

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

*Please [click here](#) for complete GAAP reconciliation information between our GAAP financial results and our non-GAAP (pro forma) financial results.*

Cisco Systems, Inc.  
Q1 FY06 Financial Results Conference Call  
Wednesday, November 9, 2005  
1:30 p.m. PT

### **Introduction**

- Hello, and welcome to Cisco Systems' first-quarter fiscal year 2006 financial results conference call. At the request of Cisco Systems, today's conference is being recorded. If you have any objections, you must disconnect.
- 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 63rd 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, Chief Development Officer.
- The first quarter of fiscal year 2006 press release is on First Call, Full National Business Wire, the European Business and Technical Wire and on the Cisco website at [www.cisco.com](http://www.cisco.com). If you would like a fax of the press release, please call 408-526-8890 and follow the instructions.
- Information regarding Cisco's financials and corresponding webcast with visuals designed to guide participants through the call are available on the Cisco website at [www.cisco.com](http://www.cisco.com) in the Investor Relations section. Additionally, a replay of this call will be available via telephone at 866-357-4205 or 203-369-0122 for international callers.
- Throughout this conference call, we will be referencing both GAAP and non-GAAP financial results. Throughout the call, we will refer to our non-GAAP results as pro forma. 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 a reconciliation table 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 risks and uncertainties that we discuss in detail in our documents filed with the SEC, specifically the most recent reports on Forms 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?
- Dennis, thank you very much.
- I would summarize the quarter as a solid quarter.
- Our balanced approach to the market, in terms of our four customer segments, core and advanced technologies and five key geographic theaters, continues to work very well, with solid results in the majority of the categories.
- For example, our very good results in the US, Asia Pacific, Emerging Market theaters, core routing and switching and advanced technologies, balanced the slower orders we experienced in Europe.
- Going into fiscal 2006, we focused additional resources and management time on five key areas in addition to our normal strategy. Those five key areas being the commercial marketplace, additional sales coverage, advanced and emerging technologies, our evolving support model and the Emerging Market theater. As we will discuss later in this call, each of these investments appear to be producing solid results.
- Now moving on to the discussion of Q1, reminding everyone that Q1 is by definition the start of our new fiscal year and as such, experiences normal seasonality, especially in the US federal business and European market, as well as being the beginning of the direct sales force new year following a super Q4.
- Q1 normally will be the lowest quarter in terms of orders and revenues, with momentum building throughout the year during normal economic times. Revenue growth was approximately 10% in terms of year-over-year, and flat relative to an extremely good Q4. Product orders grew year-over-year faster than revenues. Product orders year-over-year grew in the 12 to 13% range in Q1.
- Product book-to-bill was slightly below 1. And in anticipation of questions we usually get about the linearity of orders during the quarters, the orders gained momentum in each of the three months in terms of year-over-year growth rates throughout the quarter.

- GAAP net income was \$1.3 billion and earnings per share were \$0.20 on a GAAP basis, which includes a charge from stock options of \$0.04 per share. Pro forma net income was \$1.6 billion, and earnings per share were \$0.25. Total pro forma gross margins were 68.1%, versus last quarter's 67.9%. Pro forma product gross margins were 68.5%, versus last quarter's 68.4%.
- Staying with the same theme from the last quarter's conference call, there were a number of key takeaways from the quarter, all relating directly or indirectly to our advantages from a balanced opportunity perspective, and additional resources and management focus committed to the five key areas for fiscal 2006, discussed briefly above.
- First, from a balanced theater perspective, the advantage of having four large theaters is that when there is a challenge in one theater, it is often balanced or offset by the strength in the other three large theaters. And that is what occurred this quarter with the US, Asia Pacific and Emerging Market theaters offsetting the slowing of growth in Europe.
- The US continued to perform at the higher end of our expectations, with orders growth slightly above 15% year-over-year. This is better in terms of year-over-year growth than we experienced in any quarter during the last fiscal year.
- Our Asia Pacific operation returned to high order growth. We were very pleased with the Asia Pacific's Q1 growth of approximately 30% year-over-year in terms of orders, something we did not see in any quarter during fiscal year 2005. And our Emerging Market continued, with order growth of approximately 30% year-over-year. Japan, which represents about 5% of our business, as was probably expected by many, continued to be challenging. And Europe was slower than we expected, with orders year-over-year being flat.
- In the spring of this calendar year, our senior leadership team determined that we were where the key incremental resources and management attention areas for fiscal 2006. We decided on the five critical areas for additional growth and differentiation within our overall corporate strategy.
- First, the commercial market segment of our business; second, expanded sales coverage; third, emerging markets; fourth, expanded focus on existing and new advanced technologies, including the focus on new emerging technologies that Charlie will discuss later; and fifth, an evolution of our support model focused on customer satisfaction, loyalty, which contribute to our ability to maintain solid gross margins for our products and services.

- I'd like to briefly cover each of these five areas of focus, so as to put them in perspective our progress in Q1 and areas of possible opportunity for the remainder of the fiscal year. The first area I would like to address is the commercial market, which should be the fastest growing of our market segments in the world in terms of both new jobs and company creation.
- Starting last fiscal year and increasing this year, we made major investments and resource realignment in all of the major functions of our business. Those included sales, channels, marketing, product development, finance, solutions, services, etc., in order to better address this commercial opportunity. These investments appear to be paying solid dividends, with the commercial market segment having its strongest year-over-year growth, in the mid-20s, which is better than in any quarter in the last several years, in terms of year-over-year order growth.
- This was the only market segment where we saw solid balance across all five of our theaters, with each of the theaters' growth ranging from the high teens to approximately 50% in each of the five theaters. And as we said in last quarter's call, the commercial marketplace, while representing approximately 25% of our total product business, is delivering on our vision of being the fastest-growing large-market segment over the next five years.
- Second, as we shared with you in the last call, we made a decision to expand sales coverage, especially in the commercial and the low end of the enterprise and the emerging market areas. And this appears, as you can see from the results, to be paying off as we had hoped. In Q1, for example, over 80% of our total company incremental headcount increases of approximately 850 people, were in sales.
- Third, with the expanded organizational structure focusing on our Emerging Markets around the world, this theater grew by approximately 30% year-over-year in terms of orders. Fourth, the advanced technologies continued a solid growth in revenues in what is often a seasonally slower quarter, at approximately 25% growth in revenues year-over-year. We intend to announce two new advanced technologies before the end of this calendar year.
- And finally, our evolving support model, designed to help our customers integrate both a technology and a business architecture at a faster speed with lower risk, is paying off. And it's off to a very good, solid start, with very positive customer feedback. This is another one of those major reasons that we continue to be able to maintain very high gross margins, as experienced during this quarter. We will cover these five areas in additional detail in other sections of the call.

- Cash flow from operations was a solid \$1.4 billion. During the quarter, we repurchased approximately \$3.5 billion of common stock. We exited the quarter with approximately \$13.5 billion in cash, cash equivalents and investments. This represents our 14th consecutive quarter of having pro forma net income exceed \$1 billion and our pro forma profits exceed 20% of revenue. We continue to believe we have uniquely positioned Cisco as network IT continues to gain momentum.
- As anticipated, Q1's pro forma operating expenses were 37% of revenue, versus Q4's 36%. Our total headcount increased by approximately 850, with over 700 of those going into the sales coverage that I discussed earlier.
- In summary, we view Q1 as a solid quarter for us in most of our operational measurements. 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, a discussion on our advanced and emerging technology strategy; third, our usual summary of what went well, including a discussion of potential market share gains and strategies versus our competitors, as well as our usual areas where we can improve. The discussion will also include an expanded view of the five areas of additional focus in fiscal year '06.
- And finally, our industry guidance moving forward. Now I will turn it over to Dennis for a more detailed report on our financial results for the quarter. Dennis, back to you.

### **Financial Overview**

- Thanks, John.
- Now for some comments on our P&L.
- Total revenue for the first quarter was \$6.5 billion, an increase of approximately 10% year-over-year. Of total revenue, \$5.5 billion related to product revenue and \$1.06 billion related to service revenue.
- This was the second quarter that service revenue has exceeded \$1 billion. Service revenue includes technical support services, advanced services and other revenue.
- Of the total revenue in Q1, routing was \$1.42 billion, up 13% year-over-year. Switching was \$2.68 billion, up 3% year-over-year. Advanced technologies was \$1.21 billion, up 25% year-over-year. And Other was \$183 million, down 16% year-over-year, and services was \$1.06 billion, up 12.9% year-over-year. Other revenue was down \$35 million year-over-year due to a Q1 change in classification of mobile wireless revenue into the routing category.

- As I begin the overview of our income statement, I would like to remind you that Q1 is the first quarter that we include the impact of FAS 123R, or employee stock option expensing, in our GAAP financial statements. The stock option expense for Q1 was \$228 million net of tax, or \$0.04 per share.
- This amount is allocated in our GAAP income statement as follows; \$53 million included in cost of sales and \$264 million included in operating expenses. The resulting total expense of \$317 million, is reduced by an \$89 million tax benefit to a net impact of \$228 million.
- Please note that our GAAP income statement included in the press release, includes further detail of these amounts. We will be providing further disclosures regarding the adoption of FAS 123R in our upcoming Form 10-Q filing.
- Our financial statements for prior periods have not been restated for the effect of FAS 123, and as a result, we're not providing comparisons of Q1 GAAP results to GAAP results for the prior periods. However, we have provided a table in our press release and on our website, for your reference in comparing net income for Q1 FY '06 with prior periods.
- This table illustrates the impact that stock option expensing would have had on our previously reported GAAP net income, along with the Q1 FY '06 GAAP net income that includes these charges. In addition, we have provided a full reconciliation of the difference between GAAP and pro forma measures in our press release and in the slides that accompany this webcast.
- In Q1 FY '06, the total pro forma gross margin was 68.1%, up from 67.2% in the same period last fiscal year and up from 67.9% last quarter. On a GAAP basis, total gross margin was 67.3%. For product only, pro forma gross margin for the first quarter was 68.5%, up from 67.3% in Q1 '05, and up slightly from 68.4% last quarter.
- The increase from Q1 FY '05 was driven primarily by cost savings and volume, partially offset by discounts in mix. The improvement from last quarter was primarily a result of continued cost savings and slightly lower discounts, partially offset by mix.
- GAAP product gross margin for the first quarter was 68.1%. Our service margins on a pro forma basis for the first quarter were 66.5%, down from 67.0% in Q1 FY '05 and up from 65.2% last quarter. On a GAAP basis, service margins were 63.3%. 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 for support contract initiations and renewals.
- Our total pro forma operating expenses were \$2.4 billion, compared with \$2.1 billion in the same quarter of the previous fiscal year and compared to \$2.4 billion for last quarter. Pro forma operating expenses as a percentage of revenue were 37% in Q1 FY '06, compared to 35.4% in Q1 FY '05 and 35.9% for last quarter.

- On a GAAP basis, with the effect of FAS 123R, operating expenses for Q1 were \$2.8 billion. Our tax provision rate for the pro forma results were 28% for Q1 FY '06 and Q1 FY '05. Pro forma net income for the first quarter was \$1.6 billion, compared to \$1.5 billion in the first quarter of fiscal 2005.
- Pro forma earnings per share on a fully diluted basis for Q1 were \$0.25, up from \$0.21 in the same quarter of fiscal 2005, representing a 19% increase year-over-year. GAAP net income for the first quarter was \$1.3 billion. If we had included the FAS 123 expense previously disclosed in our footnotes, Q1 FY '05 net income would have been \$1.1 billion.
- GAAP earnings per share on a fully diluted basis for the first quarter were \$0.20. If we had included the FAS 123 expense previously disclosed in our footnotes, Q1 '05 earnings per share would have been \$0.17, representing an 18% increase year-over-year.
- You will note, whether we include or exclude stock option expense, our comparative net income trends are positive. As John mentioned earlier, book-to-bill for the first quarter was slightly less than 1.

### **Moving on to the Balance Sheet**

- Now, moving on to the balance sheet.
- You will notice that we have reclassified our cash and investments into two categories on the balance sheet; cash and cash equivalents, and investments. This is a preferred method and is based upon the nature of our investments' liquidity, versus their stated maturity date. The total of cash and cash equivalents and investments was \$13.5 billion, down from \$16.1 billion last quarter.
- During Q1, we generated approximately \$1.4 billion in cash flow from operations, compared with \$2.4 billion last quarter and \$1.5 billion in Q1 FY '05. This seasonal decrease in cash flow was due to our annual bonus payout, a slightly higher tax payment and the timing of payment for service contracts last quarter. These are normal seasonal factors when compared to previous Q1.
- During Q1 FY '06, we repurchased \$3.5 billion, or 194 million shares of our stock at an average price of \$18.03. Our cumulative purchases since the inception of the repurchase program in September 2001, are \$30.7 billion or 1.7 billion shares at an average price of \$18.14. The remaining approved amount for stock repurchase under this program is approximately \$4.3 billion.
- Since the inception of our repurchase program, the weighted average diluted shares

outstanding, including stock option activities and shares issued in acquisitions, have decreased 15.3%.

### **Moving on to Accounts Receivable**

- Moving on to accounts receivable, we ended the quarter at \$2.3 billion, up from \$2.2 billion in the previous quarter. At the end of Q1 FY '06, the DSO, or days sales outstanding, was 33 days, compared to 31 days at the end of Q4.
- Total inventory was \$1.3 billion, with pro forma inventory turns at 6.4, compared with \$1.3 billion and turns of 6.6 last quarter.
- Inventory was comprised:

<i>Raw materials</i>	<i>\$98m</i>
<i>Work in process</i>	<i>\$426m</i>
<i>Finished goods</i>	<i>\$582m</i>
<i>Spares</i>	<i>\$172m</i>
<i>Demo systems</i>	<i>\$40m</i>

- We believe this amount of inventory is appropriate for our current revenue levels . Our inventory purchase commitments for Q1 were \$922 million, as compared to \$954 million for Q4 and \$825 million for Q1 of the previous fiscal year.
- Total deferred revenue for Q1 FY '06 was approximately \$4.8 billion, down from approximately \$5 billion in Q4. Of the total, deferred product revenue was \$1.3 billion and deferred service revenue was \$3.5 billion. Product deferred revenue decreased \$101 million, primarily due to previously deferred revenue having met revenue recognition criteria during this quarter. Service deferred revenue decreased \$147 million due to the normal seasonality in our contract renewals.
- Our total Q1 FY '06 reported headcount ended at 39,262, an increase of 849 from Q4, and an increase of 4,176 year-over-year.
- In conclusion, as we continue to focus on profitable growth, in Q1 we have been able to achieve approximately 10% revenue growth year-over-year and pro forma profit of 24% of revenue, marking the eighth consecutive quarter of pro forma profit at or above 24% of revenue. In addition, we are pleased with the continuing strength in our product gross margin. And I would like to thank the manufacturing and engineering teams for just an outstanding job.
- Secondly, on a year-over-year basis, while our revenue increased approximately 10%, our

pro forma EPS increased 19%, reflecting primarily the impact of our share repurchase program. And third, I am pleased that return on invested capital, or ROIC, remains at above 50%.

- We will continue to make strategic investments in certain customer segments, technologies and theaters, while maintaining a healthy and conservative balance sheet.
- I will now turn it back over to John.

### **Now, moving on to the Quarterly Overview**

- Dennis, thank you. Nice job.
- Now moving on to our quarterly overview.
- In this section we will highlight information from our geographies and customer markets. 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 orders. As we said in the last quarter's call, this quarter we will present the data in our new theater organizational structure. In this call, we will also present the four preceding quarters, so you have a base with the new theater structure to judge seasonality and other factors.
  - The US and Canada in Q1 of this fiscal year accounted for 53% of our business. In Q4 of last fiscal year, it was 50; in Q3 of last fiscal year, 49%; in Q2, 47% of the total; and in Q1 of last fiscal year, 51%.
  - Europe. Q1, 20%; Q4 of last fiscal year, 26%; Q3, 27%; Q2, 26%; Q1, 23%.
  - Emerging Markets. Q1 of this fiscal year, 10%; Q4 of last year, 8%; Q3, 8%; Q2, 9%; Q1 of last fiscal year, 9%.
  - Japan. Q1, 5%; Q4 (of last year), 5%; Q3, 6%; Q2, 7%; Q1, 7%.
  - Asia Pacific. Q1 of this fiscal year, 12%; Q4 (of last year), 11%; Q3, 10%; Q2, 11%; Q1, 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. All of the theater, market segment and product discussions will relate to product order growth unless otherwise indicated.
- The key takeaway for the quarter, as it has been in prior quarters, was the continued balance that we've been able to achieve in our geographies, market segments,

architectural evolutions and product families.

- This quarter, the commercial market segment produced the best results, which grew year-over-year in the mid 20s. There was also good balance in terms of our product families. This quarter, our core switching product orders grew in the low double-digits year-over-year, while our core routing business grew approximately 10% year-over-year, from an order perspective, and our advanced technologies in the mid-teens, led by storage, with growth of approximately 70%; security and the networked home in the low 20s; wireless in the mid-teens; optical with a decrease of approximately 40% year-over-year; and enterprise IP communications growth increasing in the mid-30s.
- As we said earlier, revenues for advanced technologies in total grew approximately 25% year-over-year.
- From a year-over-year perspective, the commercial market segment grew in the mid 20s and the enterprise market segment grew in low double digits. Service provider growth varied dramatically by theater. Service provider growth grew in the 20s year-over-year in the US, Canada, Asia Pacific and the Emerging Markets. It was down year-over-year 40% in Japan from what had been a very strong growth, looking back one to two years, and Europe from a service provider perspective was down in the low double digits year-over-year.
- As a reminder, our business is approximately 46% from the enterprise market segment, approximately 25% each from our commercial and service provider market segments, with approximately 4% coming from the consumer market segment. As we've done in prior quarters, the geographic discussion has been in orders, and at the recommendation of several of our shareholders, we will discuss much of the quarters today in terms of order growth, and that is, in many people's opinion, an accurate indicator of key trends, momentum and future market share gains and losses. This is especially true given book-to-bill variations quarter to quarter as lead times were reduced.
- As a reminder, over the last nine quarters, our year-over-year product order growth rate has been very predictable, usually in the teens or better. As we said earlier, this quarter we saw a year-over-year product order growth rate in the 12 to 13% range for Q1, down slightly from other quarters due primarily to the slowness of our European business, while our year-over-year product revenue growth has fluctuated from mid-single digits to approximately 30% over the last nine quarters. In five of those nine quarters, revenue growth has been below the teens, including this quarter.

## U.S.

- Moving onto the US and Canadian theater, which represented 53% of our business.
- First, from a commercial market segment perspective, balance was good among the four US commercial areas. Year-over-year growth was approximately 20%, with a year-over-

year growth rate better than we had experienced in any of the quarters in fiscal 2005.

- Second, from an enterprise perspective, relative to the five US enterprise areas, excluding the federal, the average year-over-year growth in the high single-digits.
- Third, from a US federal business perspective, in what is traditionally a strong quarter, it was a very solid quarter for us, with year-over-year growth rates of approximately 30%, which is the best we've seen in several years.
- Fourth, from a US service provider perspective, Q1 year-over-year growth rate was in the mid 20s. And fifth, from a Canadian perspective, year-over-year growth for the entire country was approximately 30%.

### **Asia Pacific**

- Moving on to the Asia Pacific, which represents 12% of our total orders.
- As we said earlier, year-over-year growth rates were up approximately 30% for the entire theater. We saw solid growth from a year-over-year perspective in almost all of our large countries. India was particularly strong, achieving growth of approximately 70% year-over-year.
- We had the best quarter in China we've had in two years in terms of total orders and growth year-over-year, with Q1 growing in the high 20s year-over-year. Our Australian and New Zealand teams continue to have solid momentum year-over-year, as did our Korean team.

### **EMEA**

- Moving on to our European theater, which represents 20% of our business in Q1 versus 23% in Q1 of last year, orders in total were approximately flat year-over-year. We experienced good growth in several of the countries in Europe, including Switzerland, Denmark, Norway, Finland and in Greece. However, the large countries, such as Germany and France, remained challenging, with year-over-year growth rates down slightly in low single digits.
- Another challenging area in Europe was the UK, where we have an extremely strong and seasoned Cisco team and a great market position. During fiscal year '05, we experienced very solid year-over-year growth, averaging in the mid 20s. However, in Q1 of this year, following a trend we've heard from several of our large industry peers, we saw year-over-year growth in the low single digits.

### **Japan**

- Moving on to Japan, which represents 5% of our business, as you probably expected and have heard from some of our industry peers, the weakness that we shared with you in prior quarters is continuing. Given the economic and other challenges, this market continues to be a little bit more challenging from an economic and capital spending perspective. Year-over-year growth was down in the mid-20s and down sequentially in the mid-teens.

### **Emerging Markets**

- Moving onto our Emerging Markets, which represents about 10% of our business, there are four major geographies in our Emerging Markets theater. Those are Eastern Europe, Latin America, Middle East and Africa, and finally, Russia and the Commonwealth of Independent States. Q1 continued our stream of five consecutive quarters in a row with growth in the low 30s year-over-year.
- We are off to a good start with the Emerging Market concept and commonality of opportunities and issues. Eastern Europe, Latin America, Middle East and Africa grew year-over-year in the 30 to 45% range. Russia was up year-over-year in the mid single digits.
- In summary, while there was not good balance across all five theaters, there was exactly this broad balance across the theaters, customer segments, core products and advanced technologies, which allowed us to have the good results, despite the challenges in Europe.
- Now I would like to turn it over to Charlie for a discussion of our advanced and emerging technology strategies. Charlie?
- Thanks, John.
- John has asked me to address Cisco's strategy for describing new technologies and provide more visibility into how we will do business in this area. Cisco's first six advanced technologies represent examples of exploiting market transitions ahead of competitors and executing against the opportunity to drive growth.
- As John has said many times, the best time to capture a market transition, whether it's for technology or our business model or a new markets, is well before the transition is apparent to the mainstream of the market.
- As a reminder, we've defined an advanced technology as an opportunity, which is adjacent to our other businesses that can generate Cisco revenue of \$1 billion or more, where Cisco can secure the number one or number two market share position -- although, John, I've never seen you let us just go for number two.
- You're right, Charlie.

- With clear and sustainable differentiation over time, and that fits into our long-term architectural technology vision. We expect, as you've heard, to announce a new advanced technology every three to four months throughout this fiscal year. And we expect to announce two by the end of this calendar year.
- Now, in addition to new advanced technologies, we will from time to time, introduce new, what we're calling emerging technologies in the early phases of a new market, when it's too early to predict the eventual size of the overall market or the eventual size of Cisco's business.
- Emerging technologies are new areas which Cisco believes are promising and could mature into formal advanced technologies, but still have a degree of market risk that does not allow us to target a full billion dollars or greater run rate for Cisco at this time.
- As many of you are aware, in the last six months, Cisco publicly announced its first two emerging technologies; Application Oriented Networking, or AON, enabling application interoperability, and our IP Interoperability and Collaboration System, or IPICS, which enables radio interoperability. We've received positive initial customer interest in both these technologies, which are both in early field trials.
- Emerging technologies are a mechanism to incubate new ideas, products, business models and new markets, based on customer interest and our estimation of early potential market opportunity, with limited resources, primarily from engineering and small overlay sales. In addition to the new advanced technologies that we have indicated we will announce over the year, we also hope to announce a number of new emerging technologies as well. Thank you, John.
- Thank you, Charlie. Nice job.

### **Summary of What Went Well and Concerns**

- Moving on to our usual summary of what went well and our normal healthy concerns.
- Starting with what went well, again discussing this in terms of orders and the balance of geography, product and customer segments discussed earlier.
- From a geographic point of view, there were two major highlights. First, is the continued strength and balance in the US across all three major market segments. The growth in orders was about 15% year-over-year, was better than we saw in any quarter in fiscal year '05, and momentum combined with the additional sales rep coverage looks pretty good.
- The second major highlight was the growth and balance from our Asia Pacific operations,

where our new theater lead, Owen Chan, is off to a great start. I just visited China and India last month, and I believe that both countries are well-positioned for growth.

- As you may remember, we made our key investments in China approximately 10 years ago, and those investments have served us well over the last decade and we expect will serve us well in the future.
- Four years ago, we made our first major commitment to India, and on my most recent trip, we made additional major commitments of over \$1 billion from a sales, R&D, product development, venture capital and support perspective. On that trip, we visited the majority of our large service provider customers, key conglomerates, financial institutions and government leadership. We have had growth in India of excess of 50% in each of the last two years, and I feel that the momentum looks very solid for this year, with a very good chance of growing above 40% year-over-year, in the future, with the appropriate caveats.
- In summary, we think we are well-positioned in both China and India, and while we are cautiously optimistic about our growth in China, it would not surprise me to see India actually challenge China, from a Cisco perspective, in terms of our business revenue per year, looking out three to four years.
- We also continue to do very well throughout the rest of Asia. Australia and New Zealand continue their very solid momentum, with Australia growing approximately 40% year-over-year in this quarter, and New Zealand approximately 70%.
- From a product perspective, more and more of our large customers, especially in the enterprise, are committing to an architectural approach where routing, switching, security, wireless, IP telephony, the home and data center products are at first loosely, and then we believe, tightly coupled over time.
- There are very large advantages in terms of total cost of ownership, flexibility and time to market for customers under this approach. To put this in perspective in terms of cost of ownership, many of our customers articulate their costs as 25% being product costs, 50% supporting those products and 25% physical space and the associated expenses.
- The advantages of being the market leader in terms of innovation across, let's say, 10-plus major product areas, combined with the dramatically lower cost to support and physical requirements from a tightly coupled approach, are becoming more obvious. We continue to demonstrate market leadership in most of our product areas. When you look at our competitors in each product area, none of them go across more than two of our product areas of focus, with even close to a leadership position.
- Having just attended our annual CIO Summit with 130 CIOs, and having just met with a

large number of other global CIOs in the last month as we traveled around the world, Cisco's architectural approach is continuing to gain momentum and acceptance.

- Many of you have asked for revenue growth numbers in terms of your ability to understand market share evolution. This quarter, in terms of year-over-year growth, our revenues in the advanced technologies were in the mid 20s, as we had said earlier, with storage growing approximately 100% year-over-year from a revenue perspective, optical flat, enterprise IP communications in the low 40s, wireless in the upper teens, networked home in the high single-digits, and security in the high 20s.
- Again, I'd like to recap our position versus our competition. While we face a very large number of bigger and very effective small companies, we believe that the industry will consolidate, and that the consolidation will be along both technology and business architectural lines. We believe the technology architecture will be one where layers 1 through 7 of the OSI stack, are first loosely, and then tightly coupled. And that is exactly where you see us taking our core and advanced technology products, and Charlie, the emerging technology products that you and your team are working on as well.
- Innovation will continue to be through internal development, through acquisitions, and partnerships. In our opinion, for companies to lead, they must be able to do all three. Perhaps most importantly, companies also have to gain the confidence of their customers from a vision and strategy perspective, a product architectural leadership perspective, and a service and support perspective. We think we are very uniquely positioned to continue to win the hearts, minds and capital investments of our customers.
- In summary, while there's always room for improvement, we are pleased with our results. In our opinion, our results continue to show the effectiveness of our strategy and our ability to capitalize on major market transitions.

### **Concerns**

- Now, moving on to concerns.
- Reminding those of you who have had limited exposure to our prior conference calls, we 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 general concerns.
- First, we continue to see some swings in global economic activity and capital spending. The trends that we have discussed last quarter in Japan, especially those in the service provider space, continued, and the concerns that we shared about our peers seeing some slowing in their European operations did develop in terms of our own business.
- Germany and France continue to be relatively slow, with growth in orders, year-over-

year, down slightly. We have had a very solid success in the UK in recent years. UK is now our second-largest country in terms of total business and approximately, to put it in proportionate understanding, the size of Germany and France combined, in terms of business for Cisco.

- Therefore, when we experienced a dramatic slowing of growth in the UK in Q1, we have to have the appropriate amount of concern. This becomes even more important in Q2, in what has traditionally been a strong quarter for Europe, versus a seasonally slow Q1.
- Second area of concern. We have always had a healthy respect for our competitors, and as I've said many times before, we expect an expanding wave of low-priced competitors from Asia.
- Third, we continue to see the opportunity to move into new advanced technology markets with additional resources. We also continue to see shorter-term payback by hiring additional sales people. This second point speaks to some of the market elasticity and coverage issues.
- Therefore, we will continue to hire additional sales people, as long as we anticipate a reasonable ramp over one to two years, approaching current productivity levels. If this develops the way we anticipate, it obviously presents key opportunities in terms of revenue growth and market share gains over the next several years.
- As you would expect, there is a natural lag between when you add these resources before you get payback for several quarters. This will obviously put a little bit of expense pressure on the percentage of operating expenses in the short-run, but if executed right and the elasticity continues to be reasonably broad, it will have substantial benefits in the longer-term.
- Having said that, our experience in Q1, indicates that these new incremental sales reps are rapidly coming up to speed in terms of orders, after just several quarters of learning about their customers and Cisco.
- Fourth, we were very pleased with our year-over-year growth in the low 30s in the federal business, and we are cautiously optimistic about Q2 in the federal business. But as we have heard, learned, and from prior experience, these funds can be quickly redirected to other issues.
- And finally in terms of concerns, at the risk of repeating the obvious, as you've said in each of the conference calls for over a decade, whenever there is a GDP increase or slowdown in countries around the world, this is usually followed by a corresponding reaction in capital expenditures, and therefore, orders for Cisco and our peers.
- It is argued that GDP will continue to be a good indicator of what you should expect over

the long-run from our traditional business. However, this should also be combined with additional opportunities from advanced technologies, the service provider market segment and our commercial market segment, as well as potential market share gains.

- Our success, obviously, is dependent upon how well we execute and how well our strategy has or has not anticipated major market transitions now and in the future.

## **Guidance**

- Now moving onto guidance.
- In very simple terms, we continue to focus on our strategy for architectural differentiation, to uniquely position Cisco as our customers' networks, and therefore our industry, continue to evolve toward the benefits and value of systems approaching networking.
- As we discussed in last quarter's conference call, we will continue to provide detailed quarterly guidance one quarter at a time, and we will also be providing fiscal year guidance, which as you would expect by definition, will have more uncertainty, accuracy risk and a wider range.
- This continues to be requested by many of our shareholders. And while we clearly understand the risk and uncertainty, we believe the benefits to our shareholders outweigh the risks. However, we do want to remind you, for this yearly guidance, there will be more variability both up and down, in our best estimates, and we will always try to make the best decision for our customers and shareholders in the long-run, not tying decisions to a short-term quarterly mentality.
- As we've said on many occasions, we believe that the markets in which we participate, and according to the view of a number of industry resources, will support revenue growth in the coming years in the 10 to 15% annual growth range. And in fiscal 2006, we are continuing to stay with our prior revenue guidance of 10 to 12%.
- We were very pleased with the balance in US operations, Asia Pacific and Emerging Markets in Q1. And with the appropriate risk consideration, the odds are good that solid momentum will continue in these three theaters in Q2.
- We believe Japan will continue to be challenging.
- Europe is the most difficult theater to predict at this time, given our Q1 results, and similar experiences from some of our large industry peers. Q2 normally sees a seasonal

slowing of US federal orders, more than offset by seasonally stronger Q2 orders from Europe. This is what we would expect to happen in this quarter, and with appropriate concerns given a slow Q1 in Europe, and some of the challenges that our peers have seen.

- We also believe that the additional focus on the commercial marketplace, sales coverage and emerging markets will continue to gain traction and associated business results. Therefore, we think there are opportunities for growth as well as market share gains, in many of our products that focus on the commercial market.
- As we have discussed in a number of financial sessions, we are getting more aggressive in expanding our sales coverage, resources committed to current advanced technologies and resources focused on a second wave of new advanced technologies, including emerging technologies that Charlie discussed. Therefore, you should expect our headcount and related expenses to increase slightly in Q2 versus Q1, just as it did in Q1 versus Q4.
- With these factors in mind, our guidance for fiscal 2006 is for product orders to grow year-over-year in the 10 to 15% range, with all the appropriate caveats regarding macro issues, execution risks and a marketplace that can change rapidly in either direction.
- As we said in the Q4 conference call, we would expect when comparing Q1 and Q2 fiscal year '06, year-over-year, to Q1 and Q2 of fiscal year '05, in which we had a book-to-bill below 1, orders should most likely grow faster than revenues year-over-year. This is clearly how Q1 evolved, as expected, and we would expect Q2 to follow a similar pattern.
- In anticipation of a question in last quarter's conference call, let me use a theoretical example of how order growth and revenue growth can be different in terms of book-to-bill in Q1 and Q2. So, theoretically, let's assume that Q1 fiscal year '05, book-to-bill as announced, was below 1. Let's say the same number actually theoretically being 0.95. And let's assume that our Q1 of this year being slightly below 1 was theoretically 0.98. Therefore, if revenues grew at 10%, it would be very logical that orders would grow approximately 13%.
- Each of you can decide whether you focus on revenues or growth projections on orders as being the most accurate indicator of growth. And I realize that among our shareholders, there are people in both camps or a combination. Having said that, my view has not changed. I focus on the order momentum and providing guidance and judging the degree of success of our strategies and what's going on from a global perspective.
- Also, as we said in the last conference call, with the appropriate risk considerations, we expect Q3 and Q4 of fiscal year '06, for revenue to grow faster than orders in year-over-year comparisons, given that Q3 and Q4 of FY '05 had a product book-to-bill of greater than 1.
- In Q2 FY '06, we would anticipate product order growth rate, in terms of year-over-year,

to be in the 10 to 14% range. Our overall revenue guidance in Q2 FY '06, in comparison to Q2 FY '05, will be up year-over-year approximately 8 to 9%. From an overall sequential revenue perspective, Q2 FY '06, will be flat to up slightly, versus Q1 FY '06. Dennis will discuss this in more detail in his section.

- In anticipation of some of your possible questions regarding our level of confidence and optimism, I would summarize our position in the following terms. We are continuing to be aggressive and optimistic on what we can control and influence. Key examples of this optimism and confidence would be the following.
- First, we continue to add resources. Second, we are beginning to develop what we believe will be a second wave of advanced technologies and have set an aggressive goal of announcing a new advanced technology every three to four months during fiscal year '06.
- Third, we are getting even more aggressive on the opportunities in the commercial marketplace, as illustrated in our results and commitments in the most recent quarter. Fourth, our operational focus and results from the emerging markets are developing at, or are better than we expected. And fifth, our market share and industry leadership gains.
- 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 challenging economic times.
- And now, I'd like to turn it over to Dennis. 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 the forward-looking statements. As a reminder, we are providing guidance on a pro forma basis with a reconciliation to GAAP.

### **Detailed Guidance**

- Moving on to our detailed guidance.
- We continue to believe that for the next few years, Cisco's long-term revenue growth rate should be between 10 and 15% on an annual basis. We realize that many factors, including our own execution, will impact whether we are at the high end or the low end of this range. Additionally, we could possibly be above or below this range.
- As we said last quarter, our revenue guidance for the full fiscal year '06 is 10 to 12%. We encourage you to model conservatively, with the understanding that we will continue to provide updates and further guidance each quarter.
- Regarding gross margins, forecasting gross margin has always been challenging due to

various factors, such as shipping, volume, product mix, variable component costs, customer and channel mix, and competitive pricing pressures. We expect total gross margin to be between 66 to 67% over the course of this fiscal year.

- As we have mentioned, we continue to see investment opportunities in this first half of FY '06. Consequently, we expect that operating expenses will trend up slightly in Q2. However, we continue to expect that operating expenses for the full year will be around 36% of revenue.
- Now, some guidance specifically on Q2. We expect revenue in the second quarter of fiscal year 2006, to be up approximately 8 to 9% year-over-year. We expect the Q2 FY '06 gross margin will be approximately 67%, meaning it could be slightly above or slightly below this level.
- Operating income should be in the range of 30% of revenue. We would expect interest and other income to be approximately \$150 million in the second quarter. We expect to continue our share buyback program, but it is difficult to predict the exact weighted average share count for EPS purposes. We continue to model a net reduction of 50 million shares per quarter.
- Regarding our Q2 FY '06 GAAP earnings, before the impact of FAS 123R on stock-based compensation, we anticipate that Q2 GAAP EPS will be \$0.01 to \$0.02 lower than pro forma EPS, due to ongoing amortization of purchased intangible assets and stock-based compensation costs arising from various purchase acquisitions and investments. These charges will be reported as GAAP operating expenses. With the adoption of FAS 123R, we continue to anticipate that Q2 GAAP EPS will be a further approximately \$0.03 to \$0.04 per share lower, giving a total potential reduction of \$0.04 to \$0.06 to our Q2 GAAP EPS.
- For the FY fiscal year '06, we expect the impact of stock option expensing will be a reduction of between \$0.12 to \$0.14 to our GAAP EPS, giving a total FY '06 impact of \$0.16 to \$0.22. We anticipate the FAS 123R stock option expenses for the remainder of FY '06 will be allocated to the various line items of the GAAP income statement in similar proportions as Q1 FY '06. These expenses will continue to be reported in the individual line items on the face of the income statement and will be included in the GAAP financial statements only.
- Other than those items noted above, there are no other significant differences between GAAP and our pro forma guidance. This guidance assumes no additional acquisitions, asset impairments, restructuring, or other unanticipated events, which may or may not be significant.
- Regarding cash flow from operations, we would expect no change to our prior guidance of \$300 to 600 million per month at these revenue levels. Our tax provision rate is

expected to remain at 28% for Q2. 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 fiscal 2006 results, will be on Tuesday, February 7, 2006, 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 contain forward-looking statements, which are subject to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. These forward-looking statements include, among other things, statements regarding future events 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 due to a variety of factors, including: business and economic conditions and growth trends in the networking industry and 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 and customer lead times; changes in customer order patterns or customer mix; insufficient, excess or obsolete inventory; variability of component costs; variations in sales channels, product costs or mix of products sold; our ability to successfully acquire businesses and technologies and to successfully integrate and operate these acquired businesses and technologies; 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, shareholder and other matters; natural catastrophic events; achievement of the benefits anticipated from our investments in sales and engineering activities; our ability to recruit and retain key personnel; our ability to manage financial risk; currency fluctuations and other international factors; potential volatility in operating results and other factors listed in Cisco's most recent reports on Form 10-K, 10-Q and 8-K. 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 29, 2005 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.