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]
Q2FY24 Earnings Results Conference Call
Wednesday, February 14, 2024

Introduction

Welcome, everyone, to Cisco's second quarter fiscal year '24 conference call. This is Sami Badri, Cisco's 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 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'll 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 that are made throughout this call will be on a year-over-year basis.

The matters we'll be discussing today include forward-looking statements, including the guidance we will be providing for the third 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 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 feel free to 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 thank you all for joining us today.

We delivered a solid Q2 performance with revenue coming in at the high end of our guidance range. Strong operating leverage across our business drove our margins, which exceeded the high end of our expectations and allowed us to deliver better than anticipated earnings per share.

In Q2, we once again returned a total of $2.8 billion in value through dividends and share repurchases. We also announced today another increase to Cisco's dividend payout rate, reaffirming our ongoing commitment to returning significant value to our shareholders through consistent capital returns.
Overall, our Q2 results continued to advance our strategic business transformation around driving higher levels of software subscriptions and annualized recurring revenue, or ARR, both of which showed performance gains in the quarter.

Our pending acquisition of Splunk also further supports our transformation strategy by fueling stronger growth, expanding our portfolio of software-based solutions and generating higher levels of ARR, with roughly $4 billion in additional ARR expected upon closing and will make us one of the largest software companies in the world.

Before turning to our performance in the quarter, I'd like to start by commenting on the demand environment. First, in terms of the macro environment, we are seeing a greater degree of caution and scrutiny of deals given the high level of uncertainty. As we're hearing this from our customers, it's leading us to be more cautious with our forecast and expectations.

Second, as we discussed last quarter and subsequently saw in other technology provider results, customers have been taking time since the start of our fiscal 2024 to deploy the elevated levels of products shipped to them in recent quarters. And this is taking longer than our initial expectations.

Third, we also continue to see weak demand with our telco and cable service provider customers. This industry has seen significant pressure, and they are adjusting deployment phasing, which is weighing on our business outlook.

Given these factors, we are adjusting our expenses and investments to reflect the current environment.

That said, for the product categories in which we can measure customer inventory absorption through connections to the cloud, we are seeing steady progress. However, based on conversations with customers, we still believe we are one to two quarters away from full implementation of their inventory, which as I mentioned is longer than we expected.

We continue to track Meraki activations, which are moving slightly faster in wireless and slightly slower in switching. Using our Meraki business as a proxy for our wider enterprise networking portfolio, we expect the current implementation of shipped products to be broadly complete by the end of fiscal 2024. Looking at our wireless business as an example, we are encouraged by the number of orders of $1 million or more, which increased approximately 50% sequentially in Q2. This indicates that many wireless customers have finished absorbing what we've shipped to them and are preparing for larger deployments in the coming months.

Our team is also partnering closely with customers to assist with this heightened focus on deployments of Cisco equipment on hand, contributing to our services revenue increase year-over-year. It's also worth noting that non-hardware centric revenue in areas such as security and collaboration increased, and our observability offerings grew double digits year-over-year.

Finally, despite the near-term challenges, our win rates are stable, and on a rolling four quarter basis, our market share remained steady in three of our four largest markets.

Now moving on to our performance in Q2. As I mentioned earlier, our performance in the quarter was broadly in line with or better than our Q2 expectations.

Given the trust our customers place in us and the criticality of our technologies to the outcomes our customers are seeking, I am confident about the foundational strength of our portfolio and our future growth opportunities.

With our innovation, we deliver and enable our customers to deploy next-generation applications in a highly secure manner. As part of this, we help facilitate their growth through our products and services so that when our customers adopt new technologies, we grow alongside them.

We continue to accelerate our innovation across high growth areas. Last week at Cisco Live EMEA, we announced new capabilities in networking, furthering our vision for the Cisco Networking Cloud. We also announced several new capabilities across our security, collaboration and observability portfolios leveraging AI throughout.

We also continue to capitalize on the multi-billion-dollar AI infrastructure opportunity. This quarter, we announced the next phase in our partnership with Nvidia to offer enterprises simplified, cloud-based and on-prem AI infrastructure. This includes both networking hardware and software to support advanced AI workloads. We are clear beneficiaries of AI adoption, and this partnership further demonstrates the central role we play in AI and the overall technology ecosystem. Our combined solution will be sold through our extensive global channel with professional services and support from key partners who are committed to helping businesses deploy their GPU clusters via ethernet infrastructure.

In Webscale, we continue to see momentum with three of the top four customers deploying our hyperscale Ethernet AI fabric, leveraging Cisco validated designs for AI infrastructure. While there is tremendous opportunity ahead, we are still in the early stages of adoption of AI workloads.

In Security, we continue to execute against our product roadmap to deliver the industry's most comprehensive unified platform with end-to-end solutions. This quarter, we introduced Cisco Identity Intelligence, an analytics layer that pulls data from identity infrastructure and performs behavior-based assessments to help protect against identity-based attacks, which are at the forefront of cyber threats today.

AI is also becoming more pervasive across the Cisco Security Cloud. For example, our new AI

Assistant in Secure Access lets customers create security access policies using natural language prompts, reducing errors and speeding up policy administration by 70%.

Our new security solutions, like XDR and Secure Access are ramping quickly after being launched this fall with now over 230 Cisco XDR customers. Over the next six months, you can expect more meaningful announcements across the portfolio through our accelerated organic innovation and inorganic investments.

In addition, we have now extended our AI-powered ThousandEyes into Cisco Secure Access, joining past integrations with AppDynamics, Webex, Catalyst and Meraki platforms. ThousandEyes allows our customers to understand the digital experience of users, applications and things through billions of daily measurements of the Internet and public SaaS as well as thousands of enterprise customers creating best-in-class digital experiences for users.

In Observability, we introduced the Cisco Digital Experience Monitoring application, providing deep insights into the performance of browser and mobile applications and efficient resolution of session-level issues. Our continued generative AI innovations build upon our existing platform capabilities, further enabling operations teams to focus on what matters most, minimizing tool sprawl, improving overall performance and delivering highly secure digital experiences.

Going back to the pending Splunk acquisition, the combination of Splunk's complementary capabilities with ours in AI, security and observability will create an end-to-end data platform to enhance our customers' digital resiliency. We are excited that 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.

I would also like to provide a brief update on timing. While the closing of the acquisition of Splunk remains subject to regulatory approvals and other customary closing conditions, given the positive progress to date on the required regulatory approvals, we now expect to close the transaction late in the first quarter or early in the second quarter of calendar year 2024, which is in our fiscal third quarter.

Before I turn it over to Scott, let me summarize three key takeaways. First, we have reset our expectations for the second half of the year, given the cautious macro environment, our customers absorbing high levels of inventory, and ongoing weakness in Service Provider.

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

Lastly, our portfolio continues to get stronger and stronger every day. While we have work in front of us and despite the current environment, we remain confident in our long-term strategy. We are relentlessly focused on our commitment to driving long-term value for our shareholders and industry-leading innovation for our customers.

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

Financial Overview

Thanks, Chuck.

Our Q2 results reflect solid execution again, with strong margins and increasing operating leverage. For the quarter, total revenue was at the high end of our guidance range at $12.8 billion, down 6% year-over-year. Non-GAAP net income was $3.5 billion, down 3%. And non-GAAP earnings per share was above the high end of our guidance range at $0.87, down 1%.

Looking at our Q2 revenue in more detail.

Total product revenue was $9.2 billion, down 9%. And service revenue was $3.6 billion, up 4%.

Networking, our largest product category, was down 12%. We saw declines across Switching, Wireless and Routed Optical Networking, driven primarily by weakness in the enterprise and service provider and cloud markets.

Security was up 3%, with our Zero Trust offering growing double digits.

Collaboration was up 3%, driven by growth in Collaboration Devices and Calling, partially offset by a decline in meetings.

Observability was up 16%, driven by growth across the portfolio with continued strength in ThousandEyes network services. As Chuck mentioned, ThousandEyes helps monitor and assure digital experience everywhere, on premise, internet and the cloud.

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

We saw strong performance in our ARR of $24.7 billion, which increased 6%, with product ARR growth of 9%.

Total software revenue was flat at $4.2 billion, with software subscription revenue up 5%. 88% of our software revenue was subscription based.

Total subscription revenue increased 6% to $6.4 billion, which now represents 50% of Cisco's total revenue, an increase of 6 percentage points over last year.

RPO was $35.7 billion, up 12% year-over-year. Product and service RPO both increased 12%. In total short-term RPO was $17.9 billion, up 6%.

Q2 product orders declined 12%, a significant improvement from Q1 as customers continue to work down product shipments from prior quarters. Looking at our geographic segments year-over-year. The Americas was down 10%, EMEA down 8% and APJC was down 27%. In our customer markets, Service Provider and Cloud was down 40%, Enterprise was down 6% and Public Sector was down 5%. Backlog at the end of Q2 has now returned to normal levels.

Total non-GAAP gross margin came in at 66.7%, up 280 basis points year-over-year and above the high end of our guidance range. Product gross margin was 65.2%, up 310 basis points. The improvement was driven primarily by lower freight and component costs and favorable product mix, partially offset by negative impact on pricing. Service gross margin was 70.5%, up 140 basis points. Non-GAAP operating margin came in at 33%, up 50 basis points and exceeding the high end of our guidance range. Strong non-GAAP gross margin and continued cost management drove the leverage.

Further, we are realigning our investments and expenses to reflect the current environment to help maximize long-term value for our shareholders. As part of our announced restructuring plan, we expect to impact approximately 5% of our global workforce with estimated pretax charges of approximately $800 million.

Shifting to the balance sheet, we ended Q2 with total cash, cash equivalents and investments of $25.7 billion. Consistent with our expectations, operating cash flow was $800 million, driven in large part by the timing of federal tax payments and the higher annual payment of the TCJA transition tax.

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. Year-to-date, we have returned $5.7 billion in value to shareholders, and we plan to continue our share repurchases at the current quarterly level throughout fiscal 2024. Increasing shareholder returns through greater operating leverage, maintaining a higher level of annual share repurchases and growing our dividend is consistent with our capital allocation strategy.

Given the confidence we have in our business today, we announced we are raising our dividend by $0.01 to $0.40 per quarter. This dividend increase demonstrates our commitment to returning a minimum of 50% of free cash flow annually to our shareholders and our confidence in the strength of our ongoing cash flows.

To summarize, we executed well with continued strong margins and increased operating leverage as we help our customers complete record deployments and implementations. We continue to progress our business model shift to more recurring revenue, we are strategically investing in innovation to capitalize on our growth opportunities and are committed to delivering long-term shareholder value.

With regard to our proposed acquisition of Splunk, we continue to work through regulatory approvals and closing conditions. And as Chuck mentioned, we're optimistic that it will close ahead of what we had originally anticipated. We have not included any impact from the Splunk acquisition in our forward-looking guidance.

<u>Guidance</u>

Turning to our guidance, as previously mentioned, we have reset our expectations for the second half of the year to account for the caution around macro uncertainty, the continued absorption by our customers of record levels of product shipments they've received from us and the weakness of our service provider market.

For Q3, our guidance is as follows.

We expect revenue to be in the range of $12.1 billion to $12.3 billion.

We anticipate the non-GAAP gross margin to be in the range of 66% to 67%. Non-GAAP operating margin is expected to be in the range of 33.5% to 34.5%.

Non-GAAP earnings per share is expected to range from $0.84 to $0.86.

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

We expect revenue to be in the range of $51.5 billion to $52.5 billion.

Non-GAAP earnings per share guidance is expected to range from $3.68 to $3.74.

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

Closing

Cisco's next quarterly conference call, which will reflect our fiscal year '24 third quarter results, will be on Wednesday, May 15, 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 Cisco Investor Relations. 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 the alignment of our investments to future growth opportunities, the role that our innovation plays as our customers adopt AI and secure their organizations, the progress in our business model shift to more recurring revenue while remaining focused on financial discipline, operating leverage and shareholder returns) and the future financial performance of Cisco (including the guidance for Q3 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 reports on Forms 10-Q and 10-K filed on November 21, 2023 and September 7, 2023, 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 27, 2024 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.