

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]
Q2FY23 Earnings Results Conference Call
Wednesday, February 15, 2023

Introduction

Welcome, everyone, to Cisco's second quarter fiscal 2023 quarterly earnings conference call. This is Marilyn Mora, Head of Investor Relations, and I am joined by Chuck Robbins, our Chair and CEO; and Scott Herren, our CFO.

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

Income statements, full GAAP to non-GAAP reconciliation information, balance sheets, cash flow statements and other financial information can also be found in the Financial Information section of our Investor Relations website.

Throughout this conference call, we will be referencing both GAAP and non-GAAP financial results and we 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 done on a year-over-year basis.

The matters we will be discussing today include forward-looking statements, including the guidance we will be providing for the third quarter and full year of fiscal 2023. They are subject to the risks and uncertainties that we discuss in detail in our documents filed with the SEC, specifically the most recent reports on Forms 10-K and 10-Q, which identify important risk factors that could cause actual results to differ materially from those contained in the forward-looking statements. With respect to guidance, please also see the slides and press release that accompany this call for further details. Cisco will not comment on its financial guidance during the quarter unless it is done through an explicit public disclosure.

I will now turn it over to Chuck.

Opening Remarks

Thanks, Marilyn. I hope everyone is doing well.

With the tremendous results we delivered in the first half of the year, fiscal '23 is shaping up to be very strong, fueled by demand for our cloud-driven networking portfolio, our continued business transformation success and an improving supply situation, thanks in large part to our team's aggressive actions.

Before I dive into additional details on the quarter, I want to take a moment to say how incredibly proud I am of the team here at Cisco. While the environment we are operating in remains dynamic, Cisco is better positioned today than at any time since I became CEO almost eight years ago. We have reshaped and transformed the company and our portfolio while remaining highly disciplined, both financially and operationally. This gives me great confidence that we will continue to succeed in the long term.

Now I will touch on the quarter in more detail. Our Q2 financial results were strong as we again exceeded the high end of our guidance ranges. We delivered our second-highest quarterly revenue of \$13.6 billion, up 7%, and record non-GAAP EPS at \$0.88. We also delivered solid ARR growth, sequential non-GAAP margin expansion and record non-GAAP net income.

In terms of our business model shift, we continue to make great progress with 10% growth in software revenue and with software subscription revenue up 15%. Recurring revenue also now represents 44% of our total revenue. In addition, we have built up nearly \$32 billion in remaining performance obligations. And our backlog remains robust. Even as we drew down backlog by 6% sequentially, our total backlog still grew year-over-year. These metrics along with our increasing visibility led us to raise our full year outlook, which Scott will address in a moment.

This quarter, we also achieved record operating cash flow, enabling today's dividend increase and the buyback of over \$1 billion. We continue to deliver on our commitment to drive returns to our shareholders.

Let me also provide an update on the supply situation. While components for a few product areas remain highly constrained, we did see an overall improvement. Combined with the aggressive actions our supply chain and engineering teams took to redesign hundreds of our products, we increased product deliveries and saw significant reductions in customer lead times. As our product deliveries increased, channel inventories also declined as our partners were able to complete customer projects.

Like I shared last quarter, as supply constraints ease and lead times shorten, we expect orders would normalize from previously elevated levels as customers return to more typical buying patterns. As a result, sequential quarterly order growth is a better indicator than year-over-year growth. And in Q2, despite improving lead times, our quarter-over-quarter order growth was again in line with our historical ranges across most of our geographies and customer markets.

With that, let me touch on what we are seeing with customer demand. In our customer markets, we experienced normal double-digit sequential growth in both our Enterprise and Commercial markets while Public Sector performed better than we have seen historically. Within our Service Provider business, our order rate was below recent sequentials as some customers are absorbing the improved delivery of our products into their production environments.

We saw another consecutive quarter of rapid adoption of our 400-G, Cisco 8000 and Silicon One platforms. This reflects the ongoing investments our customers are making in our innovative solutions and AI-optimized infrastructure.

Within webscale, while we saw overall slowing due to normalizing product lead times, two of our largest customers grew their orders with us over 40% in the first half of fiscal '23. We continue to take share in this space and over the past few years, we have grown our webscale cloud infrastructure from effectively zero into a multi-billion-dollar run rate business. I am incredibly pleased about the overall progress we've made as we are continuing to win more and more use cases within their infrastructure. We are also still at the beginning of what we believe to be a massive growth opportunity going forward.

While we continue to closely monitor the global macroeconomic conditions, the overall demand environment remains steady and on par with Q1 and our pipeline and win rates remain stable.

Looking at the broader landscape, digital transformation and hybrid cloud remain top areas of spend, which is fueling growth across our portfolio. Many customers have told me that while their spend levels may be slowing in some areas, technology remains essential as it is vital to their overall business resilience, competitive differentiation, and success. In fact, Gartner and IDC's most recent surveys make it clear that technology budgets are growing as they forecast IT spend to increase in the mid to high single digits in 2023.

We are also seeing many customers moving ahead with their hybrid work, AI and ML investments while building the modern infrastructure they need to deliver on their objectives. IoT has also been accelerating. We saw record revenue growth in Q2 as customers look to connect their industrial systems in order to optimize power consumption, automation and efficiency. Lastly, cybersecurity and full stack observability remain strategic priorities where we continue to invest and innovate.

From a product revenue perspective, we saw strong double-digit growth for Catalyst 9000, enterprise routing, Wireless, Meraki, Duo and ThousandEyes, reflecting the ongoing investments our customers are making to modernize their infrastructure to rapidly digitize and secure their organizations.

We are increasing our investments in our cloud management platforms that deliver the simplicity our customers need. You will see us continue to bring AI and ML into those platforms to further simplify how networks are managed. For example, in Q2, we announced several new innovations across our cloud managed networking and security portfolios that offer greater visibility with AI-driven insights, enable secure connectivity and give our customers the ability to simplify their IT operations.

Last week, we introduced a preview of our cloud-native Full Stack Observability platform, the first network visibility solution to support open telemetry. This platform brings together our ThousandEyes and AppDynamics capabilities for unmatched data correlation and insights from the user to the application to the network. To simplify network security and policy management, our unified SASE solution, Cisco+ Secure Connect, now supports integration into Cisco SD-WAN fabrics using Viptela technology as well as our existing Meraki SD-WAN fabric.

We also introduced new flexible, more powerful and energy-efficient servers which not only help lower cost, but also help our customers meet their sustainability goals, an increasingly critical area for most of our customers.

To close, I am proud of what we achieved this quarter. We delivered a strong financial performance, innovated across our portfolio and continued to make great progress on our business transformation. In addition, the increased visibility we have from almost \$32 billion in RPO, a healthy backlog and pipeline and improving supply give us the confidence to raise our full year outlook. We expect those same factors to continue into fiscal year '24, giving us conviction in our ability to deliver on our commitments.

The modern, resilient and secure networks we are building serve as the backbone of our customers' technology strategy. Cisco is well positioned to benefit from multiyear investment cycles with our market-leading hardware as well as our innovative software and services. Together, these allow our customers to digitize rapidly, secure their environments and achieve their sustainability goals, all while delivering differentiated experiences.

Now I will turn it over to Scott.

Financial Overview

Thanks, Chuck.

We delivered another strong quarter and exceeded both our top and bottom-line expectations, driven by our focused execution, continued success of our business transformation and improved availability of supply as the actions our supply chain team have taken over the last several quarters are bearing fruit. Total revenue was \$13.6 billion, up 7%. Non-GAAP net income was a record \$3.6 billion. And non-GAAP earnings per share, also a record, was \$0.88.

Looking at our Q2 revenue in more detail:

Total product revenue was \$10.2 billion, up 9%. Service revenue was \$3.4 billion, up 2%. Within product revenue, Secure, Agile Networks performed very well, up 14%. Switching revenue grew in the double digits, with strength in campus switching driven by our Catalyst 9000 and Meraki offerings. While data center switching declined slightly, we saw strong growth in our Nexus 9000 offerings. Enterprise routing had double-digit growth, driven primarily by strength in our Catalyst 8000 Series routers, SD-WAN and IoT routing. Wireless had very strong double-digit growth, with strength across the entire portfolio.

Internet for the Future was down 1%, driven by declines in Optical and Edge. We saw growth in our Cisco 8000 offering and double-digit growth in webscale.

Collaboration was down 10%, driven by declines in Meetings and Collaboration Devices, slightly offset by growth in Contact Center.

End-to-End Security was up 7%, driven by our Unified Threat Management and Zero Trust offerings.

Optimized Application Experiences, was up 11%, driven by double-digit growth in our SaaS-based offering, ThousandEyes.

We made solid progress on our transformation metrics as we shift our business to more recurring revenue-based offerings, driven by higher levels of software and subscriptions.

We saw strong performance in our ARR of \$23.3 billion, which increased 6% with product ARR growth of 11%.

Total software revenue was \$4.2 billion, an increase of 10%, with software subscription revenue up 15%. 84% of the software revenue was subscription-based, which is up 4 percentage points year-over-year. We continue to have \$2 billion of software orders in our product backlog.

Total subscription revenue was \$6 billion, an increase of 9%. Total subscription revenue represented 44% of total revenue.

RPO was \$31.8 billion, up 4%. Product RPO increased 7%, and service RPO increased 2%, and total short-term RPO grew to \$16.9 billion.

While total product orders were down 22%, they compared against 34% growth in Q2 fiscal '22, which was one of the largest quarters for product orders in our history. We saw year-over-year declines across our geographies and customer markets. Sequentially, total product order growth was in line with our historical growth rates. Within our customer markets, we experienced double-digit sequential growth in both Enterprise and Commercial, and Public Sector was better than we have seen historically. We continue to have very low order cancellation rates, which remain below pre-pandemic levels.

Total non-GAAP gross margin came in at the high end of our guidance range at 63.9%, down 160 basis points and up 90 basis points sequentially. Product gross margin was 62.1% down 220 basis points year-over-year and up 110 basis points sequentially. Service gross margin was 69.1%, up 30 basis points. In our product gross margin, the year-over-year decrease was primarily driven by higher component and other costs. This was partially offset by our strong product mix and positive pricing as the benefits of the actions we took in the prior fiscal year flowed through as we shift our backlog.

Non-GAAP operating margin came in at the high end of our guidance range at 32.5%, down 180 basis year-over-year and up 70 basis points sequentially. The year-over-year decline was primarily driven by the higher component and other costs that I just mentioned.

Backlog for both our hardware and software products continue to far exceed historical levels. As we navigated a complex supply environment, we were able to draw down total backlog by 6% sequentially, although it still grew year-over-year. Just a reminder, backlog is not included as part of our \$31.8 billion in remaining performance obligations. Combined, our significant product backlog and RPO continued to provide great visibility to our topline.

Shifting to the balance sheet, we ended Q2 with total cash, cash equivalents and investments of \$22.1 billion. We had record operating cash flow for the quarter of \$4.7 billion, up 93% year-over-year, driven by strong collections. And we deferred our Q2 federal tax payments due to the IRS tax relief related to the California floods. We expect to pay these federal taxes by the end of the fiscal year.

We returned \$2.8 billion to shareholders during the quarter, which was comprised of \$1.6 billion for our quarterly cash dividend and \$1.3 billion of share repurchases. We also ended the quarter with \$13.4 billion in remaining stock repurchase authorization.

Today, we announced that we are raising our quarterly dividend by \$0.01 to \$0.39 per share, which represents our 13th consecutive increase. This reinforces our commitment to returning a minimum of 50% of free cash flow to our shareholders annually and confidence in the strength and stability of our ongoing cash flows.

To summarize, we had a great quarter, delivering better than expected top and bottom-line performance. We continue to make progress on our business model shift to more recurring revenue while making strategic investments in innovation to capitalize on our significant growth opportunities.

Guidance

Turning now to our guidance. Our guidance ranges reflect our strong pipeline and significant visibility, driven by healthy backlog, ARR, RPO and improving availability of supply as we continue to benefit from the actions our supply chain team have taken over the last several quarters. We expect those same factors will continue into fiscal 2024, giving us greater visibility and confidence in our longer-term goals.

For fiscal Q3, our guidance is:

We expect revenue growth to be in the range of 11% to 13%.

We anticipate the non-GAAP gross margin to be in the range of 63.5% to 64.5%.

Our non-GAAP operating margin is expected to be in the range of 33% to 34% and our non-GAAP earnings per share is expected to range from \$0.96 to \$0.98.

There is also a significant change to our full year fiscal '23 revenue and non-GAAP earnings per share guidance driven by these same factors.

For fiscal year '23:

We are raising our expectations for revenue growth to be in the range of 9% to 10.5% year-on-year.

Non-GAAP earnings per share is expected to range from \$3.73 to \$3.78.

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

Summary Comments

Well, first off, I just want to thank everybody for spending time with us today and also really thank our teams. They delivered on very strong results. I want to thank the supply chain and our engineering teams for quarter after quarter after quarter of hard work and redesigns, over 100 product redesigns, aggressive actions to get us to the position we are in today, the entire company for the progress we have made on our business transformation.

And I will just leave you with our feeling that our demand has remained stable. The business transformation is contributing significantly, our backlog, all of those give us the visibility and confidence in the future. I think the relevance of our portfolio, given the most pressing needs of our customers, is as high as it's been in a very long time, and I'm super proud of what our teams have accomplished. So look forward to talking to you in the future, and thanks for joining us today.

Closing

Thanks Chuck. Cisco's next quarterly earnings conference call, which will reflect our fiscal 2023 third quarter results, will be on Wednesday, May 17, 2023 at 1:30 p.m. Pacific Time, 4:30 p.m. Eastern Time.

This concludes today's call. If you have any further questions, feel free to reach out to 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 the success of our ongoing business transformation and operational discipline, the growth of our recurring revenue base and RPO, our healthy backlog, steps taken to improve the supply situation, strength of our cash flow generation, and commitment to shareholder returns) and the future financial performance of Cisco (including the guidance for Q3 FY

2023 and full year FY 2023) that involve risks and uncertainties. Readers are cautioned that these forward-looking statements are only predictions and may differ materially from actual future events or results due to a variety of factors, including: the impact of the COVID-19 pandemic and related public health measures; business and economic conditions and growth trends in the networking industry, our customer markets and various geographic regions; global economic conditions and uncertainties in the geopolitical environment; overall information technology spending; the growth and evolution of the Internet and levels of capital spending on Internet-based systems; variations in customer demand for products and services, including sales to the service provider market and other customer markets; the return on our investments in certain priorities, key growth areas, and in certain geographical locations, as well as maintaining leadership in Secure, Agile Networks and services; the timing of orders and manufacturing and customer lead times; significant supply constraints; changes in customer order patterns or customer mix; insufficient, excess or obsolete inventory; variability of component costs; variations in sales channels, product costs or mix of products sold; our ability to successfully acquire businesses and technologies and to successfully integrate and operate these acquired businesses and technologies; our ability to achieve expected benefits of our partnerships; increased competition in our product and service markets, including the data center market; dependence on the introduction and market acceptance of new product offerings and standards; rapid technological and market change; manufacturing and sourcing risks; product defects and returns; litigation involving patents, other intellectual property, antitrust, stockholder and other matters, and governmental investigations; our ability to achieve the benefits of restructurings and possible changes in the size and timing of related charges; cyber-attacks, data breaches or malware; vulnerabilities and critical security defects; terrorism; natural catastrophic events (including as a result of global climate change); any other pandemic or epidemic; our ability to achieve the benefits anticipated from our investments in sales, engineering, service, marketing and manufacturing activities; our ability to recruit and retain key personnel; our ability to manage financial risk, and to manage expenses during economic downturns; risks related to the global nature of our operations, including our operations in emerging markets; currency fluctuations and other international factors; changes in provision for income taxes, including changes in tax laws and regulations or adverse outcomes resulting from examinations of our income tax returns; potential volatility in operating results; and other factors listed in Cisco's most recent reports on Forms 10-Q and 10-K filed on November 22, 2022 and September 8, 2022, respectively. The financial information contained in this release 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 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.