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]
Q1FY24 Earnings Results Conference Call
Wednesday, November 15, 2023

Introduction

Welcome, everyone, to Cisco's first quarter fiscal year '24 quarterly conference call. This is Sami Badri, Cisco's new head of Investor Relations and I'm joined by Chuck Robbins, our chair and CEO; and Scott Herrin, our CFO. Having followed Cisco on the sell side for 10 years, I couldn't be more excited to join the company and look forward to engaging with you all in my new role.

By now, you should have seen our earnings press release. A corresponding webcast with slides, including supplemental information, will be available on our website in the Investor Relations section following the call.

As a reminder, we have simplified how we report product and service revenue in customer markets. Starting this quarter, we are reporting revenue in the following five categories -- Networking, Security, Collaboration, Observability and Services. And we are reporting customer markets in the following three categories -- Enterprise, Public Sector and Service Provider & Cloud.

Also, as is customary in Q1, we have made certain reclassifications to prior period amounts to conform to the current period's presentation. 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 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 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 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, Sami, and welcome to Cisco. I hope everyone is doing well, and thanks for joining us today.

We delivered a solid start to fiscal 2024 with the strongest first-quarter results in Cisco's history in terms of revenue and profitability. Our Q1 revenue was at the upper end of our guided range. EPS exceeded the high end of our guidance, driven by strength in gross margins and expense control, resulting in strong operating leverage.

Our disciplined expense management and the tailwinds from our business model transformation resulted in our highest non-GAAP gross margin in over 17 years and record non-GAAP operating margin. We also returned $2.8 billion in Q1 via cash dividends and share repurchases, delivering on our capital return commitments to our shareholders.

As we continue to transform our business towards more software and recurring revenue streams fueled by accelerated innovation, we remain committed to driving operating leverage and shareholder returns.

Now turning to the demand environment. After three quarters of exceptionally strong product delivery, our customers are now focused on installing and implementing these unprecedented levels of products. The bottleneck that we previously saw in the supply chain has now shifted downstream to implementation by our customers and partners.

Our order lead times and backlog have largely returned to normal levels. As deliveries rose, the channel inventory we track at our distributors also steadily declined during this time. Simply put, customers are now taking time to onboard and deploy these heightened product deliveries.

While the macro challenges we have discussed still exist, we believe this implementation phase is the primary reason for the slowdown in new orders. We saw it mostly with our larger enterprise, service provider and cloud customers, and it was most pronounced in October. Based on our analysis, we believe this phase is temporary and estimate there is an additional one to two quarters worth of shipped orders in customers' hands still waiting to be deployed.

This has near-term consequences for revenue and our outlook for the next couple of quarters, which Scott will discuss shortly. However, it does not change our longer-term confidence.

We expect product order growth rates to increase in the second half of the fiscal year. We also remain very confident in the foundational strength of our business and future growth opportunities given the criticality of our technologies.

Overall, our win rates are stable. Cancellation and return rates remain below pre-pandemic levels. And we have gained market share, all of which are testaments to the strength of our portfolio and how it aligns to our customers' most pressing needs.

As we look to enhance our capabilities in higher growth areas, in the first quarter of fiscal '24, we announced our intent to acquire Splunk. The combination of Cisco and Splunk will create an end-to-end data platform to enhance our customers' digital resiliency with our complementary capabilities in AI, security, and observability.

The combination of Cisco and Splunk also directly supports our strategic objectives around driving higher levels of growth, software capabilities and ARR. Together, we will bring trusted innovation leadership, an outstanding go-to-market engine and a world-class culture that will help our customers achieve their technology outcomes with innovative products and solutions.

Now let me comment on our quarterly performance. As I previously mentioned, we delivered strong revenues in Q1, which was broad-based across our product portfolio and driven by our customers' investments in generative AI, Cloud, Security and Full-Stack Observability. As expected, we continued to gain market share with the release of the calendar Q2 results, recording another quarter of year-over-year gains in three of our largest networking markets -- campus switching, wireless LAN and SP routing.

In webscale, we see continued momentum in AI with three of the top four customers deploying our hyperscale Ethernet AI fabric. We also already have line of sight to over $1 billion in orders for AI infrastructure from major cloud providers in fiscal year '25.

To help advance AI, we are working with key GPU and storage partners to create solutions including Ethernet technologies, GPU-enabled infrastructure and joint tested and validated reference architectures with a commitment to open networking for AI. Collectively, we believe there is a great opportunity for a broad set of innovations in compute, GPU, networking, software and services to support core and edge AI infrastructure.

According to the 650 Group, the AI switching market is forecasted to exceed $10 billion in 2027. Our scalable fabric for AI, coupled with the proven power saving capabilities of Cisco Silicon One, put us in a strong position to build out the infrastructure needed for AI clusters. And we are laser-focused on winning in this space.

Moving to security. We continue to execute against our product roadmap and strengthen our unified security platform. Since our Cisco XDR solution became available this summer, we have added recovery to the response process, giving security teams the ability to snapshot and restore their business-critical data at the first sign of a ransomware attack.

With our three new offers around XDR, Cisco Secure Access, and Multi-cloud defense, we already have over $500 million in the pipeline across over 1,000 customers. We also launched our new Cisco security firewall solution this quarter. We are actively engaged in competitive sales with all these products and expect to see meaningful positive results in the coming quarters.

In our collaboration portfolio, we recently introduced a range of truly game changing AI capabilities spanning the entire Webex suite as well as new devices for reimagined workspaces at our WebexOne event.

Before I turn it over to Scott, let me briefly summarize three key takeaways.

First, as we consider where we're at today, the primary issue with demand is that customers are taking time to onboard and deploy heightened product deliveries. While we are not immune to the macro, we believe this is temporary as our customers and partners continue to tell us that our portfolio is stronger than ever, and we have continued to see share gains in key markets.

Second, we remain confident in our future. With the incremental multibillion dollar AI infrastructure opportunity, the increasing criticality of security and observability and what we believe Cisco and Splunk can do together for our customers is truly exciting.

Lastly, you can always count on us to take a disciplined approach regardless of the environment. We remain committed to operating leverage, capital allocation and expense management.

I'll now turn it over to Scott to provide more detail on the quarter and our outlook.

Financial Overview

Thanks, Chuck.

We delivered solid results in Q1, driven by the prior strategic actions we took to mitigate the supply chain constraints. For the quarter, we reported strong revenue growth and a record non-GAAP operating margin. Total revenue was $14.7 billion, up 8% year-over-year, at the high end of our guidance range. Non-GAAP net income was $4.5 billion, up 28%. And non-GAAP EPS was $1.11, up 29%, exceeding the high end of our guidance range.

Looking at our Q1 revenue in more detail.

Total product revenue was $11.1 billion, up 9%. And service revenue was $3.5 billion, up 4%.

Networking, our largest product category, drove the increase with 10% growth. Within Networking, the growth was driven by Switching, where Campus and Data Center were both up double digits on the strength of our Catalyst 9000 and Nexus 9000 offerings. This was partially offset by a decline in Wireless.

Security was up 4%, driven by our Zero Trust and Threat Intelligence, and Detection and Response offerings.

Collaboration was up 3%, driven by growth in Calling and Contact Center, partially offset by a decline in Meetings.

Observability was up 21%, driven by growth across the portfolio, including double digit growth in Thousand Eyes and AppDynamics.

We continue to make progress in our transformation to more recurring revenue-based offerings.

We saw solid performance in our ARR of $24.5 billion, which increased 5%, with product ARR growth of 10%.

Total software revenue was $4.4 billion, a 13% increase, with software subscription revenue also up 13%. 85% of our software revenue was subscription-based.

Total subscription revenue increased 10% to $6.5 billion, which represents 44% of Cisco's total revenue, an increase of 1 percentage point over last year.

RPO was $34.8 billion, up 12% year-over-year. Product RPO increased 14%, and service RPO increased 11%. And total short-term RPO was up 8% to $17.6 billion.

Looking at our product orders by geographic segment. Year-over-year, overall product orders declined 20%, with the Americas down 19%, EMEA down 13% and APJC down 38%.

In our customer markets, Service Provider and Cloud was down 38%, Enterprise was down 26% and Public Sector was up slightly at 2%.

Total non-GAAP gross margin came in at 67.1%, up 410 basis points year-over-year, and 110 basis points above the high end of our guidance range. Product gross margin was 66.5%, up 550 basis points. The increase was driven primarily by productivity improvements, with lower freight, logistics and component costs. Favorable mix and positive pricing also contributed to the year-over-year improvement. Services non-GAAP gross margin was 69%, up slightly.

Non-GAAP operating margin came in at 36.6%, up 480 basis points and exceeding the high end of our guidance range. This improved leverage was driven by both our strong non-GAAP gross margin and ongoing discipline cost management.

Shifting to the balance sheet. We ended Q1 with total cash, cash equivalents and investments of $23.5 billion. We had operating cash flow for the quarter of $2.4 billion, down 40%, primarily due to the $2.8 billion tax payment related to prior quarters, which was associated with the IRS tax relief due to the California floods.

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 cap allocation strategy, we are committed to increasing shareholder returns through greater operating leverage, maintaining a higher level of annual share repurchases and growing our dividend.

We continue to invest organically and inorganically in our innovation pipeline. During Q1, we announced our intent to acquire Splunk Inc., which we expect to close by the end of the third quarter of calendar year 2024, subject to regulatory approvals and customary closing conditions, including approval by Splunk shareholders.

In Q1, we also closed several acquisitions, all of which are highly complementary to our internal R&D and aligned with our strategy to strengthen our position in Cloud, Security, Observability and AI with targeted strategic M&A.

To summarize, we delivered a solid quarter, highlighted by top-line growth and increased operating leverage that resulted in stronger-than-anticipated earnings per share. We continue to make progress in our business model shift to more recurring revenue. We remain focused on disciplined expense management without losing sight of the strategic investments necessary to innovate and capitalize on growth opportunities.

Guidance

Turning to our financial guidance. As Chuck outlined, the bottleneck that we previously saw in the supply chain has now shifted downstream to implementation by our customers and partners. Most of the supply chain constraints are now behind us. And both shipment lead times and backlog have largely returned to normal levels. Q1 product orders declined 20% as our largest customers are implementing elevated levels of product shipments from prior quarters as we delivered orders from our historically high backlog levels. As Chuck mentioned, we believe there are one to two quarters' worth of shipped orders awaiting implementation by our customers. Our revenue guidance assumes one to two quarters of lower revenue and then a return to more typical sequential growth rates.

Consequently, for Q2, we expect revenue to be in the range of $12.6 to $12.8 billion.

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

Non-GAAP operating margin is expected to be in the range of 31.5% to 32.5%.

Non-GAAP earnings per share is expected to range from $0.82 to $0.84.

For fiscal year 2024, our guidance is updated as follows:

We expect revenue to be in the range of $53.8 billion to $55 billion.

Non-GAAP earnings per share is expected to be in the range of $3.87 to $3.93.

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

I'd like to thank our teams for their focus and execution this quarter. We remain confident in the strength of the business and our ability to capitalize on the key growth opportunities ahead.

Summary Comments

Listen, we're proud of the team for the performance in Q1. Obviously a very solid quarter with the exception of this demand issue that we talked about. We'll always try to be transparent with you and share with you exactly what we're seeing. We know what's going on, we're on top of it and we do feel that it's temporary.

At the same time, we're very confident in our opportunities long term. We're confident in the AI opportunity. We're very encouraged by our improving position in security, observability. And we're also very encouraged by the opportunities that will come with the Splunk acquisition.

I think many of you know that on Monday night the waiting period for review under the Hart-Scott-Rodino Act in the U.S. expired, meaning that we've effectively passed the antitrust review period in the United States. We're excited about that. At our Partner Summit last week, the feedback on our portfolio right now was probably as good as it's been in a long time. And I also just want to reiterate our commitment to delivering value to you and our shareholders via operating leverage, capital allocation and, obviously, managing our expenses in times when we see challenges like we have right now.

So, thank you for joining us today, and I'll turn it back over to Sami.

Closing

Cisco's next quarterly call, which will reflect our fiscal year 2024 second quarter results, will be on Wednesday, February 14, 2024, 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 Department. And we thank you very much for joining the call 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 confidence in the strength of our business, future growth opportunities in AI, Security, Cloud, and Observability, product order growth rates, and our commitment to delivering operating leverage and increasing capital returns to our shareholders) and the future financial performance of Cisco (including the guidance for Q2 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: 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; our development and use of artificial intelligence; 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 Networking and services; the timing of orders and manufacturing and customer lead times; 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 other incidents; vulnerabilities and critical security defects; our

ability to protect personal data; evolving regulatory uncertainty; terrorism; natural catastrophic events (including as a result of global climate change); any 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 7, 2023. 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 28, 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.