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.
Q1 FY2004 Financial Results Conference Call
Wednesday, November 5th, 2003
1:30pm PT

Introduction

- Hello, and welcome to the Cisco Systems' First Quarter Fiscal Year 2004 Financial Results Conference Call. At the request of Cisco Systems, today's conference is being recorded. If you have any objections, you may disconnect at this time.

- Now, I would like to introduce Mr. Dennis Powell, Chief Financial Officer of Cisco Systems. Sir, you may begin.

- Good afternoon, everyone, and welcome to our 55th quarterly conference call. This is Dennis Powell with John Chambers, our President and CEO; Rick Justice, Senior Vice President of Worldwide Field Operations; Mario Mazzola, Chief Development Officer; and Charlie Giancarlo, Senior Vice President of Product Development.

- The first quarter of fiscal year 2004 press release is on First Call, Full National Business Wire, Analyst Wire, the European and Technical Wire, and on the Cisco website at www.cisco.com. 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, including the corresponding financial slides, is also 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 800-778-9712.

- Throughout this conference call, we will be referencing both Generally Accepted Accounting Principles, or GAAP, and pro forma financial results. Please note we have provided complete 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 the reconciliation tables between our GAAP and pro forma financial statements in 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 risk 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 call 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 Q1.

- In what has been a challenging environment for a number of companies over the last three years, we were pleased to report our sixth consecutive quarter 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 recovery continues.

- As we will discuss later, there was a good balance in terms of our focus on profit contribution, net income, gross margins, profitable market share gains, geographic balance, advanced technologies, and, finally, revenue growth.

- 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 were also pleased with our pro forma net income of $1.2b, which was a 9-percent quarter-over-quarter and a 14-percent year-over-year increase, which represents 23 percent of revenue. GAAP net income was $1.1b, an 11-percent quarter-over-quarter and a 76-percent year over year increase.

- We also clearly understand that future earnings growth will probably be driven primarily by top-line revenue growth and associated product increases as we continue to hold headcount relatively flat. We will be discussing the potential for growth in more detail later on the conference call, but we are continuing to see a number of signs that could be interpreted with the appropriate caveats as optimistic.

- With every functional area continuing to focus on gross margins and profit contribution, the 68.7-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 Q1, for example, we had six product areas achieving these types of improvements for our customers.

- The key takeaway here is that we are continuing to accomplish both price reductions and price performance improvements, as well as the movement into the home market while still managing our solid gross margins in individual product areas.

- The areas affected in Q1 by these price performance improvements include the Catalyst 6000, the Cisco 1700, 2600, the UBR 7200 router families, the MDS 9000 storage networking products, and VPNs. However, as we mentioned before, most product 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.

- 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 over the last several years. I want to congratulate the entire Cisco team on this multi-year focus.

- Cash flow from operations was approximately $1b. During the quarter, we repurchased $2b of common stock, and we exited the quarter with approximately $19.7b in cash, cash equivalents, and marketable investments

- Book to bill was slightly below one.

- 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 meaningful revenue growth occurring for the first time in a very, very long time, we continue to achieve some of the top financial measurements in our company's history. This combination includes GAAP earnings, pro forma earnings, cash generation, DSO, gross margins, and net income as a percentage of revenue.

- In summary, we were very pleased with most of our operational measurements, but especially profits, solid gross margins, market share gains, and revenue growth in a number of product and geographic 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, our usual summary of what went well and areas where we can improve.
    - Third -- and we're going to cover the most frequently asked questions that we've heard over the last 90 days from our shareholders, analysts, and even customers -- which was simply to provide an update on what we are seeing in terms of industry growth and specifically as it relates to our three major growth opportunities.
    - And, Finally, our industry guidance moving forward.

- Now, I'll turn it over to Dennis for a more detailed report on our financial results this quarter. Dennis?

<u>Financial Overview</u>

- Thanks, John.

- Now, for some comments on our P&L.

- Total revenue for the first quarter was $5.1b. Of this amount, approximately $4.3b related to product revenue and $838m, or 16 percent, related to service revenue. Service revenue includes technical support services, advanced services, and other miscellaneous service revenue.

- Pursuant to Financial Accounting Standards 131, which relates to additional disclosure of business segments, we have historically provided revenue by certain product categories. In an effort to provide additional transparency into our Company performance and strategy, and in recognition of the growing importance of advanced technologies, we have made some changes to our product revenue categories.

- Beginning this quarter, the four product revenue categories will be routing, switching, advanced technologies, and other.

- The categories of routing and switching are consistent with our prior reporting. The new advanced technology revenue category includes the revenue of the six technologies we have identified to you in recent quarters. And just to remind you, the six advanced technologies are currently IP telephony, home networking, optical networking, security, storage networking, and wireless. Over time, we may identify additional advanced technologies for focus and investments. In addition, we may alter investments in some currently identified advanced technologies depending on market developments, acquisitions, and resource allocation decisions.

- We plan to review this revenue presentation periodically and reflect appropriate changes as necessary.
- The "other" revenue category includes our network management software, access products, excluding wireless LAN, which is now included in advanced technologies, and other miscellaneous products.

- We have provided three years of historical data reflecting the new categories to facilitate the analysis of historical trends, and this data is available on our website.

The percentages of total revenue by category in Q1 FY '04 as compared to Q4 FY '03 are as follows:

% of Total Business –	Q104	Q403
Routers	25%	26%
Switches	41%	40%
Advanced Technologies	14%	12%
Other	4%	4%
Services	16%	18%

- Please note the above percentages are calculated on total revenue. When compared as a percentage of product revenue, advanced technologies are 17 percent in Q1 FY '04 compared to 15 percent of product revenue in Q4 FY '03.

- In Q1 FY '04, the total pro forma and GAAP gross margin was 68.7 percent, down from 69.9 percent last quarter.

- For product only, pro forma and GAAP gross margin for the first quarter was 69.1 percent, down from 70.8 percent last quarter. The 1.7 decrease in product gross margin was due primarily to a 1-percent impact from the lower margins related to Linksys. The remaining difference related to a combination of price reductions, unfavorable product mix, and other manufacturing-related charges, partially offset by the favorable impact from increased volumes.

- Our service margin on a pro forma and GAAP basis was 66.7 percent versus 66.0 percent in the previous quarter. Service margins will typically experience some variability over time due to various factors, such as the change 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 $2.0b were up slightly from the previous quarter, as predicted in our guidance last quarter. The increase was primarily due to foreign exchange impact, increased commissions, and the inclusion of a full quarter of Linksys operating expenses.

- As a percentage of revenue, pro forma operating expenses decreased to 39.2 percent in Q1 FY '04 from 41.4 percent in Q4 FY '03.

- Our tax provision rate for the pro forma results was 28 percent for Q1 FY '04.

- Our GAAP net income for the first quarter was $1.09b, or 21.3 percent of revenue, compared to $982m in the last quarter and compared to $618m in the same quarter of fiscal year 2003, representing a 76-percent increase year over year.

- GAAP earnings per share on a fully diluted basis were 15 cents, up from the prior quarter of 14 cents, and up from 8 cents per share for the same quarter in fiscal year 2003, representing an 87-percent increase year over year.

- Please note that our GAAP earnings did not include the non-cash charge related to the adoption of Financial Accounting Interpretation Number 46, or FIN 46, as outlined in our guidance last quarter because the FASB deferred the effective date until the second quarter of fiscal 2004.

- Now, as a reminder, FIN 46 addresses the consolidation of variable interest entities and requires that we account for Andiamo as if it had been consolidated since Cisco's initial investment in April of 2001. During this last quarter, the FASB decided to defer the effective date of 1046 one quarter due to open issues they identified regarding the application of the ruling. We have determined that it is prudent to wait until these issues have been fully resolved by the FASB before reflecting the non-cash charge in our financial statement.

- Pro forma net income for the quarter was $1.18b, or 23.2 percent of revenue, up approximately 9 percent from $1.09b last quarter and from $1.04b for the same quarter in fiscal year 2003, representing a 14-percent increase year over year.

- Pro forma EPS on a fully diluted basis was 17 cents, up from the prior quarter of 15 cents and up from the 14 cents per share for the same quarter in fiscal year 2003, representing a 21-percent increase year over year.

- As John mentioned, book to bill was slightly below one.

- As an additional point of reference, backlog was down very slightly from the $2b as of the end of FY '03 that we disclosed in our last 10-K.

- We mentioned last quarter that we would provide additional information regarding the impact of Linksys on Cisco's reported operation. Total Linksys revenue for Q1 FY '04 was $119m. In Q1, Linksys increased Cisco's revenue by approximately $100m from Q4 FY '03, had a negative impact of 1 percent on gross margin, as mentioned earlier, and did not change pro forma earnings per share.

- For the next two quarters, we will continue to provide insight on how this important acquisition is performing. This will represent approximately one year of additional information on Linksys.

Moving on to the balance sheet.

- The total of cash and short-term and long-term investments was $19.7b, down $1b from the prior quarter.

- During Q1 FY '04, we generated approximately $1b in cash flow from operations. This was down from Q4 FY '03 due to a year-end bonus payout, typical for Q1, and for payments we made in Q1 on previously recorded restructuring reserves.

- Additionally, during Q1 FY '04, we repurchased approximately $2b, or 102m shares of our stock at an average price of $19.55.

- Our cumulative purchases since the inception of the repurchase program in September 2001 are approximately $9.8b, or 650m shares at an average price of $15.11. As a reminder, during Q1 FY '04, the Cisco Board of Directors approved an additional $7b for our stock repurchase program. This is in addition to the $13b previously approved by the Board. Taking into account the purchases made to date, we have a remaining approved repurchase amount of approximately $10.2b. We intend to continue to be active in the market going forward.

- Accounts receivable ended the quarter at $1.4b, consistent with the prior quarter.

- In Q1 FY '04, the DSO, or day sales outstanding, was 25 days, compared to 26 days from the prior quarter.

- Net inventory was $875m at the end of Q1 FY '04, consistent with the prior quarter.

Net inventory of $875m was comprised of:

- Raw materials $37M
- Work in process $271M
- Finished goods $539M
- Demo systems $28M

- Inventory turns were 7.3 times in Q1 FY '04 versus 6.8 in the prior quarter. Our goal continues to maintain our inventory turns at approximately seven to eight times.

- Total deferred revenue for Q1 FY '04 was approximately $3.7b, down slightly from the previous quarter. Of the total $3.7b, deferred service revenue was $2.3b, and deferred product revenue was $1.4b.

- Our total Q1 FY '04 reported headcount ended at 34,237, representing a net decrease of 229 employees.

- I was pleased with our focus and execution on our three long-term key financial priorities that I outlined for Cisco last quarter.

- First, we continued to generate profitable growth, as evidenced by our increase in revenue and our profit-after-tax margin of 23.2 percent on a pro forma basis.

- Second, in Q1, we improved Cisco's productivity, as measured in terms of pro forma operating expense as a percentage of revenue from 41.4 percent in the prior quarter to 39.2 percent in Q1.

- Our long-term objective is to achieve 35 percent of operating expense as a percentage of revenue.

- And, finally, we maintained our healthy and conservative balance sheet, including strong liquidity, low DSOs, and inventory turns in line with our goals.

- I'll now turn it over to John. John?

Quarterly Overview

- Dennis, nice job.

- Now, moving on to our quarterly overview. In this section, we will highlight information from our geographies and customer segments.

- Starting with the geographies. This is the data on which I primarily rely to run our business and watch very closely on a daily basis.

- The following is the theater breakout for Q1 in terms of total product bookings, as well as Q4 and Q1 of the prior fiscal year. This provides the comparison quarter-to-quarter, as well as our year-over-year and, therefore, seasonality comparisons as well.

    - U.S.: 49% (up from 47 % in Q4)
    - EMEA: 26 % (32% in Q4)
    - Americas International: 5 % (Q4 was 4 %)
    - Japan: 9% (Q4 was 7%)
    - Asia-Pacific: 11% (Q4 was 10)

- A number of you have asked for continued geographic discussion regarding the theater and industry segments because of the rapidly changing global economic environment. We'll start with the U.S.

U.S.

- So, first, from a U.S. perspective, following a very solid Q4 in both the enterprise and service provider markets, Q1 again showed good order growth, with the U.S. increasing to 49 percent of our total product orders.

- The total U.S. orders were a little bit better than we expected. U.S. service provider orders increased approximately 10 percent from Q4 as we are continuing to see what could be some early signs of either market share gains and/or perhaps service provider capex spending in our U.S. and global markets. Only time will tell if this momentum continues to develop.

- As expected, our federal government business had a very solid Q1, with comfortably over 20 percent of our total U.S. enterprise orders. As a reminder, Q4 and Q1 of each fiscal year have strong federal government seasonality trends, with Q2 and Q3 being seasonally soft. We are seeing what could be interpreted as some continuing initial signs of an economic capex spending -- I'm sorry, of enterprise capex spending.

- From a customer CEO perspective, the opinions continue to show increasing but still very cautious optimism. To put this in perspective, about half of the CEOs that I talk with in the U.S. would describe their position as some wind at their backs for the first time in a long time. And the other half still have a "show me, wait-and-see" attitude. With the common theme of the conservative half using words that they often use, like, "I wish my business was as good as the economic numbers indicate," although almost all would say, "Overall, things feel better." While the trend is still very fragile -- the momentum is still very fragile, this is the first time in over two years that we have seen positive year-over-year order rates even though it is a modest mid-single-digit rate in our U.S. enterprise account, excluding federal.

Asia Pacific

- Moving on to Asia-Pacific, which increased to 11 percent of our total bookings. In China, we saw our traditional Q1 positive seasonality add to the uplift of the economic challenges in the prior two quarters, with order growth sequentially in excess of 30 percent. Korea was down sequentially, a little over 10 percent, and India was up over 25 percent sequentially, granted, off of a smaller base.

EMEA

- Moving on to EMEA, Q1 from a seasonality point of view is a soft quarter for Cisco. As expected, we experienced normal seasonality softness across the majority of countries in Europe. Russia continued on its normal healthy quarter-over-quarter and year-over-year double-digit growth. Service provider orders in EMEA were down slightly compared to Q4, but when taking normal seasonality into consideration, the orders were actually up year over year in the mid-teens.

- In summary, given our normal seasonality and economic challenges in several of the large countries, orders from Europe were about what we expected.

Americas International

- Moving on to the Americas International. Despite the economic challenges in our Americas International operation, we saw good order growth in Canada and Latin America. Orders grew sequentially, approximately 10 percent versus Q4. This moved our business from Americas International to 5 percent of our total bookings.

Japan

- And, finally, moving on to Japan, where strong order growth moved our Japanese theater to 9 percent of our total bookings, up from 7 percent in Q4.

- As we said last quarter, Q4 in recent years has been very challenging from our Japanese operations' point of view and a seasonality point of view. While Q4 of the last year was actually up slightly, this momentum and surprisingly cautious optimistic attitudes by both business and government leaders continued into Q1 with strong sequential order growth up in double digits and year-over-year growth above 40 percent. Service provider business, while it can be very lumpy due to large orders, was up sequentially over 30 percent. We were very pleased with both our apparent gradual improvements of the economic conditions in Japan, as well as our sales team's excellent execution.

Summary of What Went Well and Concerns

- We covered a fair amount of what went well already in our discussion, so I will try to keep this relatively short and spend a little more time, in our typical fashion, on the concerns.

- First, I think the major takeaway from our Q1 results is for the first time in over two years, we saw revenue growth in the mid-single digits, both in sequential and year-over-year comparisons to the prior quarters.

- Second, our investment in almost all aspects of our business focused on service providers produced better-than-expected results in Q1, with orders up approximately 10 percent sequentially and over 20 percent year-over-year. While it's too early to say that this momentum and market share gain and/or service provider capex spending will continue, it could obviously be a very interesting start.

- Third, from a financial metrics perspective, we continue to be very pleased with cash generation of approximately $1b, DSOs at 25 days, inventory turns at 7.3, and continued solid gross margins of 69.1.

- From a profit perspective, we were very pleased with the pro forma net income of 23 percent of revenue, which is obviously comfortably above our traditional target of 20 percent.

- Fifth, we will continue to pass price performance improvements through to our customers while maintaining the traditional Cisco "and" effect, that is, at the same time, keeping gross margins at a relatively high level.

- Sixth, our balanced approach to three major growth opportunities, which include, first, our core routing and switching; second, the service providers; and, third, advanced technologies appears to be working well. The key is can we on a sustained basis get continued reasonable growth in at least two, and ideally, all three of these areas? Our acquisition of Linksys -- and, by the way, Charlie, congratulations and nice job by Victor and Janie as well -- which was key from both an advanced technology perspective in opening up both the home networking and the SOHO market for Cisco is going extremely well.

- As promised in last quarter, we will provide several quarters of more detailed updates on Linksys. Orders and revenue shipments for the quarter came in as expected at over $40m in orders, and revenue recognition of $119m.

- 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 analyst meeting last December, an evolution in 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, and if we don't, our competition will 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 positioned the Company for the inevitable economic upturn. In short, in terms of those elements that we can control or influence, we believe that we continue to do extremely well.

- I just got corrected. A little bit of a Southern accent here on Linksys, and I don't want to discourage Charlie in any way. Orders over $140 million in orders and revenue recognition of $119 million, in case I misspoke on that one. And, Charlie, next quarter you can add another hundred million to it as 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, in part, a show-me economy, meaning that CEOs will wait to spend until they see their own revenues and profits pick up. But as we said last quarter, 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.

- While an increased number of CEOs are starting to see what they would describe as "wind at their backs" in terms of business momentum, an equal number of CEOs describe it as just "feeling better but not seeing the results yet." In many ways, this is exactly how our field sales force is feeling right now, Rick. One of the toughest things about upturns and downturns in the business is that your sales force, no matter how good they are -- and I believe we have a great one -- does not forecast the upturns or the downturns. So Rick, if you want to raise your forecast during the call, don't hesitate to do so.

- Rick Justice: No comment!

- Third, many of our large peers in the industry continue to be very cautious, especially with regard to any improvements in enterprise and service provider spending. Therefore, our results in Q1 should be considered in that context.

- The obvious concern here is that while things are starting to look better, it is still fragile and may not develop to the level that we all desire.

- Fourth, we are very comfortable with our strategy of 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 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, our normal paranoia points out this issue.

- Fifth, our strategy has been built to not vary dramatically during economic up and down. 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.

- As we have said many times before, from a geographic perspective, wherever 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.

- At this time, we'd like to cover the top question that we've heard consistently from our shareholders and analysts around the world. The most frequently asked question is:, can you provide an update on the progress in your three targeted growth areas?

- Several of you who have asked us to cover this periodically in revenue comparisons so as to understand better some of the market share data comparisons that you are seeing and asking questions about, so this time we will cover it in revenue terms.

- As we discussed before, when we talk about the areas for potential growth, we have segmented those into three very broad groups. Those three are the following -- core technologies, routing and switching, service provider markets, and advanced technology markets.

- First, relative to our core technologies, routing and switching, our switching revenues were up approximately 10 percent sequentially over Q4, with the best growth in fixed switching. The Catalyst 6000, Catalyst 4500, and the Catalyst 3550 all showed approximately 10-percent revenue growth over Q4.

- As discussed on the last conference call, our high-end routing continues to do very well, with sequential revenues up over 10 percent when compared to a very solid Q4.

- Our high-end GSR continued to lead the pace, with sequential revenues up again approximately 20 percent. As a reminder, high-end router orders can be very lumpy.

- Second, in terms of our continued progress in the service provider market, as we discussed in some detail in the geographic section, we are very pleased with our solid sequential and year-over-year growth in service provider markets. We were a little bit concerned that our peers have not seen this improvement. However, there was positive geographic balance in all of our service provider quarterly results, and I'm talking about that from the geographic theater perspective.

- Our resource commitment and mindshare improvement appears to be working well. As we said earlier, only time will tell if this positive momentum continues in terms of capex spending from the service providers.

- Third, in our advanced technologies, it was another solid quarter in terms of revenue growth. It appears that our strategy in our key targeted technologies is working reasonably well. As we discussed before, our target is to identify 12 potential advanced technologies over time that could eventually and potentially yield a $1B a year run rate for Cisco if we execute well and the market develops as we expect. Obviously, we would not hit anywhere near our goal on all six of the now-targeted advanced technologies, and eventually what we hope to be with 12 targeted advanced technology categories, so we will try to give you updates about how our progress in the advanced technology group is doing in total and about the specific product technologies periodically in our conference call.

- As a reminder, the six advanced technology markets are IP telephony, optical, storage, wireless, security, and home networking. As we discussed before, we will periodically add products and remove segments of products from these categories as we continue to refine our focus. With the new tighter alignment, these categories represented 17 percent of our total product revenue, up from 15 percent of our total product revenues in Q4.

- We were relatively comfortable with our progress to date in all six of the advanced technology areas. As expected, in total, they exceed 15 percent sequential quarter revenue growth, with the network home, security, optical, and IP telephony showing the best growth. We were a little bit disappointed with our progress in the storage area networking market, where we experienced some manufacturing issues, longer-than-anticipated sales cycles, and a few other challenges. We will continue to expect, given the moderate order volumes in each of the six advanced technologies, for each category to be a little lumpy from quarter to quarter.

Guidance

- Now, moving on to guidance.

- In very simple terms, we continue to focus to adjusting our breakaway strategy and industry consolidation strategy for the industry downturn experienced over the last several years, and then to position Cisco for the inevitable upturn.

- In typical Cisco fashion, we will continue to budget very conservative with a budget that we believe we'll have a reasonably high probability of hitting, and we will adjust this budget after the first six months of the fiscal year while continuing to provide 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 ultimate -- until the industry turnaround becomes very visible to us all.

- Q1, in terms of issues we could control or influence, was a very solid quarter for Cisco. We were especially pleased with our continued results and improvement across almost all of our areas of business. As we said in the Q4 conference call, there remains one obvious -- there remained at that point in time one obvious exception, and that was revenue growth. Q1 results saw both sequential quarter and year-over-year revenue growth in the mid-single digits for the first time in over two years. This, combined with the continued flow of reasonable economic improvement, adds confidence to our cautiously optimistic positioning in the Q4 conference call.

- As we've consistently stated, while all of us would like to believe what we do this quarter dramatically affects the results of the next quarter, we all know that is not really what happens. The business results that we reported today versus our industry peers were primarily the results of 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 market growth areas network architecture, evolution expectation, and continued focus on profit contribution. Our results 12 to 36 months from now will be dependent upon the relative success and implementation of these decisions.

- To again answer any indirect questions about my views going into Q2 as compared to my feelings going into Q1, 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 gain, 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 continuing, albeit at a slower pace than any of us would want, to be more positive. While going into Q1, this was clearly a minority view held by a minority of our customers. We are slowly seeing increasing very cautious business optimism and capital expenditures. While we are more optimistic going into Q2 compared to Q1 about the factors we do not control, recovery appears to be slowly gaining momentum but is still fragile in the minds of our customers.

- As we outlined in prior conference calls and appears to be occurring in most of our theaters, we continue to look for IT spending improvements first in the small to medium-sized business, and then expanding to specific industries and specific companies within those industries in the enterprise market at different timeframes, and then gradually expanding to include the service provider business; in summary, a gradual industry-by-industry rolling recovery.

- So with the appropriate caveats, I'm a little more optimistic on both the internal and the external issues. So in both in terms of the internal issues that we can control or influence and also a little more optimistic on the external issues that we cannot control than I was in the last conference call. 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, Q2 tends to have a positive seasonal trend, especially in Europe. However, this will be balanced, in part, by our past two quarters' seasonal success in the U.S. federal government, where we are now going into two quarters of traditionally seasonally softer orders.

- With these factors in mind, our revenue guidance for Q2 in comparison to Q1 is up slightly.

- 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 consolidations, market transitions, and very challenging economic times.

- And now, I'd like to turn it back over to you, Dennis.

- Thank you, John.

- Let me remind you again that our comments include forward-looking statements and that you should review our current and 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 overall global economic environment, we are providing pro forma financial guidance for the second quarter of FY '04 only.

- We expect revenue in the second quarter of fiscal year 2004 to be sequentially up 1 to 3 percent. This will result in a year-over-year growth for Q2 FY '04 of approximately 10 percent.

- Regarding gross margin, forecasting gross margins has always been challenging due to various factors, such as product mix, manufacturing overhead absorption, variable component costs, customer and channel mix, and competitive pricing pressures. We expect that Q2 FY '04 gross margin will be approximately 67 to 69 percent.

- Operating expenses for the second quarter of FY '04 should be up approximately 1 percent in terms of dollars, reflecting continued foreign exchange pressures, along with slight increases in certain key projects.

- 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 second quarter, reflecting the absence of gains that were realized during recent quarters as we rebalanced our fixed-income investment portfolio.

- Our tax provision rate is expected to remain at 28 percent.

- Regarding our Q2 FY '04 GAAP earnings, as we discussed earlier in our commentary, the FASB has deferred the effective date of FIN 46 to the end of Q2 FY '04, while they resolve issues related to the implementation of this ruling. FIN 46 currently 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, assuming the FIN 46 ruling is not changed substantially by the FASB and is to be implemented in the second quarter of FY '04, we estimate that we will record a one-time non-cash charge ranging from $200m to $500m, or three to seven cents per share, for the cumulative effect of implementing this new standard. This will be reported as a separate line item in the GAAP income statement.

- In addition to this non-cash charge, we will have the ongoing amortization of purchased intangible assets and deferred compensation costs estimated at approximately two cents per share, arising from various purchase acquisitions. These charges will be reported as GAAP operating expenses.

- As a result of all of these items, we anticipate that our Q2 FY '04 GAAP earnings will range from five to nine 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, assets impairments, restructurings, changes in Andiamo's valuation, or other unanticipated events, which may or may not be significant.

- We also anticipate that share count will be flat to down approximately 50 million shares in Q2.

- Regarding cash flow from operations, we would expect to continue generating an average of 300 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 its financial guidance during the quarter unless it is done through a public disclosure.

- Our next quarterly conference call, which will reflect our second quarter of fiscal year 2004, will be on Tuesday, February 3, 2004 at 1:30 PM Pacific Time, 4:30 PM Eastern Time.

- We still request that the sell-side analysts please ask only one question. And, as a reminder, we will end the call promptly 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 urged to read the documents filed by Cisco with the SEC, specifically the most recent reports on Form 10-K, 10-Q and 8-K, each as it may be amended from time to time, which identify 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; product defects and returns; litigation involving patents, intellectual property, antitrust, stockholder and other matters; the ability to recruit and retain key personnel; financial risk management; currency fluctuations and other international factors; 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 months ended October 25, 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.*