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]
Q4 FY20 Financial Results Conference Call
Wednesday, August 12, 2020

Introduction

Welcome, everyone, to Cisco's Fourth Quarter Fiscal '20 Quarterly Earnings Conference Call. This is Marilyn Mora, Head of Investor Relations, and I'm joined by Chuck Robbins, our Chairman and CEO; and Kelly Kramer, 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 first quarter of fiscal 2021. 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.

In Q2 fiscal 2019, we completed the sale of our SPVSS business. As such, all of the financial information we will be discussing is normalized to exclude the SPVSS business from our historical results.

I will now turn it over to Chuck.

Opening Remarks

Thank you, Marilyn. We hope all of you and your families are staying safe and healthy. Our thoughts remain with everyone who has been affected by the pandemic, and we are grateful to those who remain on the front lines working to help those impacted during these challenging times.

As we've been preparing for this call, it's offered me to some time to reflect on what we've achieved since I stepped into this role five years ago. Through the hard work of everyone at Cisco, we have undergone a significant transformation in the midst of some of the most complex times in our history. I am so proud of what our teams have accomplished. They have demonstrated resiliency, determination and compassion as we delivered on our financial commitments, brought market-leading innovation to our customers, transitioned our business model and driven a culture that has truly shined over the past six months. The Cisco of today is more agile, innovative and focused.

Through both organic and inorganic innovation, we delivered incredible new technology with new, more flexible consumption offers for our customers with more software and subscriptions. At our Financial Analyst Conference in 2017, we laid out key metrics for our transformation. We set a goal of 30% of our revenue to come from software, and while we achieved 29% in fiscal year '20, we did achieve 31% in Q4. We also delivered 51% of our revenue from software and services in FY20, exceeding our target of 50%. Lastly, we now have 78% of our software revenue sold as subscription, beating our target of 66%.

With our customers as our guide, we have successfully executed against our strategy to help them transform and modernize their organizations.

We launched our intent-based networking architecture using automation and machine learning to help our customers drive simplicity and cost-effective management of their networks.

As customers move more workloads to the cloud, we're offering fast, highly secure access to applications hosted anywhere - in the private data center, public cloud or a SaaS platform - with our cloud security integrated with our SD-WAN solution.

We introduced new capabilities across software, silicon and optics to help bring to life the Internet for the Future.

The innovation we've driven in our Security portfolio has helped us become the top enterprise security company in the world.

With Webex, we have the most trusted secure platform for remote collaboration for the Enterprise, and we're also delivering real-time insights for customers in their multi-cloud environments to optimize user experience with our insights and observability assets like AppDynamics.

Over the past few years, this transition has resulted in improvements in our financial performance, including expanding margins and demonstrating continued financial discipline. Once again, I want to thank our teams for what we've achieved.

If the past year has taught us anything, it's the need to always be nimble. I believe that the changes we've made to our business now put us in a position of strength as we focus on our future. We're a company that embraces change and we've shown our ability to thrive in any environment.

The past six months have unquestionably reshaped our world. Industries, governments and work have changed dramatically, and many of these changes will become permanent. At Cisco, we're committed to helping our customers truly digitize their organizations for the future - regardless of the challenges or fundamental shifts that we may face.

Like many other organizations, we've also had the opportunity to re-examine our business and our portfolio for this new world. As I said last quarter, we were going to take time to better understand the short- and long-term implications of COVID-19 and we now believe we have a better view. Based on the many conversations we've had with our customers around the world, we believe we have perspective into how they will adapt their technology strategies for the future to ensure greater resiliency, agility and innovation.

We know how to adapt our business and strategy to align with where our customers are headed. The changes we are making to our business reflect how we are leveraging our existing strengths, investing for growth and unlocking new opportunities. We will also be very disciplined on our cost structure, as we always have been. Over the next few quarters, we will be taking out over $1 billion on an annualized basis to reduce our cost structure. At the same time, we're going to rebalance our R&D investments to focus on key areas that will position us well for the future.

More specifically, we will accelerate the transition of the majority of our portfolio to be delivered as-a-Service. We will also accelerate our investments in the following areas: cloud security; cloud collaboration; key enhancements for education, healthcare and other industries; increased automation in the Enterprise; the future of work; and application insights and analytics.

At the same time, we will continue our focus in the following areas, many of which have been accelerated by the pandemic: multi-cloud investment, 5G and Wi-Fi 6, 400G, optical networking, next-generation silicon, AI and more.

These investments will help define the next phase of our transformation and allow us to bring the best, most relevant innovation to our customers in simpler, more easily consumable ways.

I am confident that once again, we have the right strategy that will deliver what our customers need from us and we will emerge from this challenging time as a stronger company than before.

Now let me discuss our performance in the quarter. While our results reflect the ongoing challenges in the current environment, we executed well.

As you would expect, the pandemic has had the most impact on our enterprise and commercial orders, driven by an overall slowdown in spending. We are seeing customers continue to delay their purchasing decisions in certain areas while increasing spend in others until they have greater visibility and clarity on the timing and shape of the global economic recovery.

Despite this challenging economic environment, the pandemic has also triggered a massive and rapid shift to remote operations and automation to maximize personal safety. With this, many customers are increasingly reliant on our broad portfolio of technologies, resulting in another quarter of strong demand for our Catalyst 9K, Security, Webex and other SaaS-based solutions.

Throughout fiscal year 2020, we demonstrated operational resilience based on our strong customer relationships, a solid financial foundation, differentiated innovation and a compelling strategic transformation built on the strength of our key technology platforms.

Now I'll cover a few highlights from the quarter.

In June we introduced an expanded Business Resiliency portfolio offering healthcare and education solutions with simpler consumption models and services to accelerate adoption. We will continue to expand this portfolio to cover areas such as social distancing in the workplace, effective virtual employee engagement at scale and pop-up connected clinics.

Within our Infrastructure Platforms business, we continued to see a strong ramp of our Catalyst 9K portfolio as many customers take advantage of their employees working from home to refresh their aging infrastructure, enabling them to simplify, secure and automate the management of their networks.

Our acquisition of ThousandEyes will complement these capabilities by adding deeper and broader visibility and analytics across networks and applications, enabling us to deliver the best possible experiences for our customers. By integrating their SaaS-based offering with our AppDynamics application intelligence portfolio and SD-WAN technology, we can provide unparalleled intelligence and insights at cloud scale, driving improved customer experience as well as reliability of their applications.

Security continues to be a top priority for our customers, particularly in this distributed digital world. Our ability to connect and protect our customers working from anywhere on any device is accelerating the adoption of our comprehensive security portfolio, resulting in double-digit revenue growth this quarter.

As more data goes to the cloud and users become more distributed, we have good momentum in our cloud security solutions, protecting workloads, applications and data. We also continue to expand our capabilities to enable simplification and automation of our customer security infrastructure; a good example of this is our SecureX platform, which is designed to unify visibility, enable automation and deliver a consistent experience. Since our launch six weeks ago, we have over 2,100 active daily customers, two thirds of which have two or more products active.

We are also delivering secure remote worker solutions that span our endpoint security portfolio, combined with the power of our Zero Trust architecture with Duo, AnyConnect, Umbrella and AMP for Endpoints.

Applications have become a lifeline for so many organizations, and this has only increased over the past few months. As organizations define what their future looks like, our collaboration technology will play a key role in evolving how they work, transact and connect. Webex had strong performance this quarter with double-digit growth as businesses, governments, educators and frontline workers everywhere have embraced remote work. We expect this momentum to continue, as we have begun to see the conversion of free trials into paid subscriptions.

AppDynamics also achieved another solid quarter. These monitoring tools offer our customers great value by providing real-time insights from a single pane of glass to optimize user experience in their multi-cloud environments.

As we think about all that we've achieved over the past five years, I want to take a moment to acknowledge Kelly Kramer, our Chief Financial Officer, who has been an incredible partner to me. She has played a key role in reshaping Cisco into the company we are today. I want to let you all know that Kelly has made the decision to retire from Cisco. Over her eight-plus years here, Kelly has led the effort to improve our financial performance, focus on investor confidence and help position Cisco for success. Kelly and I have been focused on simple, clear communication, absolute transparency, delivering on our commitments and always aligning Cisco for future growth.

Kelly has graciously agreed to stay on as CFO until we have her successor on board and will advise us with the succession process. I can assure you that with Kelly staying on during the search, and with our world-class finance team, we will have a seamless transition. Kelly, thank you so much for your partnership and your friendship; you will truly be missed.

Now, before I turn it over to Kelly, I want to reiterate my confidence for what the future holds. Over the past five years we have not shied away from making bold moves to position us for long-term growth, and now is no different.

We are committed to running a strong business, as well as leveraging technology for good to solve the world's biggest challenges and create new opportunities for the future. As we've demonstrated, we have helped our customers build resiliency in difficult environments through industry disruptions and in times of rapid growth. We will also continue to use our position to make our communities and world a better place. Whether it's tackling a global health pandemic or social injustice and intolerance, we're committed to our purpose of powering an inclusive future for all.

As we start a new fiscal year, I believe we have incredible opportunities in front of us. We will navigate the pandemic in the most effective way possible while not damaging the long-term prospects for Cisco. We remain strongly aligned to our customers' priorities and deeply committed to delivering long-term growth.

Now I'll turn it over to Kelly.

Financial Overview

Thanks, Chuck. It really has been great, and I want to thank you, the leadership team and really all of Cisco. I also want to thank my finance team, who have an amazing job. I'll certainly miss Cisco, but I'm looking forward to what's next.

I'll start with a summary of our financial results for the quarter, then cover the full year, followed by guidance for Q1.

Our overall Q4 results reflect good execution with strong margins in a very challenging environment.

Total revenue was $12.2 billion, down 9%. Our non-GAAP operating margin rate was 33%, up 0.4 points. Non-GAAP net income was $3.4 billion, down 5% year over year, and non-GAAP EPS was $0.80, down 4%.

Let me provide some more detail on our Q4 revenue.

Total product revenue was down 13% to $8.8 billion.

Infrastructure Platforms was down 16%. This is the product area most impacted by the COVID environment. We saw declines across switching, routing, data center and wireless, driven primarily by the weakness we saw in the commercial and enterprise markets. We did see pockets of strength with the continued growth of Cat 9K, which was up double digits, and the ramp of our WiFi6 products. Data center was particularly weak with the decline of the market and DRAM price declines.

Applications was down 9%; on the positive side, we saw strong double-digit growth in Webex with the importance of remote working. We also saw solid growth in AppDynamics and IoT software. This was offset by declines in unified communication and TP endpoints.

Security was up 10%, with strong performance in network security, identity and access, advanced threat and unified threat management. Our cloud security portfolio performed well with strong double-digit growth and continued momentum with our Duo and Umbrella offerings.

Service revenue was flat for the quarter, but we had growth in our maintenance business, as well as software and support services. This was offset by our advisory services, which was impacted by the COVID environment.

We continued to transform our business, delivering more software offerings and driving more subscriptions. Software subscriptions were 78% of total software revenue, up 8 points year-over-year.

Remaining performance obligations, or RPO, at the end of Q4 were $28.4 billion, up 12%. RPO for product was up 17% and service was up 9%. The continued growth in RPO demonstrates the strength of our portfolio of software and services.

In terms of orders in Q4, total product orders were down 10%. Looking at our geographies, the Americas was down 11%, EMEA was down 6% and APJC was down 13%. Total emerging markets were down 19%, with the BRICS plus Mexico down 26%. In our customer segments, Public Sector was down 1%, while Enterprise was down 7%. Commercial was down 23% and Service Provider was down 5%.

From a non-GAAP profitability perspective, total Q4 gross margin was 65%, down 0.5 points. Product gross margin was 63.2%, down 1.5 points, and service gross margin was 69.8%, up 1.9 points year over year.

Our Q4 GAAP tax rate was 16.7%, which reflects the true-ups to the annual tax rate.

In terms of the bottom line, from a GAAP perspective, Q4 net income was $2.6 billion and EPS was $0.62.

We ended Q4 with total cash, cash equivalents and investments of $29.4 billion. Operating cash flow was $3.8 billion, down 4% year over year.

From a capital allocation perspective, we returned $1.5 billion to shareholders for our quarterly dividend.

We continued to invest organically and inorganically in our innovation pipeline. Just last week, we closed our acquisition of ThousandEyes. This move is consistent with our strategy of increasing investment in innovation and R&D for our growth areas.

I'll now cover the full fiscal year results. We delivered strong margins and grew EPS in a very challenging environment. Revenue was $49.3 billion, down 5%. Total non-GAAP gross margin was 66%, up 1.4 points, and our non-GAAP operating margin rate was 33.8%, up 1.5 points.

From a bottom line perspective, non-GAAP net income was $13.7 billion, down 1%, and non-GAAP EPS was $3.21, up 4%. GAAP net income was $11.2 billion and GAAP EPS was $2.64.

We delivered operating cash flow of $15.4 billion, down 3%. Normalized for the cash received in Q1 fiscal '19 related to the legal settlement with Arista, operating cash flow was flat for fiscal '20.

From a capital allocation perspective, we returned $8.6 billion to shareholders over the fiscal year, which represents 59% of our free cash flow. That was comprised of $2.6 billion of share repurchases and $6 billion for our quarterly dividend.

To summarize, we executed well in Q4 and the fiscal year, with strong margins in a very challenging environment. We're seeing the returns on the investments we're making in innovation and driving the shift to more software and subscriptions, delivering long-term growth and shareholder value.

Guidance

Let me reiterate our guidance for the first quarter of fiscal '21; this guidance is subject to the disclaimer regarding forward-looking information that Marilyn referred to earlier.

We expect revenue to decline in the range of minus 9% to minus 11% year over year.

We anticipate the non-GAAP gross margin rate to be in the range of 64% to 65%.

The non-GAAP operating margin rate is expected to be in the range of 30% to 31%, and the non-GAAP tax revision rate is expected to be 19%.

Non-GAAP earnings per share is expected to range from $0.69 to $0.71.

Summary Comments

All right, I just want to recap and just thank, first of all, Kelly, for everything and the friendship and all the great work that you've done, and reiterate that she's going to stay with us until we actually identify her successor, and she'll help advise us through that process, so we're excited about her sticking around and helping us do that. I want to thank the team for executing through a really challenging time, and I really want to reiterate that I think that the strategy that we had going in, I believe, when we come out of the pandemic, will be more relevant to our customers than it was six, nine months ago. So I'm optimistic about the future, and we're going to continue to execute through this, and thank you all for joining us today.

Closing

Great, thank you, Chuck. Cisco's next quarterly earnings conference call, which will reflect our fiscal 2021 first quarter results, will be on Thursday, November 12, 2020, at 1:30 p.m. Pacific time, 4:30 p.m. Eastern time.

Again, I'd like to remind the audience that in light of Regulation FD, Cisco's policy is not to comment on its financial guidance during the quarter unless it's done through an explicit public disclosure.

We now plan to close the call, but if you have any further questions, feel free to contact 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 continued execution of our strategy to shift to revenue coming from software and services, the strength of our portfolio of software and services to continue to resonate with customers as they digitize their organizations, our ability to successfully rebalance our R&D investments to focus on new areas so that we can continue to offer customer relevant technology in simpler, consumable ways, our continued ability to deliver long term growth and shareholder value, and future responses to and effects of the COVID-19 pandemic) and the future financial performance of Cisco (including the guidance for Q1 FY 2021) 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; 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 routing, switching and services; the timing of orders and manufacturing and customer lead times; 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, intellectual property, antitrust, shareholder and other matters, and governmental investigations; our ability to achieve the benefits of the announced restructuring and possible changes in the size and timing of the related charges; cyber-attacks, data breaches or malware; vulnerabilities and critical security defects; terrorism; natural catastrophic events; 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 18, 2020 and September 5, 2019, 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 25, 2020 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.