2023 fourth quarter and fiscal 2023 results, will be on Wednesday, August 16, 2023, at 1:30 p.m. Pacific Time, 4:30 p.m. Eastern Time.

This concludes today's call. If you have any further questions, feel free to reach out to the Cisco Investor Relations department, and we thank you very much for joining the 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 key technologies like cloud, AI and security continuing to scale, our continued leadership in networking, the breadth of our portfolio to position us well for the future, our healthy backlog, recurring revenue streams, RPO and the continued improving availability of supply) and the future financial performance of Cisco (including the guidance for Q4 FY 2023 and full year FY 2023) 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 February 21, 2023 and September 8, 2022, respectively. The financial information contained in this release 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 29, 2023 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.