Cisco's Outlook: clearing, but still overcast

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The tech bellwether's 4Q profits fell sharply, yet CEO Chambers said Cisco may have reached a "tipping point" in demand. But what about profit margins?

In the Internet Age there may be no better bellwether than Cisco Systems (CSCO), the dominant maker of networking gear. So it was welcome news for investors when CEO John T. Chambers hinted at brighter days ahead after Cisco reported fiscal fourth-quarter earnings on Aug. 5.

Although sales in the quarter ended July 31 fell 18% from a year earlier, to $8.5 billion, Chambers said he expects sales in the current quarter to rise 1% to 3% from the quarter that just ended. That's a tad better than the flat sequential sales growth the company normally sees this time of year. So while revenues should fall about 14% this quarter from the same period a year earlier, the return to normal seasonal patterns is significant.

"We saw a number of positive signs this quarter in the economy and in our business," said Chambers. If that continues for a few more quarters, he said, "we believe there is a good chance we will look back and see that the tipping point occurred in our business" during the fourth quarter.

Investors weren't thrilled with the results. Shares of Cisco fell 3.3% in extended trading, after falling 29¢, or 1.3%, to 22.15 on Aug. 5. The report contributed to the mixed messages that Wall Street has been getting from tech's biggest suppliers. After upbeat reports from Apple (AAPL) and Intel (INTC) in July, Microsoft (MSFT) turned in a dreary fiscal fourth-quarter report on July 23.

Lower profit margins ahead?

Chambers' "message was that 'We're at the new normal,' " says Sam Wilson, an analyst with JMP Securities (JMP).

Chambers pointed to increased orders for Cisco gear as evidence that demand is strengthening. While order rates in the past two quarters were 10% to 15% below seasonal norms, "we've seen a dramatic difference" in recent weeks, the CEO told analysts.

This new normal isn't just about lower annual revenues, though. Judging from Cisco's numbers, it may also mean lower profit margins. Cisco's profits for the quarter dropped 46%, to $1.1 billion—despite steep expense cuts that exceeded Chambers' target of $1.5 billion over the past two quarters. What's more, Chambers predicted that Cisco's profit margins will fall slightly this quarter, surprising analysts. The margin drop is the main reason investors sold Cisco shares after the report, says JMP's Wilson.

Why the lower profit outlook? A big reason could be that the company is facing its most daunting competitor in years in Hewlett-Packard (HPQ), which has been rapidly expanding sales of its ProCurve networking gear. After having to beat out only far smaller rivals, "the years of Cisco's monopoly are over," says Wilson.

Less profitable new markets

Also, Cisco is wading into many new markets that can't match the profitability of its core networking businesses. These include everything from digital billboards to security systems to consumer gear. Cisco sells Linksys wireless routers and Flip portable video recorders acquired through its purchase of Flip maker Pure Digital last year. The popular video recorder brings in

roughly $400 million a year in sales, a drop in the bucket for the $29 billion-a-year company. Margins on the video cameras, which sell for $230 each and less, are nowhere near those of a $1 million router.

Cisco is also trying to crack another massive market: the computer business. During the quarter, customers began taking delivery of the company's first servers. These machines are designed to let operators of Internet and corporate data centers get far more processing power out of their servers—or enable them to buy fewer of them. Many chief information officers say they are willing to give the new systems a look, although server market incumbents such as IBM (IBM) and HP will surely fight hard to prevent major incursions.

Fortunately for investors, Cisco is now in so many businesses that some usually compensate for weaknesses in others. After years of hot growth, for example, sales of Scientific Atlanta cable set-top boxes plummeted more than 30% in the quarter, said Cisco controller Jonathan Chadwick. But sales of corporate Telepresence videoconferencing systems rose 97%.

So the outlook for tech demand remains mixed. Even BMC Software (BMC), a red-hot provider of IT management software for big corporations, saw quarterly sales clipped as customers tarried before signing contracts, says CEO Robert Beauchamp. One customer refused to sign until every one of its regional managers had set aside time for training on the software. "Customers added new steps, so it became harder to push things through their procurement processes," Beauchamp says.

Investors are hoping Chambers' "tipping point" forecast augurs more consistent results from tech companies ahead.

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