Q2 2021 Earnings Call

Company Participants

- Chuck Robbins, Chairman and Chief Executive Officer
- Marilyn Mora, Head of Investor Relations
- R. Scott Herren, Executive Vice President and Chief Financial Officer

Other Participants

- Ittai Kidron, Analyst
- James Suva, Analyst
- Jeff Kvaal, Analyst
- Meta Marshall, Analyst
- Paul J Silverstein, Analyst
- Pierre Ferragu, Analyst
- Rod Hall, Analyst
- Sami Badri, Analyst
- Samik Chatterjee, Analyst
- Simon Leopold, Analyst
- Tal Liani, Analyst
- Tim Long, Analyst

Presentation

Operator

Welcome to Cisco's Second Quarter Fiscal Year 2021 Financial Results Conference Call. At the request of Cisco, todays conference is being recorded, if you have any objections you may disconnect.

Now, I would like to introduce Marilyn Mora, Head of Investor Relations. Ma'am, you may begin.

Marilyn Mora {BIO 19771101 <GO>}

Welcome everyone to Cisco's second 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 I'm very pleased to welcome 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 sheet, 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 third quarter of fiscal 2021.

They are subject to the risks and uncertainties including cold in 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.

With that, I'll now turn it over to Chuck.

Chuck Robbins {BIO 17845882 <GO>}

Thanks Marilyn. First of all, I hope that all of you and your families are safe and healthy. This year is full of promise, as vaccines give us a path to healing and recovery. We are optimistic about the future and look forward to what lies ahead. This past quarter, our team delivered strong performance with revenues coming in at the top of our guidance range and non-GAAP EPS landing above the high end of our expectations, all supported by margin expansion and a further strengthening of our balance sheet.

More importantly, we are seeing encouraging signs of strength across our business as the recovery takes shape, with all customer segments showing improvement in year-over-year growth rates. Our employees and partners have done a remarkable job executing and innovating throughout the pandemic to help our customers connect, secure and automate to accelerate their digital agility in a cloud first world. We are partnering with them on core issues that are essential to their success, business resiliency, modernizing their IT environments and embracing secure hybrid work.

Over the past year, our customers have relied on our innovation to accelerate their digital and cloud capabilities, while protecting them from an expanding threat environment. In my numerous conversations with customers, it is clear that our technology will be a powerful engine for their recovery and growth, as their technology needs continue to evolve at a rapid pace. Building on the strength of our broad portfolio, we are focused on six strategic pillars that will deliver highly secure next-generation architectures, with unprecedented insights, automation and visibility.

First, we are building networking solutions with built-in simplicity, security, agility and automation that can be consumed as a service. Second, we are optimizing our customers' application experiences, enabling greater speed, agility and scale of cloud native applications and DevOps that deliver the best end-user experience. Third, with the future of work being hybrid, we're delivering highly secure access, a safer workplace and the best collaboration experiences, no matter whether workers are at home or in an office. Fourth, with our customers and partners, we are building the Internet for the future, by transforming connectivity and efficiently meeting the ever-growing demand for low latency and higher speeds. Fifth, with security and privacy a top priority, we are building integrated high-efficacy end-to-end security solutions, that are delivered on-prem or in the cloud. Lastly, as apps and workloads move closer to users and devices, we are developing new edge capabilities for a distributed world, while enhancing the developer experience and extending enterprise and carrier networks. I'm confident that this is the right strategy to deliver the innovation and integrated network solutions that our customers need, no matter what the future holds.

Now, moving to our performance this quarter. We continue to see signs of gradual improvement, led by order growth in our Commercial, Public Sector and Service Provider businesses, which together account for nearly three quarters of product orders. The Enterprise market remains soft, driven by some elongated sales cycles and a continued pause in spending among some customers brought on by the pandemic. From a product revenue perspective, we saw strength in our Catalyst 9K, data center switching, security, wireless and Webex portfolios.

The transformation of our business to more software and subscriptions continues to show great progress, as we achieved $3.6 billion in software revenue with 76% of our software revenue sold as a subscription. We also saw our sixth consecutive quarter of double-digit growth in our deferred product revenue. We continue to accelerate our pace of innovation, delivering unique solutions and digital capabilities as we invest in, flexible consumption models. I am confident in our ability to capture the long-term opportunities ahead, in areas such as cloud, 400 gig, 5G, security, hybrid work and next-generation applications.

Looking ahead, we are cautiously optimistic, as recent surveys of IT spending indicate year-over-year IT budget growth for calendar 2021 and Cisco remains well-positioned among CIOs top forward-looking spending priorities, including network infrastructure, cyber-security software, as well as cloud migration and cloud infrastructure. We are also mindful and vigilant about the uncertainty of the pandemic and its influence in the market, which is not fully behind us yet.

Now, let me touch on Infrastructure Platforms. To manage the highly distributed and complex nature of modern IT environments, our customers must fundamentally change how their networks are architected. To help them achieve this, we are building a unified cloud-native platform suite, to deliver secure agile networking. A good example of this is our subscription-based Intent-Based Networking portfolio and is reflected in the momentum of our Catalyst 9K family, which saw another quarter of double-digit revenue growth.

We are also delivering full-stack observability from the application to the infrastructure, to give our customers greater insights for faster, better decision making. We are doing this through key elements of our portfolio, like inter-site, ThousandEyes and AppDynamics, as well as our leading security innovations. As a global leader in transport network infrastructure, we are playing an important role in helping customers build their networks for the future. We continue to invest heavily to capture 5G, 400 gig and Wi-Fi 6 transitions to enable Open-RAN and edge services. This is reflected in our SD WAN portfolio, routing, 5G mobile core platforms, optics and automation capabilities.

In our web scale business, we delivered our fifth consecutive quarter of very rapid order growth, increasing to triple digits. And on a trailing 12-month basis, our orders grew over 60%, as we focus on delivering routing, data center switching and optical platforms, built on Cisco Silicon One, which had a -- has a better efficiency over other silicon on the market. While we could see our performance vary quarter to quarter, due to the timing of large deals, we are incredibly confident in our ability to further strengthen our position.

By building a network on Silicon One, our customers can also save up to 30% of network switching power, resulting in a meaningful reduction in their environmental footprint, as well as significant energy cost savings. Our agreement to acquire Acacia will enable us to deliver leading-edge optical technology, to meet both the bandwidth requirements and the economics of next generation networks, which is critical to providing high-speed connectivity. This is just another reason why I'm so confident we will continue to win in the web scale space.

As I've mentioned, we plan to transition the majority of our portfolio to be cloud-driven, cloud-managed and delivered as a service. If we can deliver from the cloud, we will. For example, we are looking at offering SD WAN plus cloud security as a service, along with creating other new solutions. We will also provide simplified end-to-end networking with security, reliability control and automation, plus seamless on-ramp capabilities to the cloud that no one else can deliver.

Moving to Security. We delivered another strong quarter of revenue growth, driven by increasing adoption of our next-generation cloud-based architectures which can enable fast secure access to applications and data from anywhere. With the rapid growth in modern applications and more distributed work environments, our customers are adopting new security architectures, as identity and data privacy are increasingly critical. The recent SolarWinds breach only highlights the urgent need for advanced threat defense.

Our comprehensive Security portfolio offers simplified protection for any workload on any cloud, while minimizing the attack surface and automating security policies across an organizations hybrid cloud footprint. This extends to our Secure Access Service Edge framework and zero trust architecture, where we have developed a best-in-class cloud-delivered Stack across Umbrella, secure Internet Gateway, Meraki SD-WAN and Viptela. We are also delivering leading unified detection and response capabilities built on Cisco SecureX, our cloud-native platform. Over 5,400 customers are already seeing the benefits of this platform, since it became generally available last June. We remain committed to delivering simple, integrated and highly effective end-to-end security solutions, delivered on-prem and in the cloud.

Turning to applications, which includes our collaboration portfolio. We are focused on building solutions that will enable an engaged productive workforce and an intelligent workplace, built with secure collaboration, automation and insights. Our aim is to deliver the best collaboration experience for our customers, no matter where they are. Our strong momentum with Webex continued, resulting in double-digit revenue growth. I'm so proud of the work the Webex team has done to ensure our nearly 600 million quarterly average users are able to stay connected and productive. In addition, we are connecting over 6 billion calls every month for our customers around the world.

We are bringing incredible innovation to the collaboration market at an unprecedented pace. Our goal is to deliver a 10X better experience than just in-person interactions. At our recent Webex one event, we introduced more than 50 new product and feature innovations, integrating security and privacy to deliver inclusive experiences. Some of the new powerful capabilities we announced include, noise cancellation, real-time language translation and our Webex Desk Pro series platforms. Our recently announced intent to acquire cloud-based IMImobile and Slido, furthers our vision of building a Webex suite of applications as we combine these technologies with our Webex contact center to improve customer interactions.

In summary, our strategy is clear and our business remains strong. We are executing and innovating with speed and delivered solid results with our Q2 revenue coming in at the high-end and earnings coming in above our stated guidance. As we move into the gradual recovery phase, we believe our customers will continue to turn to Cisco as their partner of choice. I am so proud of what our teams have achieved. The incredible innovation and trusted partnerships we are building will serve us well in the years ahead. While the past year has highlighted far too many inequities in our society, we believe in the power of technology to drive more inclusivity and opportunity to underserved populations and communities around the world. Which is why we are committed to powering an inclusive future for all.

With our ongoing disciplined approach to investment and innovation, we expect to be in an even stronger position post-pandemic, as our customers look to deploy their next-generation networks at the heart of their organizations. I firmly believe Cisco is well-positioned to capture the long-term growth opportunities ahead and win for years to come.

I'll now turn it over to Scott, our new CFO, to walk through our financial results. As you know, Scott has strong experience in software and a proven track record of leading successful business model transitions, from perpetual licenses to SaaS and recurring subscriptions. Scott is proving to be a powerful addition to our team, and I look forward to partnering with him, as we plan the next phase of Cisco's continued transformation.

Scott, over to you.

R. Scott Herren {BIO 18902845 <GO>}

Thanks, Chuck. Let me start by saying how excited I am to join the Cisco team at such a pivotal time in the Company's transformation. Before turning to our performance in the quarter, I thought I'd share my initial observations and key priorities. I'm impressed by the team here at Cisco and the progress the Company has made on its transformation, achieving the goals laid out three years ago of driving 50% of our revenue from software and services. It's also clear that the leadership team is unified and focused and at the strategies Chuck laid out earlier in the call, will drive our growth over the next several years. It's an exciting time to be joining the Company in this role.

In terms of my key priorities, they include the following: 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. I'm also committed to providing you the insight and metrics needed to understand and properly value our business longer term.

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 Q3. Our overall Q2 results reflect very good execution with strong margins and growth in non-GAAP net income and earnings per share in a continuing challenging environment. Total revenue of $12.0 billion came in at the top of our guidance range, flat year-over-year, as we see gradual recovery in several key product areas and sequential growth rate improvement in two out of three of our geographies. Our non-GAAP operating margin was 34.4% up 70 basis points, non-GAAP net income was $3.4 billion, up 2% and non-GAAP earnings per share was $0.79, coming in above the high-end of our guidance range and up 3% year-over-year.

Now, let me provide some more detail on our Q2 revenue. Total product revenue was $8.6 billion, down 1%. Infrastructure Platforms was down 3%. As a reminder, this is the product area most impacted by the COVID environment. Switching revenue was flat overall. We saw solid growth in data center switching, with strong growth of the Nexus 9K. We also saw continued strong momentum of the Cat 9K products within campus switching. Routing declined driven by weakness in Service Provider. Wireless had solid growth driven by the continued ramp of our Wi-Fi 6 products and strength in Meraki. Data center revenue declined, driven primarily by servers, as we experienced continued market contraction.

Applications was flat overall. We continue to see strong double-digit growth in Webex, driven by our continuing product innovations and the criticality of remote-working. This was offset by declines in Unified Communications and TP endpoints. Security was up 10%, with growth across the portfolio. Our Cloud Security portfolio performed well, with strong double-digit growth and continued momentum of our Duo and Umbrella offerings. Service revenue was up 2% driven by growth in our maintenance business, as well as solution support. And we continue to transform our business, delivering more software offerings and driving more subscriptions.

Software subscriptions were 76% of total software revenue, up 4 points year-over-year, as Chuck mentioned earlier. Remaining Performance Obligations or RPO at the end of Q2 were $28.2 billion, up 13%. RPO for product was up 17% and for service was up 10%. The continued growth in RPO demonstrates the strength of our portfolio of software and services and is another indicator of the broad recovery we see happening. In terms of orders in Q2, total product orders were up 1%, a significant improvement from Q1.

Looking at our geographies. The Americas was down 1%. EMEA was up 7% and APJC was down 5%. Total emerging markets were down 14% with the BRICS plus Mexico down 11%. In our customer segments, Public Sector was up 10%, Service Provider was up 5% and Commercial was up 1% and Enterprise down 9%. Non-GAAP total gross margin was 66.9%, up 50 basis points. Product gross margins were 66.6%, up 70 basis points and Service gross margin was 67.9%, up 20 basis points year-over-year. The growth in product gross margin was driven by positive product mix, including some software benefit and productivity improvements, partially offset by pricing.

In terms of the bottom line from a GAAP perspective, Q2 net income was $2.5 billion and earnings per share was $0.60. We ended Q2 with total cash, cash equivalents and investments of $30.6 billion, up $600 million sequentially. Operating cash flow was $3 billion, down 22% as expected, driven by a lower beginning receivables balance for the quarter, timing of payments and the restructuring payments. We expect operating cash flow growth to normalize over the course of the fiscal year.

From a capital allocation perspective, we returned $2.3 billion to shareholders during the quarter, that was comprised of $1.5 billion for our quarterly dividend and $800 million of share repurchases. Year-to-date, we've returned $4.6 billion to shareholders, which represents 69% of our free cash flow. And today, we announced a $0.01 increase to the quarterly dividend to $0.37 per share, up 3% year-over-year. This dividend increase reflects the 10th consecutive year of increasing our dividend and reinforces our commitment to returning capital to our shareholders and our confidence in the strength and stability of our ongoing cash flows.

We continue to invest organically and inorganically in our innovation pipeline. During Q2, we announced an amendment to the definitive merger agreement under which we previously agreed to acquire Acacia Communications. We expect to complete the Acacia acquisition in our fiscal Q3, subject to closing conditions, including Acacia stockholder approval. In addition, we announced our intent to acquire IMImobile, the cloud communications software and services company and Slido, a provider of SaaS-based solutions to enhance our Webex platform and our new cloud-native contact center offerings. 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 position in our focused growth areas.

To summarize, we executed well with strong margins and growth in non-GAAP net income and earnings per share growth. We're seeing returns on the investments we're making in innovation and driving the continued shift to more software and subscriptions, delivering long-term growth and shareholder value.

Now, let me reiterate our guidance for the third quarter of fiscal '21. This guidance is subject to the disclaimer regarding forward-looking information that Marilyn referred to earlier. Q3 does include an extra week, which occurs every five to six years. We've factored this extra week into our guidance for both revenue and expenses. Although it's difficult to forecast the impact of the extra week, we have assumed roughly 2% to 3% year-over-year impact on total revenue growth along with approximately $185 million of incremental cost of sales and operating expenses.

The guidance for Q3 is as follows. We expect revenue to be in the range of 3.5% to 5.5% growth year-over-year. We anticipate the non-GAAP gross margin to be in the range of 65% to 66%. The non-GAAP operating margin is expected to be in the range of 33% to 34% and the non-GAAP tax provision rate is expected to be 19%. Non-GAAP earnings per share is expected to range from $0.80 to $0.82.

I'll now turn it back to Marilyn, so we can move into the Q&A.

Marilyn Mora {BIO 19771101 <GO>}

Thanks, Scott. Michelle, let's go ahead and queue up the Q&A.

Questions And Answers

Operator

Thank you. Our first question comes from Meta Marshall from Morgan Stanley. You may go ahead.

Q - Meta Marshall {BIO 18728692 <GO>}

Great, thanks. Maybe I can start off for me, I just wanted to get a sense of where you feel like organizations are implanting for a return to work and what the hybrid workplace looks like? And when do you think that investment will take place in that architecture versus kind of when employees return to the office?Thanks.

A - Chuck Robbins {BIO 17845882 <GO>}

Yeah. Meta, thank you. I think that the -- what we have been operating under is a premise that customers will probably begin to come back to the offices and we have been thinking sort of mid-to-late summer. I think if you're watching the news this morning, you heard some of the New York companies say that they may be September. But, I would suspect that as companies look to prepare their offices for the return, in our case, we've seen significant uptake in Wi-Fi 6, as an example, as they've begun to get ready for that return. We believe that that will require switching infrastructure as people come back to the office and begin to put load on those wireless networks.

We also believe that every meeting in the future is going to be a hybrid meeting, even when people are back in the office. You'll have people in the office and you'll have people remote and in order to accommodate that, we suspect, most of our customers will be putting video units in every conference room they have, which again will also accommodate a hybrid work model, but will also drive bandwidth requirements, which could lead to switching infrastructure. So, that's the way we see it playing out over the next few months.

And we would expect that with some of the solutions we have around worker safety and the collaboration portfolio and the WiFi 6 build outs, that we'll continue to see some progress from our customers as they prepare to return.

Q - Meta Marshall {BIO 18728692 <GO>}

Great, thanks.

A - Marilyn Mora {BIO 19771101 <GO>}

Next question please.

Operator

Thank you. Jim Suva from Citigroup Investment Research. You may go ahead.

Q - James Suva

Thank you very much. Looking at your guidance, I think some investors are asking a little bit about, hey the revenue guidance is up year-over-year, quite impressively off a little bit of easy comps and also an extra week, but the EPS year-over-year, there is not much leverage there, are there additional costs or I think that less travel, is it why there is going to be more flow through to the bottom line of earnings per share?

A - R. Scott Herren {BIO 18902845 <GO>}

Yeah. Thanks, Jim for the question. And I think there's a couple of things you have to bear in mind. Not only does the extra week in Q3 bring along with it additional revenue, it brings along additional spend as well and we touched on this in the opening commentary, it's about $185 million. Our expectation is about $185 million of additional spend. Coming through when you compare year-on-year, coming through from last year, we also have comp plans reset. So, as you'd expect, commissions and bonuses are on a different track this year, than they were last year.

And FX, the weakness of the dollar is having an effect on us as well. So, when you add those up, that's what drops through to the, to the COGS and the OpEx line. We are on track, just to get ahead of maybe what you're next question would have been. We're on track with the $1 billion of savings that we talked about through the restructuring, that continues to go well, almost all of that is behind us at this point, but there is some year-on-year, things that are factoring into our spend rate for this year, for this coming quarter.

Q - James Suva

Thank you, Scott and welcome and thanks for the color and details. Looking forward to working with you. Thanks, Scott.

A - R. Scott Herren {BIO 18902845 <GO>}

And you Jim, thank you.

A - Marilyn Mora {BIO 19771101 <GO>}

Thanks, Jim. Next question please.

Operator

Thank you. Ittai Kidron from Oppenheimer. You may go ahead, sir.

Q - Ittai Kidron {BIO 5557426 <GO>}

Thanks and good luck Scott in your new role. I guess I have a couple of questions, first on the declined 9% in orders on Enterprise. Chuck, can you give us a little bit more color? It seems like a significant lag relative to the orders, when do you expect that to normalize and improve?

And then perhaps a second question more of a bigger picture one for you, Chuck. It's been a, clearly a very difficult year all-around, maybe you could give us a little bit more, the bigger picture perspective that you have here, about the Company. In what way is Cisco here and now, different in the way it operates and thinks and moves going forward versus the Cisco over a year ago, just before heading into the pandemic? I'm trying to understand kind of the lessons learned and how they are implemented and impacting the Company and how should we think about you, differently, going forward?

A - Chuck Robbins {BIO 17845882 <GO>}

Yeah, Ittai thank you. And look at, first of all, I think that if you look at the customer segments, we saw improvement across Service Provider, Commercial and Public Sector and we saw improvement in Enterprise, although it's still negative year-over-year. But, what I would tell you is, from a vertical industry perspective, we did see positive movement from industries that are not directly impacted by the pandemic. Think financial services, think manufacturing, think Technical Services and then those that are still in the midst of the pandemic continue to struggle, hospitality, retail, transportation, energy and so, I think from that perspective, it gives us confidence that, as we come out of this thing, that those industries that are being depressed by the pandemic will obviously look to the future and will recover as well.

So, the other thing that we've reflected on, is that, when we came out of the 2008 crisis, we saw Commercial lead and then Enterprise followed, and it's just been a really good sign in the US commercial business this past quarter grew 6% from an orders perspective, which I think is a nice bounce and obviously it was 1% globally. But, seeing that go positive gives us also confidence in the future of the Enterprise following.

As it relates to the bigger picture, I think we've talked a lot about giving our customers' consumption flexibility. Earlier in my comments, I actually outlined six strategic pillars that we're all focused on. I'd say that we are super optimistic about the progress we've made in the web scale space. We continue to deliver on our software revenues, which were $3.6 billion this quarter and again 76% of it coming from software. And I think that will only increase.

So, I think that those six pillars combined with more flexibility and consumption options for our customers and continued transition to software and a continued focus on web scale and and other growth opportunities, is what we're trying to do over the next two to three years.

Q - Ittai Kidron {BIO 5557426 <GO>}

Very good. Good luck.

A - Marilyn Mora {BIO 19771101 <GO>}

Thanks Ittai. Next question.

Operator

Thank you. Paul Silverstein from Cowen & Company. You may go ahead.

Q - Paul J Silverstein {BIO 1812254 <GO>}

Thanks for taking the questions. Scott, can you tell us what the rate of price degradation was, in conjunction with that, any thoughts in terms of the mortgage structure of the Company, both the gross and operating line as to both resiliency and even hopefully better as to upside in where you can drive that from?

A - R. Scott Herren {BIO 18902845 <GO>}

Yeah. Thanks, Paul. The pricing mix was really in-line with what we've seen over the last several quarters. And you'll see this next week, obviously in the queue, but I'll go ahead and give you the data point, it was 1.6% for the second quarter, slightly better actually than what we had seen in Q1 and actually modestly better than what we've seen over the trailing four quarters. So, pricing mix was as expected during the second quarter. I think as you look longer-term, the gross margin is going to bounce around a little, it always does. I think part of what is factoring into our view of gross margin ahead is the -- the benefit of a greater mix of software and services in there, being somewhat offset by some of the supply chain concerns that we have right now, that I think you've seen, not just from us, but from everyone who is building products that contain a significant amount of semiconductors.

So, we are -- we're doing what you would expect us to do on the supply chain front. We are contacting all of our key suppliers on that front. We're leveraging kind of the volume purchase that we have, extending that supply chain further out, all with the goal of ensuring we can protect customer shipments. So, there's a little bit of a headwind coming in those lines from the just the supply -- the current supply chain.

Q - Paul J Silverstein {BIO 1812254 <GO>}

Scott, I trust all the supply chain commentary, that's a transitory issue, that's going to pass. If we look beyond, assuming the orders is back to normal, it sounds like you'd be net debt out, there should be a positive trajectory at some point?

A - R. Scott Herren {BIO 18902845 <GO>}

I think that's right. I mean, we've talked about growing the percent of our business and you've seen Cisco do a really nice job of growing the percent of the business coming from software and services and obviously that comes through at a higher margin.

Q - Paul J Silverstein {BIO 1812254 <GO>}

Appreciate it. Thank you.

A - Marilyn Mora {BIO 19771101 <GO>}

Next question please.

Operator

Thank you. Pierre Ferragu from New Street Research. You may go ahead.

Q - Pierre Ferragu {BIO 15753665 <GO>}

Hey, thank you for taking my question. Scott, I have a question for you on your gross margin. I was just checking my model and I think the 66.9% you reported this quarter, is actually a record for as far back as my memory goes limits. I think it goes back quite far, so congratulations for like, a great stuff on that front. And my question is actually, how should we think about gross margin in this transition you want to accelerate and continue throughout the cloud, are we now in a phase where we should expect gross margins to add up over time, with ups and down of course, but should we expect like margin -- structural margin expansion going along with you -- with your transformation?

A - R. Scott Herren {BIO 18902845 <GO>}

Yeah, again Pierre, your model must go back to our fiscal 2006, because this was the highest gross margin we've reported since second quarter of 2006. So you're right, from that standpoint. And again, I would just in terms of where this goes longer term, I expect there to be a little bouncing around over the next couple of quarters, given some of the supply chain concerns that everyone that's building product based on semis and a slight headwind though from memory, but I think everyone in the market is going to see that same set of trends, longer term again, as we drive up the mix of software and services, that should have a positive impact on gross margins.

Q - Pierre Ferragu {BIO 15753665 <GO>}

Great. And maybe if I have a quick follow-up on the same theme. You mentioned expanding is a transition, what's up next for grab for you to evolve into the product portfolio to increase the share of technology that you deliver, as a service and cloud-based?

A - Chuck Robbins {BIO 17845882 <GO>}

Hey Pierre, It's Chuck. I'll take that one. And Scott is pretty proud of the immediate impact he had by delivering the record gross margins, being here very short time.

A - R. Scott Herren {BIO 18902845 <GO>}

I'm very impressed.

A - Chuck Robbins {BIO 17845882 <GO>}

Yeah exactly high impact. So, I think on the, as you look at the as a service offerings, what we're going to do is take -- were taking intellectual property we have in our core enterprise portfolio, we're delivering a lot of that as both cloud-delivered, as well as cloud-managed. Think about what we've done with the whole discussion we've had over the years about the Meraki platform and how we bring those capabilities to the rest of the portfolio. Taking technologies like SD-WAN and cloud security and integrating those together and delivering those as a service, which frankly are uniquely capability. That's a unique capability that we have. And so I think those are areas where you'll see that continue to move forward. In addition to anything that we've sort of virtualized over the years, you can now deliver that as a service, anything that is pure software. So, we're looking at every aspect of the portfolio.

Q - Pierre Ferragu {BIO 15753665 <GO>}

Thanks, Chuck.

A - Marilyn Mora {BIO 19771101 <GO>}

Thanks, Pierre. Next question.

Operator

Thank you. Jeff Kvaal from Wolfe Research. You may go ahead.

Q - Jeff Kvaal {BIO 3233206 <GO>}

Yes, thanks very much. I'm hoping to ask two, I guess. First is, I'm wondering, could you help us understand better the dynamics involved in the web scale progress, which product lines and what type of applications are you going to, is that a Silicon One story?

And then secondly, I was just wondering if you could help us with the expectation for the durability of the Public Sector, strength? Thank you.

A - Chuck Robbins {BIO 17845882 <GO>}

Yeah, thanks, Jeff. So let me start with the second one. The durability of the Public Sector, I think two comments on this one. Clearly the stimulus is flowing in both in the US and around the world and I think that will continue for some period of time obviously and that's certainly helping. But the other thing that I think has occurred over the last year is that countries have realized that they have to invest in infrastructure and digital infrastructure and technology, to be prepared for these sorts of crisis in the future.

So I think that notwithstanding stimulus, I think the spending we see post-pandemic, will be greater than what we saw pre-pandemic and and in fact, some of these countries have come to the conclusion that they need to take more dependency on themselves and less on some of their allies, given sort of what we've seen over the last few years and so they're beefing up their technology investments from that perspective. So, I think net, once the stimulus goes out, I still think you see a positive segment for a few years to come.

On the web scale front, I'll just take a minute to explain. We actually gave more information today than we've given, and over the last few years, many of you have heard me say that this was a marathon and we had a lot of work to do. And what has become clear to me over the last five quarters, is that the work that our teams have put in over the last five years has begun to pay off. And so, this quarter, we saw triple-digit growth year-over-year in our web scale portfolio, as I said in earlier comments. The prior four quarters, I will tell you that the growth rates, range from 17% to 74%. So it's been, up for the last five quarters, as we've talked about. From a portfolio perspective you asked, we're selling the 8000 series, which we announced in December of 2019, we're winning 400 gig franchises. We are selling some silicon, we're selling our Catalyst 9K candidate, where we saw in the rest of the portfolio as well.

And so it's, it's been pretty broad-based relative to what we are selling them, but we feel good about the investments we've made, the hard work we put in, and the last thing I'll tell you is that, the other question you're probably going to ask is, how material it is from a size perspective. And I'll tell you that, last quarter, that we just finished, it was 25% of our Service Provider segment and over the last four quarters, it's averaged 21% of that SP segment. So, it's gotten to a point where it's meaningful. So, that's why we decided to give the additional information today. Again, this business, much like the Service Provider business that we've talked about over the years, will have -- will be big deal driven, big customer-driven, so it will have a tendency to be lumpy, but I think if you look at it over the course of four quarters, six quarters, eight quarters, it's going to be, it should continue to be positive.

Q - Jeff Kvaal {BIO 3233206 <GO>}

Thank you, Chuck. Congratulations.

A - Chuck Robbins {BIO 17845882 <GO>}

Thanks.

A - Marilyn Mora {BIO 19771101 <GO>}

Next question please.

Operator

Thank you. Rod Hall from Goldman Sachs. You may go ahead.

Q - Rod Hall {BIO 20453923 <GO>}

Yeah, thanks for the question. I had two as well. One would be -- I guess one of the most surprising number is in here is the Service Provider order growth rate of 5%, I think, huge turnaround from last quarter and I think you just gave me part of the answer to that, Chuck, but just curious if you could dig into that a little bit more color, what drove that, just a little bit unexpected for me.

And then the second thing I wanted to ask, back to you, Scott. On the FX impact, is there any way you could quantify those for us? You help us understand how the dollar moves has affected for instance revenue growth year-over-year and maybe margins as well, just anything you can help us with on quantification there. Thanks.

A - Chuck Robbins {BIO 17845882 <GO>}

All right. Rod, I'll take the first one. On the SP space, so if you look at what we saw in the quarter from an order perspective, we saw a positive growth in Cable, which represents about 15% of segment. We saw triple-digit growth in web scale, which is represented 25% of the segment, and then our Telco business was down and that's roughly 60% of the business and primarily that is because of where we are in the stages with 5G, we have roughly 35 customers around the world that we're working on 5G solutions with, we have with Mobile Backhaul, with Orchestration, with Packet Core.

And so, we're just early in that transition. And I think that particular sub-segment of SP will begin to show progress for us, as we see the core backbone build outs, as we've been saying over the last few years and the good news is, we're seeing the -- we're seeing the Backhaul stuff being built, we're seeing the Packet Core decisions get made, which means that the core network backbone decisions will be made and the fact that we are being -- having some positive success in the web scale space would give me a high degree of confidence that those same products will bode well in the Service Provider space.

So, I think this has been a tough segment for us for many, many years and we're hopeful right now, with the web scale success and then with the 5G build-outs underway, that this could be a tailwind over the next few years for us.

A - R. Scott Herren {BIO 18902845 <GO>}

And, Rod, this is Scott. On the FX impact, as you know in most markets we price in USD. So, there is a limited impact from FX on the topline. But of course with the weaker dollar, we have employees worldwide, and obviously you pay them in local currency. And so, when you translate that back, it has a -- it creates a bit of a headwind for us on the OpEx side. I'm hesitant to give you an exact figure on that, but just so you can understand the dynamics, that's the way it works, and it has created a headwind for us during the second quarter.

Q - Rod Hall {BIO 20453923 <GO>}

Okay, thank you.

A - Marilyn Mora {BIO 19771101 <GO>}

Thanks, Rod. Next question.

Operator

Tal Liani from Bank of America Securities. You may go ahead.

Q - Tal Liani {BIO 1643846 <GO>}

Hello. I have two questions. One is just clarification from my understanding and I'll ask it in a general way, what's holding up the closure of Acacia and what will change now versus the delays, we've seen so far? So, that's the easy one.

The second question is, I want to understand your outlook on a product basis rather than vertical, when you -- we focus on legacy switches and routers, can you discuss the trends that you're seeing for the next four quarters or the next kind of calendar year. Where is the change, meaning, what are the areas where you see increase versus the previous quarters? Thanks.

A - Chuck Robbins {BIO 17845882 <GO>}

So, Tal I'm going to ask for clarification on the second one before I start. So, are you talking about in the Enterprise space or are you just talking about what do we feel good about from a product perspective, over the next few quarters, in general?

Q - Tal Liani {BIO 1643846 <GO>}

Exactly. I'm trying to understand it at the product level rather than the vertical level.

A - Chuck Robbins {BIO 17845882 <GO>}

Yeah. Got you. Okay. So on the Acacia thing, I think it's quite clear what occurred. We didn't have China approval, we thought we did, we didn't have it in time. So, we renegotiated the price because our contract with them had expired and candidly the performance they put up in the 18 months between our original deal and this deal was pretty astounding. So, that the price was not, was not out of the question and then we subsequently got Chinese approval and I think Scott keep me honest, but I think they have to get shareholder approval and the proxy's out. So we expect that, that should happen, it will happen during Q3 Tal, so, China approval is done. There's no more approvals to get, it's just up the shareholder vote at this point. So, we think that, that is in pretty good shape.

On the second, front. Let me just run through the portfolio and I'll tell you sort of how I feel about everything right now. So, I think the -- if you look at the, the mass scale Infrastructure, the Service Provider portfolio, whatever you want to call it, where the 8000 is and some of the other stuff that's being built for 5G and for 400 gig in the mass scale data centers, I think that that portfolio is in really good shape. And I would expect it to be a very positive contributor not only over the next year, but over the next two to three years. I think that there is -- if I look at the campus switching infrastructure, I think as customers begin to come back, they are going to look at upgrading. We've seen -- we saw significant growth last quarter in demand for Wi-Fi 6, just to give you a data point that we don't disclose anywhere, but we had, I think our orders for Wi-Fi grew 20% last quarter.

And what typically happens is that when you effectively put a lot of load on Wi-Fi like Wi-Fi 6 is going to accommodate, is going to require an underlying infrastructure upgrade to accommodate it. And when you add to that, the video load that will likely go onto these customers as they come back to the office and put video on every conference room and continue to use video, the way they've used it during the pandemic, we think that will also be a driver. So, I think we have the Catalyst 9K portfolio or the Wi-Fi 6 portfolio, we feel good about as well.

The SD-WAN technology continues to move forward. We're seeing good growth there and I think as we deliver that technology as a service integrated with our cloud security, I think that's going to be a differentiator for us. Within the Security portfolio, the teams are working on a couple of very differentiated tracks on strategy. I'd say that we need -- I'd say we need another six months or so to see how that evolves, but I feel good about what they plan to do. Our current portfolio is performing well. And they just need to execute. So, we have to see that. I think the teams have done an amazing job on what they've brought forward with the Webex platform.

Again, you have to remember in the applications space, when there -- there is probably a view on that, that when it's -- when it's not performing the way you would think. You got to remember all the phones are included in that space too. So, while Webex was up double-digits as Scott said, you've also got the drag of the handset business that's in there as well. But I think the Webex work and the pace of innovation, the feature velocity, the sweet aspect that they are looking at, I think the teams are doing a really good job and I think over the next year, you'll see us actually -- that portfolio will continue to improve. And I think we have a chance to take share back.

What did I miss? And then we're working on things like full stack observability, which are somewhat nascent. We're working on our Edge Service strategy, which is somewhat nascent. But, I feel like the -- I think the portfolio is in probably as good a shape as it's been in a while, and we just have to execute.

Q - Tal Liani {BIO 1643846 <GO>}

Great, thank you.

A - Marilyn Mora {BIO 19771101 <GO>}

Next question please.

Operator

Samik Chatterjee from JPMorgan. You may go ahead.

Q - Samik Chatterjee {BIO 15496543 <GO>}

Hi, thanks for the question. Chuck, just wanted to see if you can dig a bit deeper into the demand drivers for the Security segment here, particularly how have you seen customers respond to the recent events around SolarWinds, and if -- we would have expected a bit more momentum on the Security segment here, is that more to come, particularly, is it more going to be hardware or software that we should expect the demand from?

A - Chuck Robbins {BIO 17845882 <GO>}

Yeah, I think that what we see across that portfolio is, we had a really good quarter actually in network firewall and cloud security. So it -- it was a good quarter across the board, across the portfolio. And I think what you'll see is that, we're in the early phases I think of any positive impact that you would see from the SolarWinds build-out, because most of the customers are going in to assess like where am I, what have I missed, what do I need, what caused me to miss what I missed and then they're going to move from there. So, I think we're sort of in the midst of that right now with a lot of our customers doing those kinds of assessments. But, it's been -- from the early parts of the pandemic, when we saw VPN technology being absorbed as much as we could possibly build and then the network firewall and then combine that with the cloud security, it just -- it feels like customers are consuming whatever security they can consume right now to try to avoid those sorts of situations. So, I would think that that will continue to be positive for us.

Q - Samik Chatterjee {BIO 15496543 <GO>}

Thank you.

A - Marilyn Mora {BIO 19771101 <GO>}

Next question please.

Operator

Thank you. Simon Leopold with Raymond James & Associates. You may go ahead, sir.

Q - Simon Leopold {BIO 4081594 <GO>}

Thanks for taking the question. I wanted to ask first an easy one and then more of a thematic one. On the easy side hopefully is, just wondering if the supply chain constraints your ability to get components, if that cost you any revenue in the quarter, if you could quantify that?

And then in terms of the broader trend, maybe you could help me understand how you see the campus environment developing, because it sounds like you've highlighted a number of positives, getting back to work, long life in the Cat 9K cycle, Wi-Fi, sounds good. But, I have to imagine there are some offsets as well, maybe not as many people go back to work, legacy products rolling over, just if you could build a bridge on what's going on in campus over the longer term?

Thank you.

A - Chuck Robbins {BIO 17845882 <GO>}

All right. Scott, you want to take supply chain?

A - R. Scott Herren {BIO 18902845 <GO>}

Yeah, we didn't really see any impact on our ability to get product out the door during the second quarter. The team has stayed on top of the supply chain scenario and it's been evolving as you know, throughout the quarter. As we look ahead at Q3, that is something that is factored into our guide, both in the our expectations on the top-line and on the gross margin line, but it really hasn't been -- in the second quarter at least, it hasn't been a significant headwind for us.

A - Chuck Robbins {BIO 17845882 <GO>}

Yeah, I think that our teams are doing a good job on that, they're trying to buy ahead, trying to build inventory, our -- and I think that there is certainly some unknowns and it's certainly complex, but I think the teams have done a pretty good job navigating it and it is built into the guide. On the campus front, I think what I described is actually what I would expect for most customers. I think some of the -- the question you ask is a great -- is a philosophical discussion that we have a lot in that, when customers go back, what is it going to look like. Are more employees going to stay at home. Does that mean they're going to shrink their footprint, does COVID stay with us, do people now believe that they want to be -- they want to maintain somewhat of a social distance in the office, even post-COVID, until we really get well beyond it and does that mean you need more footprint. What's the future of shared space. Are employees comfortable coming in and sitting in a shared space that someone else occupied the day before or do they want their own space when they come in so that they feel safe in it and I think those are the kinds of things that we don't understand.

But if I net it out, I don't think personally, this is my own opinion, based on customer discussions and everything else, I don't think that some of the earlier beliefs in the pandemic where the early days is like, no one's going to go back to the office because we're actually productive at home. I think we sort of moved into that phase where people actually struggled mentally, people are -- it's -- they're not enjoying it. One of our employees said to me the other day, I don't mind the option of working from home, I don't like have being forced to work from home. And so, I really believe it's going to be hybrid where people are going to work from home as and like everybody is sort of landing here, where they'd work from home three days a week and work from the office two days a week or vice versa. The question is, what accommodations, does that lead to for customers based on employees concern over space issues, concern over future pandemics or other concern. That's what we just don't know yet.

But I do believe based on what we've seen with Wi-Fi 6, that tells me customers are getting ready and they're upgrading the wireless infrastructure now and in the Commercial space, we've seen a fair amount of the follow-on with the switching and hopefully we'll see that in the Enterprise space beyond this quarter.

Q - Simon Leopold {BIO 4081594 <GO>}

Thank you.

A - Marilyn Mora {BIO 19771101 <GO>}

Thanks, Simon. Next question.

Operator

Tim Long from Barclays. You may go ahead, sir.

Q - Tim Long {BIO 21123922 <GO>}

Thank you. Yeah, two if I could as well. First, maybe Chuck, on the Cat 9K, still -- still doing very well. Just curious, what do you think the impacts will be when some of the kind of earlier adopters licenses are coming due, so kind of what impact is that, kind of what inning are we in there?

And then second on the cloud business, curious kind of who you are winning against there, is this against the traditional competitors? Are you starting to see any wins back from White-Box or you just serving to maybe limit that where White-Box can go, with that cloud customer base? Thank you.

A - Chuck Robbins {BIO 17845882 <GO>}

Tim, thanks. So on the Cat 9K, I think the way I would think about it is that, the license, I think you're really asking about the renewal side of that piece, which in this fiscal year is -- is not significantly material, and I think I've said on a couple of calls before, it's really good the size it is this year, because it gives us a chance to test our processes and our renewal value proposition, all that stuff because it's meaningful in fiscal '22. So, teams are working hard right now to try to get ahead of that and be ready for it.

On the cloud front, what I would say is that we are -- when we announced in December 2019, we had a launch -- The Future of the Internet launch, we talked about, that we would be -- we would sell our customers' systems, integrated systems, we would sell them silicon or we would sell them White-Boxes. I mean, I'm sorry, our software. And -- and we have all three of those scenarios actually playing out right now. So, we have customers who have standardize on our systems for 400 gig. We have customers who are testing our silicon and actually putting it in White-boxes, which is, what we would expect them to do. We have some customers running our software stack on their hardware. And so -- and the people we're competing with are -- they would be quite evident to you, short of me calling them out, I think these are the traditional players that have been successful in that space and we talked a lot back years ago about the fact that we missed the first wave. And we were going to work hard to be in a position when the 400 gig transition occurred and try to work our way back in and earn that business back and I think the teams have begun to do that.

So, I'm really proud of what they've done.

Q - Tim Long {BIO 21123922 <GO>}

Okay, thank you.

A - Marilyn Mora {BIO 19771101 <GO>}

Okay. We have time for one last question. Michelle?

Operator

Thank you. Sami Badri from Credit Suisse. You may go ahead. Sami, your line is open.

A - Marilyn Mora {BIO 19771101 <GO>}

Sami. Are you on mute?

Q - Sami Badri {BIO 20178177 <GO>}

I don't think so.

A - Chuck Robbins {BIO 17845882 <GO>}

There you are.

A - Marilyn Mora {BIO 19771101 <GO>}

We hear you now, we didn't hear you before.

Q - Sami Badri {BIO 20178177 <GO>}

Okay, perfect. Sorry about that. First question is for Chuck, one thing that I think has not come up in this call is anything regarding 5G really, and we're about year-three in the telecommunications 5G cycle and at this point, a lot of people are just trying to understand what's really the effect to the equipment supply chain and how these telecommunication providers are going to consume equipment from the different vendors.

And then the other question is for Scott, you do have some M&A that has already closed in fiscal 3Q and there are projections for other closures of deals of fiscal 3Q. Does any of the guide include acquired or inorganic revenues? And if you're prepared to give us a breakout of organic versus inorganic, that'd be helpful.

A - Chuck Robbins {BIO 17845882 <GO>}

Let me take the 5G. I think what you're seeing right now, most customer -- most of our customers that are working on 5G, they've been building out the radio networks, they've been building out packet core capabilities, they've been building out mobile backhaul and in many cases, they're running these hybrid 4G - 5G backbones. With some exceptions, where you have like a standalone 5G network that's been built. And in that case, what we participate in and there, with the packet core for sure, mobile backhaul and some elements of orchestration. And what we believe is that, over the next couple of years as these providers begin to build out, a standalone 5G backbones and in many cases to serve up Enterprise services, that they will be making decisions on core upgrades to support the bandwidth and the traffic that's going to load those networks. And I think that's when we believe we will see the most of the benefit from the 5G build-out, so that's kind of where we are right now. And we're having good success in the areas that we participate, based on where they are in the lifecycle of these networks. Scott, you want to touch on the M&A question?

A - R. Scott Herren {BIO 18902845 <GO>}

Sure. Sami, we did have a couple of acquisitions that closed during the second quarter, but they were both quite small, strategically important, but not meaningful in terms of adding to the Q3 guide. We've got some more meaningful ones that we do expect to close during the quarter, obviously Acacia would be meaningful, we've got IMImobile which we expect to close during the quarter, which will have some level of impact on the guide. Neither of those are factored in at this point. So, as we get those closed and at this point, it's not exactly certain when they'll close, which is why they're not currently factored into the guide, as those close, we'll give you some insight into what our expectations are for them.

Q - Sami Badri {BIO 20178177 <GO>}

Got it. Thank you very much.

A - Chuck Robbins {BIO 17845882 <GO>}

All right. Just to wrap up, I want to -- I want to thank everybody for spending time with us today. And again, just hope that everybody stays safe as we work through what -- what we're all hopeful is the beginning of the recovery. And I think that from a business perspective, we continue to feel like that is definitely the case that we are in the midst of a recovery, which gives us a lot of optimism. I'm proud of what our teams have done. I'm proud of the innovation that we have built during this complicated time. We have Cisco Live coming up at the end of March, where there'll be a lot of innovation that we'll be announcing and based on that, and some of the performance that we see in the continued improvement of our business, I remain fairly optimistic about where we are right now, as we come through this pandemic. So, we look forward to talking to all of you on the next call.

And Marilyn, I'll turn it back over to you.

A - Marilyn Mora {BIO 19771101 <GO>}

Thanks, Chuck. Cisco's next quarterly earnings conference call, which will reflect our fiscal 2021 third quarter results will be on Wednesday, May 19th, 2021 at 1:30 PM Pacific Time, 4:30 PM Eastern Time. As a reminder, we will be presenting and hosting meetings at several Investor Conferences over the next few weeks, including the Goldman Sachs Technology and Internet Conference tomorrow. Again, I'd like to remind the audience, in light of Regulation FD, Cisco's policy is not to comment on its financial guidance during the quarter, unless it is done through explicit public disclosure. We now plan to close the call. If you have any further questions, feel free to contact the Investor Relations Day -- Investor Relations team. Have a great day.

Operator

Thank you for participating on today's conference call. If you would like to listen to the call in its entirety, you may call 1800-391-9851. For participants dialing from outside the US, please dial 203-369-3268. This concludes today's call. You may disconnect at this time.