Zscaler Q1 2023 Earnings Call – December 1, 2022

Forward-Looking Statements

This document contains forward-looking statements that involve risks and uncertainties, including, but not limited to, statements regarding our future financial and operating performance, including our financial outlook for the second quarter of fiscal 2023 and full year fiscal 2023. There are a significant number of factors that could cause actual results to differ materially from statements made in this document, including but not limited to: macroeconomic factors such as the duration and global impact of COVID-19, effects of inflation and international conflicts like the Russia-Ukraine crisis on our business, operations and financial results and the economy in general; our limited operating history; our ability to identify and effectively implement the necessary changes to address execution challenges; risks associated with managing our rapid growth, including fluctuations from period to period; our limited experience with new product and subscription and support introductions and the risks associated with new products and subscription and support offerings, including the discovery of software bugs; our ability to attract and retain new customers; the failure to timely develop and achieve market acceptance of new products and subscriptions as well as existing products and subscription and support; rapidly evolving technological developments in the market for network security products and subscription and support offerings and our ability to remain competitive; length of sales cycles; and general market, political, economic and business conditions.

Additional risks and uncertainties that could affect our financial results are included under the captions “Risk Factors” and “Management’s Discussion and Analysis of Financial Condition and Results of Operations” set forth from time to time in our filings and reports with the Security Exchange Commission (SEC), including our Annual Report on Form 10-K for the fiscal year ended July 31, 2022 filed on September 15, 2022, as well as future filings and reports by us, copies of which are available on our website at ir.zscaler.com and on the SEC’s website at www.sec.gov. You should not rely on these forward-looking statements, as actual outcomes and results may differ materially from those contemplated by these forward-looking statements as a result of such risks and uncertainties. Additional information will also be set forth in other filings that we make with the SEC from time to time. All forward-looking statements in this document are based on information available to us as of the date hereof, and we do not assume any obligation to update the forward-looking statements provided to reflect events that occur or circumstances that exist after the date on which they were made.

CEO Commentary

I am pleased to share our Q1 results. For the quarter, our revenue grew 54% year-over-year and billings grew 37% against a difficult comparison. Normalized for higher billings duration a year ago, billings grew 42% as customers continued to embrace our Zero Trust Exchange platform to secure their digital transformation. Our disciplined approach to growth is enabling our operating profits to grow 76% year-over-year with operating margins expanding by 150 basis points over the same period. Our free cash flow margin was 27%, which once again placed our performance above the Rule-of-80 for the quarter, a combination of growth and profitability that we believe only 1% of the public SaaS companies achieve. As the world's largest security cloud platform, we have outstanding unit economics in our business reflecting high-90% gross retention rate and over 80% gross margins. These industry-leading retention and margins are possible because of our differentiated service and highly scalable multi-tenant cloud platform.

In September, Zscaler celebrated our 15th anniversary. When cloud and mobility were in their infancy, we founded the company with a bold idea to transform security and the corporate network. We started with a clean-slate and created the Zscaler multi-tenant in-line cloud platform, establishing modern Zero Trust architecture. This approach is now recommended by NIST, one of the most respected standards bodies in the industry. Our Zero Trust Exchange is built on a unique architecture that securely connects users, devices, and applications using business policies, regardless of their location. I could not be more proud of all our accomplishments to date, and I want to thank our employees, customers and partners for being a part of this journey.

The vision we started Zscaler with is even more relevant today. Hybrid work and public cloud adoption are now mainstream, as organizations, large and small, are racing to ensure their business operations are agile, resilient and secure. These generational tailwinds are durable, and my conviction in our $72 billion serviceable market opportunity is greater than it has ever been.

In my conversations with hundreds of IT executives, it is clear that cybersecurity remains their #1 priority. Cyber threats, including ransomware and data exfiltration, continue to grow exponentially, as attackers exploit VPNs and firewalls. This is driving more organizations from firewall and VPN-based castle-and-moat security to Zscaler's Zero Trust architecture. To meet this need, we launched a new certification program that provides comprehensive knowledge of Zero Trust architecture and practical guidance for the planning, design, and implementation of a Zero Trust architecture, enabling networking and security professionals to lead their organizations' secure digital transformation.

In today's environment, ROI and cost optimization are becoming bigger priorities, as business leaders are being asked to do more with less. Our Zero Trust Exchange eliminates the need for traditional security devices, either as on-prem appliances or virtual machines in the cloud, that are difficult to maintain and require compromises between security, cost and user experience. Our business value message is resonating in this challenging macro environment, and more customers are willing to adopt our broader platform to consolidate multiple point products, increasing our average deal size. As a result, we are actively working on more large multi-year, multi-pillar opportunities than ever before.

To align to the increasing deal sizes in each of our geo theaters, we reorganized our field-level customer segmentation and expanded our enterprise segment efforts at the beginning of this fiscal year. When we started in enterprise segment two years ago, it started with one global leader for all geos. As this business has grown, it made sense for us to align this segment under each geo leader for faster decision making closer to the customer. These changes contributed to a late ramp in the seasonally tougher Q1, but we believe these changes position us to scale to reach our next milestone of $5 billion in ARR and beyond.

In Q1, even as we saw additional deal scrutiny and longer reviews on most deals, we grew our base of customers with $1 million or more in ARR by 55% year-over-year, ending the quarter with over 340 of these customers.

As I mentioned before, customers are increasingly buying Zscaler for Users – our complete platform for user protection which includes ZIA, ZPA and ZDX bundled together. This accelerates our customers' transformation journey and makes us a critical partner for them. Now, let me highlight several such deals.

- First, pursuing a strategic initiative to modernize their business, a top 10 global bank made a 4-year, $10 million-per-year commitment for Zscaler for Users. Driven by cloud adoption including Microsoft 365 and Zoom, this customer needed a proven and scalable SASE solution to secure thousands of branch offices and hundreds of thousands of employees operating in more than 100 countries. Importantly, we met their requirement to eliminate the risk of legacy VPNs and lateral threat movement, which was a board-level priority. Unlike a VPN in the cloud, Zscaler connects users to specific applications and not to the corporate network, which will significantly improve their security posture. As employees unwittingly bring infected laptops back to the office, organizations need a true zero-trust platform to eliminate the risk of lateral threat movement.
- Next, in an upsell deal, a Global 1000 financial services company in Asia, after deploying ZIA for 110,000 users last year, upgraded to Zscaler for Users, our entire user protection platform, for all 130,000 employees. As a growing company, they are using Zscaler to quickly and cost effectively open new branch offices with secure internet connectivity, reducing their branch opening costs by 50% compared to legacy firewall-based architecture. Also, ZPA replaces their extensive VDI infrastructure with Zero Trust access. This customer said, and I quote, "ZPA provides a far more seamless user experience versus our existing VDI solution, and now we will have visibility to which user is accessing which applications, one of our key security requirements." With this latest seven-figure purchase, this customer's total ARR more than tripled in just over one year.
- As these two wins illustrate, when these large Financial Services companies were ready to embrace the cloud, Zscaler was the only platform that met their needs. With security as a major requirement, these financial services companies chose a proxy architecture with ability to inspect TLS traffic at scale and disqualified firewall-based SASE solutions. We now have 8 of the top 10 global banks and 7 of the top 10 insurance companies outside of China as our customers.
- I am also excited to see more $1 million ACV wins in our Enterprise segment. Let me share a new enterprise customer in the tech sector who bought all 4 product pillars: ZIA, ZPA and ZDX for 4,000 users, and posture control for workloads. Zscaler is enabling their secure digital transformation with direct and seamless access to SaaS and private applications, regardless of their location. This supports their remote-first strategy, enabling them to close 12 offices and consolidate half a dozen point products. This deal was sourced by a VAR partner and speaks to the progress we are making with the channel. As this win shows, deal sizes in the smaller enterprise segment are growing as customers adopt our broader platform.

Next, we are also executing well on our Federal government opportunity, which had a strong quarter. We remain the only cloud security service to have two products at the highest level of FedRAMP certification. These certifications are driving our federal business, as the US government pursues a Zero Trust strategy to enhance the nation's cybersecurity. We had four deals in the Fed vertical that were each over $1 million, all of which included ZIA and ZPA. Our highly differentiated architecture–which connects users to applications and not to the network, eliminating lateral threat movement–was critical to winning these deals. We have now landed 12 of the 15 Cabinet-level agencies as customers, with plenty of opportunity to upsell at these very large organizations.

As I mentioned, overall demand from customers to consolidate on our platform is growing. Our net retention rate has again exceeded 125%, now for 8 consecutive quarters. Happy customers buy more, and our net promoter score continues to exceed 70, which is more than 2 times the average NPS for SaaS companies. We have a 6x upsell opportunity with our existing customers just for our core ZIA and ZPA product pillars.

An important area of continued innovation I'd like to highlight is data protection. Our comprehensive data protection offering has been gaining traction as customers are concerned about data leakage with employees working from anywhere. In Q1, we delivered an industry-first Zero Configuration Data Protection service. Leveraging and building on our eight years of innovation in AI/ML, this DLP service provides auto-classification of unstructured data to expedite deployments with zero configuration. In addition, we completed the integration of recently acquired ShiftRight's workflow automation technology with our data protection solution to enable organizations to manage hundreds of potential risks and incidents in a simple yet very sophisticated way to significantly reduce case resolution time. Data protection is the first of many areas where we will broadly integrate ShiftRight's workflow technology into the Zero Trust Exchange Platform. These additional features, combined with previously released Exact Data Match and Indexed Data Match technology, makes us the leading data protection platform in the market.

Beyond our core products, we are excited about the rapid adoption of our two emerging product pillars: ZDX to manage digital user experience, and Zscaler for Workloads to secure servers and workloads. New ACV from our workload communication product is growing nearly 100% year-over-year and our newest deception and CNAPP offerings are seeing strong customer interest. Let me highlight two upsell deals this quarter that were driven by our workload products:

- A Fortune 500 aerospace customer that is accelerating its AWS and SaaS adoption, purchased Zscaler for Workloads to inspect one petabyte of TLS-encrypted workload and IoT traffic per month, resulting in better security. This customer purchased our ZIA Transformation bundle for 115,000 users two years ago. As they have already committed to our Zero Trust architecture, it was seamless for them to add workload protection, which is built on the same core Zero Trust Exchange. This seven-figure ACV workload deal more than doubled the customer's annual spend with us.
- In another upsell win, a long-time customer upgraded and expanded their purchase to ZIA, ZPA and ZDX for 12,000 users and also added Zscaler for Workloads to accelerate their application migration to Azure. Zscaler for Workloads now represents one third of this customer's $1 million-plus annual spend with us.

As these customer wins illustrate, our proven track record running the world's largest inline security cloud makes Zscaler the obvious and trusted partner of choice. Our Zero Trust Exchange processes over 270 billion transactions inline and prevents more than 7 billion security and policy violations per day, providing our customers an unmatched network effect for superior security. Our demonstrated ability to scale our cloud platform becomes even more important as we address hundreds of millions of workloads and billions of OT/IoT devices.

In closing, while there are broader macro challenges and economic uncertainties, we are seeing an increase in large, multi-year commitments for multiple product pillars. As I mentioned earlier, as deal sizes have increased, we have adapted our field-level customer segmentation to better serve our customers and to deliver more consistent execution. Our consultative sales process enables our account teams to quantify the business value of our platform, to remain close to the customers, especially at the c-level, and to get deals across the line.

I believe periods of uncertainty can act as a catalyst for change. Customers are engaging with us to embrace zero trust architecture, consolidate point products, simplify IT and standardize on the Zscaler platform, all of which delivers better security and lower cost. CIOs are telling me that they are using this challenging environment to drive change and to eliminate the technical debt of legacy point-products which are expensive to buy and operate. Customers are increasingly turning to Zscaler in today's challenging environment. While overall IT budgets are tightening, we believe that security budgets remain more resilient. We are bringing more innovations to customers than ever before, while scaling our customer support and go-to-market organization. We believe we are still in the early innings of a significant market opportunity to enable secure digital transformation and achieve our $5 billion ARR goal.

CFO Commentary

Our Q1 results exceeded our guidance on growth and profitability, even as we managed through additional deal scrutiny and longer reviews. Revenue was $356 million, up 54% year-over-year and up 12% sequentially. ZPA product revenue was approximately 19% of total revenue, growing 78% year-over-year. From a geographic perspective, Americas represented 52% of revenue, EMEA was 33% and APJ was 15%.

Our total calculated billings in Q1 grew 37% year-over-year to $340 million, against a difficult comparison. As we expected, billings duration was a headwind to growth this quarter. Our Q1 billings duration was above the midpoint of our normal 10 to 14 months range, but was below last year's higher levels. We estimate that duration negatively impacted our billings growth by approximately 5 percentage points. Normalized for this higher duration, our billings grew 42% year-over-year.

Our remaining performance obligations, or RPO, grew 57% from 1 year ago to $2.682 billion. The current RPO is 50% of the total RPO. Our strong customer retention rate and our ability to upsell the broader platform have resulted in a high dollar-based net retention rate, which was once again above 125%. We have a strong base of large enterprise customers, which provides us with a significant opportunity to upsell our broader platform.

At the end of Q1, we had 348 customers paying us more than $1 million annually, up 55% from 224 in the prior year. The continued strength of this metric speaks to our large enterprise focus and the strategic role we play in our customers' digital transformation initiatives. We added 128 customers in the quarter paying us more than $100,000 annually, ending the quarter at 2,217 such customers.

Turning to the rest of our Q1 financial performance. Total gross margin of 81.4% was up nearly 85 basis points year-over-year. Our total operating expenses increased 12% sequentially and 53% year-over-year to $247 million, primarily due to higher compensation expenses from a very successful hiring quarter. Operating margin was 12% and free cash flow margin was 27%. We continue to expect data center capex to be around the high single-digit percentage of revenue for the full year. We ended the quarter with over $1.82 billion in cash, cash equivalents and short-term investments.

Before providing our guidance, I would like to share a few observations about the current business environment. Demand for the Zscaler platform remains strong. Across our key customer segments, we are seeing deals getting larger as customers are trying to consolidate more and accelerate their security transformation around our Zero Trust Exchange. Customers are expanding their commitments with us, from a targeted use case to a much broader platform-centric approach. In our opportunity pipeline, we are actively working on more multi-year and multi-pillar opportunities than we historically have. While good for our business, larger deals take longer to close as customers introduce more checks and reviews. In this environment, we think it's prudent to expect a higher level of review and scrutiny by our customers to continue. We will continue to balance growth and profitability based on how our business is growing. In our outlook for fiscal 23, we intend to deliver operating margin expansion of more than 150 basis points, which is an increase from our prior guidance.

Now moving on to guidance and modeling points. As a reminder, these numbers are all non-GAAP, which excludes stock-based compensation expenses and related payroll taxes and amortization of intangible assets.

For the second quarter of fiscal 2023:

- We expect revenue in the range of $364 million to $366 million, reflecting a year-over-year growth of 42% to 43%.
- Gross margins of approximately 80%.
- Operating profit in the range of $42 million to $43 million.
- Net other income of $8 million; income taxes of $4.5 million.
- Earnings per share of $0.29 to $0.30, assuming 156 million fully diluted shares. Please note that starting in fiscal 2023, we adopted the new accounting standard which requires the use of the if-converted method for calculating EPS. To account for our convertible notes, you will need to add back $360,000 in quarterly interest expense and include 7.6 million shares to the fully diluted share count.

For the full year fiscal 2023:

- We expect revenue in the range of $1.525 billion to $1.530 billion or a year-over-year growth of approximately 40%.
- Calculated billings in the range of $1.93 billion to $1.94 billion or year-over-year growth of approximately 30% to 31%. We expect our first half mix of billings to be approximately 43% of our full-year billings guide.
- Operating profit in the range of $179 million to $183 million. Our guidance reflects 150 to 180 basis points of operating margin improvement compared to last year, while growing revenue at 40%.
- Income taxes of $19 million.
- Earnings per share in the range of $1.23 to $1.25, assuming approximately 157 million fully diluted shares. As noted earlier, to account for our convertible notes in EPS, you will need to add back $1.4 million in annual interest expense and include 7.6 million shares to the fully diluted share count.

Let me conclude with comments on our investment framework. We remain confident in our ability to deliver on our tremendous growth opportunity while increasing profitability. We continue to see a robust pipeline, and are prioritizing our investments in innovation and selling capacity, while also being thoughtful and prudent in managing our overall cost structure. The recurring nature of our business model gives us good visibility on top line revenue and allows us to adapt quickly to changes in market conditions, while delivering on our operating profit and margin goals. As we have discussed, if we are growing revenue faster than 30%, you can expect less than 300 basis points of margin expansion in the year.

We remain confident of reaching 20% to 22% operating margins in the long term. With a huge market opportunity and customers increasingly adopting the broader platform, we'll continue our disciplined approach to managing our business to maximize value for our shareholders.