Q3 2021 Earnings Call

Company Participants

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

Other Participants

- Amit Daryanani, Analyst
- Ittai Kidron, Analyst
- Jeff Kvaal, Analyst
- Jim Suva, Analyst
- Meta Marshall, Analyst
- Paul Silverstein, Analyst
- Pierre Ferragu, Analyst
- Rod Hall, Analyst
- Samik Chatterjee, Analyst
- Simon Leopold, Analyst
- Tal Liani, Analyst
- Tim Long, Analyst

Presentation

Operator

Welcome to Cisco's Third Quarter Fiscal Year 2021 Financial Results Conference Call. (Operator Instructions)

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

Marilyn Mora {BIO 19771101 <GO>}

Welcome everyone to Cisco's third quarter fiscal 2021 quarterly earnings conference call. This is Marilyn Mora, Head of Investor Relations, and I'm joined by Chuck Robbins, our Chairman and CEO; and Scott Herren, our CFO. By now you should have seen our earnings press release. A corresponding webcast with slides including supplemental information will be made available on our website in the Investor Relations section following the call.

Income statements for 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 made throughout this call will be on a year-over-year basis.

The matters we will be discussing today include forward-looking statements, including the guidance we will be providing for the fourth quarter of fiscal 2021. They are subject to the risks and uncertainties including COVID-19 that we discuss in detail in our documents filed with the SEC, specifically the most recent reports on Forms 10-K and 10-Q, which identify the important risk factors that could cause actual results to differ materially from those contained in the forward-looking statements. With respect to guidance, please also see the slides and press release that accompany this call for further details. Cisco will not comment on its financial guidance during the quarter, unless it is done through an explicit public disclosure.

I will now turn it over to Chuck.

Chuck Robbins {BIO 17845882 <GO>}

Thanks Marilyn. Good afternoon and thanks for joining today. I hope everyone is staying healthy and safe as we start to see the benefits of vaccine deployments and the continuing improvement and economic activity.

I want to start by acknowledging our employees, customers and partners in India who are experiencing a devastating surge of COVID cases. Cisco is providing critical resources during this challenging time and our thoughts remain with all of you. While many of us are seeing great progress in our recovery efforts, we must remain vigilant and adaptable as we manage the ongoing pandemic around the world.

Turning to the quarter, we had impressive momentum in Q3, which gives me a great sense of optimism going forward. We returned to growth with revenue up 7%, driven by an improving macro environment, the strongest product portfolio in our history and great execution by our teams. We saw broad-based demand across the business led by our biggest growth opportunities, hybrid work, digital transformation, cloud and continued strong uptake of our subscription-based offerings. We are also seeing early momentum in the ramping of key technology cycles that are long-term growth drivers for our business such as 5G, 400 gig and Edge.

The next phase of the recovery and the future of work will be heavily reliant on our technology. Cisco's end-to-end portfolio will serve as the foundation for next-generation infrastructure solutions as well as cloud enabled delivery models and innovation, allowing our customers to move with even greater speed and agility. This will require a significant investment cycle and reinforces the strength of our strategy while driving greater opportunity to create a world that is more connected, inclusive and secure. We remain focused on accelerating innovation while simplifying the adoption of our offerings with network-wide automation, analytics and flexible-as-a-service consumption models, all aimed at improving our customers' network performance capabilities and security which we believe will drive tremendous long-term opportunities for us.

Our Q3 performance only reinforces my confidence about the future. These results reflect a return to a strong spending environment and an economic recovery that has gained momentum driven by vaccine rollouts and the easing of restrictions. As the economy has improved, customers have increased their investment across our portfolio to prepare for the upturn and return to office. In Q3, we saw 10% growth in product orders, the highest growth rate since Q1 of fiscal 2012, reflecting robust improvement across all of our customer segments and geographies.

From a product revenue perspective, we saw 6% growth led by strength across our portfolio including campus switching, routing, wireless, security, collaboration and web scale as well as from our acquisition of Acacia which closed during Q3. We continued to aggressively shift our business to more recurring revenue streams which we expect to grow over time as we expand our offerings. In Q3, we achieved $3.8 billion in software revenue with 81% of our software revenue sold as a subscription, up from 76% last quarter. We also saw another quarter of double-digit growth in our deferred revenue and remaining performance obligations. Over the past six years, we have made significant progress and now have one of the largest software businesses in the industry with an annual run rate well over $14 billion.

Let me now touch on Infrastructure Platforms, we saw strong demand across the majority of our portfolio led by our next-generation enterprise networking and service provider solutions as companies accelerate the modernization of their infrastructure. This modern infrastructure delivers higher performance and faster access to data while offering the best user experience in an increasingly distributed environment. Customers are turning to us to help them create the trusted workplace of the future with Wi-Fi access points, video endpoints, cameras and IoT sensors feeding data into DNA center DNA spaces. We are enabling operations teams to remotely monitor workplace conditions for a safe return to office.

We're also working to provide visibility beyond corporate networks, which is increasingly critical as our customers accelerate their adoption of SaaS and cloud solutions for hybrid work. At Cisco Live, we launched the industry's first enterprise-wide full stack observability offering by integrating ThousandEyes cloud intelligence with our Catalyst switching portfolio and AppDynamics. This provides IT with visibility and actionable insights across both external and internal networks to provide a seamless digital experience for users.

And with users more distributed than ever, it is vital that they have the most efficient and secure connection to the cloud. Our deep partnerships with Google, Amazon and Microsoft allow native connectivity from our SD-WAN fabric to each of these cloud offerings. With our technology, customers can reduce deployment times and connect branch offices to cloud workloads in minutes.

In our webscale business, we delivered our sixth consecutive quarter of strong order growth, which increased over 25% in the quarter and over 50% on a trailing 12 month basis. Our webscale customers are starting their 400 gig upgrade cycles and aggressively pursuing long haul build outs, while our carrier customers are exploring new architectures to realize the full potential of 5G. We are building the Internet for the future by creating breakthrough innovation with our routing, optical and automation technologies to deliver significant economic benefits. Recently, we launched a new routed optical networking solution, integrating our scalable high performance routers and Acacia's pluggable optics, which offer significant cost savings.

Last week, we announced our intent to acquire Sedona Systems to extend our cross-work automation platform to build on these capabilities. We also expanded our Silicon One platform from a routing focused solution to one which addresses the webscale switching market, offering 10 networking chips ranging from 3.2 to 25.6 terabits per second, making it the highest performance programmable routing and switching silicon on the market.

We know our customers increasingly want to consume Cisco's technology in new more flexible ways. At Cisco Live, we launched our new as a service portfolio, Cisco Plus and our first offer Cisco Plus hybrid cloud combining our data center compute networking and storage portfolio. Cisco Plus includes our plans to deliver networking as a service, which will unify networking, security and observability across access, WAN and cloud domains to deliver an unparalleled experience for our customers.

Turning to security, we had a record quarter surpassing $875 million in revenue, up 13% as we expanded our reach with customers around the world. Our security strategy is focused on delivering a simple and secure experience. We have an unrivaled ability to provide end-to-end security capabilities across users, devices, applications and data on any network or any cloud. This is a key reason why our customers trust us to help them proactively protect against and remediate threats. In fact, leading customers in every industry, including 100% of the Fortune 100 are using Cisco security solutions. These customers are increasingly deploying our Zero Trust and Secure Access Service Edge or SASE architectures along with automation, authentication and analytics capabilities.

With today's distributed workforce, companies must quickly deploy highly secure trusted access to critical applications everywhere without compromising performance. Customers like Ford are using our cloud-delivered security platform Umbrella as they secure over 100,000 of their remote team members. In this quarter Lyft turned to Cisco to strengthen their security protection for all of their users accessing their applications. By deploying our Duo portfolio, Lyft was able to provide strong access controls as they protect their user sensitive personnel and financial information while reducing their total cost of ownership by more than 50%.

With nearly $6 billion in annual R&D, the investment that Cisco is making at both security and the network continues to lead the momentum across our portfolio with 23 consecutive quarters of double-digit Umbrella cloud security growth, nearly 7,000 customers using our cloud native SecureX platform and strong platform growth with security enterprise agreements. We continued to expand our leadership with new innovations, including password-less authentication, data loss prevention, observability, cloud-based malware detection and enhancements to SecureX. We are also complementing our organic innovation with assets that enable greater security efficacy. Our intent to acquire Kenna Security will bring together their risk-based vulnerability management platform with SecureX's threat management capabilities to prioritize and more effectively manage overall risk.

Lastly, let me touch on applications. Our collaboration business continues to perform well, we had a record quarter in Webex as we execute against our strategy to power the future of hybrid work. Over the last six months, we've added more than 400 new features and devices to our Webex portfolio. We are enabling seamless experiences through our desk camera and desktop solutions while extending the Webex suite of devices, including digital signage, touchless calls, room capacity alerts and environmental sensors to help enable a safe return to the office.

Well-being is top of mind for so many right now as we face a new way of working. This is why we launched People Insights to help people monitor and manage their well-being. These new features, devices and capabilities combined with cloud calling and cloud contact center provide our customers with the most comprehensive and inclusive hybrid work platform. Last week, we announced our intent to acquire Socio Labs. By integrating Slido and Socio Labs into our Webex platform, we will also be able to provide the most comprehensive internal and external event management solution on the market.

In summary, we had a very good quarter. I'm so proud of the continued success of the business transformation our teams are driving. As I mentioned earlier, we are experiencing the strongest demand in nearly a decade. We are also seeing similar component shortage supply issues as our peers. The good news, and this is reflected in our guidance, is that we are confident we will work through this as we have already put in place revised arrangements with several of our key suppliers. We believe these actions will enable us to optimize our access to critical components, including semiconductors and take care of our customers by fulfilling their demand as quickly as possible.

Our strategy and commitment to leading with trust, innovation and choice along with our continued focus and discipline are positioning us well for growth and profitability. As we accelerate the pace of innovation for our customers and partners, it's critical that we continue to support our people, our communities and our planet. I'm very proud that Cisco was recently named the Number One best place to work in the United States by Fortune and Great Place to Work. This is a tremendous honor for us as it recognizes the incredible work of our people and the power of the culture we have created.

And lastly, in terms of actions we are taking to protect the planet. Last month, the Cisco Foundation announced $100 million over 10 years to fund non-profit grants and impact investing in climate solutions. We have already achieved 100% renewable energy in the U.S. and in many countries across Europe and this is another strong step forward. Whether it's our deep focus on delivering the best results for our customers, partners and employees or our commitment to making a difference in communities across the world, Cisco remains committed to our purpose to power an inclusive future for all. I'm quite optimistic about what's ahead and confident in our team's ability to deliver.

I'll now turn it over to Scott.

R. Scott Herren {BIO 18902845 <GO>}

Thanks Chuck. Last quarter, I identified four key priorities that we are using to define our financial strategy; driving profitable growth, a continued disciplined focus on financial management and operating efficiency, setting a long-term plan to maximize value creation through strategic transformation and examining investments both organic and inorganic. We made progress on all these fronts in Q3 and are continuing to build our financial approach based on these core pillars, providing a strong foundation for enhanced financial performance as well as long-term value creation for our shareholders.

Now let's turn to our results. I'll start with a summary of our financial results for the quarter followed by the guidance for Q4. As Chuck said, Q3 was a strong quarter across the business, we executed well with strong product orders and solid growth in revenue, net income and earnings per share.

Total revenue increased to $12.8 billion, up 7% year-on-year, exceeding the high end of our guidance range for the quarter. We saw broad strength in all product areas and geographies. We also saw continued recovery in our business and building momentum with sequential revenue growth of 7%. Our non-GAAP operating margin was 33.6%, non-GAAP net income was $3.5 billion, up 4% and non-GAAP earnings per share was $0.83, up 5% year-on-year coming in above the high end of our EPS guidance range.

Now let me provide more detail on our Q3 revenue. Total product revenue was $9.1 billion, up 6%. Service revenue was $3.7 billion, up 8%. Infrastructure platforms has rebounded nicely with revenues up 6%. Within that, switching revenue increased overall with growth in campus driven by strong double-digit growth of our Catalyst 9K products. Routing had strong double-digit growth driven by strength in the service provider market. Wireless had strong growth driven by the continued ramp of our WiFi 6 products and strengthen in Meraki. Data center revenue declined driven primarily by servers as we experienced continued market contraction.

Applications were up 5%. We continue to see double-digit growth in Webex driven by our product innovations and the value we bring to remote working. We saw growth in Unified Communications, IoT software and AppDynamics offset by a decline in TelePresence endpoints. Security was up 13% with growth across the entire portfolio. Our cloud security portfolio performed well, with strong double-digit growth and continued momentum of our Duo and Umbrella offerings.

We continued to transform our business delivering more software offerings and driving growth and subscriptions and recurring revenue. Software revenue was $3.8 billion and subscriptions were 81% of total software revenue, up 7 points year-on-year. As we continue to increase our software subscriptions, we're driving higher levels of recurring revenues, in fact the majority of our total revenue growth in the quarter came from recurring revenue streams. Additionally, the strength of our portfolio and transition to more software and services is driving growth in remaining performance obligations, or

RPO. At the end of Q3, RPOs were $28.1 billion, up 10%. RPO for product was up 15% and for service was up 7%.

There was a 90 basis points positive impact on revenue growth in the quarter related to the acquisitions of Acacia and IMImobile, which both closed during the quarter. As a reminder, these acquisitions were not factored into our Q3 revenue guide. We had strong order momentum in Q3 with total product orders up 10%. Looking at our geographies, the Americas were up 6%, EMEA was up 10% and APJC was up 31%. Total emerging markets were up 13% with the BRICS plus Mexico up 31%. In our customer segments, service provider was up 17%, commercial was up 16%, public sector was up 11%. Enterprise was flat, which is a significant improvement from last quarter.

Non-GAAP total gross margin came in at the high end of our guidance range at 66%, down 60 basis points year-over-year. Product gross margin was 64.9%, down 90 basis points and service gross margin was 68.7%, down 20 basis points. The decrease in product gross margin was largely driven by ongoing costs related to the supply chain challenges offset by positive product mix, which includes some software benefit. Price erosion was relatively moderate and in line with our historical range.

On the supply chain front, we continue to manage through the constraints seen industry-wide and continue to incur additional costs. We are partnering with our key suppliers, leveraging our volume purchasing and extending supply commitments as we address the supply chain challenges which we expect will continue. The quarter did include an extra week as we discussed on our last call, consistent with our guidance for the quarter, the benefit for the total revenue was approximately 3 points of growth. Total impact on our cost of sales and operating expenses was approximately $150 million.

Operating cash flow was $3.9 billion, down 8% driven by the timing of payments and restructuring costs. We expect operating cash flow to normalize for the full fiscal year. We ended Q3 with total cash, cash equivalents and investments of $23.6 billion, down $7 billion sequentially driven by $5.5 billion in payments for acquisitions as well as $3 billion in repayments of our long-term debt.

From a capital allocation perspective, we returned $2.1 billion to shareholders during the quarter, that was comprised of $1.6 billion for our quarterly dividend and $510 million of share repurchases. Year-to-date, we returned $6.7 billion to shareholders, which represents 64% of our free cash flow and we have $8.7 billion in capacity remaining under our current share repurchase program authorization.

We continue to invest organically and inorganically in our innovation pipeline. During Q3, we closed three acquisitions, Acacia Communications, IMImobile and Dashbase. Subsequent to the end of the quarter, we also successfully closed on our acquisition of Slido on May 4th. These investments are consistent with our strategy of complementing our internal innovation and R&D with targeted M&A to allow us to further strengthen and differentiate our market position in our growth areas. To summarize, we had a great Q3. We executed well with strong top line growth and profitability. We're seeing returns on the investments we're making in innovation and driving the continued shift to more software and subscriptions, delivering growth and driving shareholder value.

Now let's turn to our guidance for the fourth quarter of fiscal '21. This guidance is subject to the disclaimer regarding forward-looking information that Marilyn referred to earlier. Our financial guidance for Q4 is as follows: We expect revenue growth to be in the range of 6% to 8% year-on-year, reflecting again the strong demand we're seeing. We anticipate the non-GAAP gross margin to be in the range of 64% to 65%, reflecting the ongoing increase in supply chain costs we are incurring as we protect shipments to our customers. Our non-GAAP operating margin is expected to be in the range of 32% to 33% and the non-GAAP tax rate is expected to be 19%. Non-GAAP earnings per share is expected to range from $0.81 to $0.83.

Looking ahead, we're excited to announce we will host a Virtual Cisco Financial Analyst Day on Wednesday, September 15, 2021. We will post event details in the coming weeks and look forward to sharing more with you at that time.

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

Marilyn Mora {BIO 19771101 <GO>}

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

Questions And Answers

Operator

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

Q - Rod Hall {BIO 20453923 <GO>}

Yeah, guys. Thanks for the question. I wanted to start off I guess with the margin guidance and that's the thing most people are asking me about -- and I heard -- Scott, I heard you talking about the impact from increased costs, I guess maybe could you give us some more color on how sustainable those impacts are and also address the OpEx line, it looks like those costs are inflated to, I assume for some of the same reasons, but just the sustainability of these cost pressures and these kinds of margins you're guiding for as we look forward? Thanks.

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

Yeah. Thanks, Rod. On the -- starting with the gross margin, the impact you're seeing in the Q4 guide on gross margin is really driven by supply chain. And it has a couple of elements to it; one is unit costs, so that -- we've got and actually it was announced today from Gardner, we've got the Number One supply chain team in the world two years in a row. That team has done a great job getting ahead of the issues that everyone in the industry is seeing. So with that, though, we've locked in both supply and pricing with some of the key component providers that we've got going ahead, that's what you see built into the margin guide. And I think the supply chain issues will stay with us at least through, from what I can see, at least through the end of this calendar year.

On the OpEx side, it's a little bit different, when you look at the -- we're right on track, let me just start by saying before you ask, we're right on track with the savings associated with the restructuring that we announced earlier this year, earlier this fiscal year. We said at the time we would reinvest some of that into the growth of the business overall and that's what you see happening. So when you look at the year-on-year growth in OpEx, it's driven by the integration of the acquisitions that closed during the quarter, little bit of a headwind from FX as the dollar has weakened. And then the higher commissions given the robust strength of the top line, commissions are up and reset of the variable comp plans. That's what's driving it and I think that the sustainability to get to your point, as I expect to see some of the supply chain issues linger with us through the end of the calendar year, first half of our fiscal year.

A - Chuck Robbins {BIO 17845882 <GO>}

Yeah. Hey, Rod, this is Chuck. I just want to add a little color to that. So as we began to realize that we were going to have the incremental cost, we had to make some decisions. And I think, obviously, we do believe these are temporary, we'll have to see how long they last. But based on that and based on the fact that we are seeing such momentum in the business right now, we decided to continue to invest in the business to drive the growth that we are feeling right now. And when you see the balance of the growth across all the businesses, you see the regional balance, it was balanced across the technology areas, it was balanced across segments. And then you think about that in the context of some of these real major trends that are occurring that were on the front end of like the 400 gig transition, like the success we're having in webscale, the service provider 5G build out, the hybrid work and return to office, we talked about WiFi 6 leading to campus switching, which we're seeing play out now and the security business had a record quarter at a time where most or every customer is suggesting that they're going to be spending more over the next 12 months on cybersecurity. So we felt like it was prudent to continue to invest to meet the demand and deal with some of the short-term pain and then we think we'll get to the other side of it.

Q - Rod Hall {BIO 20453923 <GO>}

Great. Okay, thanks a lot. I appreciate it.

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

Thanks, Rod.

A - Marilyn Mora {BIO 19771101 <GO>}

Thanks, Rod. Next question please.

Operator

Samik Chatterjee from JP Morgan, you may go ahead.

Q - Samik Chatterjee {BIO 15496543 <GO>}

Hi. Thanks for taking my question. Chuck, I guess somewhat following up on Rod's question here. I think the macro expectation here is that we will be going through a period of higher inflation and you've seen that somewhat in the supply chain but also in other aspects as well. Can you just help us think through what are the levels that the company has as you navigate through that and particularly how are you trying to balance that against the risk that some of your customers might be pulling ahead or are those pulling ahead demand just secure product from you?

A - Chuck Robbins {BIO 17845882 <GO>}

Yeah, a couple of great questions. Number one, what we do know is that if we come to the conclusion that any of these cost increases or these -- this inflation, as you mentioned it, are going to be more sustained than we will look at strategic price increases where we have to, and that work's already underway, there is already some decisions that we've made, so will continue -- we will do that. It's a pretty dynamic situation as you know.

And then on the pull ahead, this is a question that we've been asked. And while it's impossible to really quantify what that might be, it's going to be pretty obvious that if a customer has extended lead times, they're probably going to place orders sooner than when they were that just makes sense. But we also have proxies that we would be looking for to really reflect that being a major issue like order cancellations, if they're placing these orders in multiple -- against multiple channels and then canceling when they get it out of one channel, we don't see that. You would see more of that pull ahead from the enterprise and obviously commercial and small business, you probably wouldn't see as much and those were pretty significant growth engines for us this past quarter. So we don't see any glaring red flags although we would certainly agree that there is probably some level of early ordering going on.

Q - Samik Chatterjee {BIO 15496543 <GO>}

Okay. Thank you.

A - Marilyn Mora {BIO 19771101 <GO>}

Thanks Chuck. Next question?

Operator

Meta Marshall from Morgan Stanley. You may go ahead.

Q - Meta Marshall {BIO 18728692 <GO>}

Great, thanks. Appreciate the question. Where do you think customers are on return to work planning, are your larger customers maybe further along than smaller customers or vice versa? And then just what are you seeing from some of the spending from the impacted industries from last year? Thanks.

A - Chuck Robbins {BIO 17845882 <GO>}

Great question. So first of all, I think it's the inverse. I think we're seeing the small businesses in the commercial customers moving a little faster, although we saw enterprise pickup in Asia and in Europe and we've done a deep analysis with our team, the U.S. improved, and we would expect next quarter and the next fiscal year for U.S. enterprise to actually improve significantly from where we are today. And I think on the industry front, we were doing the review in the U.S. and we've actually seen double-digit growth in hospitality and healthcare and retail and we've even seen the cruise lines making significant purchases as they prepare to go back out. So we think that that is definitely a sign that we're on the road to recovery, and I would say that, the other thing I would highlight is, as our customers think about hybrid work and they think about the return to office, we've talked about the prevalence of WiFi 6, we saw continued strength in WiFi and we said once that begins to happen that we believe there would be a campus switching upgrade follow and the Cat 9K has had four quarters of increasing growth in double digits the last few quarters from a demand perspective, so we've seen that happen as well. So I think that, overall, I think it's happening as we thought it would and perhaps even at an accelerated pace.

Q - Meta Marshall {BIO 18728692 <GO>}

Okay, great. Thank you.

A - Marilyn Mora {BIO 19771101 <GO>}

Thanks Meta. Next question please?

Operator

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

Q - Tal Liani {BIO 1643846 <GO>}

Hi guys. I have two questions, related and not related. First question is the pricing environment, we see price increases across the board, we see component shortages, does it impact pricing of your products and is there any plan or have you already adjusted prices for that? That's number one.

The second one, I'm trying to understand the year-over-year trends in the context of easy comps versus real growth. And I know it's hard to say it, but it's hard to quantify, but can you at least qualitatively speak about the fact of when you grow 7% then we deduct the acquisition impact et cetera? What's the impact of the environment really improving in your comments versus just easy comps because last year was so weak because of COVID? Thanks.

A - Chuck Robbins {BIO 17845882 <GO>}

Yeah, Tal, that's great. I'll comment on the first one -- I'll comment on both of them and then Scott can add onto it. So on the pricing front, it says, I've said a few minutes ago, I think we have made some decisions on certain products that we will be making price increases on and we're looking surgically at the rest of the portfolio based on where we have costs that we believe are going to be sustained. But we're airing hard right now on taking care of our customers and trying to get optimize our ability to deliver to them right now because we think that improves our relationships and it improves our position over the long-term with these customers, so that's what we're doing.

On the year-over-year trends, I think that, what I would point too, is the real thing that I think is substantive is the demand side of what we've seen. And because you're right, you can do some math that gets at the revenue in Q3, but I think that based on what we see and the demand that we see, we do believe this is certainly -- it's a positively evolving marketplace for us and I think the work we've done over the last year, we pivoted our strategy a year ago based on what we thought would happen post pandemic, the teams have been executing really hard and it's great to see the customers embracing the solutions that we're delivering out there. So we feel like it's sustainable and...

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

Yeah. I think, Tal, when you look at the year-on-year, I think the context you need to put around that is the improving trend that we've seen, right. We've seen four to five now consecutive quarters of quarter-on-quarter improvement and really the improvements across the board. It's in each geo and it's in each product line. So we're seeing continued improvement and that obviously bodes well for looking out at Q4 and into the future. I think the other thing that -- we've talked about the robust demand that we've had and you see the revenue that we printed in Q3. What you didn't see is we also have built up a healthy backlog at this point. And so I think coming into Q4, not only do we have a very high percentage of recurring revenue as -- that we know will come into the revenue stream during Q4. We've got a sizable backlog at this point of orders to fulfill and we know exactly what's in the pipeline. So really feel good about the sequential trend that we're seeing across the business.

A - Chuck Robbins {BIO 17845882 <GO>}

Yeah, I think, Tal it's a really good point that Scott makes. I mean there is a revenue headwind that we're facing based on the supply chain. So notwithstanding what's going on in the supply chain, our revenue guide would have been higher which could have probably flowed through to improving EPS as well. So it's a complicated thing that we're navigating through right now, but I'll tell you, notwithstanding that, it's the best I felt about the business and our momentum and where we are in quite a while.

Q - Tal Liani {BIO 1643846 <GO>}

Great. Thank you.

A - Marilyn Mora {BIO 19771101 <GO>}

Next question please.

Operator

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

Q - Ittai Kidron {BIO 5557426 <GO>}

Thanks. Couple of questions from me. Chuck, I do want to follow-up again on the demand side. Trying to gauge how much of what you're seeing right now is things that were delayed during COVID that are being fulfilled now versus acceleration of future plans into now. I'm just trying to think sort of what is a normalized demand pattern for you once the noise of COVID for worst last year for better right now kind of goes away maybe you can help us think about that?

And then for Scott on the growth guidance for next quarter, can you call out specifically the impacts of the acquisitions, what is the growth guidance without Acacia, IMI, Dashbase and Slido that you just closed on?

A - Chuck Robbins {BIO 17845882 <GO>}

Yeah, Ittai. Thanks. So I'll try to do -- I'll try to answer what you asked, but I think it's a difficult one to really be definitive about, but I think there's a couple of aspects going on. I certainly believe there are projects that customers put on hold that they are now accelerating now that they have better visibility into what the return looks like. I definitely think that's happening.

I also think you're second point is happening. I think that every customer is looking at modernizing their infrastructure because no one wants to be caught flat-footed by the next crisis. And everyone has realized the power of technology during this timeframe so I think there is an element of increased investments that we'll see across all the technology areas as well as obviously cybersecurity, et cetera. But the other thing I think that's really important is that we've been investing for a long time against a lot of these big market transitions that are starting to come to life. I mean, you remember, Ittai, we didn't play in the webscale space five years ago, we didn't play. And now we're seeing that was almost a quarter of our service provider business again this quarter and it's still growing robustly. I mean it grew over 25% this quarter against a quarter or a year ago that was in excess of 70% growth so it's not -- it's still accelerating.

And then you got 5G that's starting to play out the way -- as we've all been waiting for it to play out. You've got this return to office and hybrid work with WiFi 6 and the campus upgrades that we've talked about and you've got this cybersecurity concern that is only exacerbated by everything we see in the press by all the continuing attacks and at a time where we had record revenues. So we -- I think all of those things are playing into it and that's what leads us to feel pretty good about where we are right now.

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

And Ittai, on your second question about the impact of acquisitions. We've said in the opening commentary that for Q3, it was about 90 basis points of growth and that was not part of our Q3 guide, those -- each closed during the quarter. So when we look ahead at Q4 of the revenue growth that we've laid out there about a 1.5 is driven by the acquisitions, mostly driven by Acacia.

A - Chuck Robbins {BIO 17845882 <GO>}

Two other things Ittai on that particular question that I wanted to point out, if you don't mind. The first is, we see a revenue headwind from the supply chain issue in Q4. As I said earlier, if we didn't have the supply chain challenges, we would have been guiding higher on revenue, which is reflected what Scott mentioned about the backlog coming into the quarter.

The second thing is, this business transformation that we have been working on for the last five or six years. If we go back to the first quarter, our CEO and then we look at the quarter that we're entering into, the recurring revenue that we're pulling off the balance sheet that we have visibility to today that will be part of Q4 revenue is up 64% during that timeframe. So we have a lot more visibility and it just says that the whole rationale for why we've been driving this business model transformation, which is a big complex change to get to, but that has helped us in a big way in allowing us to actually deliver the revenue we're talking about next quarter. So the benefits that we believed were there for the business model. I think this is probably the quarter where we're feeling the positive impact of that more than any other quarter.

Q - Ittai Kidron {BIO 5557426 <GO>}

That's great. Thanks, appreciate it.

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

Thanks Ittai.

A - Marilyn Mora {BIO 19771101 <GO>}

Thanks Ittai. Next question please.

Operator

Simon Leopold from Raymond James. You may go ahead.

Q - Simon Leopold {BIO 4081594 <GO>}

Thank you. Appreciate it.

A - Marilyn Mora {BIO 19771101 <GO>}

Simon? I think we lost you.

A - Chuck Robbins {BIO 17845882 <GO>}

Lost you Simon.

A - Marilyn Mora {BIO 19771101 <GO>}

Are you there Simon?

Operator

We'll go to the next question. Simon can queue back up again by pressing star one. Amit Daryanani from Evercore. You may go ahead.

Q - Amit Daryanani {BIO 7113568 <GO>}

Perfect. Thanks for taking my question. I have a question and a follow-up. Just when I think about your guide and the gross margin drop of 150 basis points, I'm curious would you attribute the entire drop to supply chain issues or is there anything else that play as well? That's one.

And then the second question was really hoping you could unpack the service provider growth with sort of accelerated a fair amount and we just talked about the trends you've seen in the traditional service provider more of the webscale business and whether that acceleration is coming from would be helpful? Thank you.

A - Chuck Robbins {BIO 17845882 <GO>}

Scott, do you want to take gross margins.

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

Yeah, I will. It is driven by supply chain and it comes in a couple of flavors. Having done the work that we've done to protect shipment to our customers with our unit price increases, unit cost increases on certain components that's built into it. There is also increased expedite fees again to ensure that we can -- that we get the components in and we can get the product back out the door and a slight increase in freight. So it really is all tied to supply chain.

A - Chuck Robbins {BIO 17845882 <GO>}

Yeah. And then Amit on the service provider growth. I'm glad you asked the question because I should have pointed it out. We saw double-digit growth across all of the subsegments of service providers, so cable, carrier as well as webscale. So it was very balanced across the three and it's not one segment carrying at -- which is why another reason that we're optimistic. The demand side we saw was so consistent across all our customers and so consistent across geographies and so consistent across the product portfolio, but in the SP space, it was double-digit across all of those segments.

A - Marilyn Mora {BIO 19771101 <GO>}

Next question please.

Operator

Simon Leopold from Raymond James. You may go ahead.

Q - Simon Leopold {BIO 4081594 <GO>}

Sorry about that. Can you hear me now?

A - Chuck Robbins {BIO 17845882 <GO>}

We can. Yes, we can.

Q - Simon Leopold {BIO 4081594 <GO>}

And my AirPods decided they wanted to stop working. Sorry about that. So I was looking to see if maybe you could help bridge the gross margin headwinds in terms of the supply chain, in that, we know there are multiple aspects it's not just the chip shortages, but things like air freight and then having to add maybe extra hours and paying over time when things come later because of the shortages. So if there was some way to maybe bridge the components that would help us understand how the recovery might manifest itself? Thanks.

A - Chuck Robbins {BIO 17845882 <GO>}

Yeah. Simon when you're AirPods went out, Amit was on the same wavelength, as you and he asked the exact same question. So I'll give the same answer. It really is kind of two or three aspects that are driving it all related to supply chain, unit costs are up and that's based on the work that our supply chain team has done to ensure that we can get supply, and so that -- such that we can deliver for our customers the gear that they need to get from us. They've all got significant transformation underway as well within their shops to support the new hybrid work environment and so we're working as hard as we can to make sure we can deliver product to them. So unit costs are slightly higher and that's SMEs, that's memory and it's in certain other smaller commodities across the board.

The second is, freight costs are higher. And as freight costs go up, obviously, that hits gross margin and then finally expedite fees as we're getting product in the doors. So it's all tied to various elements of supply chain.

A - Marilyn Mora {BIO 19771101 <GO>}

Thanks Simon.

Q - Simon Leopold {BIO 4081594 <GO>}

Appreciate. Sorry, you have to repeat yourself.

A - Chuck Robbins {BIO 17845882 <GO>}

No problem.

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

No, it's okay. It's all right.

A - Marilyn Mora {BIO 19771101 <GO>}

All right. Michelle, queue us up for the next question.

Operator

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

Q - Pierre Ferragu {BIO 15753665 <GO>}

Hey, guys. Thank you for taking my question. I have two like a quick follow-up, if I may. The first one is, so if I look at your software revenue sequentially, it went from $3.6 billion to $3.8 billion so that's rounded numbers, but it suggests you have like kind of mid-single digit sequential growth in software, which is very positive, very exciting. Is that the kind of right run rate level of growth we should expect for your software business? And then Scott just to confirm, given that move in mix, in revenue mix, in product portfolios, in a situation in which the supply chain were not disrupted we could have expected some tiny sequential improvement in gross margins, right?

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

Yeah, that's right. Mix is definitely as we continue to add more recurring revenue, particularly around software as you pointed out, but also our tech support services, those are higher gross margin. Those long-term will be a tailwind to our gross margins, the supply chain issues obviously more than offset that.

In terms of your question on software growth, the numbers that you're using are a little bit rounded, but you're on the right thread. We're seeing nice growth in software and in fact, I mentioned that, 81% now of that is driven by subscription and recurring revenues. So 7 point improvement in the amount of that software revenue that's recurring. That is great news longer-term, as you know with recurring revenue, particularly when it's ratable, you see less of the impact upfront. So there is a bit of a bow wave and you see it in the growth of our RPOs and the growth of our deferred revenue on products. So each of those are growing, that's also a sign of the growth within our software product set.

I mean, we're now -- when you just do the quick math, right. We're now one of the biggest software companies in the world, right, north of $14 billion in software revenue and I don't think anyone thinks of Cisco in those terms.

Q - Pierre Ferragu {BIO 15753665 <GO>}

Thanks. And a quick follow-up for you, Chuck, if I may. You having introduced sentence -- first sentence in your press release, you're talking about the next uptake of your subscription base based offerings. So could you give us a sense for, it almost sounds like you feel you are like on an inflection point or on the turning point on that front, are you expanding your portfolio in terms of software that's subscription-based offering at the moment or are you expecting the uptake of these products to reaccelerate on the back of the pandemic. What did you mean exactly?

A - Chuck Robbins {BIO 17845882 <GO>}

Yeah. So Pierre, it's -- I think there's couple of things going on. Number one, we have seen just over the last few years continued acceleration in our software business. Every acquisition we do, that's the business model, so from that perspective, it comes in. From an organic perspective, we're building more software assets, we're delivering more software solutions and then we're actually looking now, we announced Cisco Plus at Cisco

Live, which is how do we deliver virtually anything that we build as a service should our customers want to consume it that way. So we're just embarking on that which is another big part of our portfolio which will create more recurring revenue for the future. So that's what I'm talking about.

Q - Pierre Ferragu {BIO 15753665 <GO>}

Okay, that makes sense. Thank you very much.

A - Marilyn Mora {BIO 19771101 <GO>}

Thanks, Pierre. Next question.

Operator

Paul Silverstein from Cowen. You may go ahead.

Q - Paul Silverstein {BIO 1812254 <GO>}

Appreciate taking the questions. Two quick questions. One, Chuck it seems been a long time since you all have disclosed what the size of your various customer segments and given the impact or what I would expect would be the impact of U.S. federal stimulus, what's going on in service provider enterprise and different trends. Can you update us on how big those sectors are including U.S. Federal?

And then the other question would be your services business, you had a great quarter, it was extremely strong up 8%, is that -- is there a one-off in that or is that indicative up somewhat have been low-single digit growth, it's a very prominent number. Any insight you can share and what we should expect going forward and what's driving?

A - Chuck Robbins {BIO 17845882 <GO>}

Yeah, Paul. I don't have the percentage of -- we haven't given that information on the percentage of segments for a while. I would say, if we could couch that until perhaps September when we do our analyst meeting, unless you have some...

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

No, the only thing I would add is that, when you compare us to some of our peers when we break out enterprise versus commercial, many of them combine those two together, so...

A - Chuck Robbins {BIO 17845882 <GO>}

Most of them do.

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

Yeah. Yeah, so just bear that in mind as you're trying to compare us across the board.

A - Chuck Robbins {BIO 17845882 <GO>}

Yeah. And...

Q - Paul Silverstein {BIO 1812254 <GO>}

Scott I'm aware, but if I may, I mean, obviously with this magnitude of the U.S. federal stimulus that's already been passed in the various additional progress the proposed and federal rights. Not only does that impacted public sector but it's also impact enterprise not just for you but for a lot of folks, it'd be great if you updated us with some point -- with those numbers, that'd be great?

A - Chuck Robbins {BIO 17845882 <GO>}

Yeah, that makes sense. I got it. And what was the second question, Paul?

A - Marilyn Mora {BIO 19771101 <GO>}

Services growth.

A - Chuck Robbins {BIO 17845882 <GO>}

The services growth.

Q - Paul Silverstein {BIO 1812254 <GO>}

Services growth, what's driving it. Is it anomaly, is it the new norm?

A - Chuck Robbins {BIO 17845882 <GO>}

Yeah. Overall, obviously quite pleased with the progress on our services business. There is -- in Q3 though, I remember, there was an extra week. And since a lot of services, a lot of that is ratable, that extra week turns into an extra week of revenue during the quarter. So there is a one-off anomaly that's driving that outsized growth in Q3.

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

Yeah. And then once you normalize that out, you should think about the same normal rates you've been seeing.

Q - Paul Silverstein {BIO 1812254 <GO>}

All right. I appreciate it. Thank you.

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

Thanks.

A - Marilyn Mora {BIO 19771101 <GO>}

Next question please.

Operator

Thank you. Tim Long from Barclays. You may go ahead.

Q - Tim Long {BIO 21123922 <GO>}

Thank you. Two questions for me to both on gross margins. Actually I'm just kidding. Chuck, first one here, can you just talk a little bit about kind of your visibility, so some of your peer companies and others in the industry given what's going on with lead times, you obviously have a revenue and a cost impact here, but what has that done to kind of how far out you can see and plan and kind of the whole backlog versus book and ship for the business for the next few quarters?

And then second, if you could just touch on the cloud vertical, sounded like it was pretty strong again. Could you just give us a little color of kind of what is driving that? I think there had been some campus strength with those customers, but can you talk to us a little bit about the breadth of product that's driving that, is it a lot of 8-K or are you starting to see software in silicon starting to contribute a little bit. So any color there would be great? Thanks.

A - Chuck Robbins {BIO 17845882 <GO>}

Yeah, Tim. Thanks. I'll make one quick comment on the visibility thing and I'll let Scott comment and then I'll take the cloud one. I would say that the thing that I would tell you is, if we were in the middle of Q3, I can tell you that our supply chain team was a little, I guess, concerned about what they could see for the next two months at that time. And when we started building the guide and working through what we thought they could deliver and build in Q4, they had a reasonable degree of confidence. So what that says to me is they're getting better visibility and so I think it's just going to improve from here. So that's sort of what we've been doing with the last couple of months.

Scott, do you want to add anything?

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

Yeah. From a reported revenue standpoint, which I think is probably at least part of your question, Tim, we've got good visibility at this point, given the size of our backlog that we roll into Q4 with as well as the amount of revenue that's now recurring that will come off the balance sheet. So you add those two together and then look at -- we have a good feel obviously for what's in the pipeline at this point, so we have pretty good visibility at this point.

A - Chuck Robbins {BIO 17845882 <GO>}

Yeah. And then on the cloud vertical, I would say that, one of the customers we have had a very strong sort of enterprise networking portfolio relationship with. But beyond that, all of it is really being driven by infrastructure going into their cloud assets. And so we are -- we have sold significant amounts of 8Ks into that infrastructure, but we do -- we have sold silicon standalone as well. We have our software running on one of their pieces of hardware, and in some case, we have their software running on our switching hardware and we're working on Whitebox ODM with a couple of them relative to our silicon. So we have -- all the variations that we announced in December of 2019, we are actively involved in right now, and the good news is, there's a lot of systems desire as well.

Q - Tim Long {BIO 21123922 <GO>}

Okay. Thank you.

A - Chuck Robbins {BIO 17845882 <GO>}

Just as a add on to that, last time we talked about 400 gig and there always seems to be a question about 400 gig. Our customer count on 400 gig went up by 50% during the quarter. So we did see a continued uptake on that technology and that's super early, as you know.

Q - Tim Long {BIO 21123922 <GO>}

Great. Thank you.

A - Marilyn Mora {BIO 19771101 <GO>}

Next question please.

Operator

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

Q - Jim Suva {BIO 6329522 <GO>}

Thank you so much for all the details and clarification. I just had one question. Can you give us some commentary on like your hyperscale traction, it appears service providers bouncing back pretty strong and for a while, it seemed like the hyperscale wasn't quite as strong as you would hoping and you're putting more efforts into it and it seems like now your commentary is quite a bit more positive, is that some new product wins, some share gains, prudency [ph] and traction of it, but any commentary on that would be greatly appreciated? Thank you.

A - Chuck Robbins {BIO 17845882 <GO>}

Yeah, Jim. So we've had six consecutive quarters of very strong double-digit growth ranging from mid-teens to triple digits. And so -- and that's in the webscale vertical and it's been a combination -- it certainly has been share gains because we didn't have any presence before. So as I've joked on calls before, it's one of the few markets where we actually have the opportunity to go gain share. And so that's been positive, we've worked hard on these relationships and so that has expanded. We had a two-day customer briefing with one of the -- one of them two weeks ago and that particular briefing was all about our enterprise portfolio. So we're seeing both sides but we are definitely seeing the success that I just mentioned with Tim's question around the cloud vertical in the cloud infrastructure.

Q - Jim Suva {BIO 6329522 <GO>}

Thank you so much.

A - Marilyn Mora {BIO 19771101 <GO>}

Thanks Jim. And we have time for one more question.

Operator

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

Q - Jeff Kvaal {BIO 3233206 <GO>}

Thank you. It was nicely said. My question is actually on the margin side. It sounds as though you are getting better visibility on the component availability. So I guess I'm wondering should we be expecting that the margin headwind would abate through the year? And then as part of that, has anything changed in terms of what you expect to happen to the margin structure over time as we get past these constraints? Thank you.

A - Chuck Robbins {BIO 17845882 <GO>}

Yeah, Jeff. As we talked about earlier, I think some of the supply chain issues we have that we're seeing certainly from a supply standpoint are going to be with us through the end of the calendar year. But there's no question, we've also got some good tailwinds in the gross margin line, when you think of the amount of the faster growth rate of services and the ratability of that which contributes significantly now to the revenue line, that's at a higher margin and our software business, which year-on-year grew at 13% and is now on a run rate of about $14 billion per year software business, that obviously comes at a higher margin too. So while we do have supply chain headwinds, we've also got some nice tailwinds that are coming in.

Q - Jeff Kvaal {BIO 3233206 <GO>}

Okay. And then the concept is that once we get past these fairly a femoral and long grand scheme of things supply challenges then we should expect the gross margins to reflect the mix shift software and drift higher?

A - Chuck Robbins {BIO 17845882 <GO>}

That's the right way to think about it.

Q - Jeff Kvaal {BIO 3233206 <GO>}

Yes, okay. Excellent. And then, I'm sorry, did you give us a number on how much you might have shipped had you not had supply chain constraints?

A - Chuck Robbins {BIO 17845882 <GO>}

Yeah, that's -- we talked about that in the last day or so and it's really difficult to get a number, I'd say it had been a point or 2. I mean, particularly in the guide front, I think that's a reasonable thing to think about it. It's -- I mean our guys were stressed. And in Q4, they have very little -- they're committed to what they think they can build, but it's tough right now. So you cannot extrapolate with the growth rate we saw in the product side and then with the corresponding guide that we're -- our backlog is certainly increasing. So if we had the capacity to ship, we would, but we just don't have it.

Q - Jeff Kvaal {BIO 3233206 <GO>}

Okay.

A - Chuck Robbins {BIO 17845882 <GO>}

All right. Let me just wrap up by first and foremost thanking all of you for spending time with us today. And despite the predominant discussion point here, which has been our health in gross margins relative to supply chain. I hope our confidence came across and that we feel really good about the portfolio, we feel really good about the reopening, we feel good about our teams, I'm really proud of what they've accomplished. Look, I'm really pleased that our customers are choosing to spend their dollars with us as they come back. I think that's a great statement of confidence and I think that it also proves that we are going to be critical to the rebound in the recovery and the return to office. So thanks for being with us and we look forward to spending time with you all, and I'm going to kick it back to Marilyn.

A - Marilyn Mora {BIO 19771101 <GO>}

Thanks Chuck. Cisco's next quarterly earnings conference call, which will reflect our fiscal 2021 fourth quarter and annual results will be on Wednesday, August 18, 2021 at 1:30 PM Pacific Time, 4:30 PM Eastern Time. As a reminder, we will be presenting and hosting meetings at several conferences over the next few weeks. Please visit the Cisco Investor Relations website for the latest event schedule and access information.

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 contact the Cisco Investor Relations team, 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 866-461-2738. For participants dialing from outside the U.S., please dial 203-369-1354. This concludes today's call. You may disconnect at this time.
