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]
Q3 FY21 Earnings Results Conference Call
Wednesday, May 19, 2021

Introduction

Welcome, everyone, to Cisco's Third Quarter Fiscal 2021 Quarterly Earnings Conference Call. This is Marilyn Mora, Head of Investor Relations, and I'm joined by Chuck Robbins, our Chairman 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 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 on a year over year basis.

The matters we will be discussing today include forward-looking statements, including the guidance we will be providing for the fourth quarter 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 the 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, Marilyn. Good afternoon, and thanks for joining today. I hope everyone is staying healthy and safe as we start to see the benefits of vaccine deployments and the continuing improvement in economic activity.

I want to start by acknowledging our employees, customers and partners in India, who are experiencing a devastating surge of COVID cases. Cisco is providing critical resources during this challenging time and our thoughts remain with all of you. While many of us are seeing great progress in our recovery efforts, we must remain vigilant and adaptable as we manage the ongoing pandemic around the world.

Turning to the quarter, we had impressive momentum in Q3, which gives me a great sense of optimism going forward. We returned to growth with revenue up 7%, driven by an improving macro environment, the strongest product portfolio in our history and great execution by our teams. We saw broad-based demand across the business, led by our biggest growth opportunities- hybrid work, digital transformation, cloud and continued strong uptake of our subscription-based offerings. We are also seeing early momentum in the ramping of key technology cycles that are long-term growth drivers for our business, such as 5G, 400G and edge.

The next phase of the recovery and the future of work will be heavily reliant on our technology. Cisco's end-to-end portfolio will serve as the foundation for next-generation infrastructure solutions as well as cloud-enabled delivery models and innovation, allowing our customers to move with even greater speed and agility. This will require a significant investment cycle and reinforces the strength of our strategy while driving greater opportunity to create a world that is more connected, inclusive and secure.

We remain focused on accelerating innovation while simplifying the adoption of our offerings with network-wide automation, analytics and flexible as-a-service consumption models, all aimed at improving our customers' network performance capabilities and security which we believe will drive tremendous long-term opportunities for us.

Our Q3 performance only reinforces my confidence about the future. These results reflect a return to a strong spending environment and an economic recovery that has gained momentum driven by vaccine rollouts and the easing of restrictions.

As the economy has improved, customers have increased their investment across our portfolio to prepare for the upturn and return to office. In Q3 we saw 10% growth in product orders, the highest growth rate since Q1 of fiscal 2012, reflecting robust improvement across all of our customer segments and geographies. From a product revenue perspective, we saw 6% growth led by strength across our portfolio, including campus switching, routing, wireless, security, collaboration and webscale, as well as from our acquisition of Acacia, which closed during Q3.

We continue to aggressively shift our business to more recurring revenue streams, which we expect to grow over time as we expand our offerings. In Q3, we achieved $3.8 billion in software

revenue with 81% of our software revenue sold as a subscription, up from 76% last quarter. We also saw another quarter of double-digit growth in our deferred revenue and remaining performance obligations. Over the past six years, we have made significant progress and now have one of the largest software businesses in the industry, with an annual run rate well over $14 billion.

Let me now touch on Infrastructure Platforms. We saw strong demand across the majority of our portfolio, led by our next-generation enterprise networking and Service Provider solutions, as companies accelerate the modernization of their infrastructure. This modern infrastructure delivers higher performance and faster access to data while offering the best user experience in an increasingly distributed environment.

Customers are turning to us to help them create the trusted workplace of the future, with WiFi access points, video endpoints, cameras and IoT sensors feeding data into DNA Center and DNA Spaces. We're enabling operations teams to remotely monitor workplace conditions for a safe return to office.

We're also working to provide visibility beyond corporate networks, which is increasingly critical as our customers accelerate their adoption of SaaS and cloud solutions for hybrid work. At Cisco Live, we launched the industry's first enterprise-wide full-stack observability offering by integrating ThousandEyes' cloud intelligence with our Catalyst switching portfolio and AppDynamics. This provides IT with visibility and actionable insights across both external and internal networks to provide a seamless digital experience for users.

And with users more distributed than ever, it is vital that they have the most efficient and secure connection to the cloud. Our deep partnerships with Google, Amazon and Microsoft allow native connectivity from our SD-WAN fabric to each of these cloud offerings. With our technology, customers can reduce deployment times and connect branch offices to cloud workloads in minutes.

In our webscale business, we delivered our sixth consecutive quarter of strong order growth, which increased over 25% in the quarter and over 50% on a trailing 12-month basis. Our webscale customers are starting their 400G upgrade cycles and aggressively pursuing long-haul buildouts, while our carrier customers are exploring new architectures to realize the full potential of 5G.

We are building the internet for the future by creating breakthrough innovation with our routing, optical and automation technologies to deliver significant economic benefits. Recently we launched a new routed optical networking solution integrating our scalable, high-performance routers and Acacia's pluggable optics, which offer significant cost savings. Last week we announced our intent to acquire Sedona Systems to extend our Crosswork automation platform to build on these capabilities.

We also expanded our Silicon One platform from a routing focused solution to one which addresses the webscale switching market, offering 10 networking chips ranging from 3.2 to 25.6 terabits per second, making it the highest-performance programmable routing and switching

silicon on the market.

We know our customers increasingly want to consume Cisco's technology in new, more flexible ways. At Cisco Live, we launched our new as-a-service portfolio, Cisco Plus, and our first offer, Cisco Plus Hybrid Cloud, combining our data center compute, networking and storage portfolio. Cisco Plus includes our plans to deliver Networking-as-a-service, which will unify networking, security and observability across access, WAN and cloud domains to deliver an unparalleled experience for our customers.

Turning to Security. We had a record quarter, surpassing $875 million in revenue, up 13% as we expanded our reach with customers around the world.

Our security strategy is focused on delivering a simple and secure experience. We have an unrivaled ability to provide end-to-end security capabilities across users, devices, applications and data on any network or any cloud. This is the key reason why our customers trust us to help them proactively protect against and remediate threats.

In fact, leading customers in every industry, including 100% of the Fortune 100, are using Cisco security solutions. These customers are increasingly deploying our Zero Trust and secure access service edge, or SASE architectures, along with automation, authentication and analytics capabilities.

With today's distributed workforce, companies must quickly deploy highly secure, trusted access to critical applications everywhere without compromising performance. Customers like Ford are using our cloud-delivered security platform, Umbrella, as they secure over 100,000 of their remote team members.

And this quarter, Lyft turned to Cisco to strengthen their security protection for all of their users accessing their applications. By deploying our Duo portfolio, Lyft was able to provide strong access controls as they protect their users' sensitive personal and financial information while reducing their total cost of ownership by more than 50%.

With nearly $6 billion in annual R&D, the investment that Cisco is making in both security and the network continues to lead to momentum across our portfolio, with 23 consecutive quarters of double-digit Umbrella cloud security growth, nearly 7,000 customers using our cloud native SecureX platform, and strong platform growth with Security Enterprise agreements.

We continue to expand our leadership with new innovations, including passwordless authentication, data loss prevention, observability, cloud-based malware detection and enhancements to SecureX.

We are also complementing our organic innovation with assets that enable greater security efficacy. Our intent to acquire Kenna Security will bring together their risk-based vulnerability management platform with SecureX's threat-management capabilities to prioritize and more effectively manage overall risk.

Lastly, let me touch on Applications. Our collaboration business continues to perform well. We had a record quarter in Webex as we executed against our strategy to power the future of hybrid work.

Over the last six months we've added more than 400 new features and devices to our Webex portfolio. We are enabling seamless experiences through our Desk Camera and Desk Hub solutions while extending the Webex suite of devices, including digital signage, touchless calls, room capacity alerts and environmental sensors to help enable a safe return to the office. Well-being is top of mind for so many right now as we face a new way of working. This is why we launched People Insights to help people monitor and manage their well-being. These new features, devices and capabilities, combined with cloud calling and cloud contact center, provide our customers with the most comprehensive and inclusive hybrid work platform.

Last week we announced our intent to acquire Socio Labs. By integrating Slido and Socio Labs into our Webex platform, we will also be able to provide the most comprehensive internal and external event management solution on the market.

In summary, we had a very good quarter. I'm so proud of the continued success of the business transformation our teams are driving.

As I mentioned earlier, we are experiencing the strongest demand in nearly a decade. We are also seeing similar component shortage supply issues as our peers. The good news, and this is reflected in our guidance, is that we are confident we will work through this, as we have already put in place revised arrangements with several of our key suppliers. We believe these actions will enable us to optimize our access to critical components, including semiconductors, and take care of our customers by fulfilling their demand as quickly as possible.

Our strategy and commitment to leading with trust, innovation and choice, along with our continued focus and discipline, are positioning us well for growth and profitability.

As we accelerate the pace of innovation for our customers and partners, it's critical that we continue to support our people, our communities and our planet.

I'm very proud that Cisco was recently named the #1 best place to work in the United States by Fortune and Great Place to Work. This is a tremendous honor for us, as it recognizes the incredible work of our people and the power of the culture we have created.

And lastly, in terms of actions we are taking to protect the planet, last month the Cisco Foundation announced $100 million over 10 years to fund nonprofit grants and impact investing in climate solutions. We have already achieved 100% renewable energy in the U.S. and in many countries across Europe, and this is another strong step forward.

Whether it's our deep focus on delivering the best results for our customers, partners and employees, or our commitment to making a difference in communities across the world, Cisco remains committed to our purpose to power an inclusive future for all. I'm quite optimistic about what's ahead and confident in our team's ability to deliver.

I’ll now turn it over to Scott.

Financial Overview

Thanks, Chuck. Last quarter I identified four key priorities that we are using to define our financial strategy: driving profitable growth, a continued disciplined focus on financial management and operating efficiency, setting a long-term plan to maximize value creation through strategic transformation, and examining investments, both organic and inorganic.

We made progress on all these fronts in Q3 and are continuing to build our financial approach based on these core pillars, providing a strong foundation for enhanced financial performance as well as long-term value creation for our shareholders.

Now let's turn to our results. I'll start with a summary of our financial results for the quarter, followed by the guidance for Q4.

As Chuck said, Q3 was a strong quarter across the business. We executed well with strong product orders and solid growth in revenue, net income and earnings per share.

Total revenue increased to $12.8 billion, up 7% year-on-year, exceeding the high end of our guidance range for the quarter. We saw broad strength in all product areas and geographies. We also saw continued recovery in our business and building momentum with sequential revenue growth of 7%.

Our non-GAAP operating margin was 33.6%. Non-GAAP net income was $3.5 billion, up 4%, and non-GAAP earnings per share was $0.83, up 5% year-on-year, coming in above the high end of our EPS guidance range.

Now let me provide more detail on our Q3 revenue.

Total product revenue was $9.1 billion, up 6%.

Service revenue was $3.7 billion, up 8%.

Infrastructure Platforms has rebounded nicely, with revenues up 6%. Within that, switching revenue increased overall, with growth in campus driven by strong double-digit growth of our Catalyst 9K products. Routing had strong double-digit growth, driven by strength in the service provider market. Wireless had strong growth, driven by the continued ramp of our WiFi 6 products and strength in Meraki. Data center revenue declined, driven primarily by servers, as we experienced continued market contraction.

Applications were up 5%. We continue to see double-digit growth in Webex, driven by our product innovations and the value we bring to remote working. We saw growth in unified communications, IoT software and AppDynamics, offset by a decline in TelePresence endpoints.

Security was up 13%, with growth across the entire portfolio. Our cloud security portfolio performed well, with strong double-digit growth and continued momentum of our Duo and Umbrella offerings.

We continued to transform our business, delivering more software offerings and driving growth in subscriptions and recurring revenue. Software revenue was $3.8 billion and subscriptions were 81% of total software revenue, up 7 points year over year. As we continue to increase our software subscriptions, we're driving higher levels of recurring revenues. In fact, the majority of our total revenue growth in the quarter came from recurring revenue streams. Additionally, the strength of our portfolio and transition to more software and services is driving growth in remaining performance obligations, or RPO. At the end of Q3, RPOs were $28.1 billion, up 10%. RPO for product was up 15% and for service was up 7%.

There was a 90 basis point positive impact on revenue growth in the quarter related to the acquisitions of Acacia and IMImobile, which both closed during the quarter. As a reminder, these acquisitions were not factored into our Q3 revenue guide.

We had strong order momentum in Q3 with total product orders up 10%. Looking at our geographies, the Americas were up 6%, EMEA was up 10% and APJC was up 31%. Total emerging markets were up 13%, with the BRICS plus Mexico up 31%. In our customer segments, Service Provider was up 17%, commercial was up 16%, public sector was up 11%. Enterprise was flat, which is a significant improvement from last quarter.

Non-GAAP total gross margin came in at the high end of our guidance range at 66%, down 60 basis points year-over-year. Product gross margin was 64.9%, down 90 basis points, and service gross margin was 68.7%, down 20 basis points. The decrease in product gross margin was largely driven by ongoing costs related to the supply chain challenges, offset by positive product mix, which includes some software benefit. Price erosion was relatively moderate and in line with our historical range.

On the supply chain front, we continue to manage through the constraints seen industry-wide and continue to incur additional costs. We are partnering with our key suppliers, leveraging our volume purchasing and extending supply commitments as we address the supply chain challenges, which we expect will continue.

The quarter did include an extra week, as we discussed on our last call. Consistent with our guidance for the quarter, the benefit to total revenue was approximately 3 points of growth. Total impact on our cost of sales and operating expenses was approximately $150 million.

Operating cash flow was $3.9 billion, down 8%, driven by the timing of payments and restructuring costs. We expect operating cash flow to normalize for the full fiscal year.

We ended Q3 with total cash, cash equivalents and investments of $23.6 billion, down $7 billion sequentially, driven by $5.5 billion in payments for acquisitions, as well as $3 billion in repayments of our long-term debt.

From a capital allocation perspective, we returned $2.1 billion to shareholders during the quarter. It was comprised of $1.6 billion for our quarterly dividend and $510 million of share repurchases. Year-to-date, we returned $6.7 billion to shareholders, which represents 64% of our free cash flow, and we have $8.7 billion in capacity remaining under our current share repurchase program authorization.

We continue to invest organically and inorganically in our innovation pipeline. During Q3, we closed three acquisitions: Acacia Communications, IMImobile and Dashbase. Subsequent to the end of the quarter, we also successfully closed on our acquisition of Slido on May 4. These investments are consistent with our strategy of complementing our internal innovation and R&D with targeted M&A to allow us to further strengthen and differentiate our market positions in our growth areas.

To summarize, we had a great Q3. We executed well, with strong top line growth and profitability. We're seeing returns on the investments we're making in innovation and driving the continued shift to more software and subscriptions, delivering growth and driving shareholder value.

Guidance

Now let's turn to our guidance for the fourth quarter of fiscal '21. This guidance is subject to the disclaimer regarding forward-looking information that Marilyn referred to earlier.

Our financial guidance for Q4 is as follows: We expect revenue growth to be in the range of 6% to 8% year-on-year, reflecting again the strong demand we're seeing. We anticipate the non-GAAP gross margin to be in the range of 64% to 65%, reflecting the ongoing increase in supply chain costs we're incurring as we protect shipments to our customers. Our non-GAAP operating margin is expected to be in the range of 32% to 33% and the non-GAAP tax rate is expected to be 19%. Non-GAAP earnings per share is expected to range from $0.81 to $0.83.

Looking ahead, we're excited to announce we will host a virtual Cisco Financial Analyst Day on Wednesday, September 15, 2021. We will post event details in the coming weeks and look forward to sharing more with you at that time.

Summary Comments

All right, let me just wrap up by first and foremost thanking all of you for spending time with us today. And despite the predominant discussion point here, which has been around gross margins relative to the supply chain, I hope our confidence came across, and that we feel really good about the portfolio, we feel really good about the reopening, we feel good about our teams. I'm really proud of what they've accomplished. Look, I'm really pleased that our customers are choosing to spend their dollars with us as they come back. I think that's a great statement of confidence. And I think that it also proves that we are going to be critical to the rebound and the recovery and the return to office. So thanks for being with us, and we look forward to spending time with you all, and I'm going to kick it back to Marilyn.

Closing

Thanks, Chuck. Cisco's next quarterly earnings conference call, which will reflect our fiscal 2021 fourth quarter and annual results, will be on Wednesday, August 18, 2021, at 1:30 p.m. Pacific Time, 4:30 p.m. Eastern Time.

As a reminder, we will be presenting and hosting meetings at several conferences over the next few weeks. Please visit the Cisco Investor Relations website for the latest event schedule and access information.

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 is done through an explicit public disclosure.

We now plan to close the call. If you have any further questions, please feel free to contact the Cisco investor relations team, 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 continued execution of our strategy, our ability to lead the next phase of the recovery as our customers accelerate their adoption of hybrid work, digital transformation, cloud, continued strong uptake of our subscription-based offerings, our investments in innovation, and accelerated shift to more software offerings and subscriptions) and the future financial performance of Cisco (including the guidance for Q4 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, other intellectual property, antitrust, stockholder and other matters, and governmental investigations; our ability to achieve the benefits of the 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 February 16, 2021 and September 3, 2020, 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 nine months ended May 1, 2021 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.