Company Name: Cisco
Company Ticker: CSCO US
Date: 2017-05-17
Event Description: Q3 2017 Earnings Call

Market Cap: 248,978.69
Current PX: 56.56
YTD Change($): +13.23
YTD Change(%): +30.533

Bloomberg Estimates - EPS
Current Quarter: 0.769
Current Year: 3.069
Bloomberg Estimates - Sales
Current Quarter: 12874.077
Current Year: 51697.586

Q3 2017 Earnings Call

Company Participants

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

Other Participants

- Mark Moskowitz
- Ittai Kidron
- James E. Faucette
- Simona K. Jankowski
- Kulbinder S. Garcha
- Jess Lubert
- Pierre C. Ferragu
- Steven Milunovich
- Rod Hall
- Vijay Bhagavath
- Paul Silverstein
- Tal Liani

MANAGEMENT DISCUSSION SECTION

Operator

Welcome to Cisco Systems' third quarter fiscal year 2017 financial results conference call. At the request of Cisco Systems today's conference is being recorded. If you have any objections you may disconnect.

Now I would like to introduce Ms. Marilyn Mora, Head of Investor Relations. You may begin.

Marilyn Mora

Thanks, Sean. Welcome, everyone, to Cisco's third 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 made available on our website in the Investor Relations section following the call. Income statements, full GAAP to non-GAAP reconciliation information, balance sheets, cash flow statements, and other financial information can also be found in the financial information section of our Investor Relations website.

Throughout this conference call, we will be referencing both GAAP and non-GAAP financial results, and we will discuss product results in terms of revenue, and geographic and customer results in terms of product orders, unless stated otherwise. All comparisons 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 fourth 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 Forms 10-K and 10-Q which identify important risk factors that could cause actual results to differ materially from those contained in the forward-looking statements. With respect to guidance, please also see the slides and press release that accompany this call for further details.

As a reminder, Cisco will not comment on its financial guidance during the quarter unless it is done through an explicit public disclosure.

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

Charles H. Robbins

Thank you, Marilyn, and good afternoon, everyone.

Our results this quarter demonstrate that we are delivering against our strategic priorities and realizing the benefits of our investments to transform our business and drive long-term shareholder value. We delivered a solid quarter with total revenue of $11.9 billion and non-GAAP earnings per share of $0.60. We had strong margins yet again and great operating cash flow, up 10%. We are managing the business well through a multiyear transformation of the company while remaining focused on delivering customers' unparalleled value through highly secure, software-defined automated and intelligent infrastructure.

We are on a journey, which as we've consistently stated, will take a number of years, but we are pleased with the progress we're making. As our customers add billions of new connections in the years ahead, the network will become more critical than ever. They will be looking for intelligent networks that deliver automation, security, and analytics that help them derive meaningful business value from these connections. These will be delivered through a combination of new platforms as well as software and subscription-based services, which we have been focused on accelerating over the last 18 months.

My vision for this company is to be the most relevant and most important partner for our customers as they enable their digital businesses, and we will deliver on that vision. I look forward to discussing this in a lot more detail at our Investor Day on June 28.

We continue to innovate across our networking portfolio, with analytics being a key element of this innovation. This quarter, we completed the acquisition of AppDynamics, enabling us to provide customers with unprecedented visibility across networking, data center, security, and applications. As I talk to our customers and partners, I'm getting great feedback about the value of the insights AppDynamics provides to help them make informed business decisions. We're in the early stages of scaling out the AppDynamics solutions through the Cisco sales force and partner ecosystem, and I'm excited about the future of this space.

We were also pleased to announce our intent to acquire some new additions to our software and analytics portfolio. Software-defined WAN is a critical transition and addresses the evolving customer demands in branch routing as a foundational block of executing and cloud networking. Viptela combined with Cisco's IWAN technology will provide an industry-leading cloud-first SD-WAN platform that addresses the edge networking needs of our most demanding customers. MindMeld provides an AI platform to build intelligent and human-like conversational interfaces for any application or device and will complement our already strong collaboration portfolio.

These acquisitions support our goal of offering customers extraordinary value through a combination of organic and inorganic innovation, and they are aligned to our strategy of investing to drive long-term growth and helping us transition to more recurring software and subscription revenue.

We will continue to deploy our capital resources to give us first-mover advantage as we extend our technology portfolio. In addition to our inorganic growth, we're seeing strong organic growth of our next-generation products and solutions in both networking and security.

Now let me share some business highlights, starting with our security business, which has never been more relevant as we've seen in recent days. Last week's WannaCry ransomware attack was another example of the devastating impact cybercrime can inflict on individuals, companies, and countries around the world. Since Friday's attack, our Talos cyber threat intelligence team has been working around the clock to dissect the WannaCry ransomware, understand its attack patterns, and keep our customers protected. It's important that the tech industry and customers work together to defend against these attacks from cyber criminals. We will continue to do everything we can to help our customers anticipate, prevent, and protect themselves from any future attack by harnessing the intelligence of the network and the power of our security portfolio.

Our security business delivered another solid quarter with 9% revenue growth and 39% deferred revenue growth, reflecting our combination of best-of-breed solutions together with the industry's broadest security portfolio and a highly effective end-to-end security architecture.

We continue to lead in network security. Our next-generation firewall portfolio grew 49% with 6,000 new customers in the quarter, bringing our total customer base to over 73,000. We expanded our portfolio with the announcement of our Firepower 2100 Series, which offers both performance and protection for mission-critical applications. Our advanced threat portfolio continues to deliver strong revenue growth of over 30%. And we added 6,600 new customers, bringing the total number of AMP customers to over 35,000.

Now let's turn to collaboration. In January we introduced Cisco Spark Board, the first all-in-one cloud-based collaboration and meeting room solution. We've seen good early traction with this SaaS-based service, with nearly 700 customers adopting the solution in the quarter. This is a great example of the transition I mentioned earlier focused on moving from standalone systems to best-of-breed products combined with software subscriptions.

Our intended acquisition of MindMeld will help us simplify and enhance the collaboration experience even further through the power of artificial intelligence and machine learning. As chat and voice quickly become the interfaces of choice, MindMeld's AI technology will enable Cisco to deliver unique experiences throughout its portfolio. This acquisition will power new conversational interfaces for Cisco's collaboration products, revolutionizing how users will interact with our technology while increasing ease of use and enabling new capabilities. For example, users will be able to interact with Cisco Spark via natural language commands, providing an experience that is highly customized to the user and their work.

In our data center switching business, we now have a combined install base of over 20,000 customers who are using our portfolio to help them build, run, and manage their private and hybrid cloud environments.

Our ACI portfolio grew 42%, as customers move to 100-gig and look to automate the network and increase network performance, visibility, and security. We added almost 1,200 new Nexus 9000 customers in the quarter, bringing the total install base to 12,000. Our APIC adoption continues to increase rapidly, with over 380 new ACI customers in Q3, bringing our total to nearly 3,500.

Before I turn it over to Kelly, let me reiterate a few key points. I'm pleased with the progress we're making. As I've consistently stated, this transition will take time, but we're remaking this company to succeed in a dramatically changing marketplace. We are laser-focused on delivering innovation as well as aggressively managing the business to optimize profitability, cash flows, and value for our shareholders.

Kelly?

Kelly A. Kramer

Thanks, Chuck. I'll start with a summary of our financial results for the quarter followed by the Q4 outlook.

Q3 was a solid quarter, with financial results consistent with our expectations. We executed well, driving solid profitability, strong cash flow, and we continued to deliver on our strategic growth priorities. Total revenue was $11.9 billion, down 1%. Non-GAAP EPS was $0.60, up 5%. And operating cash flow grew 10% to $3.4 billion. We generated 31% of our total revenue from recurring offers, up from 29% a year ago. We continue to be extremely focused on driving margins and profitability, increasing our non-GAAP operating margin to 32.3%, up 2.3 points.

Before I go through Q3 in more detail, I want to remind you that Q3 last year included an extra week. It resulted in higher revenue in that quarter of $265 million, $200 million of which was in services and $65 million from our SaaS businesses like WebEx and some from product distribution. We also had non-GAAP higher cost of sales and operating expenses of $150 million. This netted to $115 million of higher non-GAAP operating income last year.

So on to this quarter. Total product revenue was flat year-over-year. I'll walk through each of the product areas. Switching grew 2% with solid growth in data center switching driven by ongoing strengths in the ACI portfolio which was up 42%. We also saw slight positive growth in our campus business. Routing was down 2% driven primarily by weakness in mobile packet core. Collaboration was down 4%, but adjusting for that extra week last year, it was down 2%. The drivers are primarily a decline in unified communications endpoints partially offset by continued growth in WebEx. Deferred revenue grew 10%. Data center declined 5% with the continued market shift from blade to rack; however, we are seeing solid traction with our hyperconverged offering, HyperFlex.

This quarter, we also further extended our innovations in UCS with new converged solutions for IBM VersaStack and with our strategic with Docker to deliver containerized applications. Wireless grew 13% with strong Meraki performance as well as the ramp of our 11ac Wave 2 portfolio. We continued to innovate with the launch in the quarter of new wireless networking solutions including a new Wave 2 access point and a wireless controller.

Security was up 9% with strong performance in Unified Threat Management with growth of approximately 50% as well as growth of over 30% in both advanced threat and web security. Deferred revenue grew 39% demonstrating the value of our solutions and ongoing delivery of innovation. Services was down 2%. Normalized for the extra week, it grew 4%. We're continuing to focus on renewals and attach rates.

We drove good growth in deferred revenue which was 13% in total with product up 26% and services up 7%. Deferred products revenue from our recurring software and subscription businesses was up 57% to $4.4 billion, which included the acquisition of AppDynamics during the quarter. Excluding AppDynamics, the increase was 51%. In terms of orders, total product orders declined 4%.

Looking at our geographies, which is a primary way we run the business. Americas was down 4%, EMEA was down 6% and APJC grew 2%. Total emerging markets declined 12%, with the BRICS plus Mexico down 10%. In our customer segments, enterprise declined 2%, commercial grew 1%, public sector was down 4% and service provider declined 10%.

From a non-GAAP profitability perspective, total gross margin was 64.4%, down by 0.8 points. In Q3 2016, the extra week resulted in a 0.5-point benefit in that quarter. So adjusting for that, total gross margin decreased 0.3 points. In Q3 2017, our product gross margin was 63.2%, down 1.3 points, and service gross margin was 67.8%, growing 0.7 points. We increased our operating margin by 2.3 points to 32.3% from a year ago. In terms of the bottom line, we grew non-GAAP EPS 5% to $0.60 while GAAP EPS was $0.50.

We ended Q3 with total cash, cash equivalents and investments of $68.0 billion, with $2.9 billion available in the U.S. From a capital allocation perspective, we returned approximately $2 billion to our shareholders during the quarter. That included $0.5 billion of share repurchases and $1.5 billion for our quarterly dividend, reflecting the 12% increase we announced last quarter. To summarize, Q3 was a solid quarter and we executed well. We're focused on driving operational efficiencies and profitability, enabling us to make the strategic investments to drive long-term shareholder value.

Let me reiterate our guidance for the fourth quarter. This guidance includes the type of forward-looking information that Marilyn referred to earlier. We expect revenue in the range of minus 4% to minus 6% 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 in the range of 29.5% to 30.5%. And the non-GAAP tax provision rate is expected to be 22%. Non-GAAP earnings per share is expected to range from $0.68 to $0.62.

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

Charles H. Robbins

Thanks, Kelly, and thanks again to all of you for joining us today.

As I mentioned earlier, we delivered another solid quarter and we are executing well. We're confident in our strategy for long-term growth and profitability. We believe that the network will become increasingly important in solving our customers' most complex business problems and helping them get secure and stay secure. We also believe that we will continue to see strong momentum in our shift towards more software and subscription revenue. This reflects the success of the investments we're making in these areas, together with the flexible consumption and buying models we're offering our customers.

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

Marilyn Mora

Great. Thanks, Chuck. Sean, let's go ahead and open the line for questions. And while Sean is doing that, I'd like to remind the audience that we ask you to ask one question so we have plenty of time to take all of your questions today.

QUESTION AND ANSWER SECTION

Operator

Thank you, ma'am. We will now begin the question-and-answer session. Our first question is coming from the line of Mr. Mark Moskowitz of Barclays Capital. Your line is now open. You may begin.

<Q - Mark Moskowitz>: Yes, thank you. Good afternoon. I wanted to see if we can understand more of the guidance, Kelly and Chuck. The revenue is a little lighter than we had anticipated. Is that a function of macro factors? Or is that a function more of the shift to the subscription model? Or maybe there's going to be some disturbance here and there. Clearly, the deferred revenue product revenue growth is quite nice. I'm just wondering if there's any sort of puts and takes you can walk us through there, greatly appreciate it.

<A - Charles H. Robbins>: Kelly, why don't you take him through the bridge, and then I'll just make some comments.

<A - Kelly A. Kramer>: Sure. So, Mark, when we look at guidance, it's a combination of many factors, right? It starts with our backlog and then the orders momentum, the funnel, and then yes, definitely, we take into account our transition to more software and subscriptions and how that's impacting it. So when I look at the guidance we just gave, our orders were a little weaker in Q3 which does mean that I'm starting with a lower backlog than anticipated. And then what I'm assuming when I look at the order strength, we're assuming what we saw in Q3 continues on in Q4.

So just to give some color around that, where we had been facing headwinds all quarter long was SP and emerging. We saw them get worse this quarter. That you saw in the numbers there. I'm expecting that to continue. And then we saw some new kind of macro issues in areas like public sector in the U.S. fed space and things like that.

So I'm assuming that that orders momentum we saw in Q3 is going to continue on in Q4. And then finally, we are seeing an impact, because you're seeing it go to the balance sheet, of this transition that we are just accelerating through, to the tune of 1.5 to 2 points. So the combination of those three things are driving the guidance into that minus 4% to minus 6% range.

<A - Charles H. Robbins>: Yes. Just, Mark, a couple of comments on what Kelly just described. I mean the public sector business, particularly in the United States, the federal business is – frankly, it's about 1 point of that guide. It's a pretty significant stall right now with the lack of budget visibility. And when you think about the strategy that we're deploying, the 57% growth in the software and subscription business, if you just go back eight quarters ago, we had $2 billion on our balance sheet relative to software and subscription.

And the first two or three quarters, we were convincing the teams that that was the shift we were going to make. And now we have more than doubled that to $4.4 billion, and the growth there is accelerating. So we're very pleased with that transition. And at the same time we deal with all of these challenges, we remain very committed to earnings. We remain very committed to our capital return strategy.

<A - Marilyn Mora>: Great. Thanks, Chuck. Sean, we'll take the next question, please.

Operator

Thank you. The next question is coming from the line of Ittai Kidron from Oppenheimer. Your line's open. You may begin.

<Q - Ittai Kidron>: Thanks. Chuck, I'm going to take a U-turn this time actually and not ask you about the data center business but rather focus a little bit more on the gross margin. Some of the commentary in your press release talked about some pricing pressures. If you could, give us a little bit more color on the guidance and your gross margin assumption into the guidance. How much of that is mix related? And how much of that is pricing? And any color you can give on the pricing; how much is competitive versus – I don't know – product shifts or something like that, that will be great.

<A - Charles H. Robbins>: Thanks, Ittai. So, Kelly, let's have the same strategy. Do you want to go through the math on this on this? And then...

<A - Kelly A. Kramer>: Yes. So, Ittai, when we look at the drivers of our gross margin, price in Q3 actually has been in the same range that it was pretty much last year as well as last quarter in terms of the price index that we're seeing. So that's in the same range. Again, it's high but it's in the range. It's not increasing.

I would say in terms of the guidance for Q4, we're assuming that. We are also making sure the teams are being very aggressive where they need to be aggressive in areas and against competitors where we need to be. But overall, the pricing hasn't changed dramatically besides the normal erosion that we see in certain business lines.

I'd say in terms of mix, that hasn't dramatically changed as well. With switching being positive this quarter, that helped a lot. And again, while the mix isn't changing, there are mix changes within the ease in the guidance going forward, but it's nothing dramatic. So I'd say we feel good about being able to continue driving the margins that we have.

The only other piece I'll comment on because we mentioned it before, we are still seeing some cost pressure from the increase in DRAM pricing that got baked in both our Q3 as well as into Q4. But we've been doing a lot of work, and our supply chain team has been working with our suppliers to make sure we can secure our forward supply at prices that we can plan at. So I think we've pretty much got that boxed in for the guidance.

<A - Marilyn Mora>: Great, thanks.

<A - Charles H. Robbins>: It's good.

<A - Marilyn Mora>: Thanks, Kelly. Let's go ahead and move on to the next question.

Operator

Thank you. The next question is coming from James Faucette of Morgan Stanley. Your line's open. You may begin.

<Q - James E. Faucette>: Thanks very much, just a couple of quick follow-up questions to some of the comments that have already been made. Can you talk a little bit about the orders? And you mentioned that fed was weak. But when you look at the other areas of weakness, can you talk about like what's driving those, et cetera? And I guess more long term, you continue to see good deferred revenue growth, and you mentioned security. What are the priorities that your customers are showing in the security space generally? And what are you able to address now versus what are things that they're asking for that you think you need to improve on? Thanks.

<A - Charles H. Robbins>: Great. Thanks, James. And so we have some order color and then security, so let me take the order stuff and then, Kelly, chime in as you'd like. So if we just go around the globe, let me just highlight what we saw. And I'm just going to tell you what drove the weakness in these areas, so you can assume the other pieces of the business were pretty much as expected. In the Americas, it was primarily the U.S. federal. There's so much uncertainty around budgets. The U.S. federal business was a significant driver. Mexico, there has been a lot of uncertainty in Mexico, and that was actually down 49% for us year over year. So there's a great deal of uncertainty around the investment landscape there. And then the third element would have been the service provider business in the Americas. So those were the things that really drove the orders in the U.S.

In Europe, the UK – the currency issue in the UK is real and was very impactful in that business. And then we continue to see pressure in the Middle East relative to oil prices. We also – obviously, there's been a lot of uncertainty around the geopolitical dynamics, some of which has been clarified recently, obviously. And we did see some strength in some countries there but the UK is a big country for us. And the Middle East, obviously, with the uncertainty around oil prices continues to be a little bit of pressure as well.

In APJC, we saw Japan and Australia were reasonable. India was solid again. In China, we had tough comps from the SP Video business from a year ago that we talked about. So that's really what we saw from an orders perspective. I think if you look at customer segments, just to give you some color, enterprise the challenge was largely driven by Europe. Commercial, the lightness there was driven by Europe. Public sector, as I said, was U.S. federal and SP was fairly inconsistent. So, Kelly, any comments on that?

<A - Kelly A. Kramer>: No, you've covered it.

<A - Charles H. Robbins>: And just quickly on the security since you snuck that one in too, James. What our customers – what we see happening in security right now is that as our customers prepare for the next few years, and literally adding billions of new connections, we obviously believe that the network is going to become even more relevant than it ever has been. And our customers are going to need to deal with that scale. They're going to need significant automation. They're going to need greater insights coming out of their technology infrastructure like the network through analytics. They're going to need security embedded at the network-layer because you're going have to begin to secure the infrastructure the minute these packets hit the wire.

So what they're look for is – they are looking for an end-to-end architecture now for dealing with security. They're looking for an open architecture that actually allows them to buy the best-of-breed technology which we have across many elements of what they're trying to do. But they are looking for an architecture and they're looking for – to leverage as much of that from the cloud and which correspondingly turns into the subscription business as you pointed out. So that's what we see happening there. There's obviously lots of other areas within that architecture that we don't play today where we could. And we continue to assess all of those opportunities.

<A - Marilyn Mora>: Thanks, Chuck. Next question, please.

Operator

Thank you. The next question is coming from Vijay Bhagavath of Deutsche Bank. Your line is open. You may begin.

<A - Marilyn Mora>: Vijay, are you there? Vijay?

<A - Charles H. Robbins>: Okay.

<A - Marilyn Mora>: Okay. Hey, Sean, why don't we move to the next question?

Operator

Will do, ma'am. The next question on queue coming from Simona Jankowski of Goldman Sachs. Your line's open. You may begin.

<Q - Simona K. Jankowski>: Hi. Thank you. It's Simona Jankowski. Just a couple of follow ups. First, if you can clarify in terms of the weakness you saw incrementally in the service provider and emerging market theaters, how much of that was related to competition or pricing pressure such as from Huawei versus some of the macro factors you discussed? And then just a quick follow-up on how did your cloud business do this quarter?

<A - Charles H. Robbins>: So let me comment on the first one and then, Kelly, maybe you can talk about the cloud business and how we – I'll talk about both of them but then how we measure that specifically. So the weakness in emerging in SP I would say – in emerging I would say it's less. We clearly – we've had competition from several vendors and clearly Huawei is a very strong competitor. I don't feel like it has increased significantly in the emerging countries. It's been pretty consistent there and our teams know how to compete and we continue to evolve our strategy and bring different tools to help them compete. So I wouldn't say that had much to do with it. I think on our overarching cloud business, Simona, we look at that in many, many different ways.

So we look at obviously our private cloud business which is made up of the UCS business as well as our data center switching portfolio, which we talked about earlier, both of those. The UCS business was down 5% as you saw and then the – obviously our next-generation switching portfolio continues to do well, the ACI element's up 42%.

And if you're asking about the MSDC guys, which are the webscale cloud guys, it's the same as we were last quarter of these. We're engaging with them on an individual basis. We look at the big ones as, frankly, markets of one. We have made great progress with a few of them. Others we're in the early stages. And we have co-development opportunities, but I would tell you we're in very deep discussions with most all of them and we're looking at very strategic partnerships that scale beyond even just selling infrastructure to them in many cases. So, I'm not sure where you're going with cloud. Hopefully one of those answer has covered what you were looking for.

<Q - Simona K. Jankowski>: Okay. Thank you, Chuck. We'll take the next question, Sean.

Operator

Thank you. Next question is coming from Jess Lubert of Wells Fargo. You may now begin.

<A - Marilyn Mora>: Jess? Are you there? Jess? All right. Why don't we go ahead and move on to the next question?

Operator

Thank you. The next question on queue is coming from Kulbinder Garcha of Credit Suisse Securities. Your line's open. You may begin.

<Q - Kulbinder S. Garcha>: Thank you for the question. For Chuck maybe, on the revenue side, I take your point on the macro economy and the weakness in emerging markets...

<A - Charles H. Robbins>: Hey, Kulbinder, could you speak up just a hair, buddy?

<Q - Kulbinder S. Garcha>: Sorry [indiscernible] (29:14). My question is on revenue growth. I take the drivers of the weak guidance you're talking about. I guess the broader question is how important is getting this company back to growth? Cause it looks like last year you didn't grow, this year you're probably not going to grow very much either, especially organically. So, does something more transformative have to happen on the M&A front? Do you think this is temporary in nature? I know you're having this headwind of this business transformation, but just the importance of revenue growth for Cisco as a company, if you could comment on that for the long-term. Thanks.

<A - Charles H. Robbins>: Yes, Kulbinder. I think that when we look to the future right now and you really think about the number of new connections that are going be added – that our customers will be adding over the coming years and the need for automation, the need for analytics and security, what we have done – and it will be done – our solutions that we bring in the space will be a combination to your point of inorganic capabilities as we have shown our ability to do as well as some organic innovation.

I've talked to several of you over the last few quarters about the fact that we went in and reallocated a fair amount of our R&D expense last year and over the last 18 months, and many of those solutions are targeting these next-generation networks that our customers are going to need to build out to support this new infrastructure.

And with a high degree of automation across the network, with a high degree of analytics, with distributed compute capabilities for processing the data at the edge, as well as this security piece. So, we have future innovation that will come in that space. We'll also use a combination of inorganic options where we need it. And we believe that as we get into that next generation of the networks that the customers need to build out that we will be – we'll be very successful with our capabilities.

<A - Marilyn Mora>: Thanks, Kulbinder. Sean, next question, please.

Operator

Thank you. The next question is from Jess Lubert of Wells Fargo. You may now begin.

<Q - Jess Lubert>: Hello? Can you hear me?

<A - Marilyn Mora>: Yes.

<A - Charles H. Robbins>: We can.

<Q - Jess Lubert>: Okay, good. I was hoping you could provide a little more detail regarding the order weakness you're flagging in the North American service provider vertical last quarter. If I remember correctly, you suggested orders there were improving a little bit. So, I just wanted to understand the change, to what degree it's a technology issue versus a macro issue, the duration you think that's likely to be weak for and if there's any areas within the vertical that are better or worse, that would be helpful. Thanks.

<A - Charles H. Robbins>: Jess, let me just give you a couple of comments and then Kelly can give us any specifics. As I said two quarters back, I think, when we had the negative 10% growth or 12% or whatever it was, 12% I think.

<A - Kelly A. Kramer>: Yes.

<A - Charles H. Robbins>: Our entire SP business around the world is driven by very large customers, and so when some number of them have an off quarter, it can affect the business. And I think the Americas would be probably an example of that this quarter as well. And the Mexico business that I discussed is heavily influenced by service providers. And so that's a bit of what we've seen. We had some customers in the U.S. that performed very well this quarter for us, and others that did not. Kelly, any comments on the numbers?

<A - Kelly A. Kramer>: Yes. No, I'd say I think you hit on it. I mean, I think with the Americas being down so much, it was a combination of Mexico. Again, these are big customers, and that was down. Chuck already mentioned Mexico was down 49%. It was a huge chunk of that was in the SP. And then in the U.S., the service provider, that was modestly down, not dramatic at all. And again, that is – again, we had a lot of customers that were up and a lot that were down, so balanced overall.

<A - Marilyn Mora>: Thanks, Kelly. Next question, please.

Operator

Thank you. The next question is coming from Pierre Ferragu of Sanford Bernstein & Company. Your line's open. You may begin.

<Q - Pierre C. Ferragu>: Thank you for taking my question. I was wondering, Kelly and Chuck, how much we should read in the weak guide you gave us against at least expectations we had on the Street. Is there a change we should expect in your seasonality pattern? As you're going towards more subscription services, like the natural, like strength of the fourth quarter that we've seen in the past, is that something that we should expect to see changing over time?

<A - Charles H. Robbins>: I'll make a comment, and then let Kelly answer the seasonality portion of it. But clearly the transition to the software and subscription business obviously impacts how to think about guidance going forward. And when we see particularly large quarters with high growth like we saw this quarter, I think it will have an impact. I'm not sure exactly how we look at what it means seasonally. Kelly?

<A - Kelly A. Kramer>: Yes, I do think that the model that we've looked at tried and true over the years where we could look at normal sequential from Q3 to Q4, I think those models are changing because we are accelerating what is – we're putting more on the balance sheet than what is amortizing off. While part of our revenue guide takes into account the growth of what's coming from our recurring offers, we're still adding so much more because we're adding more and more offers every day.

So I do think it is changing a bit. I think we'll talk about this a bit more when we get to our Analyst Conference in June as well. But we'll give you clarity of how we can continue to model that. We certainly still have a big chunk of our business that's driven by the core orders and the book-and-ship because we still have a lot of business that we haven't transitioned yet. But as we drive more and more of that, I do think it's going to have to change how we've modeled in the past as an analyst, and we'll give you that clarity to help that.

<A - Marilyn Mora>: Thanks, Pierre. Let's go ahead and take the next question.

Operator

Thank you. The next question is coming from the line of Steve Milunovich of UBS Securities. Your line is open. You may begin.

<Q - Steven Milunovich>: Thank you very much. Kelly, can you give us any guidance by product segment for next quarter? For example, services I assume will be up again. So in terms of the deceleration of the downside, where will we see that? Will switching likely be down, routing be down more? In terms of things getting a bit worse, where do you think we'll see that?

<A - Kelly A. Kramer>: Again, you know, Steve, that because so much of our core business is still very much related to the orders that we have yet to book, our backlog accounts for less than a third, and so much of our quarter comes from orders yet to come. We don't give guidance by business unit. But directionally, I think you're thinking about it the right way. I think in last quarter, we tried to guide when we were talking about routing, we knew we had stronger as a quarter going in routing, which is why it wasn't as bad as it had been the quarter before, this quarter on revenue. So again, it takes into account all of that.

I do think, as you know, our switching business is very fluid, so I don't think you should assume that that is going to continue to be – that goes up and down, so I don't think you should draw a trend having that being positive this quarter. So I think it's very fluid within business units.

<Q - Steven Milunovich>: Thank you.

<A - Marilyn Mora>: Thanks, Kelly. Sean, next question?

Operator

Thank you. Our next question is coming from Rod Hall of JPMorgan. Your line's open. You may begin.

<Q - Rod Hall>: Hi, guys. Thanks for taking the question. I just wanted to see if you could comment a little bit on the 31% recurring revenue. Maybe help us understand how much of that is Smart Net and maintenance-type services and how much is, let's call it, next-gen recurring revenue.

And then I also would like it if you could comment – I know the carrier situation in the U.S. is pretty weak, and we've seen that across other companies as well. But could you comment on specific projects like the metro optical build-out? Is that still a bright spot? Do you still see that project moving ahead as expected? Thanks.

<A - Kelly A. Kramer>: Sure, I'll hit the first one. So yes, so if I break out the 31% – so the way to think about it, Rod, is basically 90% of my services revenue is recurring. So of the 31%, 75% of that dollar amount, so over $3.6 billion – 75% of that comes from the services business. On the product side, 10% of my product revenue is now coming from recurring, so => that's over $900 million, so 25% of that over $3.6 billion. And so again, I think that the services has continued to be in that 90% range. And again, what we're really trying to drive is more and more of those offers on the product side.

<A - Charles H. Robbins>: Rod, this is Chuck. Six quarters ago, the product number I think was 6%. So we have made progress and we'll continue to as we see the amount of business that we're putting on the balance sheet is accelerating.

On your second question, we absolutely continue to see the projects like metro optical moving forward. We actually continue to do well in some of the next-generation areas that we're working with many of the U.S. service providers. So we see that going well. And we do believe that as they make some of these transitions, we are going be right in the middle of them with them.

<A - Marilyn Mora>: Next question, please?

Operator

Thank you. The next question is coming from Vijay Bhagavath of Deutsche Bank. Your line's open. You may begin.

<Q - Vijay Bhagavath>: Yes. Thanks. Yes. Hi, Chuck. Yes. Hi, Kelly.

<A - Kelly A. Kramer>: Hey, Vijay.

<A - Charles H. Robbins>: Hey, Vijay.

<Q - Vijay Bhagavath>: All right. Chuck, just – I'm a research analyst. So, I've noticed you're using AI, machine learning quite a bit more recently. So like to get your idea, Chuck, and also, Kelly if you could, in terms of which might be the product areas within Cisco where you'd apply AI, machine learning to the max initially? Where you see kind of low-hanging fruit immediate kind of business outcomes from AI, machine learning? Would it be in which parts of the portfolio? Thanks.

<A - Charles H. Robbins>: Thanks, Vijay. Yes, it's – your point is actually quite accurate that we look at how we use it – use both of those as tools across our entire portfolio. And I would tell you that there are initiatives underway and there are active solutions already in the marketplace that have elements of that in our security portfolio. There are absolutely elements of that that are in our collaboration portfolio already. We see lots of opportunities when you start talking about automation and analytics and things like network assurance capabilities or in service provider, self-healing networks. So we see the opportunity across everything we do. And we have initiatives both already working with customers as well as a lot of work going on inside the business units to leverage AI, machine learning and other technologies going forward.

<**A - Marilyn Mora**>: Thanks, Vijay. Next question, please?

Operator

Thank you. The next question is from Paul Silverstein of Cowen & Company. Your line's open. You may begin.

<**Q - Paul Silverstein**>: Thank you. I'm hoping for a clarification on two different issues. One, going back to the earlier question on pricing. Kelly, did I hear you say that pricing was relatively stable? And can you give us some granularity in terms of what you're seeing in Europe, switching and routing in terms of pricing? And then just very quickly, two quarters ago you quantified the impact of the shift to recurring model. I think you'd cited 100 to 200 plus basis point adverse impact. Can you give us quantification of that impact this quarter?

<**A - Kelly A. Kramer**>: Sure. So on the pricing, yes, just to give you the clarification of the pricing – and I'll pull up actually between Europe here if you give me a second. But – so to clarify, so we do have normal price erosion every period for – mostly in our switching and routing portfolio, those are the ones that are most sensitive to it. It's been in the same consistent percentage in terms of price reduction year-over-year than it has been both last quarter a year ago. So in the last four – we had one favorable quarter where we had some favorability from some rebates. But overall, it's been in the same range so it hasn't gotten worse. I'll pull up – I'll try to pull up here as I'm answering the second question: any difference between Europe and the Americas? But I think it's fairly consistent across the regions.

The second clarification was on – what was it, Marilyn, the...

<**A - Charles H. Robbins**>: On the impact of the recurring business...

<**A - Kelly A. Kramer**>: Oh, yes. Yes. So I have been saying it's in the 1% to 2% range. It is definitely pushing closer to the 2% range at this point. I mean I think it's clearly driven – we shared with you the balance and that's accelerating and I certainly look at the short-term portion of that and try to quarterize that to get it. But it's definitely pointing to the 2% more than the 1%.

<**Q - Paul Silverstein**>: Okay.

<**A - Kelly A. Kramer**>: And, Paul, I'll get back to you on that through IR on the – if there's any difference between Americas and Europe on that.

<**A - Marilyn Mora**>: Thanks, Paul. We'll take our next question.

Operator

Thank you. Next question is from Tal Liani of Bank of America. Your line's open. You may begin.

<**Q - Tal Liani**>: Hi, guys.

<**A - Kelly A. Kramer**>: Hey, Tal.

<**Q - Tal Liani**>: If my numbers are correct, your recurring revenues grew 6% year-over-year and was 14% the previous [ph] quarters (43:30). And I'm trying to see what could cause reacceleration. The question I have is whether you focus the recurring part mostly on new types of businesses such as security and others? Or you can find ways to go back to switching and routing and change either pricing scheme or add features or do something such that recurring revenues – outside of maintenance of course – recurring revenues grow and you can add softer features on top that will do that. The question is whether the customers will accept it or this is going to be a traditional business model forever?

<**A - Charles H. Robbins**>: Yeah. Tal, thanks for the question. So even in our current deferred revenue from software and subscription, there are elements of our core portfolio that are included in that $4.4 billion that you saw primarily through our Cisco ONE offerings that we put together. Probably 18 months ago, we started that journey and we got those offers and they've begun to ramp. But we also are looking – obviously, Security is ramping. Collaboration has

been the one probably the longest in this model. But we do believe that across the portfolio with future offers, we have the opportunity to do that and you'll see that as we deliver on some of the new capabilities. Kelly, any commentary on that?

<A - Kelly A. Kramer>: Yes. On the slowdown. So, Tal, we're actually not slowing down. The reason it looks like it's slowing down is for the services piece we do have the extra week compare. So if you adjust for that, it's up double digits in total. And if I look at just product, the growth of product which I said is over $900 million, that's growing 34% year-over-year and it was 30% last quarter so that continue to grow faster.

<A - Marilyn Mora>: Great.

Marilyn Mora

Thanks, Kelly. Thanks, Tal. I believe that was our last question. Chuck, maybe I'll turn it over to you for some final words.

Charles H. Robbins

Yes. So, first of all, I want to thank all of you for joining the call today. I want to just take a minute and reiterate that I believe that our strategy is working and I'm optimistic about where we're going to go over the next three to five years. We set out 18 months ago to transition the business to one of more software and subscription. At the time, eight quarters ago, it was $2 billion on our balance sheet. Today we've more than doubled that, up 57% this quarter to $4.4 billion and accelerating. So I believe that is working and we'll continue to shift more and more of our offers into that space.

We also obviously wanted to be very clear about the areas that we needed to invest in and you've seen significant investments in security and collaboration over the years. About 15 months ago we made obvious reallocations of expenses more towards the core and you're going to see future innovation in that space as well. Our customers really are going be adding billions of connections in the future and they are going to need a next generation network with security automation and analytics.

And so we're transitioning the business model. We're transitioning the network offers that we're going to deliver to our customers as they move into this next generation. And at the same time, we are leveraging our capability to do inorganic as well as organic innovation to make that happen. And in the midst of all this change, we remain very committed to our execution model and ensuring that we're focused on profitability as well as capital returns to our shareholders.

So that's a summary of where I think we are right now. And I wanted to thank all of you for spending time with us today. Thanks.

Marilyn Mora

Thanks, Chuck. And I'll go ahead and close it up here. Cisco's next quarterly earnings conference call which will reflect our fiscal 2017 fourth quarter and annual results will be on Wednesday, August 16, 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, feel free to contact the Investor Relations department here and we thank you very much for joining today's call.

Operator

Thank you for participating on today's conference call. If you would like to listen to this call in its entirety, you may call 1-866-443-8010. For participants dialing from outside the U.S., please dial 1-203-369-1121. This concludes today's call. You may disconnect at this time.