Q2 2017 Earnings Call

Company Participants

- Charles H. Robbins, Chief Executive Officer & Director
- Kelly A. Kramer, Chief Financial Officer & Executive Vice President
- Marilyn Mora, Head of Global Investor Relations

Other Participants

- Ittai Kidron, Analyst
- James E. Faucette, Analyst
- Jayson A. Noland, Analyst
- Jeffrey Kvaal, Analyst
- Jess Lubert, Analyst
- Justin Wainwright, Analyst
- Mark Moskowitz, Analyst
- Mitch Steves, Analyst
- Paul Silverstein, Analyst
- Pierre C. Ferragu, Analyst
- Simon M. Leopold, Analyst
- Steven M. Milunovich, Analyst
- Vijay Bhagavath, Analyst

MANAGEMENT DISCUSSION SECTION

Operator

Welcome to Cisco Systems Second Quarter and Fiscal Year 2017 Financial Results Conference Call. At the request of Cisco Systems, today's call is being recorded. If you have any objections you may disconnect. Now I'd like to introduce Marilyn Mora, Head of Investor Relations. Ma'am, you may begin.

Marilyn Mora {BIO 19771101 <GO>}

Thanks, Sam. Welcome everyone to Cisco's second quarter fiscal 2017 quarterly earnings conference call. This is Marilyn Mora, Head of Investor Relations and I'm joined by Chuck Robbins, our CEO, and Kelly Kramer, our CFO.

By now you should have seen our earnings press release. A corresponding webcast with slides, including supplemental information, will be available on our website in the Investor Relations section following the call. Income statements, full GAAP to non-GAAP reconciliation information, balance sheets, cash flow statements and other financial information can also be found in the Financial Information section of our Investor Relations website.

Throughout this conference call we will be referencing both GAAP and non-GAAP financial results, and will discuss product results in terms of revenue and geographic and customer results in terms of product orders, unless stated otherwise. All comparisons throughout this call will be made on a year-over-year basis unless stated otherwise.

The matters we will be discussing today include forward-looking statements, including the guidance we will be providing for the third quarter of fiscal 2017. They are subject to the risks and uncertainties that we discuss in detail in our documents filed with the SEC, specifically the most recent reports on form 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. As a reminder, Cisco will not comment on its financial guidance during the quarter unless it is done through an explicit public disclosure.

As a reminder, in Q2 fiscal 2016, on November 20, 2015, we completed the sale of the customer premises equipment portion of our SP video connected devices business and accordingly had no revenue or expense from that business in Q2 fiscal 2017. As such, all of the revenue, non-GAAP and product orders information we will be discussing is normalized to exclude the SP video CPE business from our historical results. We have provided historical financial information for the SP video CPE business in the slides that accompany this call and on our website, to help understand these impacts. As a reminder, the guidance we provided during our Q1 earnings call also has been normalized in the same way.

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

Charles H. Robbins {BIO 17845882 <GO>}

Thank you, Marilyn, and good afternoon everyone. We performed well this quarter, delivering total revenue of $11.6 billion and non-GAAP earnings per share of $0.57. We drove strong profitability, healthy cash flow and growth in deferred revenue, continuing our shift toward software and recurring revenue. We also drove 51% growth in our product deferred revenue related to our recurring software and subscriptions which now stands at $4 billion. We're also pleased that the board approved a 12% increase to our quarterly dividend to $0.29.

We are delivering against our strategic priorities, offering unparalleled value to our customers and we're executing and managing the business to deliver greater shareholder return. Through a disciplined investment approach, we are focused on expanding our growth opportunities and strengthening our customer value proposition.

We were very pleased to announce our intent to acquire AppDynamics as a continuation of our strategy to provide customers with deep analytics across the data center, the network as well as their applications. Increasingly, customers are seeing significant business value being delivered through applications and access through intelligent networks. Combining Cisco's infrastructure, networking and security analytics with the application analytics from AppDynamics, we will provide customers with unprecedented insights to improve business performance.

The conversations I have every day with business and government leaders around the world reinforce the importance of our strategy. They look to Cisco to connect everything and everyone by building highly secure, software defined, automated and intelligent infrastructure platforms. We offer these solutions through a variety of consumption options, giving our customers choice and flexibility.

I'd now like to cover some key business highlights, starting with our security business. We had another great quarter in security, which continued its strong momentum and growth. Revenue grew 14% and deferred revenue grew 45%, reflecting the strength of our best-of-breed offerings and architectural approach to security from the network to the endpoint to the cloud. Two weeks ago, we released the 10th Annual Cisco Cybersecurity Report, which highlights the increasing risk customers are facing around the world.

Of the organizations we surveyed, over one-third of those who experienced a breach in 2016 reported substantial losses to their business. Customers are relying on Cisco's comprehensive portfolio of best-of-breed security products and services, brought together in an integrated architectural approach to prevent and reduce the risk of business loss. As a proof point, deployments of our advanced threat solutions continue to be strong, as we added over 6,000 new customers, bringing the total to approximately 29,000 now using AMP, which led to revenue growth of 65% in the quarter.

Similar to our success in the advanced threat market, we added over 5,500 next-generation firewall customers, bringing our total customer base to 67,500. In addition to our leadership in network and advanced security, Cisco is leading the market in delivering innovative cloud-based security solutions. Last week, we announced Cisco Umbrella, the industry's first secure Internet gateway to address new enterprise security challenges in today's mobile and cloud world. Cisco Umbrella is designed to help users gain secure access to the Internet anywhere they go, even when they are off the enterprise network.

Now let's turn to collaboration. This quarter, we saw strong customer growth across our collaboration portfolio, with revenue growing 4% and deferred revenue growing 14%. Further expanding our portfolio of subscription-based offerings, we introduced Cisco Spark Board, the first all-in-one cloud-based collaboration and meeting room solution. Cisco Spark Board enables screen sharing, interactive white-boarding and videoconferencing and is complemented by a new version of our Cisco Spark application, a messaging and meeting platform for mobile and desktop endpoints. In the few weeks since launch, we have already had several hundred Cisco Spark Board customers who will be receiving ongoing innovation as part of the Cisco Spark subscription that they purchased together with the device.

We are seeing good customer momentum in our data center business, with customers choosing Cisco for the breadth of our private and hybrid cloud solutions. Across our next-generation data center portfolio, we saw healthy customer traction, including our ACI data center switching portfolio grew revenue by 28%. This includes 1,300 new Nexus 9000 customers and 450 new ACI customers in Q2, bringing the total installed base to 10,800 and 3,100 respectively. We are the only company to offer end-to-end visibility and security for 100-gig network build-outs.

In our core business, the network has never been more relevant in a world of increasing connectivity driven by cloud, social, IoT and digitization. Over the last year, we have been working hard on driving innovation in our core business and we are starting to see some of the benefits, such as our wireless portfolio this quarter. We believe we are in the early stages of a product innovation cycle driven by security, automation and analytics across the portfolio.

To further strengthen our cloud, software and IoT portfolio, as I mentioned earlier, we announced our intent to acquire AppDynamics, a market leader in application intelligence whose solutions are helping the world's largest companies improve their application and business performance. Customers will now have unprecedented insight into their data center, security infrastructure and networking performance through real-time application analytics in the cloud and on premise.

Approximately 75% of AppDynamics' product revenue is subscription-based, which aligns well with the way customers increasingly want to consume technology and with Cisco's strategic objective of moving towards more recurring revenue. The growing customer demand for real-time data is enabled by the increasing number of connected devices. We continue to build on the Jasper cloud IoT platform with new solutions. Today Jasper connects more than 40 million devices including over 12 million connected vehicles, and we're adding more than 1.5 million new devices per month. The number of enterprise customers utilizing data from the Jasper platform has grown from 4,000 a year ago to more than 9,000 this quarter.

In summary, we are confident in our strategy. We are delivering accelerated innovation across our portfolio and we are pleased with the momentum across our businesses and in our strategic shift towards recurring software and subscription-based revenue.

Now let me hand it over to Kelly to walk through our Q2 results and outlook in more detail.

Kelly A. Kramer {BIO 18951157 <GO>}

Okay, great. Thanks, Chuck. So I'll start with an overview of our financial results for the quarter, followed by some comments about our capital allocation and the Q3 outlook. Overall, Q2 was a solid quarter with revenue of $11.6 billion, down 2%, and non-GAAP EPS of $0.57, flat year-over-year.

We continued to make progress on our strategic growth priorities while maintaining rigorous discipline on profitability and cash generation. As part of our strategy to drive long-term profitable growth, we're prioritizing key investments, both organically and inorganically, such as the intended acquisition of AppDynamics. Today our board approved an increase of $0.03 to the quarterly dividend, bringing it to $0.29 per share, a 12% increase, representing a yield of approximately 3.5% on today's closing price. We remain firmly committed to our capital allocation strategy and returning value to our shareholders.

Let me provide some more details on our revenue breakdown. Total product revenue was down 4% and let me walk through each of the product areas. Switching declined 5%, driven by weakness in Campus partially offset by strength in the ACI portfolio, which was up 28%. Routing was down 10%, although we did see growth in orders. Collaboration grew 4% driven by ongoing solid performance of WebEx, unified communications and TelePresence.

We saw good momentum again in the transition to subscriptions and SaaS offers with deferred revenue growing 14%. Data center declined 4%, impacted by the continued market shift from blade to rack, though last week we announced expansion of our UCS portfolio by offering the Microsoft Azure stack on UCS via an integrated validated system that enabled organizations to deliver Microsoft Azure services from their on-premise data centers. The joint Cisco and Microsoft solution provides the tools for enterprises to grow and modernize their applications in a highly flexible and scalable hybrid cloud environment.

Wireless grew 3%, with ongoing strength in Meraki and the continued ramp of our 11ac Wave 2 portfolio. Security grew 14% with deferred revenue growth of 45%, as we offer more solutions to customers with increasing software content that result in greater recurring revenue. We had very strong performance in our advanced threat security of 65% as well as strength in unified threat management and web security solutions. Our focus continues to be developing a best-of-breed portfolio while offering customers the benefit of deep architectural integration spanning the network cloud at endpoint which we believe is outpacing our competitors.

Services continues to execute well, growing 5% with a strong focus on renewals and attach rates. Overall, we drove 13% growth in total deferred revenue with product up 19% and services up 9%. We continued to build our product deferred revenue related to recurring software and subscription businesses to $4 billion, up 51%. We made good progress on increasing our recurring revenue, with 31% of our total Q2 revenue generated from recurring offers, up from 28% a year ago. In terms of orders, total product orders growth was flat with book-to-bill greater than 1.

Let's take a look at our geographies, which is a primary way we run the business. We're seeing continued strength in the Americas which grew 4%. EMEA was down 4% and APJC was down 5%. Total emerging markets declined 7% with the BRICs plus Mexico down 5%. In terms of customer segments, enterprise grew 1%, commercial grew 3%, public was down 6%, public sector was down 6% and service provider declined 1%.

From a non-GAAP profitability perspective, total gross margin was 64.1%, down slightly by 0.1 points. Our product gross margin was 62.4%, down 0.9 points and service gross margin was 68.8%, growing 2.1 points. Operating margin was solid at 31%. We're maintaining our discipline and driving productivity with an ongoing focus of cost improvements and operational efficiencies, making the necessary trade-offs to drive operating margin.

At the bottom line, we delivered non-GAAP EPS of $0.57 and GAAP EPS of $0.47. We delivered operating cash flow of $3.8 billion and ended Q2 with total cash, cash equivalents and investments of $71.8 billion with $9.6 billion available in the U.S. From a capital allocation perspective, we returned $2.3 billion to shareholders during the quarter that included $1 billion for share repurchases and $1.3 billion for a quarterly dividend.

To summarize, we had solid performance in Q2 and managed the business well. We're making the investments we need to deliver shareholder value over the long term, and we are being very disciplined in driving continuous cost efficiencies.

Let me now reiterate our guidance for the third quarter. This guidance includes the type of forward-looking information that Marilyn referred to earlier. As a reminder, the third quarter of last year included an extra week, which resulted in higher revenue of $265 million and higher non-GAAP cost of sales and operating expenses of $150 million, netting into $115 million of non-GAAP operating income.

The guidance for the third quarter is as follows. We expect revenue in the range of minus 2% to 0% year-over-year. 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 the range of 29% to 30%, and the non-GAAP tax provision rate is expected to be 22%. Non-GAAP earnings per share is expected to range from $0.57 to $0.59. My guidance does not reflect any impact from AppDynamics.

I will now turn it back to Chuck for some closing comments.

Charles H. Robbins {BIO 17845882 <GO>}

Thanks, Kelly. Once again we had a solid quarter and I'm pleased with how we're executing against our strategy. Let me summarize why I'm confident in our ability to bring even greater value to our customers, partners and shareholders.

First, we delivered strong innovation in key areas such as security, collaboration, and next-generation data center as we continue to also drive innovation in our core. Second, we have strong momentum in our transition as seen with 51% growth in our product-deferred revenue related to our recurring software and subscriptions as we continue to add more software offers like you see with Cisco Spark Board. Third, profitable growth. We continue to stay focused on driving productivity and operational efficiencies. And lastly, we remain committed to increasing shareholder return as you've seen with our dividend increase of 12%.

Our customers have never cared more about what technology can do for their business. They're looking for speed, agility, visibility and security in everything that they do. Cisco is uniquely qualified to meet these demands with our ability to drive automation, analytics with intelligence and security, all the way from the network to the application, and that's why I'm confident in our future.

Marilyn, now I'll turn it back to you for questions.

Marilyn Mora {BIO 19771101 <GO>}

Great. Thanks, Chuck. Sam, let's go ahead and open the line for questions. And I just wanted to remind folks while Sam is doing that, I'd like to remind the audience that we ask you to ask one question.

Q&A

Operator

Thank you. Our first question comes from the line of Pierre Ferragu with Bernstein. Your line is now open.

Q - Pierre C. Ferragu {BIO 15753665 <GO>}

Hi everybody. Thank you for taking my question. I was trying to understand where we stand in the weakness you saw when you talked about three months ago. If I look at your guide, so it's fairly encouraging. It shows that we're getting back to a sequential growth that is better than slightly above what you've done on average in recent years. And then if I hear your current, so Campus was very weak in the quarter, routing as well. And you see all this coming back in routing, and my question would be whether you see something similar in Campus. Can we expect that part of the business to improve in coming months and coming quarters? And then maybe just more broadly, what's you're feeling about the macro today? The uncertainty and the weakness in orders you could see three months ago, is this something that is improving now already or not.

A - Charles H. Robbins {BIO 17845882 <GO>}

Thanks, Pierre. Let me just start and then Kelly, you can add whatever you like here. I think as it relates to our core portfolio, we have seen obviously some macro dynamics. Europe is clearly stressed with all the geopolitical dynamics that are occurring in Europe right now across several countries. And we also have begun to invest pretty significantly over the last year, and you will see it over the coming year, in ensuring we had the appropriate investments in innovation in our core.

But you also see what we did with AppDynamics. And what I would tell you is, that when you combine the analytics that we can deliver out of the data center with the analytics that we'll deliver out of the core networking space with our security threat information and analytics out of our security portfolio, combined with the application analytics that they have, we believe that we can create a differentiated architecture for our customers going forward. And that's the purpose in the acquisition and what we intend to do going forward. So, Kelly, any other comments on the macro and the sequentials?

A - Kelly A. Kramer {BIO 18951157 <GO>}

No, I think just to add to that, I think we do feel good about what we're seeing from macro in the U.S. certainly, and in commercial and enterprise. And I'd say to your point, Pierre, when you do adjust for that extra week last year, our guide, we always call it like we see it. And it does show a bit of improvement there on both the top line and bottom line. So I think – like Chuck said, I think the U.S. is solid, and again we're still cautious on outside the U.S. and Europe and Asia.

A - Marilyn Mora {BIO 19771101 <GO>}

Great. Thanks, Kelly. Sam, we'll go ahead and take our next question.

Operator

Certainly. Our next question is from Jim Suva with Citi. Your line is now open.

Q - Justin Wainwright {BIO 19560263 <GO>}

Hi. This is Justin on for Jim Suva. Thanks, Chuck and Kelly, for taking the question. I was just wondering if you could comment a little bit on your partnership with Ericsson. I know recently you've had a couple different rollouts and then some good press releases in terms of what you're doing. I was just wondering if you could maybe provide any sort of updates or any sort of milestones now that it's been about a year since you've had the partnership going? Thanks

A - Charles H. Robbins {BIO 17845882 <GO>}

Yeah, I think it was Justin, right?

A - Kelly A. Kramer {BIO 18951157 <GO>}

Yep.

A - Charles H. Robbins {BIO 17845882 <GO>}

That correct? Justin, thanks for the question. It's pretty timely, in fact. Obviously there's been a lot of uncertainty on the Ericsson side and we believe that all the original business drivers that led us to establish the partnership with Ericsson are still very valid. I think we have had some 300 customer engagements together. And their new CEO came onboard just about five weeks ago, I believe, and we have been in a great deal of discussion since then on ways in which we could accelerate the partnership. He is committed to continuing and trying to make this as successful as we possibly can. We're going to meet again in Barcelona at Mobile World Congress and I'd say we're focused right now on, how do we accelerate from here.

A - Marilyn Mora {BIO 19771101 <GO>}

Thanks, Justin. Sam, we'll go ahead and take the next question please.

Operator

Thank you. Our next question is from Paul Silverstein with Cowen & Company. The line is open.

Q - Paul Silverstein {BIO 1812254 <GO>}

If I could ask for a quick clarification and then a question. Kelly, I think last quarter you quantified the impact of the shift in the business model as over 2 percentage points in terms of the hit to growth as you increase your future visibility on the shift. Can you update? I don't think I heard you give an update this quarter. Then the question....

A - Kelly A. Kramer {BIO 18951157 <GO>}

No, yeah, I think what I say is between 1% and 2%, right. So we're in that 1.5% to 2% range.

Q - Paul Silverstein {BIO 1812254 <GO>}

Okay. And would that be your expectation on an ongoing basis?

A - Kelly A. Kramer {BIO 18951157 <GO>}

Well again, as we continue to accelerate the growth, as we're continuing to grow it like we have been growing it, I referred it may get even more until it evens out, but in the last few quarters it has been in that range.

A - Marilyn Mora {BIO 19771101 <GO>}

Thanks, Paul. Sam , we'll take the next question.

Operator

Thank you. Our next question is from Mitch Steves with RBC Capital Markets. Your line is now open.

Q - Mitch Steves {BIO 19155169 <GO>}

Hey, guys. Thanks for taking my question. So I kind of want to circle back in the security piece. You guys had given out advanced threat numbers in the past and the breakdown there. So how does the margin structure change as you guys grow the advanced threat and the web security piece versus the legacy security portfolio you've had?

A - Kelly A. Kramer {BIO 18951157 <GO>}

Yeah, we don't share gross margins by business unit, but I can tell you, the margins are growing in our security portfolio overall between the mix of the growth in these areas and the acquisitions and the SaaS businesses we've been adding. So it's very accretive to the Cisco average.

Q - Mitch Steves {BIO 19155169 <GO>}

Okay, got it. And then just one quick small follow up. Just on the repatriation potential, are you guys leaning more towards essentially M&A or buybacks or a dividend? Because you guys have raised it by 12% now, so I was just wondering how you guys think about that.

A - Charles H. Robbins {BIO 17845882 <GO>}

I think, Mitch, first priority will be strategic investments that we'll make and then obviously followed with a focus on continued capital allocation and our commitment to returning capital to shareholders. So it would be a combination.

A - Marilyn Mora {BIO 19771101 <GO>}

Thanks, Chuck. Sam, let's go ahead and tee up for the next question.

Operator

Thank you. The next question is from Jeff Kvaal with Nomura. Your line is open.

Q - Jeffrey Kvaal {BIO 3233206 <GO>}

Yes. Thank you very much for taking the question. One of the big themes with some of the other folks across the comm landscape of course, is web-scale. That wasn't a major theme of the opening script. I'm hoping that you could help us understand your positioning in web-scale, certainly in switching where the competition is heightened and also in routing and even DCI. Thank you.

A - Charles H. Robbins {BIO 17845882 <GO>}

Yeah thanks, Jeff. So as we look at MSDC, what we've given you guys over the last few quarters is sort of a very fixed list of 10 customers that we have given. And I've said over and over that we have been spending a lot of time with these customers, really focused on understanding what their unique needs are. Frankly, some of them are so big, they're a market of one and to themselves. And I'm very pleased with the progress we're making.

If you look at those 10, just to give you the numbers this time, overall those 10 would be down. But if you normalize out one of those providers and you take the combination of the other nine – and that one has some pretty tough year-over-year comps – the other nine were up double digits. And we have one of the largest that was up triple digits for the second quarter in a row. So I feel like we're making good progress, but we still have a long way to go.

A - Marilyn Mora {BIO 19771101 <GO>}

Thanks for the question, Jeff. We'll go ahead and take the next question, Sam.

Operator

Our next question is from Ittai Kidron with Oppenheimer. Please go ahead with your question.

Q - Ittai Kidron {BIO 5557426 <GO>}

Thanks. Chuck, appreciate the opportunity. I guess I'm going to sound like a broken record and ask the same question I ask every four or five quarters now, which is your data center revenue. Your server business, which is again, continued to stay in range, not showing much progress. How do you feel about the progress that you're making over there with hyperconverge? It just doesn't seem to be moving the dial yet. How do you resolve the issues in this business going forward?

A - Charles H. Robbins {BIO 17845882 <GO>}

Yeah thanks, Ittai. We can always count on you for that question. So first of all, I think in our next-gen data center switching portfolio, you can see continued performance and continued good adoption of those solutions from our customer base. I think on the hyperconverged, we certainly would like to see it moving more quickly. We have recently had a release of software that has helped with some of the capabilities, and I think that there are a couple more coming that should continue to give us more capabilities in that space. And I think that we're also looking, as you would expect, at our broad strategy in the data center and where we need to go to ensure that we best position ourselves going forward. So that work is going on as well right now, Ittai.

A - Marilyn Mora {BIO 19771101 <GO>}

Thanks, Chuck. Sam, let's go ahead and tee up the next question.

Operator

Yes, next question is from Vijay Bhagavath with Deutsche Bank Securities. Your line is open.

Q - Vijay Bhagavath {BIO 6022835 <GO>}

Yeah, thanks. Yeah hi, Chuck, Kelly.

A - Kelly A. Kramer {BIO 18951157 <GO>}

Hi, Vijay.

Q - Vijay Bhagavath {BIO 6022835 <GO>}

Yeah, hi.

A - Charles H. Robbins {BIO 17845882 <GO>}

Hey, Vijay.

Q - Vijay Bhagavath {BIO 6022835 <GO>}

Yeah, hi. I'd like to get your bigger picture thoughts, Chuck and Kelly, on how you plan to broaden your senior management team. Any new areas or skill sets you'll be looking for in the management team to drive top line growth through the rest of this year and over the next few years? And is the strategy focused primarily on doubling down on security, analytics, AI, automation? Or are there any new areas?

A - Marilyn Mora {BIO 19771101 <GO>}

Hey, Vijay, don't mean to interrupt. Can you speak up just a little bit?

A - Charles H. Robbins {BIO 17845882 <GO>}

We're having trouble hearing you.

Q - Vijay Bhagavath {BIO 6022835 <GO>}

Can you guys hear me now? Can you guys hear me now?

A - Marilyn Mora {BIO 19771101 <GO>}

Not really. Try a little louder.

Q - Vijay Bhagavath {BIO 6022835 <GO>}

Okay. Is this better?

A - Marilyn Mora {BIO 19771101 <GO>}

Better.

A - Charles H. Robbins {BIO 17845882 <GO>}

That's better.

Q - Vijay Bhagavath {BIO 6022835 <GO>}

Okay. Yeah, I mean, Chuck, my question was more around on the senior management team. Any new skill sets, any new areas or avenues you'll be looking for to round out the management team to drive top line growth? Or will you primarily be doubling down on security, analytics, AI? Thank you.

A - Charles H. Robbins {BIO 17845882 <GO>}

No, you know what, it's a great question. I think that when you look at the improvement we've been making around our transition to software and subscription business, you can assume that we'll continue to look for people who have those kinds of capabilities. And if you look at even the AppDynamics acquisition, David Wadhwadi, who is their CEO, was one of the key drivers behind the software transition that occurred at Adobe. So he very much understands how this transition will occur.

You can assume that we're adding talent in the areas of artificial intelligence, machine learning, analytics, software skills around simplicity and automation. As you know, if you look at our core, one of the biggest things our customers are looking for is to take out the cost of operating this infrastructure. And so as we build out automation capabilities that allow them to very dynamically change their environments as opposed to the manual way it's been done in the past, those skill sets as well. So it's a combination of all of those in addition to security and all the other areas you mentioned, so it's broad based.

A - Marilyn Mora {BIO 19771101 <GO>}

Thanks for the question, Vijay. We'll go ahead and take the next question.

Operator

Thank you, next question is from Steve Milunovich with UBS Securities. Please go ahead with your question.

Q - Steven M. Milunovich {BIO 1504637 <GO>}

Thank you. Kelly, you mentioned the percentage of recurring revenue is 31%. If you exclude services, are we still around 9% to 10% of product revenue being recurring?

A - Kelly A. Kramer {BIO 18951157 <GO>}

Yes.

Q - Steven M. Milunovich {BIO 1504637 <GO>}

And is there any way to turn that core routing switching business into something more recurring? I mean, we've never seen a hardware company do that, if you will, but through ELAs or something else, is there any way to turn that into a little more of a subscription consistent basis?

A - Kelly A. Kramer {BIO 18951157 <GO>}

Yeah, that's a great question, Steve. Yeah. So actually product as a percentage of my total product revenue, it's up to 10% now this quarter for the first time, so we're happy about that. And we are trying to make that shift in the core part of the business. Cisco ONE is an example of where we are taking our ELAs and our big cross enterprise ELAs that really are a core networking business to do that. So we're trying to find ways to find other offers.

I'll just point to another example though like the Spark Board that Chuck mentioned. It's a great new innovation and extension of TelePresence, but it's a great example of where we're selling that. We used to sell it always as a system. Now we're selling the equipment, but we're selling it with a subscription. So that's an example of how we've been able to kind of to drive new offers that had been traditionally just pure system or hardware. And again, the teams are driving hard to find more ways to accelerate new offers that way.

A - Charles H. Robbins {BIO 17845882 <GO>}

Yeah, Steve, just I want to just make a couple of comments on this. One, if you look six quarters ago when I came into the job, our overall revenue, our recurring revenue was 26% in the first four quarters. We spent time taking our teams and helping our teams understand the transition that we were going to make. So in the first four quarters, we gained 2 points. We took it up to 28%, and in the last two quarters we've added 3% so we've accelerated it. So it's going to 31 in the last two quarters. And on the product side, that went from 6% to 7% in the first year and then in the last two quarters, it's gone from 7% to 10%. So I think we're finding ways to move that forward.

As it relates to the core, I think you'll see us come out with services around automation and analytics and other things that will be sold as subscriptions on top of the platforms. And the last thing I'll tell you is that we pulled one of the key leaders from the security portfolio, who had really driven the whole product management portion of that transition to the heavy content of software and subscription that you see today, and he is now leading that force in our core networking space in the enterprise networking. So it's clearly a focus that he's trying to drive for us.

A - Marilyn Mora {BIO 19771101 <GO>}

We'll take the next question.

Operator

Our next question comes from the line of Mark Moskowitz with Barclays. Please go ahead.

Q - Mark Moskowitz {BIO 4281182 <GO>}

Yes, thanks. Good afternoon. Just following up on the cash repatriation M&A question, Chuck. I just want to get a sense going forward, should we think about a continuation of more the string of pearls approach to more to AppDynamics, or you make more sizable acquisitions? And then, Kelly, I wanted to get a sense if you could help us understand how we should think about deferred revenue? Clearly growing nicely. What is the feedback loop a year or a year and a half out from now in terms of does the gross margin start to trend higher because of the deferred revenue mix has become a recurring configuration? Thank you.

A - Charles H. Robbins {BIO 17845882 <GO>}

Hey, Mark. First off, I'll take the repatriation and the M&A question and, Kelly, you can take the next one. So and you're free to make comments on mine as well, so.

A - Kelly A. Kramer {BIO 18951157 <GO>}

Thank you.

A - Charles H. Robbins {BIO 17845882 <GO>}

I think our M&A strategy is going to remain intact. Repatriation doesn't fundamentally change how we think about what we're going to do going forward. You can assume that we'll continue to look for opportunities that drive the business value and the relevance to our customers like we did with AppD. I mean, they have a tremendous platform that really translates application analytics to real business performance information for our customers.

And just to comment on AppDynamics, they have a very robust enterprise solution that is delivered either from the cloud or on premise and can be delivered to the customer on premise or in the cloud. So it's very flexible. And they basically have 275 of the Fortune 2000 and they really have never had a substantial partner model. So those are the reasons we think that makes a lot of sense. So strategic alignment and the ability for us to take it through our ecosystem are always positive. So, Kelly, comments on the deferred and the margins.

A - Kelly A. Kramer {BIO 18951157 <GO>}

Yeah, on the deferred, Mark, I mean that is part of why we're trying to make this shift to software. It's our customers want those offers and to have easier way to run their IT departments. But it clearly enables us to get higher margins, for sure. And it's not only just the gross margin coming out of deferred revenue, but we're looking at our whole end-to-end operations, and how we go to market, how we drive operations in the back end here. And there's real opportunities to drive both gross margins and operating margins. So that's why we're so focused on it. That's why we're looking at acquisitions to add to it, and it will continue to help improve our mix on the margins line.

A - Marilyn Mora {BIO 19771101 <GO>}

Thanks, Chuck and Kelly. Sam, let's go ahead and take the next question.

Operator

Yes, our next question is from James Faucette with Morgan Stanley. Please go ahead with your question.

Q - James E. Faucette {BIO 3580933 <GO>}

Thank you very much. I just wanted to ask about product gross margins. They were a bit weaker than we had at least modeled, and I think in the 8-K there is some indication there was some pricing, but would like some more color there. I guess particularly, one thing that we noticed that the A-Pac margins were – looked particularly weak. Is this related to customer geography? Just a little help on understanding kind of where the pressures are on product gross margins.

A - Kelly A. Kramer {BIO 18951157 <GO>}

Yeah, sure. I'll take that one, and a great question. Gross margins, we've been – again continue to operate well. I'll say there were two specific kind of headwinds that we faced this quarter. And to your point on APJC, I'll refer back to a year ago, we were benefiting from a national program in China where they were rolling out set-top boxes to tier 2 and tier 3 cities. Not our set-top boxes, but we were providing the smartcards to go with that, which they're basically for secure access and it was very, very high margin. So we had, if you go back a year ago, SP video in Asia was extremely strong because of that. That program has dramatically slowed down. And again, that pure margin just isn't there anymore, and you're seeing that flow through both the margins and the year-over-year revenues for both SP video and APJC.

The other item that's a headwind for us this quarter is we are facing a significant cost increase to our memory costs, our DRAM memory costs that we're paying. It's a very tight supply right now and we're seeing dramatic increases there. So that's hurting us quite a bit as well. But other than that, I'd say the color's in the same line. Our pricing is in – it's in the ranges that we've been the last six to eight quarters. I'd say a little on the higher end, but in line with where we were Q3, Q4. A little worse in (37:06) last quarter, but we were very low last quarter. So in the normal ranges. But really it's those two specific things. And I will say that I do anticipate those two headwinds to remain there next quarter as well as we had very strong SP video, that China program, in Q3 as well. Okay?

A - Marilyn Mora {BIO 19771101 <GO>}

All right. Let's go ahead and take the next question, Sam.

Operator

Yes. Our next question is from Jess Lubert with Wells Fargo Securities. Your line is open.

Q - Jess Lubert {BIO 16169643 <GO>}

Hi, guys. Thanks for taking my question, and congrats on a nice quarter. First, just had a clarification. There are a number of articles regarding a faulty clocking component over the last few weeks. Just wanted to see if you could comment to what degree that is or isn't impacting customer activity.

And then the question, I was hoping you might be able to update us in a little greater detail regarding the trends you are seeing in the service provider vertical. You mentioned some encouraging order development. So was hoping you can help us understand what you're seeing across geographies, what you're seeing from a product perspective, and to what degree that improvement is coming from routing, optical, security or some other part of the service provider business.

A - Kelly A. Kramer {BIO 18951157 <GO>}

Sure. I'll start on the supplier component issue. So yeah, those articles are out there. We have had an issue from a supplier come out, and we did book a reserve for $125 million, you can see in our GAAP results and in the press release, to cover that. We always, and continue to stand by our customers through any situations like this. This is very proactive. This is a failure rate that will happen over time, but we're working with our customers to work through that. So we're not anticipating any impact from that from a top line perspective.

A - Charles H. Robbins {BIO 17845882 <GO>}

Yeah, I'll take the SP question, Kelly. So, Jess, on the service provider space, it's really similar to last time. We talked about SP CapEx. Different service providers are looking at different areas of investment depending on what's going on in their network. So you have some who are looking at macro radio densification as an example and others are looking at building out capacity in the core. And it's a segment that is very dominated by large customers. So from a quarter-to-quarter basis, any number of customers that make any sort of shift in their buying behavior can have an impact either positively or negatively. So it's a space that I would just encourage you to look at longer term.

But we did see, you know, we saw definite improvement. We saw, I would say from a regional perspective, what I would tell you is the Americas was very strong and we saw general weakness in Europe and in the China space you had a lot of this SP video implication that Kelly was talking about earlier. So overall, I think the teams did a great job. I think the teams are working incredibly well on sort of the next generation of capabilities in the platforms and in some of the software and automation, and some of the same themes that we've been talking about in the enterprise core networks, and I feel good about where they are right now.

A - Marilyn Mora {BIO 19771101 <GO>}

Thanks for the question, Jess. We'll go ahead and take the next question, Sam.

Operator

Thank you. Our next question is from Simon Leopold with Raymond James. Please go ahead.

Q - Simon M. Leopold {BIO 4081594 <GO>}

Great. Thank you for taking my question here. I wanted a little bit of hand holding and help with interpreting this deferred revenue growth. So 51%, obviously a very big number. Looking at the balance sheet, it looks like it rose year-over-year by about $1.9 billion and you talked about the total of, I guess, software and recurring revenue at $4 billion. Could you help us get a better understanding of what are the components? And I'm presuming there's some elements that maybe are growing much slower, some growing faster. So help us understand what are the big drivers for that 51% growth. Thank you.

A - Kelly A. Kramer {BIO 18951157 <GO>}

Sure, so yeah. So that 51% growth is year-over-year growth of over $1.3 billion and everything's growing in that space. I'd say from a pure size, collaboration and security and Meraki are the biggest pieces of that, because they have just continued to grow their businesses significantly. And they're all growing huge double digits. But I will also say my switching, my routing, as well as data center and we've done Cisco ONE bundles as well as big enterprise license agreements. They've also been growing huge double digits as well. So at the end of the day, the year-over-year increase is across the board. Everything is up massively to drive to that 51%. And again, just the biggest chunk of it between collaboration, security and wireless, they are two-thirds I'd say of the balance, but the other pieces are rapidly -

A - Charles H. Robbins {BIO 17845882 <GO>}

Wireless being Meraki.

A - Kelly A. Kramer {BIO 18951157 <GO>}

Yeah, wireless being Meraki, yes. Hopefully that gives you the color you're looking for.

A - Marilyn Mora {BIO 19771101 <GO>}

All right. Thanks, Kelly. Sam, let's go ahead and take that next question.

Operator

Thank you. Our next question is from Jayson Noland with Robert Baird. Your line is open.

Q - Jayson A. Noland {BIO 15941997 <GO>}

Okay, great. Thank you. And, Kelly, just to clarify, there's no expectation of revenue or earnings impact from this clock issue in the current quarter?

A - Kelly A. Kramer {BIO 18951157 <GO>}

Not as of right now. Again, we're working very proactively with our customers and in terms of how quickly and where they want to do their replacement. So we're working very, very closely, but as of right now we have not seen and don't anticipate any massive revenue impact from this.

A - Marilyn Mora {BIO 19771101 <GO>}

All right. Well, thank you. And that was our last question for today. I'm going to turn it over to Chuck for some closing remarks.

A - Charles H. Robbins {BIO 17845882 <GO>}

Yeah, just a couple of comments, and first of all, I want to just thank you all again for joining us today. We did deliver strong innovation I believe which was reflective in the performance that we've had in security, collaboration, next-gen data center, and we continue to drive innovation in our core enterprise and SP portfolio. The deferred revenue from our subscription and software businesses is indicative I think of the transition that you should continue to expect from us.

We will continue to focus on driving profitable growth with productivity and operational efficiencies, and you also can count on the fact that we remain very committed to our shareholder return as was indicated in both our buybacks and our dividend and then the increase in the dividend this quarter. So I just want to thank all of you for being with us today. And then, Marilyn, I'll let you take it from here. Thank you.

A - Marilyn Mora {BIO 19771101 <GO>}

Thank you, Chuck. So Cisco's next quarterly earnings conference call, which will reflect our fiscal year 2017 third quarter results, will be on Wednesday, May 17, 2017, at 1:30 p.m. Pacific Time, 4:30 p.m. Eastern Time. Again, I'd like to remind the audience that in light of Regulation FD, Cisco's policy is not to comment on its financial guidance during the quarter unless it is done through an explicit public disclosure.

We now plan to close the call. If you have any further questions, please feel free to reach out and contact the Cisco Investor Relations group, and we thank you very much for joining the call today.

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 1-866-357-1423. For participants dialing from outside the U.S., please dial 1-203-369-0115. This concludes today's call. You may disconnect at this time.
