Company Name: Cisco
Company Ticker: CSCO US
Date: 2018-11-14
Event Description: Q1 2019 Earnings Call

Market Cap: 200,823.15
Current PX: 44.33
YTD Change($): +6.03
YTD Change(%): +15.744

Bloomberg Estimates - EPS
Current Quarter: 0.721
Current Year: 3.015
Bloomberg Estimates - Sales
Current Quarter: 12504.375
Current Year: 51641.933

Q1 2019 Earnings Call

Company Participants

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

Other Participants

- James E. Faucette
- Vijay Bhagavath
- Rod Hall
- Paul Silverstein
- Samik X. Chatterjee
- Jim Suva
- Tejas Venkatesh
- Sami Badri
- Jeffrey Thomas Kvaal
- Srini Pajjuri
- James E. Fish
- Simon M. Leopold

MANAGEMENT DISCUSSION SECTION

Marilyn Mora

GAAP and Non-GAAP Financial Measures

Income statements, full GAAP to non-GAAP reconciliation information, balance sheet, cash flow statements, and other financial information can also be found in the Financial Information section of our Investor Relations website

Throughout this conference call, we will be referencing both GAAP and non-GAAP financial results and will discuss product results in terms of revenue and geographic and customer results in terms of product orders, unless stated otherwise

Charles H. Robbins

Q1 Highlights

Revenues, Margins, Cash Flow, EPS Growth

- We delivered another great quarter
- It is absolutely clear that the strategy and transformation that we laid out three years ago is working

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- We accelerated revenue growth, expanded margins, and generated strong operating cash flow and double-digit EPS growth
- We saw broad-based growth across all of our geographies, product categories, and customer segments
  - This was driven by strong execution, differentiated innovation, and our transition to more software and subscription offerings
- We are well-positioned to capture significant growth opportunities while creating long-term value for our shareholders

Enterprise and Application

- In today's environment, there is an ever-increasing number of connected devices with users expecting an always-on experience with access to any application
- The Enterprise has expanded to now include multiple clouds, and applications are evolving at an unprecedented rate
- Customers, facing a new level of complexity, are increasingly seeing value of our integrated platforms over standalone products

Network and Security

- We are fundamentally changing the Network and Security industry
- We're building an architecture that is designed to securely connect any user on any device on any network to any application running anywhere
  - This creates an enormous opportunity for us as we deliver a multi-domain, intent-based networking architecture that drives automation, simplicity, and agility for our customers

Infrastructure Platforms

Strategy and Intent-Based Architecture

- Now let's take a more detailed look at our results as we continue to deliver new innovation across our entire portfolio
- Starting with Infrastructure Platforms
- Over a year ago, we set out on a strategy that would disrupt how growing data, from a proliferation of new connected devices and complex traffic flows, would be managed and secured from the private enterprise into multi-cloud environments
- We brought to market an intent-based architecture capable of capturing business intent and applying it across wired, wireless, and enterprise routing, including SD-WAN.
  - This allows our customers to automate their operations, applications, and security policies for efficiency and business agility

Catalyst 9000 Family of Switches

- This value proposition resonates strongly with our customers and is driving continued strong customer ramp of our Catalyst 9000 family of switches
- Yesterday, at our Partner Summit, we announced several exciting new additions to this architecture
- We launched the next editions to the Catalyst 9000 family, the Catalyst 9200 and the Catalyst 9800
  - The Catalyst 9200 series of switches extend intent-based networking to simple branch deployments and midmarket customers
- The Catalyst 9800 is our newest wireless controller
- We continue to help our customers run consistent security automation and analytics services across wireless and wired environments
  - The Catalyst 9800 gives our customers ultimate flexibility, running anywhere from on-premise, in any cloud, or embedded virtually on Catalyst 9000 switches

Security and SD-WAN Technologies

- We also announced a major new architectural change for the modern branch network
- Cisco is unifying our security and SD-WAN technologies to help organizations embrace the cloud faster, with choice and confidence
- We provide the simplest way to integrate SD-WAN with our cloud security
  - This is a great example of how the expansion into the cloud is driving our entire portfolio

Connectivity and Data Growth

- In the data center, as more customers move to multi-cloud environments, the need for secure virtualized infrastructure grows
- Our strategy is to enable our customers to address increasing connectivity and data growth while securely enabling workloads across any combination of private, public, or multi-cloud environments

Investment

- We continue to invest in innovation to help our customers transform their data centers for improved efficiency, scale, and resiliency
  - This has resulted in tremendous traction with our Nexus 9000, ACI and UCS solutions as we architect security from the application to the network and support cloud workloads wherever they may reside

Nexus Switch Portfolio

New Nexus 400-Gig Switches

- Building on the success of our industry-leading Nexus switch portfolio, we recently unveiled new Nexus 400-gig switches
- We are committed to leading the market transition from 100-gig to 400-gig, providing customers with increased bandwidth and scale, and their data center environments powering any workload in the cloud

- The addition of 400-gig to our Nexus portfolio extends the power of ACI, providing intent-based networking to enterprises, Web-scale and service providers, to enable them to build compact, fully-automated, high bandwidth fabrics

- Cisco is the only company that not only delivers a best-of-breed 400-gig portfolio but also brings customers the architectural solutions for today's multi-cloud world

Hybrid Cloud Portfolio

- Last week, we expanded our hybrid cloud portfolio by introducing the industry's first hybrid solution for Kubernetes on Amazon Web Services
  - We are delivering a hybrid cloud solution that is designed to enable our customers to easily connect, secure, and monitor Kubernetes-based applications across on-premise and the AWS cloud

Security Business

Growth and Goal

- Turning to our Security business
- We again delivered another robust performance with double-digit growth
- Our goal is to be our customers' number one security partner
- We are building a comprehensive and integrated security portfolio focused on effectively detecting, rapidly containing and quickly responding to threats
  - Spanning from the Edge to the data center and to the cloud, our customers' users' devices, applications, and data are protected wherever they are

SaaS-Based Offerings, Duo Solutions and Integration

- We continue to add more SaaS-based offerings to our broad security portfolio
- A great example of this is our recent acquisition of Duo Security, which provides cloud-based identity solutions for unified access security, and multi-factor authentication
- Duo solutions play an important role in extending our intent-based architecture into multi-cloud environments, simplifying policy for cloud security and expanding endpoint visibility coverage
- The integration of Cisco's network device and cloud security platforms with Duo's zero-trust authentication and access products is designed to allow us to easily and securely connect users to any application on any network device

Applications

AppDynamics Solution

- Moving to Applications
- Data intelligence continues to be critical for organizations to improve business outcomes and agility

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- Our AppDynamics solution uniquely addresses this need resulting in another quarter of strong double-digit growth
- Our innovative capabilities in application monitoring and analytics provides unparalleled real-time business insights to our growing customer base, making us the clear market leader

Collaboration Business

- We achieved a solid quarter in our collaboration business, and continue to set the standard for how people connect, collaborate and create every single day
  - We are defining the future of productivity and collaboration by providing customers of all sizes with a comprehensive portfolio to help them share data through any device anywhere

Collaboration Solutions

- Customers recognize the value we bring with more than 95% of the Fortune 500 using our collaboration solutions
- We're delivering unique capabilities, enabling rich collaborative experiences, increased productivity and helping our customers transform their workspaces
  - This is accomplished through our new modern Webex experience, AI-enabled devices, and enhanced interoperability across our on-premise and cloud solutions

Investments with New Hybrid Solutions

- Yesterday, we expanded our collaboration offerings with a full suite of cloud calling and team collaboration tools to extend our customers' on-premise investments with new hybrid solutions from the cloud to the end user
  - These innovations include the availability of BroadSoft cloud calling with Webex Teams through Service Providers, 85-inch Webex Board, and our new portfolio of huddle room solutions with Room Kit Mini and Webex share

Summary

In summary, we had a great quarter, and our opportunity has never been greater

Our growth continued to accelerate as we executed well against our strategy, continued to drive innovation across our portfolio, and delivered more software and cloud-based offerings

It is clear our customers are looking to Cisco as a trusted partner to help them operate in a multi-cloud world and to transform their businesses

We are well-positioned with our growing portfolio across multiple domains as we continue to innovate to bring our customers a more secure, automated, and simple IT infrastructure

Portfolio

- We believe the strength and differentiation of our portfolio, combined with the power of our business model provides us with a strong foundation for FY2019 to create long-term growth and shareholder value

Kelly A. Kramer

Financial Highlights

Product Orders, Net Income and EPS

- I'll start with a summary of our financial results for the quarter followed by the guidance for Q2
- We executed well across the business with strong orders, revenue growth, margins, EPS, and operating cash flow
- We had continued momentum in product orders, which grew 8%
  - Total revenue was $13.1B, up 8%
- Our non-GAAP operating margin rate was 31.9%
- Non-GAAP net income was $3.5B, up 14%, and non-GAAP EPS was $0.75, up 23%

Revenues

Products, Infrastructure Platforms, Routing and Wireless

- Let me provide some more detail on our Q1 revenue
- Total product revenue was up 9% to $9.9B.
- Infrastructure Platforms grew 9% with strong growth across all businesses
- Switching had another great quarter with growth in campus driven by the continued ramp of the Catalyst 9000 and growth in data center driven by the Nexus 9000
- Routing returned to growth driven by Service Provider
- Wireless had double-digit growth with strength in our Wave 2 offerings and Meraki
- We also saw a good growth in data center driven by servers and HyperFlex

Applications, Security and Software Subscriptions

- Applications was up 18% with growth across all the businesses
- We saw good growth in Unified Communications, TelePresence, and AppDynamics
- Security was up 11% with strong performance in identity and access, advanced threat, and unified threat
- Service revenue was up 3% driven by software and solutions support
- We continue to transform our business delivering more software offerings and driving more subscriptions
  - Software subscriptions were 57% of total software revenue, up 5 points y-over-y

ASC 606

- To remind you, we adopted ASC 606 in Q1
- There have been no changes to our offerings to customers or our cash conversion cycles

- This is purely an accounting change
- It does impact the metrics that show our continued business transformation
  - We think the most meaningful metric going forward is software subscriptions as a percentage of total software revenue

Acquisitions, Product Orders, Markets and Customer Segments

- When we look at the impact of acquisitions in our Q1 results y-over-y, there was an 80-basis-point positive impact on revenue
- We saw strong momentum in Q1 with total product orders growing 8%
- Looking at our geographies, Americas grew 8%, EMEA was up 6%, and APJC was up 12%
- Total emerging markets was up 16% with the BRICS plus Mexico up 19%
- In our customer segments, Enterprise was up 15%, Commercial grew 8%, Public Sector was up 8%, and Service Provider grew 2%

Gross Margins, operating Margins and EPS

- From a non-GAAP profitability perspective, total Q1 gross margin was 63.8%, up 0.1 points
- Product gross margin was 63.2%, up 0.2 points, and Service gross margin was 65.7%, up 0.1 points
- Our operating margin was 31.9%, up 1.5 points
- In terms of bottom line, from a GAAP perspective, Q1 net income was $3.5B and EPS was $0.77

Cash and Cash Flow

- We ended Q1 with total cash, cash equivalents, and investments of $42.6B.
- Q1 operating cash flow was $3.8B, up 22%, with FCF of $3.6B, also up 22%
  - Normalized for the $400mm legal settlement we received from Arista, operating cash flow was up 9%

Capital Allocation and M&A Perspective

- From a capital allocation perspective, we returned $6.5B to shareholders during the quarter that was comprised of $5B of share repurchases and $1.5B for our quarterly dividend
- From an M&A perspective, we closed two acquisitions in Q1 with Duo Security and July Systems
  - These moves are consistent with our strategy of increasing investment and innovation in R&D for our growth areas

Summary

- To summarize, we had a great Q1
- We executed well with strong top line growth and profitability

- We're seeing the returns on the investments we're making in innovation and driving the shift to more software and subscriptions, delivering long-term growth and shareholder value

Guidance

SPVSS Business

- Let me reiterate our guidance for Q2 FY2019
- This guidance includes the type of forward-looking information that Marilyn referred to earlier
- Note that we have normalized our second quarter guidance to exclude the SPVSS business for Q2 FY2018 which we divested on October 28, 2018
  - We have provided historical financial information for the SPVSS business in the slides that accompany this call

Revenue Growth, Gross Margin Rate, Tax Rate and EPS

- We expect revenue growth in the range of 5% to 7% y-over-y
- We anticipate the non-GAAP gross margin rate to be in the range of 63.5% to 64.5%
- The non-GAAP operating margin rate is expected to be in the range of 30.5% to 31.5%, and the non-GAAP tax provision rate is expected to be 19%
- Non-GAAP EPS is expected to range from $0.71 to $0.73

QUESTION AND ANSWER SECTION

<Q - James E. Faucette>: Maybe I'll direct to say, Chuck and Kelly, and you guys can answer where you think is appropriate, but one of the key questions we've been getting from investors is if you're seeing any change in customer behavior either because of pending tariff implementations or macro conditions around the world. In this past quarter, you've seen a lot of volatility on exchange rates, as well as the pending implementation of these tariffs, so wondering if you're seeing any change, whether customers pulling forward deals or reducing deal size, et cetera? Thank you very much.

<A - Charles H. Robbins>: First of all, the tariffs were immaterial to us in Q1, the 10% tariffs. I think we implemented them with a month to go, so we did not see any impact. But I can tell you that from a demand perspective, when we implemented the pricing changes, which we told you we would on the last call, we saw absolutely no demand change from the week before and the week after we did that.

We have talked to all of the sales leaders around the world, and I could tell you there are probably only a handful of customers that have made any indication to us right now that they are doing any pull-forwards. That doesn't mean that there is not stuff out there that we don't see, but in general we do not view this as a broad-based issue. And our momentum from the first week of the quarter to the last week of the quarter was incredibly consistent. So, Kelly, any comments?

<A - Kelly A. Kramer>: If I look at the linearity by month through the quarter of Q1, it was the exact same as it was in Q1 2018. So for the 10% tariffs, we didn't see any pull-ins.

Just to kind of remind everybody, we are actively working with our supply chain to mitigate as much of this as possible, and we've made progress. For that that we couldn't mitigate, we passed on, and we passed on the price impacts just for the products impacted vs. broad-based. We were very specific and surgical where we applied it but overall we are very specific. Going into Q2, like Chuck said, it's pretty straightforward, but I would hope that it is a potential that drives some demand. But the underlying strength of the IT environment is still there.

<A - Charles H. Robbins>: Two other quick comments. I can just tell you personally, I haven't had one conversation with any customer around the tariffs at this point. Secondly, I think that once we got past the midterms, we've begun to hear some positive, at least, headlines relative to the discussions, and I remain fairly optimistic that this has become a top priority for the administration, and we're hopeful that they'll come to some agreement before we move to anything more significant.

<Q - Vijay Bhagavath>: I have a bigger-picture question for both of you, if I may, which is the subscriptions model, the promise was to get a higher share of the purchasing dollars, the customers' budgets. Is that starting to happen? Are you starting to see it in your sales figures? And if you could give us any data anecdote saying, yes, now that we have kind of expanded and extended software subscriptions across the portfolio, we are seeing X percentage more of the customers' share of IT spending purchasing dollars would be very helpful. Thanks.

<A - Charles H. Robbins>: Let me comment because this was at the heart of our presentations this week at the Partner Summit and there's a significant recognition that I think is occurring in the marketplace right now. If you look at what our customers are dealing with, they are dealing with a world that truly does involve consuming services from multiple cloud providers. Most of our customers have well over 100 and beyond SaaS applications that they're dealing with. They still have increased investments in the data center. They're beginning to see IoT explosions at the Edge, data at the Edge, mobile workers everywhere, interconnectivity with suppliers and customers. And what that has done is it's completely made obsolete the original assumptions on which they defined their IT infrastructure. And so the IT infrastructure was built based on assumption of traffic flows that just fundamentally don't exist anymore.

And so what we're seeing is that they now need to drive security in policy and automation from the campus to the data center to the branch into the cloud, and they're looking more and more at the simplicity of having a single architecture to provide that capability. So one of the big things that we talked about this week was the need to drive multi-domain architectures for our customers which actually give them the ability, and you're seeing us extend and connect like policy in the campus with policy in the data center. So you're seeing ACI being connected into DNA and our Software-Defined Access technology in the campus so that we can extend policy.

You saw it this week with the branch where we integrated our SD-WAN with our cloud security portfolio. And I think we're seeing that come through in more and more of these broad-based software licenses that we continue to see our customers adopting. So I think that we are seeing that play out exactly as we thought, Vijay.

<Q - Rod Hall>: I wanted to focus in on product revenue growth. It was really strong for the quarter, 9%. I know that's with SPVSS, which if anything dragged that down. And then, I mean, it feels like you've been pretty conservative in the guidance and I know you'll probably say, no, we aren't, but I'm just curious what could go better in this guidance, what you're contemplating in terms of elements of conservatism? Can you give us any idea of how you're thinking about that forward quarter right now and how things might go better if let's say we do get a trade deal, et cetera?

<A - Charles H. Robbins>: I would say the last two quarters were probably the most consistent strong quarters that we've seen in years, honestly. And I think it's a combination, as we've talked about, of the macro environment but also frankly the innovation.

If you look at the portfolio that we have put out there and you look at the number of announcements and the technology and the innovation that we delivered this week, I think you're going to continue to see strong execution. We're really proud of what our teams have done. And I think that the recognition by the customers of this architectural shift that I was talking about earlier is really beginning to play out.

So we feel really good about how we're performing. I'll let Kelly comment on both the product revenue growth and the outlook.

<A - Kelly A. Kramer>: I feel like this is a pretty good guide and actually better theoretically than maybe you guys were expecting. And don't forget that 6% growth in the midpoint of the guide we gave you, again excluding SPVSS out of both periods, obviously, is really solid, because we have much tougher comparison from a year ago. I mean, we see the strength. And I'm just trying to balance it with – there is a lot of unknown depending on what tariffs do, but underlying strength in the macro gives us good confidence. So I feel actually very, very good about the call and...

<Q - Rod Hall>: Just one comment on that. What I was saying, I didn't mean that it was disappointing from a guidance point of view. I just meant that you were so strong on growth in the reported quarter, why not be more, I guess, aggressive with the guidance? That was really what I was asking.

<A - Kelly A. Kramer>: And there is one – there is – you bring up a good point which I do want to get out there. Our growth was very, very strong in Q3, and again, back to ASC 606, under the new accounting rules – as you know, we have a very strong presence in the enterprise. Our Enterprise business is going very, very well.

Whenever we sign these big multiyear enterprise agreements, under the new accounting rules, that will accelerate revenue. So in this current Q1, software came in very, very strong because we happened to have two very large, multiyear enterprise agreements with some large enterprises, where in any one quarter I might have one, but this was a big one. So that's one additional piece to it, but overall, I'd say all of the underlying fundamentals are very, very positive.

<A - Charles H. Robbins>: These Enterprise agreements are actually reflective of what the question that Vijay asked.

<Q - Paul Silverstein>: Just two quick questions on pricing and the drag from the shift to recurring or does ASC 606 address that? And the bigger question for you and Chuck, and, Chuck, if you can't answer this, I'm hoping you'll answer a different question, but I hear you keep citing the strength of the macro environment and the thought arises that it's far from even throughout the world.

The U.S. has been strong, but there are plenty of other places far less so. In fact, I don't think the word strong would apply. And yet your revenue, on a very broad base across geos is very strong and far outstripping what we see from the macro perspective.

If you can't answer for the disconnect, my question to you would be, what do you think is the time period? I know it's still early in the Catalyst switch architecture upgrade cycle. How far do you think that has to go? Where do you think you are in that process? How much strength is there to come? Thank you.

<A - Charles H. Robbins>: You'll talk about pricing and the other thing. Let me give you the broader answer, Paul. I think you're right and, I mean, when you look at our results on an orders perspective and you see emerging countries up 16% in the face of a rising dollar, that's different than what we've seen historically when we were – what I would say is we were directly connected to the global GDP and we moved with it.

I think it – maybe this was the beginning of us answering the question that I've been asked the last two calls which is how much of this is macro and how much of it is your own execution? When we begin to perform differently than what's perceived to be in the macro, I think that'll give us insight into how much of it is our execution, our innovation.

The other thing I'd point out is that – and by the way, in the emerging countries, just to be clear, it was very consistent across-the-board. So we had incredible strength in – we did have incredible strength in India. It was our Q2 50%-plus growth in India. So we have really done a great job there and it's not just the large service providers. We had a large public sector deal this quarter. So we're – that is a key market for us that we intend to win in and the teams are doing a good job there.

But I think the other thing to consider is that when you look at our customers, even in a tough economic environment, what is one of the things that you want to do when you're in a tough economic environment is you want to continue to drive cost and productivity in your business. And at the heart of the automation strategy and at the heart of some of the SD-WAN stuff and at the heart of re-architecting the infrastructure, the ending result is to drive cost out and drive productivity up.

So it's unclear to me at this point what any sort of significant macro shift is going to do to the spending in this environment because it is connected to what you're trying to achieve when you do have a tough macro environment. So we're going to have to see how it goes, but – so that question.

On the Catalyst 9000, look, we're still incredibly early. I mean, it's incredibly early. We just launched another product that addresses a market size similar to what we launched a year and a half ago. And so we're just on the front end of it. And as the customers adopt that architecture, then you're seeing – we announced a wireless portfolio that's going to fit within that. In the spring, you'll see SD-WAN get integrated into the overall architecture in addition to the innovation we announced this week. So we feel good about where we are and we'll see how the macro plays out.

<A - Kelly A. Kramer>: On the price, we saw from a rate impact [indiscernible] (28:56) about 1.9 points down, so slightly up from what it has in the last couple quarters but still better than it was, say, in Q1 of 2018. But a slight tick up, 1.9 points.

<Q - Samik X. Chatterjee>: Kind of had another macro question, which is just to focus on your EMEA business. You had a strong quarter there. Which are the countries kind of driving that strength? And as we kind of get to this point where we have some more clarity building around Brexit, are you seeing any kind of enterprise customers starting to sort of come off the fences and start to invest a bit more given that there's now more kind of clarity building around what the eventual deals will look like?

<A - Charles H. Robbins>: I think that, for us, Europe has held up in a time where there's been ongoing uncertainty, and I think this shows the resilience that we've seen around the world in the face of a lot of uncertainty. You have Brexit, you've got Italy, you've had elections, you've got Merkel's announcement, and yet we still see continued strength and it's been pretty consistent for the last – what is it, Kelly – four to six quarters. I'd say it's been fairly consistent growth. So our teams are doing a good job there. I think that we're continuing to execute, and I think that any clarity on any of these issues like Brexit can do nothing but help in my opinion. So, Kelly?

<A - Kelly A. Kramer>: I'd just say it is very broad-based. I'd say enterprise is exceptionally strong, so there's no – and the UK specifically has been pretty good for us over the last – as I said – the last four quarters. So I think it does just go back to it's a resilient IT environment.

<Q - Jim Suva>: I just have one question, and that is on memory pricing. Can you just remind us of, when memory pricing was going up, say the past 12 or 24 months, what the actions the company did? And more importantly, what is the strategy going forward as memory pricing appear to have softened? How should we think about that in your strategy or pricing or impact to your company? Thank you so much.

<A - Kelly A. Kramer>: So the historical – what we did with memories around DRAM specifically, it was a combination of just prices going up and consistently for all of 2017 and 2018, and it was a very tight supply. So our strategy was securing supply. We bought inventory ahead. We did everything we could to try to minimize the impact. We had big purchase commitments. And we are still seeing y-over-y price increases. In this quarter, we still are seeing the prices being higher than they were a year ago.

The good news is, though, when we look forward – and like I alluded to on the last call – we should see it go from a headwind to a tailwind starting in H2 our fiscal quarter. So Q3 and Q4, we fully, fully expect the DRAM to be a tailwind for us, which will be good. And this quarter had an impact. It will be less of an impact next quarter, and then we get to goodness. And we did, much like we're doing with tariffs, we did pass through a lot of the memory costs through price increases over that time as well.

<Q - Tejas Venkatesh>: I wanted to focus on the Enterprise orders, which were up 15%, I think the best since 2011. Where is that strength coming from? And are there businesses that are accelerating vs. the reported quarter? And maybe secondly, somewhat related, you called out strength in Service Provider Routing, but Enterprise Routing is a significant portion of your routing business and it was down a lot last year after the Viptela acquisition. Now that that's partly integrated, how is it going?

<A - Charles H. Robbins>: I would say if you look at our Enterprise business, it was incredibly consistent globally. It was incredibly consistent across the breadth of our portfolio. I think every product category we had grew in the Enterprise space, and it's largely driven by the strategy in the automation side that we brought forward that's represented and sort of proxied by the Catalyst 9000 from a revenue perspective.

We've also – our team, and we've talked about this before, back in Q4 of 2018 – well, if you go back to Q3 call, we said that we felt confident that the SD-WAN solutions would begin to be rolled out in Q4. We saw that, and so we've seen continued adoption of that, and I think with the announcements we made this week with the native integration into our cloud security portfolio, that you'll even see that continue. So I think our teams are doing a good job of helping our customers understand that cost and the operational simplicity that they can gain from some of the architectures that we're bringing forward, and I think that's what's driving it. Kelly, any comments?

<A - Kelly A. Kramer>: It was across all – basically, we were up across when I look across our businesses, basically just about everywhere, so it was again broad-based.

<Q - Sami Badri>: My main question has to do with Service Provider growth in the quarter, and you made a comment earlier about India being up 50%. If you were to exclude the India growth in the quarter, would Service Provider be flat to down? Maybe you could give some perspective on that. And then the second part is, as you think about the Service Provider segment or the customer vertical in the next year or two, are you seeing some customer spend being held back with the onset of 5G spending and deployments coming into the picture? And if we were to see a 5G revenue type of spending deployment or acceleration, where in the next four quarters do you think that would start to be very noticeable?

<A - Kelly A. Kramer>: I'll take the first one on the Service Provider excluding India. I will just say that our Service Provider segment was up in the Americas and EMEA, as well, so again, it was...

<A - Charles H. Robbins>: It was positive everywhere.

<A - Kelly A. Kramer>: ...it was not driven by India though India had a very strong Service Provider as well. But it was up.

<A - Charles H. Robbins>: It was up everywhere.

<A - Charles H. Robbins>: I would say just a quick characterization on this market, and we've talked about this before, different customers, different markets are at different phases of their architectural transitions, and we're seeing in Asia we had a couple big wins obviously where we're helping them re-architect their networks, try to simplify their architectures, and a lot of that is in some ways to prepare for 5G, so we're executing better. But I think I'll still say what we've been saying is that we've been doing planning with many of the customers on 5G. I had a call with one CEO today talking about their rollout plans. So we're actively in the discussions and our teams are working on architectural designs to accommodate.

You're going to see them going to trials. In fact, you've all heard some of the U.S. providers are going into trials in Q1 next CY. I still believe it'll be calendar 2020 before we see anything if we're looking forward some broad-based movement, but we'll see how it goes. If they move faster, then obviously we could be a beneficiary of that, but we're staying close to it right now.

<Q - Jeffrey Thomas Kvaal>: I have a question and a clarification. The question is on the 400-gig side, I think some of your peers in the space are hoping that this would be an opportunity for them to make insertions into the Web-scale market. It seems, Chuck, from your language, that you're focused primarily on the Enterprise market. So I guess, I'm wondering, if not now for Web-scale, when, if I have that right? And then, Kelly, maybe on the clarification side, could you help us understand if you've baked anything into the January outlook for pass-throughs of memory prices or increases in tariffs or what have you? Thank you.

<A - Charles H. Robbins>: I said in the opening comments that we were absolutely focused on Web-scale. And I think this does represent an architectural transition that gives non-incumbents the opportunity to insert, so we will look for those opportunities as well. I think when you look at the 400-gig advantages we have, we're bringing forward – much like we do with the Nexus, we're going to have a merchant version and then we have an ASIC-based version we'll be delivering. We have telemetry, we've got optics, security automation, backward and forward compatibility that are going to provide differentiators for us. We're co-chairing some standards boards. We can extend ACI from the private cloud into the public cloud across these. So we think we have a lot of advantages. The teams, you know, we have the ability to analyze data flows with Security ACI automation policy.

So the whole intent-based portfolio that our teams in the data center actually introduced years ago, we think, will be a big differentiator, as well as the breadth of the options that we'll have in the 400-gig space, but we absolutely do see the Web-scale as an opportunity that we're going to go after here.

<A - Kelly A. Kramer>: In the January outlook, like I said when I was talking about component costs and memory costs, I still will have some headwind in Q2 from memory as well as some costs around the MLCCs, and I have an assumption baked in on certainly the tariff costs if they go up to 25%, as well as an assumption on what we can offset with the prices pushing through, so it's all incorporated in the guide I gave you on the gross margin.

<Q - Jeffrey Thomas Kvaal>: I meant on the revenue side, the pass-through on tariffs or memory and how much of that [indiscernible] (40:03).

<A - Kelly A. Kramer>: So it's the same. I'll tell you, from an overall perspective, let's assume they do cut in in January. Because we will honor quotes if they have quotes in the system that they took that we haven't taken the order yet. It'll take a while before both the price increase cuts through, as well as even when the tariffs do cut in on the cost side, we'll bleed through the inventory that has brought in at the lower cost. So the real full big impact we'll feel when the tariffs go to 25%, if they go to 25%, will be in Q3, but I have baked in some incremental on both the revenue and the margin side from January.

<Q - Srini Pajjuri>: One clarification and a question. First on ASC 606, is it just a one-quarter benefit to revenue? Or do you expect any more in Q2 or going forward? And then the question is you're talking a little bit about some of the metrics that you used to give us on the recurring front, not being as relevant going forward. Could you give us some more color on that and what sort of metrics that we should focus on? And then if you have any targets for those new metrics going forward? Thank you.

<A - Kelly A. Kramer>: So on the first question on ASC 606. So we will benefit from that going forward. The point I was making earlier was this was a little abnormal this quarter because we had two very large enterprise multiyear deals that were very heavy software content that we recognize – now in the new accounting rules, you recognize upfront. So just to remind everybody of where we are impacted on mostly from ASC 606.

When we have enterprise agreements, whether these are term-based or not, we will recognizing them upfront if basically the functionality of the software goes to the customer. So a lot of the Enterprise agreements we have will all be recognized upfront. Cisco ONE, for example, a lot of that's going to be recognized up front, and even a portion of our Enterprise Networking like the Catalyst 9000 subscription, a portion of that now will be up front even though some is still deferred. So it's accelerating basically big enterprise license agreements. So this quarter we had two very large ones, but we will be benefiting going forward and again, it's incorporated in the guide and overall long-term, it'll be in that 1% to 1.5% range.

<A - Charles H. Robbins>: When we set out to move to more of a software and subscription model, the real benefit for us is it gives us the opportunity to go in and monetize those licenses again in three years. That has not changed, and that was the big benefit because if you looked at the way we sold a switch previously, as an example, we would sell a switch with integrated software onetime and perhaps five to seven years later we'd go in and try to sell another one.

In this model, the underlying ability for us to go in at either the three-year or the five-year point, whenever that subscription is up and renew it, that still exists. This is just an accounting change. So the underlying value to our business is still valid. So we're going to continue to move very hard in this direction.

<A - Kelly A. Kramer>: And so on the metrics then to your second question there, so that's why to that point we think the right metric is looking of our software what percentage is subscriptions, right? And that continues to just increase. And I'll use the Catalyst 9000 as an example. We've talked in the past where we used to sell the previous switch, say it sold for $100, and we recognized that $100 upfront. Before ASC 606, we sold that Catalyst 9000 for $100, but 25% of it was deferred and we recognize that 25% over say a three-year term, and then they would renew it for another three-year term.

With ASC 606, that 25% that was deferred, about 12% is now deferred and the other 11% is recognized up front. But that full 25% is what we renew, and so that's why when you look at the software, that's still subscription software. That's why we think that's the relative metric.

We don't think like looking at our deferred revenue, we looked at that in the past. I mean, that was a proxy, but as you saw from our disclosures, we wrote off $1.3B of that balance with the adoption of the new standard for those enterprise agreements and for Cisco ONE. So looking at that isn't as meaningful. And even with the recurring, like using that Catalyst 9000 example, it's not as meaningful. That's kind of why we think using subscriptions, it shows we're still making the transformation. It shows that we're making progress and have that – again, nothing's changed with the customer. We still have that stickiness of having that subscription and the ability to continue to build out our offers with them.

<Q - James E. Fish>: Just a quick one for me. The Edge is a topic popping up more and more. I guess, what are your thoughts around the move towards a distributed environment, how that will impact Cisco, and what investments are being made to win there?

And just secondly, there's been a lot of larger M&A over the last few months. How is Cisco viewing the M&A pipeline today? And if a large enough deal were to come along, would this impact that share buyback plan? Thanks.

<A - Charles H. Robbins>: Let me talk a little bit about the Edge, and I'm going to pile on with a little bit of the cloud – a little bit of discussion around what we see happening with applications in the cloud and some of our announcements, and then we'll talk about the M&A question.

So, first off, the Edge is incredibly important, and I think that's what's leading us in many cases to some of these strategic partnerships that you hear us building with the Web-scale providers. Some of those are multi-faceted where there's an Edge component involved because for us to be able to aggregate the data and give the application developers the ability to run micro services at the Edge, that's why we put x86 into our access products so that you can actually run services from within applications out at the Edge and process data as you need to.

We've also built some data fabric technologies, like, Kinetic, that are being used by our customers today; very early days. So we think that what this Edge dynamic does is it gives us the ability to re-architect the Edge like what you're seeing with SD-WAN, but frankly, it makes the network more relevant in the world that we live in today because the traffic flows and where the data is, where the applications are, where your users are, it's all just fundamentally dynamic, and so you have to architect an environment that accommodates for anything, anywhere. And so we think that this is actually good for us over time, and we'll continue to build technology that enables our customers to deal with it.

The other thing I want to just talk about relative to this, because part of the reason that these Web-scale partnerships are so important is that we are enabling these developers with things like the Kubernetes solution that we have to actually build applications once and then move them seamlessly between private cloud and public cloud. And we did that with our Google announcement, we've done it with our Amazon announcement.

So what I think is going to happen is instead of creating this complex software architecture at the core that is necessary to map applications back and forth, for future apps, they're going to be built on Kubernetes and we're going to give the customers if they want to start in the public cloud they can seamlessly move them into the private cloud, or if they build them in the private cloud they can move them in the public cloud. And with our ACI being extended into the cloud now, customers can actually seamlessly take their policy in an ACI architecture and extend it into any cloud that they like.

So we're trying to make that simple, and we think the combination of that and the Edge actually brings the network much more value in the future.

There was a question...

<A - Charles H. Robbins>: About M&A. Sorry, Jim. We've always said we'll look at any opportunity that arises if it strategically aligns and it's good for us fiscally. And I would say that the deals that you've seen done over the last few months have zero bearing on how we think about it. We continue to look at the opportunities that make sense for us and are part of our financial plan and make sense for us from that perspective, and that's how we'll continue to look at it.

<Q - Simon M. Leopold>: I just wanted to ask one quick one and one thematic. On the quick one, there were some press reports about layoffs, and I know Cisco regularly does some pruning, if you could address that.

And thematically, I'd like to get an understanding of how you think about the SD-WAN products. You've been in this marketplace for a while now, and it looks like it's getting traction. But my thought is this is a headwind for your router business but a tailwind for the SD-WAN platforms. How do you see this playing out over, let's say, the next several quarters? Thank you.

<A - Charles H. Robbins>: Let me address both. The first is that the restructuring that's going on right now is – first of all, it's not an OpEx reduction, and I've actually taken this issue and talked head-on with our employees about what's going on right now very directly. And majority of this is part of the customer experience transition. If you look at what we've done relative to the software portfolio and how we're building out these offers for our customers, any great software company has a very successful customer experience organization.

And if you'll recall, we've brought in Maria Martinez from Salesforce back in May of this year, and she has been putting together a strategy for how we need to be structured for the future. And this is actually just – it's an unfortunate step that we needed to take in order to expeditiously get to where we need to be relative to dealing with the renewals and the lifecycle that our customers are going to want us to drive with them in this new portfolio. So that's really the predominant driver for what's going on right now. And again, I've been very clear with our employees. We've been very open and transparent with them about what's going on.

On the SD-WAN side, I think it's probably generally accurate what you described. However, I think that there's been such a stall in the Enterprise Routing business for the last couple years, waiting for this to take off that I would view it as a net positive now because we have movement. And you've got to remember, many branches are going to – they're going to leverage SD-WAN technology on top of one of our ISRs anyway. So you're going to see various flavors at the Edge. You're going to see some software-only on x86-type platforms all the way up to software running on high-end ISRs because you still need a high-performance branch but you want the flexibility in how you dynamically route your traffic out of that branch. So I view it as a positive, and frankly I think when you see the Enterprise business, the consistency we've seen over the last few quarters, I think SD-WAN's a big part of that.

Charles H. Robbins

Closing Remarks

I think I'll just leave you with I think that our teams are executing incredibly well

There's clearly some uncertainty out there, but I think the macro economy has shown a level of resilience that not many people expected

I think that what we're beginning to see and what is coming through here is that while the cloud four or five years ago was viewed as an existential threat to our business

- I fundamentally believe that the cloud and the transition to the cloud that our customers are undergoing is actually driving our growth now

So we feel good about where we are. We feel good about the innovation, and we feel good object our team's execution

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