Company Name: Cisco
Company Ticker: CSCO US
Date: 2017-08-16
Event Description: Q4 2017 Earnings Call

Market Cap: 161,701.76
Current PX: 32.34
YTD Change($): +2.12
YTD Change(%): +7.015

Bloomberg Estimates - EPS
Current Quarter: 0.605
Current Year: 2.443
Bloomberg Estimates - Sales
Current Quarter: 12090.619
Current Year: 48296.222

Q4 2017 Earnings Call

Company Participants

- Marilyn Mora
- Charles H. Robbins
- Kelly A. Kramer

Other Participants

- Ittai Kidron
- James Suva
- Pierre C. Ferragu
- Steven Milunovich
- Vijay Bhagavath
- Timothy Patrick Long
- Tal Liani
- Paul J. Silverstein
- Rod Hall
- Simon M. Leopold
- Jeffrey T. Kvaal
- Mark Moskowitz

MANAGEMENT DISCUSSION SECTION

Marilyn Mora

GAAP and Non-GAAP Financial Measures

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’ll discuss product results in terms of revenue and geographic and customer results in terms of product orders unless stated otherwise

All comparisons throughout this call will be made on a y-over-y basis unless stated otherwise, and the full-year revenue and non-GAAP comparisons have been normalized to exclude the divested SP Video CPE Business from our historical results

Charles H. Robbins

Business Highlights

Opening Remarks

- As you know, it's only been seven weeks since we last spoke at our Financial Analyst Day, and our overall outlook remains consistent with what we outlined at that time
- In FY2017, we continued to execute well against our vision of delivering customers a highly secure, intelligent platform for their digital business
- We managed our business through a dynamic environment, and at the same time, delivered significant innovation to further accelerate the next phase of our transformation

Revenue, EPS, Margins and Cash Flow

- In Q4, we generated revenue of $12.1B and non-GAAP EPS of $0.61
- For the full FY, revenue was $48B, and we delivered non-GAAP EPS of $2.39
- We drove strong margins and record operating cash flow for the year
- Our results demonstrate solid execution against our strategic priorities, accelerating our pace of innovation, increasing the value of the network, and delivering technology in the way our customers want to consume it

Network Intuitive

- In June, we announced a new era of networking with the launch of The Network Intuitive
- This is an example of the industry-leading innovation Cisco's providing to its customers
- The Network Intuitive. is a new intent-based network that creates a fully integrated, intuitive system that is designed to anticipate actions, stop security threats in their tracks, and continue to evolve and learn over time
- We are applying the latest technologies such as machine learning and advanced analytics to operate and define the network

New Catalyst 9000 Switches

- From a security standpoint, the new network enables our customers to detect threats in encrypted traffic with unprecedented accuracy using Cisco's encrypted traffic analytics and intelligence from Cisco's Talos cyber intelligence unit
- We have created the only network that is designed for security while maintaining privacy, solving a previously unsolvable problem
- Our new Catalyst 9000 switches represent the foundation of our intent-based networking capabilities and provide highly differentiated advancements in security, programmability, performance, and lower operating costs by innovating at the hardware and software layer
  - This offering is also a great example of how we are moving our core business to a recurring revenue model
  - Customer reception to this new innovation has been incredibly positive
  - As we've always said, transitions of this nature are multiyear, but during the first four weeks in the market, our pipeline and product orders are strong, with over 200 customers having ordered the new Catalyst 9000, the heart of The Network Intuitive. platform

Software Value Proposition

  - Our software value proposition in this portfolio is also compelling, as the large majority of our customers are adopting the most advanced subscription offer available
  - Building on this early success, we intend to further accelerate our leadership in intent-based networking through the combination of our expertise in network infrastructure, AppDynamics visibility into applications, and Viptela's automation capabilities
  - I believe that over the next several years, we will see continued increasing relevance of technology as customers add billions of new connections to their enterprises
  - The network has never been more critical to business success, and we are looking forward to helping our customers take advantage of the insights and intelligence that are only accessible through our highly differentiated platforms

Strategic Partnerships with Apple, IBM, and Microsoft

  - In Q4, we also announced an extension of our strategic partnerships with Apple, IBM, and Microsoft
  - We plan to deliver the first enterprise security application on Apple iOS, and we are integrating our comprehensive security portfolio with IBM's Cognitive Security Operations Platform
  - Additionally, we are collaborating with Microsoft in two important ways
    - First, we are implementing a software layer on our data center switches that gives Microsoft the flexibility to run their own operating system on our industry-leading hardware platforms in their Azure infrastructure
    - Second, we are collaborating together to enable businesses to build and host their IoT applications in Microsoft Azure while extending the power of those applications to the edge via Cisco's leading fog computing solutions

Security

- Now let's review other key parts of our business starting with Security
- We believe we are well-positioned as the number one enterprise security vendor
- With growing cyberattacks and the need for our customers to protect their business-critical data and applications, we are aggressively providing security everywhere:
  - In the network
  - In the cloud
  - And at the endpoint
- We don't believe any other company can match our capabilities given the criticality of the network in our customers' security architecture
- Our best-of-breed products and integrated security architecture combining analytics and automation are winning in the market
- Our Security Business delivered a solid quarter, with double-digit orders and 49% deferred revenue growth
  - This caps off a year in which we delivered 9% revenue growth with more than $2B in revenue, making us the only company growing at this scale
- Our leadership position in network security continues to expand, driven by our next-generation firewall portfolio with over 6,000 new customers added in the quarter, which is three times our nearest competitor, bringing our

total customer base to nearly 80,000

Advanced Threat Portfolio

- Customers continue to rapidly adopt our advanced threat portfolio
- We delivered revenue growth of 9%, and we added over 7,600 new customers, bringing the total number of AMP customers to over 42,000
- Building on our differentiated security innovations, we recently completed the acquisition of Observable Networks, which extends our Stealthwatch solution into the cloud with highly scalable behavior analytics and comprehensive visibility
- This platform expands our cloud security capabilities by providing greater support and compliance for applications deployed in Amazon Web Services, as well as Microsoft Azure environments
- Additionally, to combat the 90% increase in cyberattacks against IoT devices over the last year, we launched IoT Threat Defense solution, an extensible, scalable security architecture created to defend devices in connected healthcare, electric utilities, and manufacturing industries

Data Center

Multicloud

- In the data center, we're helping our customers take full advantage of a multicloud world that has become the norm in managing their applications and hybrid cloud solutions
- Our goal is to deliver the best multicloud platform built on an intelligent, intuitive network, enabling faster automated and highly secure delivery of applications in the cloud
- We believe Cisco is best positioned to do this, as everything we do in the data center is in support of both modern and traditional applications, both on-premise and in the cloud
- Cisco has led the industry over the past four years with ACI combined with UCS, Tetration, CloudCenter, and our Security Solutions
- In Q4, we saw strong performance of our multicloud infrastructure portfolio combined with our cloud-based SaaS offerings including WebEx and Meraki cloud networking
  - For example, ACI, our fastest-growing data center switching platform, had a record quarter with growth of 38%

Customer Adoption

- We continue to see strong customer adoption driven by our ability to accelerate data center application deployments across private to public clouds
- HyperFlex, our hyperconverged offering combined with CloudCenter is gaining traction with customers, benefiting from simplicity and scalability to support their hybrid cloud strategy
- You will see us continue to strengthen our partnerships with public cloud providers as they look to Cisco to help our joint customers manage workloads across their private and public clouds
- Lastly, we are delivering the right consumption models to enable continuous value and innovation for our customers

Deferred Product Revenue

- Our strong momentum continued in Q4, with 50% growth to $5B in deferred product revenue related to software and subscriptions, which has doubled from two years ago
- For the first time, over $1B or 11% of our product revenue came from recurring offers, which grew 40% y-over-y
- Overall, 31% of our total revenue was recurring, and revenue from subscriptions now represents 51% of our software revenue
- Going forward, you should expect to see our software business benefit from the transition of our campus networking portfolio to a subscription model

Summary

To summarize, our Q4 and full FY results reflect a strong year of progress

We see tremendous opportunity in intent-based capabilities across our portfolio, and we will continue to evolve our business to be the leading provider of highly secure, software-defined, automated and intent-based infrastructure

Our innovation is as strong as ever, as we focus on accelerating our core networking, security, software and cloud-based businesses

While it will take time, I firmly believe our core business is better positioned for the long term as we realize the benefits from our next-generation intent-based networking portfolio

Kelly A. Kramer

Financial Highlights

Revenue, EPS, Cash Flow and Operating Margin

- I'll start with a summary of our financial results for the quarter and full FY followed by Q1 outlook
- This quarter played out generally as we expected, and as we indicated in our guidance in our last call, we executed well, drove solid profitability, strong cash flow, and we continued to deliver on our strategic growth priorities
- Total revenue was $12.1B, down 4%
- We continued to focus on driving margins and profitability with strong non-GAAP operating margin of 31.5%
- Non-GAAP EPS was $0.61, down 3%, and operating cash flow was strong, growing 5% to $4B.
- For the full FY, we had revenue of $48B, down 2% with product down 3% and services up 3%
- Non-GAAP operating margin was a record $15.2B expanding to 31.6% of revenue, up 0.6 points
- Non-GAAP EPS, also a record, was $2.39, up 1%, and we generated record operating cash flow of $13.9B, up 2%

Products Revenue

- Let me provide some more details on our Q4 revenue breakdown
- Total products revenue was down 5%
- Switching declined 9% driven by weakness in campus, partially offset by growth in the ACI portfolio, which was up 38%
- We saw good initial traction of our new intent-based networking portfolio of the Catalyst 9000 family of switches
- Routing was down 9% driven by weakness in enterprise access
- We did see a spending pause related to our acquisition of Viptela that we will integrate into our SD-WAN portfolio
- Collaboration was down 3% due primarily to a decline in Unified Communications endpoints, partially offset by continued growth in conferencing

Deferred Revenue

- Deferred revenue grew 4%
- Combined with the unbilled deferred, the two were up 16%
- Data Center declined 4% with the continued market shift from blade to rack
- However, we did see solid traction of our hyperconverged offering, HyperFlex
- During the quarter, we launched our UCS M5 servers bringing greater simplicity and performance for next-generation data-intensive workloads and applications
- Wireless grew 5% with strong Meraki performance, as well as the ramp of our 802.11ac Wave 2 portfolio
- Security was up 3% with strong performance in unified threat, web security and advanced threat, offset by declines in our legacy firewall products
- We did see very strong order growth during the quarter
- Deferred revenue grew 49% as we continued to drive more subscription-based software offers

Service Revenue

- Service revenue was up 1% driven by growth in software and solutions services, partially offset by a decline in hardware maintenance
- We drove good growth in deferred revenue, which was up 12% in total, with product up 23% and services up 6%
- Deferred product revenue from our recurring software and subscription offers was up 50% to $5B
- We continued to transform our business to delivering more software offerings and driving more subscriptions and recurring revenues
- In Q4, we generated 31% of our total revenue from recurring offers, an increase of almost 4 points from a year ago
- Revenue from subscriptions increased 18% and now represents over 50% of our software revenue
- In terms of orders in Q4, total product orders were flat

By Geography

- Looking at our geographies, Americas was down 2%, EMEA was up 3%, and APJC grew 2%
- Total emerging markets declined 2% with the BRICS plus Mexico also down 2%
- In our customer segments, Enterprise declined 1%, Commercial grew 4%, Public Sector was up 2%, and Service Provider declined 7%

Product Backlog, Gross and Operating Margin

- Our product backlog as we ended Q4 was $4.8B, up 3% compared to the end of FY2016
- From a non-GAAP profitability perspective, total Q4 gross margin was 63.7%, down 0.9 points
- Product gross margin was 61.9%, down 2 points, and service gross margin was 68.8%, growing 1.8 points
  - While our total gross margin was solid, our product gross margin is continuing to be negatively impacted by memory pricing, which we expect to continue in the near term
- Our operating margin was strong at 31.5%
- For the full FY on a non-GAAP basis, our total gross margin was 64.3%, a decrease of 0.4 points, with product gross margin down up 0.9 points, and service gross margin up 1.1 points
- Our non-GAAP operating margin expanded to 31.6%, up 0.6 points by our focus on driving cost improvements, operational efficiencies and productivity

EPS, FCF, Share Repurchases and Dividend

- In terms of the bottom line, our Q4 non-GAAP EPS was $0.61, down 3%, while GAAP EPS was $0.48
- For the full year, we had non-GAAP EPS of $2.39, up 1%, while GAAP EPS was $1.90
- We ended Q4 with total cash, cash equivalents and investments of $70.5B, with $3B available in the U.S.
- Q4 operating cash flow increased a solid 5% to $4B, with FCF of $3.8B, up 7%
- From a capital allocation perspective, we returned $2.6B to shareholders during the quarter
  - That included $1.2B of share repurchases and $1.4B for our quarterly dividend
- For the full FY, operating cash flow grew 2% to a record $13.9B with FCF of $12.9B, up 4%
- We returned $9.2B to shareholders over the FY through share buybacks and dividends, which represented 71% of our FCF
- We are firmly committed to continuing our capital allocation strategy of returning a minimum of 50% of our FCF to shareholders annually

Summary

- To summarize, in Q4 and for the full FY, we executed well and we're focused on driving operational efficiencies and profitability to drive strong cash flow, enabling us to make the strategic investments to build long-term shareholder value

Guidance

Revenue, Gross & Operating Margin, Tax Rate and EPS

- Let me reiterate our guidance for Q1 FY2018
- This guidance includes the type of forward-looking information that Marilyn referred to earlier
- We expect revenue in the range of minus 1% to minus 3% y-over-y
- We anticipate the non-GAAP gross margin rate to be in the range of 63% to 64%
- The non-GAAP operating margin rate is expected to be in the range of 29.5% to 30.5%, and the non-GAAP tax provision rate is expected to be 22%
- Non-GAAP EPS is expected to range from $0.59 to $0.61

Product Reporting Categories

- Consistent with how we talked about our business at our Financial Analyst Conference, in FY2018, we will be redefining and simplifying our product reporting categories to better align with our evolving business model
- We will continue to primarily run and operate our business by the three geographic segments, and so this change will only impact how we report on our products
- Starting in Q1 FY2018, we will realign our reporting into five distinct categories:
  - Infrastructure platforms
  - Applications
  - Security
  - Services
  - And other

Charles H. Robbins

Outlook

As we'd discussed many times in the past, we're working on a multiyear transition

And while I'm confident with our progress, it's clear there's more for us to do

In Q4, we made ongoing progress, generating 31% of our total revenue from recurring offers and growing 50% in deferred product revenue related to software and subscriptions to $5B

I'm optimistic about our future, the direction we're headed, and how we're transforming Cisco for the future

We are well-positioned to succeed in a cloud and digital-ready world, where the network is one of the most strategic assets for our customers

Looking forward to FY2018, as I said earlier, you can expect us to do the following:

- Execute against our strategy and invest in priority areas to drive profitable growth and enhance shareholder value
- Leverage the power of the network to maximize our opportunities and differentiation in existing and new markets

- Drive relentless focus on innovation, creating continuous customer value across every element of our portfolio
- And drive the right consumption models for our customers and accelerate our shift towards more software and subscription revenue

QUESTION AND ANSWER SECTION

<Q - Ittai Kidron>: I guess just a couple for me, just sort of easy clarification. Kelly, you haven't mentioned the number of Cisco ONE customers. I would love to get that. And then, a pseudo-question itself, Chuck, Switching has had a little bit of a difficult year. I think three out of the four quarters was down quite substantially actually on a y-over-y basis. As we look into 2018, how do you think about that business in that year? Is that another year of transition to where the portfolio through, for example, your most recent announcements will go for potential pause and update and learning curve, where that business could still be prone to declines? Or we should finally see some better results in that category?

<A - Charles H. Robbins>: Ittai, I'm shocked you asked a Switching question. Kelly…

<A - Kelly A. Kramer>: I'll answer the easy one first.

<Q - Ittai Kidron>: I've given up on the Data Center business.

<A - Kelly A. Kramer>: Okay. Good. Well, I have an easy answer. On Cisco ONE, we have over 20,000 customers now with Cisco ONE.

<Q - Ittai Kidron>: Perfect. That's great.

<A - Charles H. Robbins>: Okay. So, Ittai, let me touch on the Switching situation. First of all, the results we saw this quarter were not a surprise to us. If you think about our guide last quarter, we anticipated this. And we also knew at the time that we were going to be making the announcement in June about the new platform, and so we anticipated these results.

Now, any time we do a major platform announcement, particularly in Switching, there is a period of time where our customers pause, because they want to understand what this means. So we did see a pause and we actually anticipated it, but we saw great traction with the new platform. As I said earlier, just in the four weeks where we closed the quarter, we had 200 customers that embraced this new architecture and purchased the new Catalyst 9000 platform. And as I said in the opening comments, the great majority of them also opted for the advanced software subscription that goes on top of it, and we've had a lot of conversations over the last two years as to whether we could really drive a subscription business on our core Switching platforms. And what we see is that at least early indications are that we can do that.

So, we talked about our Data Center business. The ACI portfolio, again, record quarter, growing 38%. And then if you look at what we launched in the campus, typically what we see is these are three-year cycles to transition these platforms, but this is also not a typical platform transition. This is not speeds and feeds only. We brought forward some incredible innovation in this platform.

And if you think about not only the actual product itself, but the solutions that we announced around automation, which really gets at the operating expenses that our customers are incurring to manage their infrastructure, you're looking at one of the key drivers of why customers move to the cloud. It was because of the complexity and the cost of their private infrastructure. So the ability to go drive significant cost out for our customers while managing this stuff over the next few years, we think is a huge difference from a normal transition.

And the other is the fact that we launched Encrypted Traffic Analytics, which is our ability to determine when there's malware inside encrypted traffic without decrypting it, and that's an innovation that only Cisco can actually deliver. And both of those pieces of technology are what are included in that advanced subscription, which is what tells us that the customers see tremendous value in that subscription.

So normally, we see three years. It's very early. And we would like to believe that we can accelerate that based on the incremental innovation that's being delivered as part of the platform, Ittai, but let's see how it goes over the next quarter or two.

<Q - James Suva>: Last quarter, I believe you gave a little bit of commentary of a bit of a pause in the federal government spending and also Europe. It appears – is that still continuing yet? Has it taken a step up to improve or deteriorate a little bit? And how should we think about that? And does Europe have any impact from Brexit? Thank you very much.

<A - Charles H. Robbins>: Hey, Jim. Thanks for the question. And since you asked, why don't I just quickly cover sort of all the headwinds that we talked about in Q3. I'll give you a quick update on all of them, including the two that you asked. First of all, we talked about Mexico last quarter, which is generally in the same state it was last quarter. We didn't see any significant change, and again that's largely driven by Service Provider weakness due to regulatory transitions as well as geopolitical dynamics, NAFTA renegotiation, et cetera. Emerging countries were slightly better but there's still just tremendous uncertainty and disparity between performance in those countries, and Service Provider is generally the same as it was last quarter.

The two that you asked about in particular, we did see some shifts. In U.S. Federal, I would say in Q3 we had a real lack of clarity around budgets. In early May, we began to see obviously the clarity with a continuing resolution. And the way that the dollars get released in Federal, we're in like the fourth phase based on how they prioritize releasing those budget funds. So we saw some improvement, not where we'd like for it to be, but we saw some improvement particularly late in the quarter, and obviously in Federal, we're going to be facing the same issue again in 90 days at the end of September as we try to get another budget resolution passed. But you can see on a global public sector perspective, you saw our orders last quarter were at minus 4%. This quarter, they were at plus 2%, and that was clearly – a big part of that was the improvement we saw in the U.S. Federal business.

On the UK, if you go back to Q3, we talked about it being significantly down, and one of the primary drivers was the headwind created by currency. In Q4, what I'll tell you is that headwind from currency remained. It did not ease up. However, our teams did a really amazing job and we saw significant improvement in our Enterprise and Commercial business in the UK. And if you look at the overall performance in EMEAR, you can see that the strengthening in the UK for us actually helped achieve the result at the EMEAR level. I'll say one final thing in UK. While Enterprise and Commercial were – we saw a good uptick, Service Provider remained about the same. All right?

<Q - Pierre C. Ferragu>: I'd like to get a sense for how you see like your near-term trend in the business? If I look at your revenue guide for next quarter, so we are still slightly down year-on-year, but sequentially, the kind of revenue change you're guiding for is actually probably better than the average seasonality for Q1 of the last few years. So, am I right thinking the environment – you see the environment, the business environment slightly improving sequentially after this quarter, this weaker quarter, you were anticipating? So that's on the revenue front.

And then on the margin front, I think like from the top of my mind, you've probably been beating your gross margin guidance range for like eight or nine quarters in a row or something like that. And your gross margin came in slightly down sequentially. And so – and you're guiding for a slightly lower operating margin next quarter than what consensus is anticipating. So, if you could give some perspective on what's happening at the gross margin level, it's relatively small movement, but I'm sure you can give us some visibility on what were the drivers there? Thank you.

<A - Charles H. Robbins>: Yeah. Pierre, let me give you a little color on the revenue question and sort of the business conditions. And then I'll let Kelly talk about Q1 guide as well as the margins. In general, I think if you just look at our order rates that we released today, we went from negative 4% last quarter to flat in Q4 – I'm sorry, from Q3 negative 4% to flat in Q4. So clearly that we saw improvement there. I will tell you that across the customer segments, just so you have some visibility, I think we showed the high-level numbers, I'll give you a little bit of a double click.

On the Enterprise side, we didn't see a lot of variability around the world in the performance there. Commercial, every region around the world improved from Q3 to Q4. Public Sector, every region improved from Q3 to Q4. And SP, we had weakness everywhere. So that's just sort of little color on the orders that we saw in Q4. Kelly, you want to talk a little bit about the revenue guide and margins?

<A - Kelly A. Kramer>: Yeah. Sure. On the revenue guide, as you know, Pierre, we call it like we see it. And as Chuck mentioned, the bookings being much better in Q4 than Q3 certainly helped a lot. And I'll just mention that we are starting off with a strong backlog with our backlog being up 3%. And we have good momentum as we go in the quarter. So we feel good about the revenue call for Q1. As I talk about margins, yeah, our margins for Q4 were in the range, but we definitely saw in our product margins go down 2 points y-over-y. And it really comes down quite simply to 3 points. The one and the biggest impact by far has been the increase of memory pricing and DRAM specifically. For the overall business, that accounts for more than half of the 2 point decline.

The second point that's really impacting that is an overall productivity. Whenever you have large parts of portfolio or my largest business unit down 9% like Switching, which is also a very profitable business, it impacts your ability to get cost savings in that quarter. So that was the second biggest driver. And then we just had a third driver but to a much lesser extent was a slight uptick in pricing erosion.

<Q - Steven Milunovich>: On the Security side, you said at the Analyst Day you expect low to mid-teens growth. You did talk about strong orders today, but the revenue growth was much less. I think you cited some legacy products holding things back. Do you have confidence that the reported revenue is going to get back into the double digits consistently?

<A - Charles H. Robbins>: Yes, Steve. So first off, I'll say on the Security, this is – I have zero concerns about the business. This is a revenue timing issue. Our orders were – they were some of the strongest, we saw some of the strongest order growth in the quarter as we've seen in the last two years. So, it's simply a revenue timing issue. It's funny if you go back to Q4 2015, the First Call I did, there was concern about our Security revenue at 4%, and at the time our deferred software was growing 26%. And this time, we had 3% revenue but our deferred software was growing 49%. So the strength in the business, I'm still comfortable with. Kelly, any comments on it?

<A - Kelly A. Kramer>: No. I think you said it well, and it's literally just timing. We expect an uptick come back there in the next quarter.

<Q - Vijay Bhagavath>: My question is on what feedback and commentary you're hearing from your sales teams, your top customers, channel partners in this new model to purchase products like the Catalyst 9000 with subscriptions being OpEx dollars? Hopefully you get the software security feature attached. And then the next part of the question is, is demand for the subscriptions OpEx model primarily coming from your U.S. corporate customers or are you also seeing...

<A - Kelly A. Kramer>: Hey, Vijay. Can you speak up a little bit? It's a bit hard to hear you.

<Q - Vijay Bhagavath>: Okay. So I think – yeah, the question is what commentary you're hearing from your customers and channel partners and your sales teams on purchasing the newer products such as the Catalyst 9000 with software and security features using the subscriptions model, and is it…

<A - Kelly A. Kramer>: Vijay, speak up just a tad bit higher there. We…

<A - Charles H. Robbins>: I got the first part.

<Q - Vijay Bhagavath>: Yeah. Can you guys hear me now?

<A - Kelly A. Kramer>: Much better.

<A - Charles H. Robbins>: That's much better. Much better.

<Q - Vijay Bhagavath>: Yes. So yeah, I think the first part of the question is the commentary from your customers on purchasing new products with subscriptions model. The second part of the question is, is the demand for the subscriptions model primarily coming from U.S. customers? Or are you seeing overseas demand as well for subscriptions-based purchasing? Thanks.

<A - Charles H. Robbins>: Okay. So I'll answer the first part, and I think Kelly – I have an instinctive answer on the second part, but you probably have the mathematical answer. So what we're – first, well, I think that when you look back at what we announced probably I think back with seven weeks ago, so it must have been eight weeks ago or nine weeks ago when we announced The actual Network. Intuitive., it was probably one of the most significant launches we've had in almost a decade.

And what I would tell you is, there's a lot of emotional momentum right now within the employee base, with our customers, with our partners, with our sales organization about the innovation. And specifically, your question, I think that what we always knew is that when we attempted to introduce a subscription model on a Switching product, we knew that we had to bring innovation that had such a high return for our customers that they would not have a problem buying it in that model, and that's what we've seen.

When you look at the automation platform that we're delivering to our customers and we're going to continue to enhance over the next several years and you look at the security capability that, frankly, only Cisco with our understanding of the network and with our threat intelligence that we get from Talos and with our ability to build silicon that can actually make that happen, I think our customers are actually quite pleased with the innovation. And so far, we've seen a high correlation with that to the advanced subscription. So, as far as the geographic issue, Kelly?

<A - Kelly A. Kramer>: Yeah. I mean, as far as the geographic, it's following very closely with our natural foot. We definitely have more in the Americas, but we have a very healthy pipeline in Europe, as well as APJC, so it's getting traction everywhere.

<Q - Timothy Patrick Long>: Just wanted to check in on the web scale client base. How did that trend in the quarter? And you could also address the – kind of the Switching and Routing competitive environment there? It seems like white box is really not taking off, but some of your competitors are having good traction. So, if you could just update us on progress with that large customer base, that's great. Thank you.

<A - Charles H. Robbins>: Yeah. Thanks, Tim. So when we were together seven weeks ago, the story here hasn't changed significantly. As I've said in the past, we have re-engaged in a very big way. I will tell that you we've had some wins. We actually had the press release that I talked about in my earlier comments with Microsoft about running their OS on our cloud silicon switches, and we continue to make traction with these customers.

As I've said, we're looking at each of them very individually as to what it is they need, and we're also looking at broad-based partnerships with them not only for their own infrastructure, but as they realize that the importance of having this multicloud capability and the ability to run not only applications in a central public cloud but be able to run portions of those applications out at the edge of the network, is leading to a very complementary partnership that we're talking about with all of them. So I would say that not a lot has changed in the last seven weeks, but we still continue to make solid progress. And I'm optimistic.

<Q - Tal Liani>: I have actually two questions, but it's about margin and cash. You touched on it a little bit, but you knew about memory pricing when you entered the quarter. I think when you gave the guidance, still product gross margin was weak. What was the delta? What was weaker than expected during the quarter that drove gross margin down? And the second question is cash repatriation. If it doesn't happen, you already now have $70B in cash, but only $3B in the U.S. So, do you consider plan B for bringing the cash to the U.S.? Or any other use for the cash?

<A - Kelly A. Kramer>: All right. Hi, Tal. So on the memory, yeah. We've talked about memory for the last three quarters, and then we started to see this as a headwind initially in Q2, and it's just gotten progressively worse. I think it's very much public information that the prices continued to decline. And in this scarce supply environment, our supply chain team has done a great job securing supply for us, but those prices continue to be at market – at prices as it goes forward, so it's continuing to be a moving target. And again, as I will say to the guide, our gross margin ended up in the range of our guide. So, those are just some of the variables as we go forward. As I look forward, I think we expect the memory pressure to continue on in the near term and we're taking that into account as we give you guidance going forward for Q1.

On the cash, yeah. We have $3B of cash domestically. We've been accessing commercial paper. We increased that a little bit this past quarter, and we've been able to access and get access to capital to take out debt if we need to as we go forward, because, again, we are continuing to ensure we have the flexibility we need, whether it's for strategic M&A or to continue with, obviously, our dividend and share repurchase. So we don't see any issues with that going forward, and we'll continue to be as efficient as possible as managing our cash and any debt we need to take out.

<Q - Paul J. Silverstein>: Just two clarifications from Kelly, and then a question. The clarifications being, Kelly, you mentioned the tick-up in price erosion. Did that remain below 3%? And then on the other clarification. On the Switching commentary, can you give us the Data Center switching growth all-in beyond just the ACI portfolio and what the campus switching decline was? And the real question is, looking at the drag on growth from the shift to subscriptions, what was [Audio gap] (41:23)…

<A - Marilyn Mora>: Paul?

<A - Kelly A. Kramer>: Paul?

<A - Marilyn Mora>: Paul, are you on mute?

<A - Kelly A. Kramer>: [Indiscernible] (41:34).

<Q - Rod Hall>: I wanted to, Kelly, maybe get you to comment on the inventory movement. The inventory is up quite a bit this quarter. I'm assuming that might be forward purchasing in memory, and then I assume that might protect your margins looking forward. But I wonder if you – could you confirm that? And if it is the case that it's memory, how long are you protected? How long are you hedged?

And then also, Chuck, maybe going back to that carrier order volume. Could you just maybe dig into where you're seeing weakness in orders in the network? Can you help us pinpoint that? Or is it more broad and related to product slowdown? Just kind of generally from a part of the network point of view, where is that sluggishness materializing? Thanks.

<A - Kelly A. Kramer>: Yeah. So, Rod, on the inventory, you're correct, a large majority of the inventory increase is driven by memory advance purchases. So that protects us for a large portion, but we also have been – as I mentioned in the last call, we've also been securing and committing to our purchase commitments for even more access to supply. That also will ensure that we have the supply albeit perhaps at higher prices if they continue to rise. But the bulk of the inventory going up, the $400mm is memory, and then there's also a little bit of just inventory built up as we continue just to execute on our revenue in Q1.

<A - Charles H. Robbins>: And hey, Rod, on the second part, thanks for asking about the Service Provider business. I think the way I would characterize it is, it's less about different portions of the network, and it's really about the disparity across large customers, as I've said in the last couple of calls. We literally had some very big customers that were growing double digits and others that were on the opposite side of that. So, it really is more of a customer variability issue than it is a single place in the network infrastructure that is causing a problem. And that's what we've seen for several quarters, and again, some of it is based on regulatory issues and geopolitical dynamics. Others are based on consolidation going on in a certain part of the industry. So that's kind of the color as to how I see it. Hopefully that's helpful.

<Q - Paul J. Silverstein>: So let me ask a question and then two clarifications. The question being, what was the drag on growth from the shift to subscriptions this quarter? And can you talk about what your product segment growth would look like on a normalized basis, i.e., adjusting for the shift in subscriptions? I'm aware that Wireless LAN and collaboration have been the two places in Security where it's been first implemented. But can you talk to us about what the growth will look like on a product line basis correcting for that?

And the clarification, Kelly, you mentioned a tick-up in price erosion.

<A - Kelly A. Kramer>: Yeah.

<Q - Paul J. Silverstein>: Was it still below 3%? And can you tell us what the decline in campus switching was? And what was the all-in growth rate of Data Center? So not just ACI, but taking into account the 7000 and whatever other products are in that. Thanks a lot.

<A - Kelly A. Kramer>: Yeah. Sure. So, on the shift, first, it's not much different than we told you. It's basically about 2%, between the 1.5% and 2%. And you hit the – obviously it's Security it impacts the most. Collaboration has always been that way, and that just continues to grow. But if you restated it, Security be impacted, Wireless would be impacted, and now with Cisco ONE really ramping up and it's added hundreds of millions of dollars onto the balance sheet, that would have an impact as well. And that is the piece that will accelerate even more as we get more traction on the Catalyst 9000 switches platform. So it's kind of across the board.

In terms of Data Center overall, so if I look at Switching, and Switching being down 9%, the bulk of it was campus switching, and that was over double digits. So that was the biggest drag. Data Center, Switching all-in was basically flattish to slightly up. But basically flattish.

<Q - Paul J. Silverstein>: And price decline?

<A - Kelly A. Kramer>: Oh, and price decline, yes, it is – you're talking about a y-over-y rate impact?

<Q - Paul J. Silverstein>: Yes.

<A - Kelly A. Kramer>: Yeah. So it is below the 3%. And you'll…

<Q - Paul J. Silverstein>: Great.

<A - Kelly A. Kramer>: …you'll see that in the K.

<Q - Paul J. Silverstein>: Thank you.

<A - Kelly A. Kramer>: [ph] 2 points (46:42). Yes.

<Q - Simon M. Leopold>: I wanted to see if we could maybe double-click down on the Security business in light of the headlines we've heard in the security space over the last couple months in terms of attacks. I think in the case of [ph] nuanced (47:09) highlighted employing Cisco. And I recall your discussions in the past about the need for Security to be an architectural solution and not a point solution. So it sounds like the market is moving towards the pitch you've made. And it's made sense for a long time. I'm just trying to see if you can help us quantify the outlook for your Security business if you see an inflection point of the business moving more towards a solution sale than point products vs. what we've seen in the past. Thank you.

<A - Charles H. Robbins>: Thanks for the question, Simon. The short answer is yes. And what's happened is, if you think about how our customers are building their IT infrastructure or their – how their IT assets are being deployed, they're in a massively distributed mode. And they're trying to navigate and manage technology assets spanning from the public cloud to connected vehicles, connected mining operations, all the way back to their private data center over to SaaS applications. So the architecture of sort of hairpinning all that stuff back to a central point in the enterprise is not going be sustainable.

Therefore, we see our customers transitioning to a new and fundamentally new architecture that's enabled by the network. And that's why they're moving to the security architecture because, as I said, our teams have built this strategy where you have to deploy security everywhere which is at the endpoint in the network in the cloud. And I think as it relates to some of the attacks, I don't remember the number exactly last quarter or the quarter before relative to our – the threat, new threat customers that we have, the AMP customers. But I believe the 7,600 this quarter was a pretty significant increase over what we saw during a quarter over the last two quarters, and I think that's probably related to not only the architectural buy-in that our customers have, but also the fact that that solution was pretty resilient during the recent ransomware attacks.

<Q - Jeffrey T. Kvaal>: And I would like to delve into the Service Provider outlook a little bit if we could. It sounds as though we understand that things aren't perfect around the world for you. My question is, how much of where we are in Service Provider do you consider to be typical? And how much of this is structural? I mean, do you think that we should see the Service Provider orders be in that 1% to 3% growth range that you've highlighted for the overall business? Thank you.

<A - Charles H. Robbins>: Let me see if I can break this down into three sort of qualitative areas that I think we are focused on that can actually improve the service provider performance over the next three to seven quarters over the next two years. I think first is we have increased our presence, our relevance in the web scale cloud providers that we've talked about. That's first and foremost. Second is there's innovation that we are working on that we talked a little bit about at the Financial Analyst Conference that will be coming out probably a few quarters from now, that will give us some transition opportunities in some of our platforms. And then finally, I think the other is there's – but I would characterize it as a combination of sort of macro issues as well as technology transitions. I think you're going see customers and we're beginning to have discussions with customers who are thinking about 5G.

And while we're not in a macro radio space, one of the key things that they are working on or thinking about is, as I add a significant number of new devices at higher speeds and lower latency out at the edge of the network, what is that going to mean for the performance I'm going to need in the core of the network. So I think as we see some of the geopolitical dynamics hopefully settle down, but I wouldn't count on that right now, but the overall – I think the 5G trend in that transition is the other one that could help us over the next couple of years.

<Q - Mark Moskowitz>: Just want to follow up on the gross margin question. A lot of focus today on the call. How should investors anticipate potential margin volatility over the next one to two years related to the transition to the highly attractive subscription model? And then, Kelly, can you weigh in on rev rec ASC 606? Like when could we see Cisco introduce some guidance around that as well? Thank you.

<A - Kelly A. Kramer>: Sure. So on the gross margin, I think we need to – we will have an impact on the memory for the next couple quarters coming up here for sure. I think the public information out there on what's happening with the supply, there are people that think that maybe it eases up, but it's too hard to call. So I think that's going to be a headwind for us. I think the other parts of gross margin are continuing to – we're executing and managing those well like we always have on the cost savings side then managing price as well. So I think it's really the big question mark and the big headwind is the memory.

On the rev rec change of ASC 606, we will be giving more color on that in our 10-K and kind of give you a feel of what some of the implications will be. So we'll get more color in that and we'll try to quantify for you the impact from a revenue and bottom line perspective. I will also just reference you back to – I did have a page in the Analyst Conference deck laying out what of our offers would be impacted and what wouldn't be to kind of give you a feel along those lines as well to help you think through it. But we'll give you progressively more details starting with our 10-K coming up here in a few weeks.

Charles H. Robbins

Highlights

Innovation

- I think there are four key messages that I would probably leave you with
- First is that this launch that we announced back about eight weeks ago was the first of what I believe you should expect from us in just an ongoing cycle of innovation, and very positively received by the press, analysts, customers, partners, employees
  - And I said, when I took this job, we're going to increase the pace of innovation, and this is the first wave of what you're going to see coming from us

- And when you look at the innovation that was introduced, particularly around the automation, around the new platform and the innovation we drove in the security capabilities, that's what you're going to see from us going forward

Network

- Secondly, I think with our customers and the environments in which they are operating now, the network's never been more relevant
- I talked about how they're building out their infrastructure in very distributed ways
  - They're managing hundreds of thousands of devices today, and they have to be ready to manage a million or more by 2020
  - And I think that is why this automation and analytics capability and the security built into the network is so important

Multicloud Environment and Strategy

- The third is that we continue to have our customers looking for us to help them really build out this secure, intelligent platform that spans across this multicloud environment for their digital business, and I think that our security results on the number of new customers embracing the technology, I think, is indicative of how they're buying into this new architecture
- And then fourth, I would say that the strategy we laid out, we are executing very well against. We're managing the business through this transition
  - When you look at the year that we just completed, having record EPS, record cash flow, at the same time that we, this past quarter, increased the software and subscription deferred business, 50% to $5B

Closing Remarks

And so, I'm very pleased with where our teams are, what our teams are doing, how we're executing and how we've increased the innovation and the response from our customers

So we look forward to talking to you all again next quarter, and thanks for joining us today