These prepared remarks should be viewed solely in conjunction with the related quarter's conference call webcast and press release, which can be found here. The webcast includes the prepared remarks as well as a question and answer session.

Please click here for complete GAAP reconciliation information between our GAAP financial results and our non-GAAP financial results.

Cisco Systems, Incorporated [CSCO]
Q3FY24 Earnings Results Conference Call
Wednesday, May 15, 2024

Introduction

Welcome, everyone, to Cisco's third quarter fiscal year 2024 conference call.

This is Sami Badri, Cisco's Head of Investor Relations, and I'm joined by Chuck Robbins, our Chair and CEO; and Scott Herren, our CFO.

And given our recently closed acquisition of Splunk, we are also joined by Gary Steele, the former CEO of Splunk, which is now a Cisco company.

By now, you should have seen our earnings press release.

A corresponding webcast with slides, including supplemental information, will be available on our website in the Investor Relations section following the call.

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

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

All comparisons 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 and full year of fiscal 2024.

They are subject to risks and uncertainties that we discuss in detail in our documents filed with the SEC, specifically the most recent report on Forms 10-K and 10-Q, which identify important risk factors that could cause actual results to the 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.

Opening Remarks

Thanks, Sami, and thank you all for joining us today.

We delivered a solid performance in Q3, with organic revenue coming in at the high-end of our guidance range.

Strong operating leverage across our business drove gross margins to exceed the high-end of our expectations, resulting in better-than-anticipated earnings per share performance.

We once again delivered good growth in annualized recurring revenue, remaining performance obligations and subscription revenue.

We have transformed our business model with revenue from subscriptions now accounting for more than half of our total revenue even before the addition of Splunk.

With the success of our transformation, we are well-positioned to drive long-term growth powered by innovation across the organization.

I want to thank the entire Cisco team, as it is through their dedicated efforts that our research and development engine has never been stronger across Networking and Silicon, Observability, Security, Collaboration and AI.

The strength of our core business continues to produce strong cash flows, reinforcing our ongoing commitment to delivering consistent capital returns.

In Q3, we returned $2.9 billion in value to our shareholders through share repurchases and cash dividends in the quarter, with a total of $8.5 billion in value returned year-to-date.

Q3 was significant for us in two important ways.

First, I couldn't be more excited about the successful close of our Splunk acquisition, Cisco's largest ever.

Our acquisition of Splunk was completed midway through our Q3 on March 18, earlier than initially anticipated.

Splunk significantly expands our portfolio of software-based solutions, contributing over $4 billion in annualized recurring revenue, and adds to our position as one of the largest software companies in the world.

We are thrilled to welcome the Splunk team to Cisco and are very excited about what we can deliver for our customers as we integrate our complementary Security and Observability capabilities.

Our unified platform will revolutionize how customers connect and protect their organizations, using data in new ways to enhance their entire digital footprint.

Second, we introduced Cisco Hypershield, our most significant new security innovation with a ground-breaking AI-powered approach to highly distributed security, a first of its kind.

Combining Security and Networking in a way only Cisco can, Hypershield is built into the very fabric of the network, bringing the power of hyperscaler security and connectivity to the enterprise.

I will talk more about these developments and our innovation momentum in a few moments, but now I'd like to turn to our performance in Q3 and what we're seeing in terms of customer demand.

The breadth of our portfolio, together with our many touch points with partners and customers around the world, provides us with differentiated insight into what's happening in our customer base.

Based on activations to the cloud, which we track, as well as conversations with our customers and partners, we believe that the products customers have on hand are being steadily deployed in line with the expectations we laid out last quarter, meaning we currently expect customers to complete the installation of the majority of their inventory by the end of our fiscal year in July.

At a time where customers are ruthlessly prioritizing their IT investments, we saw product order growth in two of our largest product portfolios, data center switching and campus switching, as well as product order growth in our Security and Collaboration product categories.

Overall, product orders were up 4%, and excluding Splunk, product orders were flat year-on-year.

In our customer markets, public sector was strong in EMEA and APJC, but continuing resolution discussions in the US temporarily impacted public sector performance in the Americas.

We believe this has since cleared with the subsequent signing of the most recent US Federal Government funding legislation.

While our telco and cable customer demand remain muted worldwide, we are encouraged to see early signs of stabilization and improved performance in webscale in terms of pipeline and orders.

Overall, our win rates are stable and we saw increased strength as we moved through the quarter.

This reflects our competitive strength and successful execution and gives us confidence in the long term.

We also know that the value of our portfolio is greater than ever, as evidenced by recent sell-side research IT spending surveys, which show that Cisco is expected to be the only net share gainer within large network budgets over the next 12 months.

Now let's look at our performance in Q3 in more detail.

We saw revenue growth in Security and double-digit growth in Observability year-over-year excluding Splunk, as customers looked to enhance their digital resilience with Cisco's technologies.

In the past year, we've accelerated our pace of innovation in Security, and I'm proud of what our teams have achieved.

As I mentioned earlier, last month, we introduced Cisco Hypershield, the first truly distributed AI-native cybersecurity solution, which will be built into our networking fabric.

This new innovation leverages the recently closed Isovalent acquisition to facilitate deployment in software, and the first shipment is scheduled for August this year.

This launch furthers our vision for the Cisco Security Cloud, which is expected to deliver the industry's most comprehensive unified platform with end-to-end solutions, making it easier for our customers to protect against the threats of today and tomorrow.

Our newest available Security solutions, XDR and Secure Access, continue to ramp quickly with strong customer feedback.

Just last week at RSA, we also announced the integration of Cisco XDR with Splunk Enterprise Security, which will give our customers even more value and insights.

The closing of the Splunk acquisition in Q3 will also enable us to begin driving revenue synergies in our Security and Observability markets.

Upon closing the deal, we identified 5,000 existing Cisco customers who have the potential to become meaningful Splunk customers, and our sales teams are already making those connections.

We also see significant opportunities for revenue synergies by leveraging Cisco's robust partner and customer ecosystem in markets where Splunk had limited or no presence.

this week, Splunk was ranked as the Leader in Gartner's Magic Quadrant for Security Incident and Event Management, which is a testament to the strength of the offering and the continued business momentum that Splunk has delivered.

We are working on a rapid integration, investing in both product integration and go-to-market resources, starting with aligning our Cisco and Splunk sales forces and accelerating channel enablement processes for cross-selling and upselling our combined solutions.

We also continue to capitalize on the multibillion-dollar AI infrastructure opportunity.

In webscale, we continue to see momentum with three of the top four hyperscalers deploying our Ethernet AI fabric, leveraging Cisco-validated designs for AI infrastructure.

In the past two quarters, Cisco has been granted additional design awards based on our 51.2 terabit G200 Silicon One ASIC.

We expect these awards to yield orders in fiscal year 2025, reinforcing our confidence in our line of sight to $1 billion of AI product orders in fiscal 2025.

Additionally, for those leading-edge enterprise customers who seek to be the early adopters of AI, our partnership with NVIDIA will offer easy to deploy cloud-based and on-prem networking solutions for AI inferencing.

We believe we are well-positioned to be the key beneficiary of AI enterprise application proliferation with the breadth of our portfolio and the vast amounts of data we see.

Before I turn it over to Scott, I'd like to share one more update.

Earlier today, we announced that Jeff Sharritts, our Chief Customer and Partner Officer, is departing Cisco and that Gary Steele, Splunk's former CEO, has been named Cisco's new President of Go-to-Market.

Gary is well-known for his operational excellence, and in this new role, he will work closely with me to set and execute against our strategic plans and goals for the company.

He will continue to lead the Splunk team through the integration process to ensure a seamless integration into Cisco.

Gary's operational mindset, combined with his intense focus on simplicity and proven ability to drive growth, position him well in this role, and I look forward to working closely with him in this new capacity.

I'd also like to take a moment to thank Jeff for all that he's helped Cisco achieve, which is quite a long list of accomplishments in his 24 years here.

Moving back to Q3, let me briefly summarize.

While our core product portfolio is trending toward normalization as we continue to see customer deployments of shipped equipment progress, we are pleased that our Security and Observability portfolios have continued to grow and are significantly enhanced by the acquisitions of Splunk and Isovalent.

As our customers adopt and deploy AI, they need the infrastructure to power it, the data to develop it and the security to protect it, and we believe only Cisco can deliver and integrate all three.

With our unified platform approach, vast global partner ecosystem, and ability to support hybrid and multi-cloud environments, we will deliver innovation at an unprecedented pace and scale to organizations around the globe.

I'll now turn it over to Scott to provide more detail on the quarter and our outlook.

Financial Overview

Thanks, Chuck.

Our Q3 results reflect solid execution with strong margins and a stabilization of orders.

Both including and excluding Splunk, our revenue, gross margin and non-GAAP earnings per share were at or above the high-end of our Q3 guidance range.

Total revenue was $12.7 billion, down 13% year-over-year.

Splunk contributed $413 million in revenue in the partial quarter post-close.

Non-GAAP net income was $3.6billion, down 14%.

Non-GAAP earnings per share was $0.88, down 12%.

The interest cost of financing the Splunk acquisition slightly more than offset the positive operating impact of Splunk.

The net effect was a negative impact of $0.01 on non-GAAP earnings per share.

Looking at our Q3 revenue in more detail, total product revenue was $9 billion, down 19%, and service revenue was $3.7 billion, up 6%.

Networking, our largest product category, was down 27%.

We saw declines across most of the portfolio and all geographic segments due to the continued implementation of inventory by our customers.

Bear in mind that our Q3 2023 Networking revenues benefited from significant shipments of excess backlog.

Security was up 36% including the benefit received from the Splunk acquisition.

Excluding Splunk, Security grew 3%, driven by growth in SASE and double-digit growth in our zero trust offering.

Collaboration was flat, driven by growth in our cloud calling and contact center offerings, offset by declines in meetings and devices.

And Observability was up 27%, driven by growth in ThousandEyes network services and the benefit from the Splunk acquisition.

Excluding Splunk, Observability grew 14% for the quarter.

As Chuck said, we have successfully transformed our business model.

ARR ended the quarter at $29.2 billion, which increased 22% due to continued strong performance and contribution from Splunk.

These factors also drove our product ARR growth of 44%.

Without Splunk, ARR was $25 billion, up 5%, and product ARR was up9%.

Total subscription revenue increased 12% to $6.9 billion, which now represents 54% of Cisco's total revenue.

Without Splunk, total subscription revenue was up 5%, representing 53% of Cisco's total revenue.

Total software revenue was up 5% at $4.5 billion, with software subscription revenue up 17%.

Without Splunk, total software revenue was down 4% and software subscription revenue was up 6%.

91% of our total software revenue was subscription-based.

Total RPO was $38.8 billion, up 21% due to both strong performance and the Splunk acquisition.

Product RPO grew 29%.

Total short-term RPO was $20.1 billion, up 19%.

Without Splunk, RPO was $35.3 billion, up 10%, with product RPO also growing at 10%.

Q3 product orders were up 4%.

Excluding Splunk, product orders were flat year-over-year.

We see customer product implementations progressing in line with our expectations, and we expect these deployments to be largely complete by the end of our current fiscal year.

Looking at our geographic segments year-over-year, the Americas was up 6%, EMEA was up 4% and APJC was down 1%.

In our customer markets, service provider and cloud was up 10%, public sector was up 6% and enterprise was up 2%.

Total non-GAAP gross margin came in at 68.3%, up 310 basis points year-over-year and above the high-end of our guidance range.

Product gross margin was 66.9%, up 240 basis points, of which Splunk contributed 70 basis points.

The remaining improvement was driven primarily by favorable product mix and lower freight and other costs.

Service gross margin was 71.6%, up 430 basis points.

Non-GAAP operating margin came in at 34.2%, up 30 basis points, driven by our continued commitment to disciplined spend management.

Operating cash flow was $4 billion, down 24%.

Shifting to the balance sheet, we ended Q3 with total cash, cash equivalents and investments of $18.8 billion.

Uses of cash during the quarter included a net outflow of $27.4 billion related to our acquisition of Splunk, and in line with our capital allocation strategy, we returned $2.9 billion in value to our shareholders, including$1.6 billion for our quarterly cash dividend and $1.3 billion of share repurchases.

Year-to-date, we've returned $8.5 billion in capital to our shareholders.

To summarize, we successfully completed the acquisition of Splunk, drove strong non-GAAP margins and increased our operating leverage in the quarter.

Guidance

Turning to our financial guidance that includes our integration of Splunk, for Q4, our guidance is as follows.

We expect revenue to be in the range of $13.4 billion to $13.6 billion.

We anticipate the non-GAAP gross margin to be in the range of 66.5% to 67.5%.

Non-GAAP operating margin is expected to range from 31.5% to 32.5%.

Non-GAAP earnings per share is expected to range from $0.84 to $0.86.

Our Q4 guidance includes $950 million to $1 billion in revenue from Splunk and non-GAAP EPS of negative $0.03 as the interest impact more than offsets the operating benefit.

In Q4, we're assuming a non-GAAP effective tax rate of approximately 18%.

For fiscal year 2024, our guidance is as follows.

We expect revenue to be in the range of $53.6 billion to $53.8 billion.

Non-GAAP earnings per share guidance is expected to range from $3.69 to $3.71.

We're assuming a non-GAAP effective tax rate of approximately 19%.

Looking beyond Q4 and into our fiscal 2025, in addition to the top line benefits from the Splunk acquisition, there are a few points to bear in mind as you build your models.

First, we expect revenue growth to be in the low to mid single-digit range next year.

Second is the interest impact from the acquisition, which we expect to be a headwind of approximately $350 million per quarter, including both the foregone interest from cash off the balance sheet and the additional interest payments on debt.

Third, we're working to quickly integrate Splunk into our product offerings, go-to-market engine, and expect to invest in OpEx in fiscal 2025 to drive those revenue synergies.

Given these points, we expect fiscal 2025 operating margin to be in line with our Q4 guidance.

We'll give more formal guidance as we get to the next earnings call, but I want to make sure you had those three thoughts in mind.

And as we've stated, we expect the deal to be non-GAAP earnings per share accretive in fiscal 2026 and beyond.

Closing:

As a reminder, we will be hosting our 2024 Investor Day as part of Cisco Live on June 4, 2024.

Cisco's next quarterly call, which will reflect our fiscal year 2024 fourth quarter and full year results, will be on Wednesday, August 14, 2024 at 1:30 PM Pacific Time, 4:30 PM Eastern Time.

This concludes today's call. If you have any further questions, please feel free to contact the Cisco Investor Relations department, and we thank you very much for joining the call today.

The prepared remarks set forth above and the related conference call may be deemed to contain forward-looking statements, which are subject to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. These forward-looking statements include, among other things, statements regarding future events (such as our ability to bring together networking, security, observability, and data to enable us to offer digital resilience to our customers, the stabilization of demand for our products, and the addition of Splunk to our product line as a catalyst for future growth) and the future financial performance of Cisco (including the guidance for Q4 FY 2024 and full year FY 2024) that involve risks and uncertainties. Readers are cautioned that these forward-looking statements are only predictions and may differ materially from actual future events or results due to a variety of factors, including: business and economic conditions and growth trends in the networking industry, our customer markets and various geographic regions; global economic conditions and uncertainties in the geopolitical environment; our development and use of artificial intelligence; overall information technology spending; the growth and evolution of the Internet and levels of capital spending on Internet-based systems; variations in customer demand for products and services, including sales to the service provider market and other customer markets; the return on our investments in certain priorities, key growth areas, and in certain geographical locations, as well as maintaining leadership in Networking and services; the timing of orders and manufacturing and customer lead times; supply constraints; changes in customer order patterns or customer mix; insufficient, excess or obsolete inventory; variability of component costs; variations in sales channels, product costs or mix of products sold; our ability to successfully acquire businesses and technologies and to successfully integrate and operate these acquired businesses and technologies; our ability to achieve expected benefits of our partnerships; increased competition in our product and service markets, including the data center market; dependence on the introduction and market acceptance of new product offerings and standards; rapid technological and market change; manufacturing and sourcing risks; product defects and returns; litigation involving patents, other intellectual property, antitrust, stockholder and other matters, and governmental investigations; our ability to achieve the benefits of restructurings and possible changes in the size and timing of related charges; cyber attacks, data breaches or other incidents; vulnerabilities and critical security defects; our ability to protect personal data; evolving regulatory uncertainty; terrorism; natural catastrophic events (including as a result of global climate change); any pandemic or epidemic; our ability to achieve the benefits anticipated from our investments in sales, engineering, service, marketing and manufacturing activities; our ability to recruit and retain key personnel; our ability to manage financial risk, and to manage expenses during economic downturns; risks related to the global nature of our operations, including our operations in emerging markets; currency fluctuations and other international factors; changes in provision for income taxes, including changes in tax laws and regulations or adverse outcomes resulting from examinations of our income tax returns; potential volatility in operating results; and other factors listed in Cisco's most recent reports on Forms 10-Q and 10-K filed on February 20, 2024 and September 7, 2023, respectively. The financial information contained in the prepared remarks and the related conference call should be read in conjunction with the consolidated financial statements and notes thereto included in Cisco's most recent reports on Forms 10-Q and 10-K as each may be amended from time to time. Cisco's results of operations for the three and nine months ended April 27, 2024 are not necessarily indicative of Cisco's operating results for any future periods. Any projections in the prepared remarks and the related conference call are based on limited information currently available to Cisco, which is subject to change. Although any such projections and the factors influencing them will likely change, Cisco will not necessarily update the information, since Cisco will only provide guidance at certain points during the year. Such information speaks only as of the date of the prepared remarks and the related conference call.