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]
Q4FY23 Earnings Results Conference Call
Wednesday, August 16, 2023

Introduction

Welcome, everyone, to Cisco's Fourth Quarter Fiscal '23 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 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 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 first quarter and full year of fiscal 2024. 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 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

Thanks, Marilyn, and good afternoon, everyone. Fiscal '23 was a milestone year for Cisco. We delivered on our operational and financial goals while accelerating our transformation. We achieved record revenue and earnings per share in both the fourth quarter and the full year. We

also generated strong margins, record operating cash flow and strong shareholder value, returning $10.6 billion via share repurchases and increasing cash dividends.

In FY '23, we delivered nearly $57 billion in revenue, up 11% year-over-year, the highest revenue growth rate in over a decade. Overall, customer demand also remained solid. In Q4, we achieved over 30% total sequential product order growth, the second highest in 20 years, with double-digit increases across all customer markets.

As we look to build on this strong performance going forward, we remain focused on the following:

First, growing market share in all key areas of our business.
Second, driving innovation and extending our leadership by investing in significant new opportunities for growth in AI, cloud and security.
Third, delivering long-term sustainable value creation for our stakeholders.
And fourth, transforming our business model by growing recurring revenue.

Consistent with what we said last quarter, we expect to build on our record results, delivering modest revenue growth in fiscal year '24, with the bottom line growing faster than the top line, demonstrating operating leverage. Our outlook reflects good visibility and predictability, driven by healthy backlog, ARR and RPO. We remain deeply committed to building shareholder value and increasing returns to our investors. We will do this through a long-term commitment to greater operating leverage while increasing our annual share repurchases and growing our dividend.

Now, let me share additional detail on the quarter and key growth opportunities ahead for Cisco.

First, one of our greatest competitive advantages is our pace of innovation. This quarter, we announced new solutions spanning generative AI, hybrid work, security, full stack observability and sustainability. In addition, we remain focused on delivering a more unified and simpler experience for our customers.

As I've stated in the past, we knew that as our backlog cleared, we would see corresponding market share gains. With the release of the calendar Q1 results, we gained over 3 percentage points of market share year-over-year in our three largest networking markets: Campus Switching, Wireless LAN, and SP routing. We expect further share gains in these areas as market share numbers are released for calendar Q2.

Second, the acceleration of AI will fundamentally change our world and create new growth drivers for us. While AI has been an important element in our products for several years, this quarter we announced new market-leading AI technologies across our Collaboration and Security portfolios designed to boost productivity, enhance policy management, and simplify tasks.

We also launched new AI scale infrastructure innovation to allow our customers to process AI workloads more efficiently. Cisco's ASIC design and scalable fabric for AI position us very well

to build out the infrastructure that hyperscalers and others need to build AI/ML clusters. This is a huge opportunity for Cisco, and we are laser focused on leading and winning in this space.

As a result of our innovation in this area, we expect ethernet will lead in connecting AI workloads over the next five years. To accelerate this transition, Cisco became a founding member of the Ultra Ethernet Consortium, an industry-wide effort to drive open largescale Ethernet-based fabrics for high performance networking.

In June, we launched our next generation Silicon One switching ASICs to support largescale GPU clusters for AI and ML workloads. We are seeing early success in hyperscale ethernet AI fabric deployments. To date, we have taken orders for over $0.5 billion for AI ethernet fabrics. We are also piloting 800G capabilities for AI training fabrics.

Overall, Cisco is committed to helping our customers navigate this transition in a trusted and responsible way to deliver on the full promise of this technology, and we are well positioned to win.

Next, Security remains a top priority. Our AI-driven Security Cloud platform has comprehensive capabilities across the network, endpoint, and the cloud, helping to simplify security management while increasing efficacy.

Our new technologies like XDR, multi-cloud defense and cloud secure access, a Secure Service Edge solution, are seeing rapid early adoption. For example, Goldman Sachs has been one of our early adopters of our multi-cloud defense solution. In addition, we are working with Apple to incorporate Cisco's Secure Access solution into iOS and macOS.

These innovations, combined with our recent acquisitions, show how we are extending our security portfolio with deep telemetry, AI and identity threat capabilities. Given our installed base of 300,000 Cisco security customers, we believe we have the opportunity to accelerate revenue growth in security over the next few quarters.

To summarize, we had a phenomenal year. Our fiscal year '23 and Q4 results demonstrate the strength of our business today and are a solid foundation for future growth.

I also want to be very clear on our commitment to increasing shareholder returns through capital return, innovation, and strong execution. Last quarter, we committed to operating leverage in Q4 and fiscal year '24 and our guidance today reflects this. Today, I want to confirm that this will be our long-term strategy beyond fiscal year '24. We will also drive a high degree of consistency into our stock repurchase program and will maintain the quarterly levels in the range that we have over the past few quarters.

Finally, I want to take a moment to thank our teams, who all played an important role in delivering these record full year results and their deep commitment to our -- to the success of our customers and partners. With our focus on innovation and our commitment to operational excellence, I have tremendous confidence in our ability to capitalize on the many opportunities ahead.

I'll now turn it over to Scott.

Financial Overview

Thanks, Chuck. I'll start with a summary of our financial results for the quarter, then cover the full fiscal year, followed by our guidance.

As Chuck said, we delivered another record quarter driven by focused execution, continued business transformation and the actions we took during the year to mitigate supply issues. We reported our strongest ever revenue, non-GAAP operating margin, earnings per share and operating cash flow in Q4. Total revenue was $15.2 billion, up 16% year-on-year at the high end of our guidance range. Non-GAAP net income was $4.7 billion, up 36%. Non-GAAP EPS was $1.14, up 37%, exceeding the high end of our guidance range.

Looking at our Q4 revenue in more detail:

Total product revenue was $11.7 billion, up 20%. Service revenue was $3.6 billion, up 4%.

Within product revenue, Secure, Agile Networks, our largest product category, was very strong, up 33%. Switching revenue had double-digit growth with strength in both campus and data center switching, driven by our Catalyst 9000, Nexus 9000, and Meraki offerings. Enterprise routing declined, driven primarily by Access, partially offset by strength in our Catalyst 8000 Series, SD-WAN and IoT routing. Wireless had double-digit growth driven by our WiFi6 products and Meraki wireless offerings.

Internet for the Future was up 3%, driven by growth in our Core Routing products, including strong growth in our Cisco 8000 offering. We also saw double-digit growth in Webscale.

Collaboration was down 12% driven by declines in Collaboration Devices and Meetings, partially offset by growth in Cloud Calling and Cloud Contact Center.

End-to-End Security was flat, with growth in our Zero Trust offerings offset by a decline in our Network Security offerings.

Optimized Application Experiences was up 15%, driven by growth across the portfolio, including double-digit growth in ThousandEyes and AppDynamics.

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

We saw solid performance in our ARR of $24.3 billion, which increased 5%, with product ARR growth of 10%.

Total software revenue accelerated to $4.6 billion, an increase of 17%, with software subscription revenue up 20%. 85% of our software revenue was subscription-based.

Total subscription revenue was $6.6 billion, an increase of 13%.

RPO was $34.9 billion, up double-digits at 11%. Both product and service RPO had strong growth, with product RPO up 12% and service RPO up 9%. Total short-term RPO grew to $17.9 billion.

Total product orders were down 14% year-on-year but grew sequentially by more than 30%. This was against a strong performance in the year-ago quarter, where we delivered the second-highest orders in absolute dollars in the history of the company. The aging of our backlog has continued to improve as the supply situation normalizes and, as expected, increased customer deliveries reduced our year-end backlog to roughly double historical levels as we enter fiscal '24. Order cancellation rates remain below pre-pandemic levels, which reflects the true demand and criticality of our technologies to our customers.

Total non-GAAP gross margin came in at 65.9%, exceeding the high end of our guidance range and up 260 basis points. Product gross margin was 65.5%, up 420 basis points. The increase was primarily driven by positive pricing and product mix as we realized the benefits from the actions we took in the prior fiscal year. We also drove productivity improvements, with lower freight and logistics, component, and other costs. Services gross margin was 67.5%, down 150 basis points year-over-year.

Non-GAAP operating margin came in at 35.4%, exceeding the high end of our guidance range and up 300 basis points. This improved leverage was driven by both our strong non-GAAP gross margin and ongoing cost management.

Shifting to the balance sheet. We ended Q4 with total cash, cash equivalents and investments of $26.1 billion. We had record operating cash flow for the quarter of $6 billion, up 62%, driven primarily by strong top line performance and the deferral of our Q4 federal tax payment. Consistent with our prior commentary, the IRS tax relief related to the California floods postponed our current year federal income tax payment until Q1 of our fiscal '24. Consequently, in Q1 of fiscal '24, our federal income tax related cash outflows will include an incremental $2.8 billion of payments for these prior quarters.

This quarter, we returned $2.8 billion to shareholders comprised of $1.6 billion for our quarterly cash dividend and $1.3 billion of share repurchases. Consistent with our capital allocation strategy that we outlined last quarter, we are committed to increasing shareholder returns through a greater operating leverage while increasing our annual share repurchases and growing our dividend.

Turning to the full fiscal year, we delivered record results in revenue, net income earnings per share and operating cash flow. Revenue for the year was $57 billion, up 11%, and non-GAAP earnings per share was $3.89, up 16%, demonstrating again the operating leverage that we've been driving.

In terms of our software metrics:

Total software revenue for the full year was up 12% at $17 billion, with the product portion up 14%. 84% of software revenue was subscription based, which is up 2 percentage points.

Total subscription revenue was $24.6 billion, an increase of 10%.

Total non-GAAP gross margin was 64.5%, down 10 basis points. On the bottom line, non-GAAP net income was $16 billion, up 13%. We delivered record operating cash flow of $19.9 billion, up 50% compared to fiscal '22, driven primarily by strong results, linearity, collections and the federal tax deferral, as noted previously.

We returned $10.6 billion in value to our shareholders via cash dividends and stock repurchases. This is comprised of $6.3 billion in quarterly cash dividends and $4.3 billion of share repurchases. We increased our dividend for the 12th consecutive year in fiscal 2023, reinforcing our confidence in the strength and stability of our ongoing cash flows.

We continue to invest organically and inorganically in our innovation pipeline during Q4. We closed the acquisitions of Lightspin Technologies, Smartlook and Armorblox. These investments are consistent with our strategy of complementing our internal innovation and R&D with targeted strategic M&A.

To summarize, we had a very strong quarter and fiscal year with record results. We executed well, delivering double-digit top line growth, 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 Q1, our guidance is:

We expect revenue to be in the range of $14.5 billion to $14.7 billion.
We anticipate the non-GAAP gross margin to be in the range of 65% to 66%.
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 $1.02 to $1.04.

For fiscal year '24, our guidance is as follows:

We expect revenue to be in the range of $57 billion to $58.2 billion.
Non-GAAP earnings per share is expected to range from $4.01 to $4.08.

In both our Q1 and full year guidance we're assuming a non-GAAP effective tax rate of 19%.

Summary Comments

First of all, I want to thank our teams and just say how proud I am of the work that's gone into the last couple of years to actually deliver the record results that we did. We're incredibly proud of the share gains that we expected to gain, and we are. I'm proud of the team and the new innovation that's being delivered in areas like AI and security and across the portfolio in observability and core networking and SP routing; all of these areas, the teams are doing an amazing job.

And our portfolio is very relevant to the customer priorities that we see around the world. I've never seen such consistency around the priorities in virtually every customer around the world. And our portfolio lines up nicely against the key things that our customers are trying to achieve.

I'm also very proud of the team and Scott and the rest of the finance organization for what they've done. And we're very happy to provide clarity on our commitment to our shareholders with the operating leverage and the buybacks and our dividend as we look to the future. So thanks for joining us today.

Closing

Thanks, Chuck. I'll go ahead and wrap us up. Cisco's next quarterly earnings conference call, which will reflect our fiscal year 2024 first quarter results, will be on Wednesday, November 15, 2023, at 1:30 p.m. Pacific Time, 4:30 p.m. Eastern Time.

This concludes today's call. And of course, if you have any further questions, feel free to reach out to Cisco's Investor Relations group, and we thank you very much for joining today's call.

The prepared remarks set forth above and the related conference call may be deemed to contain forward-looking statements, which are subject to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. These forward-looking statements include, among other things, statements regarding future events (such as continued strong customer demand, gains in market share, innovations in AI, security, and cloud, our ability to capture future opportunities, and our commitment to the expansion of operating leverage and increase of shareholder returns over the long term) and the future financial performance of Cisco (including the guidance for Q1 FY 2024 and full year FY 2024) 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 May 24, 2023 and September 8, 2022, 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 months and the year ended July 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.