

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 pro forma financial results.

Cisco Systems, Inc.
Fourth Quarter and Fiscal Year 2003 Quarterly Conference Call
Tuesday, August 5th, 2003
1:30pm PT

Introduction

- Good afternoon, everyone, and welcome to our 54th quarterly conference call.
- This is Dennis Powell with John Chambers, our President and CEO; Rick Justice, Senior Vice President of Worldwide Field Operations; and Charlie Giancarlo, Senior Vice President of Product Development.
- The Fourth Quarter and Fiscal Year 2003 press release is on First Call, Full National Business Wire, Analyst Wire, the European Business and Technical Wire, and on the Cisco website at www.cisco.com in the Investor Relations section.
- If you would like a fax of the press release, please call 408-526-8890 and follow the instructions.
- We want to remind you that all of the information regarding the replay of this conference call is available on the Cisco website at www.cisco.com in the Investor Relations section. Additionally, a replay of this call will be available via telephone at 888-568-0916.
- We continue to provide financial slides as part of our webcast to help summarize key information provided in this call for our investors. To view and access these slides, please log on to our website in the Investor Relations section.
- Throughout this conference call, we will be referencing both GAAP and pro forma financial results. Please note we have completed GAAP reconciliation information on our website in the Investor Relations section. Additionally, we have provided information relating to both our GAAP financial results and our pro forma financial results along with a reconciliation table between our GAAP and pro forma financial statements and our press release.
- The financial results in the press release are unaudited.
- The matters we will be discussing today include forward-looking statements and as such are subject to the risks and uncertainties that we discuss in detail in our documents filed

with the SEC, specifically, the most recent reports on Form 10-K and 10-Q and any applicable amendments which identify important risk factors that could cause actual results to differ from those contained in the forward-looking statements. Unauthorized recording of this conference is not permitted. Consistent with previous quarters, we will conclude our call promptly at 3:00 PM.

- I will now turn it over to John for his commentary on the quarter. John?

Opening Remarks

- Thank you, Dennis.
- Now, moving on to the discussion of Q4.
- In what continued to be a challenging environment for a number of companies in the information technology industry, we were pleased to report our fourth consecutive quarter this fiscal year of having pro forma net income exceed \$1b and our profits exceed 20 percent of revenue. We continue to believe we have uniquely positioned Cisco as the inevitable recovery occurs, whether it is one quarter or in multiple quarters.
- As we will discuss later, there continues to be good balance in terms for our focus on profit contribution, net income, gross margins, profitable market share gains, geographic balance, and advanced technology market results.
- In a time period where profits are extremely important and many of our best competitors continue to lose money or post very small profits, we are also pleased with our pro forma net income of \$1.09b, which was 5-percent year-over-year increase and represents 23 percent of revenue. GAAP net income was \$982m, a 27-percent increase year over year. This compares to a net loss of the 11 key competitors which we have been tracking for the last several years, with a combined pro forma loss of \$345m and a GAAP loss of \$1.2b in their most recently reported quarter.
- We also clearly understand that future earnings growth will probably be driven primarily by top-line revenue growth. We will be discussing the potential for growth in more detail later in this conference call, but we are starting to see some very early signs that could be interpreted with the appropriate caveats as cautiously optimistic.
- With every functional area continuing to focus on gross margins and profit contribution, the 69.9-percent total gross margin continues to exceed our own stretch goals. As we have discussed in prior quarter calls, we continue to dramatically improve our price performance and/or price reductions in almost all product areas over the last year. In Q4, we had over eight product areas achieving these types of improvement for our customers.
- The key takeaway here is that we are accomplishing both price reductions and price performance improvements, as well as movements into the home market while maintaining our solid gross margins.
- A few of the new areas affected in Q4 by the price performance improvements included the Catalyst 4000, 2900 Mid-Range Routers, 10000 Edge Service Router, storage and voice products, technology trade-in programs for end-user customers, and continued

focus on channel profitability with additional discounts on select Catalyst 2950 and 3550 switches.

- However, as we mentioned before, most price reductions do not translate into higher total sales in the present environment, but we believe this is the right thing to do for our customers, channel partners, shareholders, and for Cisco in the long run.
- As we articulated before, this balance between customer price performance advantages and profit contribution to Cisco may be one of our best accomplishments as a company. Our continued balance of both profits and customer success is something that only a few IT companies accomplished during the industry downturn. I want to congratulate the entire Cisco team on this multi-year focus.
- Cash flow from operations was approximately \$1.5b.
- During the quarter, we repurchased \$1.4b of common stock. We exited this quarter with over \$20b in cash, cash equivalents, and marketable investments, which was an increase over Q3 of more than \$300m, even after the \$1.4b stock repurchase.
- Book to bill was slightly above one, with a number of our key product areas and geographies achieving solid and potentially interesting levels of order growth over Q3. As a reminder, Q4 is usually a stronger seasonal quarter for Cisco versus Q3.
- While there is always room for improvement, we continue to be very pleased with our ability to deliver differentiated value to our customers' highest priorities, which are productivity, cost savings, and standard-of-living improvements.
- In terms of our financial metrics, with the obvious exception of revenue growth, we continue to achieve some of the top financial measurements in our company's history. Those include GAAP earnings, pro forma earnings, cash generation, DSOs, gross margins, and net income as a percentage of revenue.
- In summary, we are very pleased with most of our operational measurements, but especially pro forma profit, our solid gross margins, and market share gains in a number of product areas. Dennis will cover some of these items in more detail later in the discussion.
- In the remainder of today's call, we will use the following format:
 - First, our standard financial and quarterly overview.
 - Second, many of our shareholders have repeatedly asked how we're applying our resources for our opportunities for growth once the economic recovery occurs. Given the completion of another fiscal year, we thought this would be an appropriate time to discuss both our key growth areas and market opportunities in this section and to give an update on the current status.
 - Third, as usual, our summary of what went well and areas where we can improve.
 - And, finally, our industry guidance moving forward.

- Now, I'll turn it over to Dennis for a more detailed report on our financial results in the quarter. Dennis, it's all yours.

Financial Overview

- Thanks, John.
- Please note our Q4 results include Linksys as of May 31, 2003, the date of the acquisition. I will provide some additional detail on Linksys later in this financial overview.
- Now, for some comments on our P&L.
- Total revenue for the fourth quarter was \$4.7b. Of this amount, approximately \$3.9b related to product revenue and \$840m, or 18 percent, related to service revenue. Service revenue includes technical support services, advanced services, and other miscellaneous service revenue.
- Fiscal year 2003 total revenue was \$18.9b, the same as in fiscal year 2002. Of the \$18.9b, \$3.3b, or approximately 18 percent, was service revenue.
- Pursuant to Financial Accounting Standards 131, which relates to additional disclosure of business segments, we break out revenue by the following categories: routers, switches, access, other, and services.
- The "other" revenue category includes security, optical, software products, IP telephony, Linksys, and other miscellaneous products. As we go into FY '04, we will continue to evaluate our revenue segmentation reporting, particularly as it relates to the "other" category.
- In order to more closely align with market share reporting and in response to input from our investors, we have made certain reclassifications to our product segment reporting for Q4 FY '03 and Q3 FY '03. These reclassifications were made to more clearly report revenue related to our advanced technologies. As an example, we reclassified security modules on the 2600 and 3600 from routers to security, which is included in the "other" revenue segment. The impact of the reclassification was relatively insignificant, and no segment changed more than 1 percent.
- The segment percentages of total revenue from Q3 to Q4 FY '03 are as follows:

<u>% of Total Business –</u>	<u>Q303</u>	<u>Q403</u>
Routers	26%	26%
Switches	40%	39%
Access	5%	5%
Other	11%	12%
Services	18%	18%

- In Q4 FY '03, the total pro forma and GAAP gross margin was 69.9 percent, down from 70.8 percent last quarter and compares to 67.7 percent on a pro forma basis and 68

percent on a GAAP basis for the same quarter in fiscal year 2002. This is at the higher end of the guidance we provided last quarter of 68 to 70 percent.

- For product only, pro forma and GAAP gross margin for the fourth quarter was 70.8 percent, down from 71.4 percent last quarter. This .6-percent decrease in product gross margin was due primarily to price reductions and an unfavorable product mix of 1.2 percent, a .7-percent impact from inventory provisions, and a .3-percent impact from lower margins related to Linksys, partially offset by 1.6 percent in cost savings.
- Our service margin on a pro forma and GAAP basis was 66 percent versus 67.9 percent in the previous quarter. Service margins will typically experience some variability over time due to various factors, such as changes in mix between technical support services and advanced services, as well as the timing of support contract initiations and renewals.
- Our total pro forma operating expenses of \$1.9b were up slightly from the previous quarter, partially due to an increase in prototype expenses in R&D and the impact of foreign exchange rates in Q4.
- Our tax provision rate for the pro forma results was 28 percent for Q4 FY '03.
- Our GAAP net income for the quarter was \$982m, or 20.9 percent of revenue, compared to \$987m in the last quarter and \$772m for the same quarter in fiscal year 2002, representing a 27-percent increase year over year.
- GAAP earnings per share on a fully diluted basis was 14 cents, flat from the prior quarter, and up from 10 cents per share from the same quarter in fiscal 2002, representing a 40-percent increase year over year.
- Pro forma net income for the quarter was \$1.09b, or 23.2 percent of revenue, up slightly from \$1.08b last quarter and \$1.04b for the same quarter in fiscal year 2002.
- Pro forma earnings per share on a fully diluted basis was 15 cents, flat from the prior quarter, and up from 14 cents per share for the same quarter in fiscal year 2002.
- Fiscal year 2003 GAAP net income was \$3.6b, and earnings per share was 50 cents, as compared to fiscal year 2002 net income of \$1.9b and earnings per share of 25 cents.
- On a pro forma basis, fiscal year 2003 net income was \$4.3b and earnings per share was 59 cents, versus net income of \$2.9b and earnings per share of 39 cents in fiscal year 2002.
- As you know, Cisco's acquisition of Linksys was completed on May 31, 2003 at a purchase price of approximately \$480m.
- As a reminder, Cisco recognizes two-tier revenue on a sell-through basis using information from distributors. We applied this revenue recognition methodology to Linksys on the date of the acquisition. Therefore, only products shipped and sold through to the end user are recognized in revenue in Q4 FY '03.

- In Q4, Linksys increased revenue of Cisco by approximately \$20m, had a negative impact of .3 percent on gross margin, as mentioned earlier, and did not change earnings per share.
- Going forward for a few quarters, we will continue to provide insight on how this important acquisition is performing as part of our discussion on advanced technologies.

Moving on to the balance sheet :

- The total of cash and short-term and long-term investments was \$20.7b, up more than \$300m from the prior quarter.
- During Q4 FY '03, we had generated approximately \$1.5b in cash flow from operations. Our total cash generated from operations was over \$5.2b for fiscal year 2003, as compared to our pro forma net income of \$4.3b, which illustrates the continued quality of our earnings.
- During Q4 FY '03, we repurchased approximately \$1.4b, or 83m shares, of our stock at an average price of \$17.25. For all of fiscal year '03, we repurchased approximately \$6b, or 424m shares of our stock at an average price of \$14.10.
- Our cumulative purchases since the inception of the repurchase program are approximately \$7.8b, or 548m shares at an average price of \$14.29, leaving a remaining approved repurchase amount of approximately \$5.2b. We intend to continue to be active in the market going forward.
- Accounts receivable ended the quarter at \$1.4b, up slightly from the prior quarter.
- In Q4 FY '03, the DSO, or day sales outstanding, was 26 days, which compares to 23 days from the prior quarter.
- Net inventory was \$873m at the end of Q4 FY '03, up slightly from \$765m at the end of Q3, primarily as a result of the Linksys acquisition.
- Inventory turns were 6.8 times in Q4 FY '03 versus 7.0 in the prior quarter. Excluding Linksys, our inventory turns were 7.2 times in this quarter. Our goal continues to be to maintain our inventory turns at approximately seven to eight times.
- Total inventory of \$873m was comprised of:
 - Raw materials \$38M
 - Work in process \$291M
 - Finished goods \$515M
 - Demo systems \$29M
- Total deferred revenue for Q4 FY '03 was approximately \$3.8b, flat with the previous quarter. Of the total \$3.8b, deferred service revenues were \$2.4b, and deferred product revenues were \$1.4b.

- Our total Q4 FY '03 reported headcount ended at 34,466, representing a decrease of 302 employees before considering the addition of 267 employees from the acquisition of Linksys.
- In conclusion, I was pleased with our solid financial performance during the quarter and our year-over-year improvement.
- Going into FY '04, there are three long-term key financial priorities that I see for Cisco: first, to generate profitable growth opportunities while supporting Cisco's business model of 20-percent profit after tax; second, to focus on improving Cisco's productivity, as measured in terms of operating expense as a percentage of revenue; and, finally, to maintain our healthy and conservative balance sheet, including strong liquidity, low DSOs, and inventory turns in line with our goal.
- I'll now turn it over to John. John?

Quarterly Overview

- Thank you, Dennis.
- Now, moving on to our quarterly overview.
- In this section, we will highlight information from our geographies, technology product areas, and customer segments.
- Starting with the geographies. This is the data on which I primarily relied to run our business and watch very closely on a daily basis. The theater breakout for Q4 in terms of total product bookings was:
 - U.S.: 47 % (up from 45 % in Q3)
 - EMEA: 32 % (balanced with Q3, 32 %)
 - Americas International: 4 % (Q3 was 5 %)
 - Japan: 7% (Q3 was 8%)
 - Asia-Pacific: 10% (the same that it was in Q3)
- A number of you have asked for continued geographic discussion regarding the theater and industry segments because of this rapidly changing global economic environment. The U.S. increased to 47 percent of our total product orders. The following discussion will focus on quarter-over-quarter improvement in orders.

U.S.

- The total U.S. orders were a little better than we expected.
- U.S. service provider orders were up slightly. The continued challenge in the service provider capex spending was balanced by our improving position in most U.S. service providers. These results were in line with our expectations. However, the sequential order growth and balance across our eight enterprise areas and the federal area were better than we expected.

- While the majority of our customers' CEOs continue to remain conservative, we are starting to see a cautious but gradual and potentially meaningful increase in CEO confidence in their business and their view of the economy.
- Also, while it's too early to say, the following is a definite trend, and it is difficult to precisely measure because of our channel strategy. We believe we are also seeing an increase in small- to medium-sized business orders with Cisco.

EMEA

- Moving on to EMEA, Q4 was another good quarter, with reasonably good balance across key European geographies. Our four largest operations and eight of the top 10 countries showed quarter-over-quarter growth, with Italy, France, Russia, and Sweden showing the best growth of the larger countries.
- Our service provider orders were up sequentially in high single digits in what is clearly a challenging capex environment. In summary, in terms of our year, growth in Europe was slightly better than we expected.

Americas International

- Americas International is performing satisfactorily in what continues to be a very challenging market, representing 4 percent of Cisco's total business. Our Mexican operation showed solid quarter-over-quarter growth, achieving their best numbers in almost two years. However, Canada and Brazil were a little bit more challenged in Q4.

Asia Pacific

- Moving on to Asia-Pacific, which has consistently over the last year been the most predictable performer of our theaters, it remained steady at 10 percent of our total business. We saw reasonably good sequential growth throughout much of our Asia-Pacific operation, including Australia, Korea, and Taiwan.
- China was relatively flat, and India was down sequentially. And, finally, moving on to Japan, which represents 7 percent of our total business, Q4 has traditionally been a challenging seasonal quarter for our Japanese operations, with the previous two years' Q4 being sequentially down in terms of orders and double digits. However, in this Q4, we actually saw a slight order increase.
- In late July, I had a weeklong trip to Japan, where we called upon many of our large customers, channel partners, and government officials. In complete candor, I was expecting very conservative and possibly even pessimistic feedback on their economy and business momentum. While I don't want to make too big of an issue out of this, I was pleasantly surprised to see that first -- albeit very cautious -- optimism across the majority of people I talked with in almost three years. Whether this will translate into economic activity and eventual business for Cisco remains to be seen.
- Having said that, we do have a very strong team and leader in Japan's operations, which continues to operate effectively in a challenging market.

Future Growth Opportunities/ Challenges

- In the following section, we will attempt to provide additional information in terms of our business momentum, opportunities for growth, feedback on the investment decisions that

were made one to three years ago, and some of the challenges we face so that you can better utilize and better analyze our current progress or lack of progress and our strategy to position Cisco for future growth.

- As we have discussed many times before, when we talk about areas for potential growth, we have segmented those areas into three very broad groups. Those three are the following:
 - First, our core technologies, routing and switching
 - Second, service provider
 - Third, advanced technology markets
- We will also discuss two additional markets in which we made major investments over the last several years and provide some initial results. These markets, which make up the fourth and fifth area of today's growth discussion, are the U.S. federal government business and Cisco's advanced services.
- Starting with our core technologies, routing and switching, the opinions vary dramatically on what will be the growth of these product areas during normal economic times. My own view is that the projections made at the height of an economic cycle were obviously too optimistic, and projections made at the bottom of the IP slowdown may prove to be too conservative. And to put these improvements in proper perspective, I want to remind everyone once again that Q4 does have, even in periods of potentially flat revenue growth, positive seasonality.
- So what I'd like to do is to share with you the trends regarding orders for Q4.
- We saw solid, sequential quarter-over-quarter growth in high-end routing and high-end switching. In particular, we were both pleased and pleasantly surprised when our GSR, our high-end router, orders grew to approximately 200m during Q4.
- The sequential increases in excess of 25 percent versus Q3 obviously signals customer confidence for Cisco at the high end of our product range. The 12000 series, combined with our core and edge service provider routing platforms, continued to gain market share versus the competition. But we also want to remind you that high-end router orders can be lumpy across quarters.
- To put the orders in the current quarter of the 12000 into perspective, just one product family generated in Q4 almost 1.5 times the total estimated product revenue of our largest router competitor in their most recent reported quarter.
- Mid-range and low-end routing were a little bit weaker than we would like to have seen. However, mid- and low-end switching were solid in terms of quarter-over-quarter order growth, and we continue to see major acceptance of Gigabit Ethernet. In Q4, we passed an important milestone in booking more than one million 10/100/1000 ports. We saw a great acceptance of 10/100/1000 Gigabit Ethernet over our entire modular product line.
- Second, in terms of our continued progress in the service provider market, in prior conference calls, we've covered our service provider strategy and progress in a great deal of detail. So in this section, we'll not spend as much time on it as we have traditionally

done. However, having said that, we continue to be very pleased with our resource investments, expanding customer partnerships, key technology and architectural wins, and with our quarter's sequential growth.

- Our investments over the last two to three years and the results there are starting to continue to meet or exceed our expectations.
- In a market that has contracted this calendar year, we appear to be executing reasonably well with our sequential orders being up in mid-single digits for our global service providers.
- Third, in our advanced technologies, it was another solid quarter in terms of order momentum. It appears that our strategy and key targeted technologies is working reasonably well. As we discussed before, our target is to identify 12 potential advanced technologies that would eventually yield \$1b-a-year run rates for Cisco if we execute well and the market develops as we expect. Obviously, we would not hit anywhere near all of our goals on all of the now six and eventually 12 targeted categories, so we will try to give you updates about our progress in the advanced technology group in total and about the specific product technologies periodically in our conference calls.
- As a reminder, the six advanced technology markets that we're focused on are IP telephony, optical, storage, wireless, LANs, security, and home networking, and represent approximately 17 percent of our product bookings in the most recent reported quarter.
- We are relatively comfortable with our progress to date in all six of the announced advanced technology areas. In total, they exceed 20-percent sequential order growth, with IP telephony, storage, and optical growing the fastest sequentially in terms of orders.
- At this time, I'd like to add a little bit more detail on these three areas:
 - In terms of IP telephony, we shipped our two-millionth IP phone at the end of July, and to date, we have shipped over 13 million voice-over-IP ports. To date, we have shipped more IP phones than all of our competitors combined, and we continue to be the only major voice-over IP provider to all three customer segments, that being service provider, enterprise, and commercial. In terms of momentum, our IP telephony sales, it took us three years to sell our first million phones. It took us only last fiscal year to sell our next million phones.
 - From a storage perspective, we increased our number of end-user customers from 43 in Q3 to a total of approximately 140 in Q4. We also made a decision to reduce prices by an average of approximately -- while the range was literally from the high teens to 60 -- an average of 30 to 35 percent, and our continued focus on market share balanced with profit contribution. Orders for the MDS 9000 after pricing reduction grew sequentially by approximately 45 percent.
 - We were pleasantly surprised by the growth of our optical business, with orders being the best we've seen in almost two years, and showed an increase of approximately 40 percent over Q3.

- We would continue to expect, given the moderate order volumes in each of our six advanced technologies, for each category to be a little bit lumpy from quarter to quarter.
- The fourth and fifth areas that we will cover will be federal government business and advanced services. The decision to apply additional resources and management focus in these areas, with the obvious goal to grow revenues and profits, were expanded approximately two to three years ago. In terms of the federal government business, over the last three years, we dramatically expanded our focus to a longer-term investment cycle in terms of people, product development, advanced services, security, and other issues.
- In short, we've moved more of our focus from a one- to two-year implementation to a three- to five-year investment cycle. As we discussed before, the results continue to be very positive. In Q4, our federal business grew comfortably sequentially in double digits over Q3 and represented approximately 20 percent of our U.S. enterprise business, up from single digits several years ago. For the entire fiscal year, our orders crossed the \$1b threshold for the first time.
- The other area that we have applied a lot of investments, realignments, and focus is the area of advanced services. Traditionally, we combined professional services with our products and lines-of-business focus, similar to what many of our large competitors have done. While this approach did help sell some basic products, the contribution margin was negative, and we actually at times competed with our partners, who were interested in providing similar services.
- A little over two years ago, we made the decision to realign five different professional services group into one under the leadership of Gary Moore, who reports to Wim Elfrink, the senior vice president in charge of our customer advocacy groups. We defined the charter to focus on profit contribution, customer satisfaction, revenue growth, and speed of implementation. At the same time, the challenge was to focus on tight coordination, rather than competition with our partners, and focus on return on investment for our customers. The progress is very steady, moving from negative contribution margin, to positive 10 percent in fiscal year '02, to approximately 20 percent in fiscal year '03. In fiscal year '03, we grew our revenue by over 20 percent to 400 million, doubled our contribution margin, and achieved at the same time approximately a 20-percent productivity improvement from the group.
- Our new approach received extremely positive reviews from both our end-user customers and our partners. Depending on how successful we are in our continued implementation, this area has the potential to be \$1b in business for Cisco in the next three to five years, and at the same time, result in a very tight, positive work relationship with our partners and to complement their focuses on professional services.
- Today we have discussed five key potential areas for growth, as well as identified some of our concerns that we need to overcome to achieve our potential growth. We are pleased with our overall progress in each of these areas, although, as always, there's room for continued improvement.

- In summary, while all of us wish that we could dramatically affect the next one to two quarters, based on our activities of today, the decisions were made two to three years ago, and how effective we are in implementing these decisions, combined with the overall economic environment, are the key determinants of this quarter and probably the next several quarter results.

Summary of What Went Well and Concerns

- First in terms of what went well. We covered a fair amount of what went well already in the discussion, so I'll try to keep this relatively short and spend a little more time in our typical fashion on the concerns.
- We continued to execute well in terms of our financial matrices of gross margins at 69.9 percent, DSOs at 26 days, cash generation at \$1.5b from operations, total cash and equivalent over \$20b, as Dennis said earlier, and inventory turns at 6.8.
- From a profit perspective, we were very pleased with a net income of 23 percent of revenue, which is obviously comfortably above our traditional target of 20 percent. To accomplish approximately \$1b of pro forma net income in the current environment continues to be a major achievement.
- Third, we will continue to pass on price performance improvements through to our customers while maintaining the classical what we believe the traditional Cisco “and effect”, that is, at the same time, keeping gross margins at a relatively high level.
- Fourth, while there's room for improvement in a few key product areas, we were pleased with the balance of business across almost all of our product lines.
- Fifth, as we said in the prior section, our strategy in terms of focusing on our advanced technology markets, new potential growth markets, and expanding existing markets appears to be working well.
- Our acquisition of Linksys, which was key, both from an advanced technology perspective and opening up both the home networking and the SOHO market for Cisco, is going extremely well. We want to welcome the members of the Linksys team to our Cisco family.
- In an area that is difficult to quantify but extremely important to our ability to achieve our long-term goals, we continue to make solid progress in expanding our internal teamwork and organizational evolution. This is key to enable us to address the many opportunities and challenges as we move from selling boxes to selling systems, expanding expectations on quality, and driving toward increased productivity of \$700,000 per employee. The cross-functional leverage enabled by our IT networking solutions requires effective cross-functional teamwork at a much higher level than in the past.
- And, finally, from an architectural perspective, we continue to see the evolution of what we believe will be four generations of network architectures: first, the basic convergence of data, voice, and video into systems-integrated best-in-class networks; second, end-to-end IP networks; third, what we believe will be a network of networks; and, fourth, what

we discussed in our analysts' meeting in December, an evolution to the intelligent information network.

- We continue to see multiple supporting views from our customers and partners indicating this network evolution will probably happen, and we think we are truly uniquely positioned if we continue to execute effectively to utilize these architectural evolutions to the benefit of our global customers and to Cisco.
- In summary, while there's always room for improvement, we are very pleased with how we've positioned the Company for the inevitable economic upturn. In short, in terms of these elements that we can control or influence, we believe that we continue to do extremely well.

Concerns

- Moving on to concerns, reminding those who have had limited exposure to our prior conference calls, we will try to give equal balance to both what went well and our concerns.
- Given our normal sense of healthy paranoia, we have a number of typical general concerns:
 - First, today's economy remains a show-me economy, meaning that CEOs will wait to spend until they see their own revenues and profits pick up. But for the first time in a long time, we are seeing a number of potentially positive signs of economic recovery, business improvements, and CEO confidence, and, therefore, potential capex spending in our area. Having said that, all of us should be quick to remember that there were a number of projections in calendar year 2001 and 2002 that indicated stronger second-half economic recoveries, which for a variety of reasons did not develop. The obvious concern here is that while things are starting to look better, it is still fragile and may not develop to a level we all desire.
 - Second, capex. Spending in the service provider market segment continues to be a major issue with many of our service provider customers continuing to cut their budgets. While capex remains a major industry issue, we are continuing to improve our position in most of the service providers around the world and especially in terms of the new service revenue generation opportunities for these customers. And as we said earlier, we are pleased with our Q4 sequential orders up in the mid-single digits.
 - Third, in our travels around the world, almost all government and business leaders agree that there cannot be a sustained global economic recovery without the U.S. leading the way. And as we have said many times before, in our own view, although it may be in the minority, we will see this recovery gradually, first, in small to medium businesses, second, in enterprise businesses, although not in total but in a gradual way by type of industries and companies within those industries, and with industries perhaps, such as airlines and possibly service providers being at the back end of the recovery in capex spending.

- Fourth, while we are very comfortable with our strategy evolving through the four phases of network evolution and believe we have positioned ourselves very well versus all of our key competitors, assuming this market evolves in the way we think it should, we are surprised that our peer competitors are not following this broad strategy. And, therefore, by definition, we are either going to be very right or possibly wrong. If we are wrong, we will obviously adjust, but as always, normal paranoia points out this issue.
- The next area we'd like to cover is our strategy that has been built in to not only adjust dramatically whether the economy recovery occurs in one quarter or multiple quarters in the future. In a time period where companies and their leaders can be very quickly second-guessed for taking good business risk or making predictions about an uncertain future, which, by definition, some will be right and some will be wrong, we will continue to be aggressive in taking business risk. It is important for our shareholders to remember that taking good business risk is an integral part of our strategy, and we will continue to be aggressive in our business strategy and conservative in our financial reporting. The bottom line on this is you don't achieve the type of growth Cisco had in the past and hopefully will in the future without taking some good business risk, which, by definition, will result in some misses. We believe that the benefit to our customers, shareholders, partners, and employees outweighs the risk, and we continue to live with the constructive criticism that goes with this strategy. We also continue to be concerned by the large number of our peers who are struggling and their conservative views of the outlook of our industry, and they could possibly be right.
- Finally, given that consumer spending has held up remarkably well so far during the downturn, a valid concern by many remains that consumer spending would slow down before the business spending picks up. As we've said many times before, from a geographic perspective, where there is a GDP slowdown in countries around the world, this is usually followed by a reduction in capital expenditures, and, therefore, orders for Cisco and our peers. It is our view that GDP will continue to be the best indicator of what you should expect from Cisco in each of these markets, assuming we execute reasonably well. This trend continues in terms of potential orders in key countries around the world.

Guidance

- Now, moving on to guidance.
- In very simple terms, we continue to focus on adjusting our breakaway and industry consolidation strategy for the current industry downturn and then to position Cisco for the next upturn. In typical Cisco fashion, we will continue to budget very conservative with a budget that we believe we have a reasonably high probability of hitting, and we will adjust this budget after the first six months of the fiscal year while providing guidance one quarter at a time. We encourage our investors to adopt a similar philosophy and not let expectations get ahead of our ability to achieve the results until the industry turnaround becomes visible.

- Q4 -- in terms of issues we could control or influence, it was a very solid quarter for Cisco. We were especially pleased with our continued results and improvements across almost all areas of our business. There remains one obvious exception, and that is revenue growth. As I've said earlier, while all of us would like to believe that what we do this quarter dramatically affects the results for next quarter, we all know that this is not really what happens. Business results that we reported today versus our industry peers were primarily the result of the decisions and actions we took 12 to 36 months ago, combined with the current economic conditions. Similarly, we are making decisions and allocating resources in terms of our three major growth areas -- network architecture evolution, expectations, and continued focus on profit contribution. And our results 12 to 36 months from now will depend on the relative success and implementation of these decisions.
- To again answer any indirect questions about my views going into Q1 as compared to my feelings going into Q4, I would summarize these views in the following way.
- In areas that we can control or influence, such as how we are managing our business, focus on profit contribution, cash generation, profitable market share gains, product evolution, gross margins, etcetera, I continue to be more optimistic than I was going into the past quarter. In short, for those elements that we can control or influence, my confidence is continuing to increase.
- From an external perspective, for the first time in a very long time, I believe the external factors are slowly starting to be more positive. This is still a minority view held by a minority of our customers, and we are seeing some very early indications that the economic recovery may be slowly gaining momentum. Obviously, this view could be wrong, or even if it is right, as you've seen over the last few years, unexpected events could rapidly change the direction of the economy and Cisco's opportunities. Also, our view has not changed in terms of how we anticipate our customers' business improvements and corresponding investments in technology.
- As we outlined in our prior conference call, we look for IT spending improvements first in the small- to medium businesses, and then expanding to specific industries and specific companies within those industries and the enterprise market at different timeframes, and then eventually expanding to include service provider business. In summary, a gradual industry-by-industry rolling recovery, starting in the U.S.
- So with the appropriate caveats, I'm a little more optimistic on both the internal issues that we can control and the external issues that we cannot control than in recent quarterly conference calls. However, it would not be a big surprise to us if the economic factors were to increase or decrease versus our expectations to see our business results do the same. Simply put, as our customers' business improves, so will our business if we execute properly with a slight lag time.
- In terms of seasonality, as we've said a number of times over the years, Q4 is seasonally a solid quarter for us because of year-end focus and the appropriate incentive to go along with the end of the fiscal year. Our fiscal Q1 has traditionally been slower than the pace in Q4 due to a number of factors, including a slow start in our EMEA operations due to summer vacation of many of our European customers and our sales meetings where we

pulled in our field organizations from each of the theaters during the month of August to invest in their future education and our priorities for the next fiscal year.

- With these factors in mind, our revenue guidance for Q1 in comparison to Q4 is up slightly. Also, our most likely scenario is for bookings to be down, to be a little less than revenues as we continue to gradually bring down lead times.
- When you think about it, what we are really saying is that we expect lead times to tighten a little bit more. This is a requirement for our customers given their tight control on their capex and slow internal approval cycles that will result in requests for even shorter delivery times than you would expect in traditional economic environments.
- While we remain very optimistic for the longer term and are very slowly becoming a little bit more cautiously optimistic in the short term, there continues to be a lot of variables in the short term in the “show-me” economy that could result in surprises to our guidance. We will continue to budget very conservative, a half-year at a time, and we'll adjust at mid-year.
- As always, I want to thank our shareholders, customers, employees, and partners for their support and continued confidence in our ability to execute during rapid industry consolidation, market transitions, and very challenging economic times.
- And now, I'd like to turn it over to you, Dennis.
- Thank you, John.
- Let me remind you again that our comments include forward-looking statements, and you should review our recent SEC filings that identify important risk factors, and actual results could differ from those contained in forward-looking statements.
- Given the continued uncertainty surrounding many of the variables that could impact our industry and the global economic environment, we are providing pro forma guidance for the first quarter of FY '04 only. We expect revenue in the first quarter of fiscal year 2004 to be sequentially up 2 to 4 percent, including Linksys revenue of approximately \$115m.
- Regarding gross margins, forecasting gross margins has always been challenging due to the various factors, such as product mix, manufacturing overhead absorption, variable component costs, customer and channel mix, and competitive pricing pressures. We expect that Q1 FY '04 gross margins will be approximately 67 to 69 percent, with Linksys negatively impacting gross margins by 1 percent.
- Operating expenses for the first quarter of FY '04 should be up 2 to 3 percent in terms of dollars, reflecting factors such as the incremental cost of Linksys, foreign exchange costs, and sales commissions. In FY '03, we incurred less sales commission expense due to not achieving sales force quotas in certain geographies.
- We will continue to focus on cost control, especially as it relates to discretionary spending and headcount, but at the same time, we need to ensure we continue to invest in key areas of opportunity. We would expect interest and other income to be approximately \$100m in the first quarter, reflecting the absence of gains that were

realized during recent quarters as we rebalanced our fixed-income investment portfolio. Our pro forma tax provision rate is expected to remain at 28 percent.

- Regarding our Q1 FY '04 GAAP earnings, as we disclosed in our most recent 10-Q filing, we have determined that the new accounting standard, Financial Interpretation 46, regarding consolidation of variable interest entities requires that we account for Andiamo as if it had been consolidated since Cisco's initial investment in April of 2001. This new accounting standard requires variable accounting for substantially all Andiamo employee stock options because the ending purchase price of Andiamo will be primarily derived from a revenue-based formula. Therefore, in the first quarter of FY '04, we will record a one-time non-cash charge of approximately \$400m, or six cents per share, for the cumulative effect of implementing this new accounting standard. This will be reported as a separate line item in the GAAP income statement.
- In addition to this charge, we will have the ongoing amortization of purchased intangibles and deferred compensation charges estimated at two cents per share arising from various purchase acquisitions, including the additional amortization related to the Linksys acquisition. These charges will be reported as GAAP operating expenses. As a result of these two items, we anticipate that our Q1 FY '04 GAAP earnings will be approximately eight cents lower than our pro forma earnings for the same period.
- Other than the charges just described, there are no other significant differences between GAAP and pro forma guidance considered at this time. This guidance assumes no additional acquisitions, asset impairments, restructurings, change in Andiamo's valuation, or other unanticipated events, which may or may not be significant. We also anticipate that share count will be flat in Q1, reflecting the inclusion of Andiamo shares as a result of its consolidation for accounting purposes under Financial Interpretation Number 46.
- Regarding cash flow from operations, we would expect to continue generating an average of \$300m to \$400m per month at these revenue levels.

Closing Remarks

- Again, I would like to remind you that in light of Regulation FD, Cisco plans to retain its long-standing policy to not comment on financial guidance during the quarter unless it is done through a public disclosure. To learn more about Cisco, in addition to contacting our Investor Relations Department, we do encourage all of our investors to utilize Cisco's Investor Relations website.
- Our next quarterly conference call, which will reflect our first quarter of fiscal 2004, will be on Wednesday, November 5, 2003 at 1:30 PM Pacific Time, 4:30 PM Eastern Time.
- We still request that sell-side analysts please ask only one question. And as a reminder, we will end the call at 3:00 PM Pacific Time.
- Operator, please open the floor to questions.

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 Litigation Reform Act of 1995. These forward-looking statements include, among other things, statements regarding future events and the future financial performance of Cisco 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. Readers are referred to the documents filed by Cisco with the SEC, specifically the most recent reports on Form 10-K and 10-Q, each as it may be amended from time to time, which identify important risk factors that could cause actual results to differ from those contained in the forward-looking statements. Among the important factors or risks that could cause actual results or events to differ materially from those in the forward-looking statements in the prepared remarks and the related conference call are: business and economic conditions and growth trends in the networking industry in various geographic regions; global economic conditions and uncertainties in the geopolitical environment; overall information technology spending; the growth 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; the timing of orders and manufacturing lead times; changes in customer order patterns or customer mix; insufficient, excess or obsolete inventory; variability of component costs; increased price competition; variations in sales channels, product costs, or mix of products sold; the ability to successfully acquire businesses and technologies and to successfully integrate and operate these acquired businesses and technologies; increased competition in the networking industry; dependence on the introduction and market acceptance of new product offerings and standards; rapid technological and market change; manufacturing and sourcing risks; litigation involving patents, intellectual property, antitrust, stockholder and other matters; the ability to recruit and retain key personnel; financial risk management; and potential volatility in operating results, among others. 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 Form 10-K and Form 10-Q, each as it may be amended from time to time. Cisco's results of operations for the three and twelve months ended July 26, 2003 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.