Zscaler Q2 2024 Earnings Call – February 29, 2024

Forward-Looking Statements

Unless otherwise noted, all numbers presented will be on an adjusted, non-GAAP basis. Reconciliation of GAAP to the non-GAAP financial measures is included in our earnings release.

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 third quarter of fiscal 2024 and full year fiscal 2024. 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 influences and instability, including the ongoing effects of inflation, geopolitical events, operations and financial results and the economy in general; risks related to the use of AI in our platform; the impact of a government default or shut-down; 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 products and subscriptions 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; useful lives of our assets and other estimates; 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 Securities and Exchange Commission (SEC), including our Quarterly Report on Form 10-Q for the fiscal quarter ended October 31, 2023 filed on December 6, 2023 and our Annual Report on Form 10-K for the fiscal year ended July 31, 2023 filed on September 14, 2023, 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 Q2 results, which once again exceeded our guidance for the top line and the bottom line, even amidst an ongoing challenging macro environment. Revenue grew by 35% year over year, and billings grew by 27%. Our customer base spending $1 million or more continues to grow by over 30%. Our operating profit more than doubled year-over-year and our Free Cash Flow margin reached a record for Q2. During the quarter, we made solid progress on our strategy to scale our go-to-market engine to reach our goal of $5 billion and beyond in ARR. To augment our already strong sales team, we are adding more experienced leaders with a proven track record of running large operations. Considering these leadership changes, I'm particularly proud of our field sales execution this quarter.

Before getting to the details of our fiscal Q2, let me share a few observations on the business environment. Based on my conversations with hundreds of CIOs and CISOs, I expect demand for Zero Trust security to remain robust in 2024 and expect customer budgets for Zero Trust to be up this year, particularly in light of the recent surge in the number of high-profile breaches. Threat actors continue to exploit vulnerabilities of firewalls and VPNs, which allow them to spread ransomware laterally inside an organization. In a recent example, a VPN vulnerability was so severe that CISA, the US Cybersecurity agency, took the extraordinary step of mandating that Federal civilian agencies disconnect their Ivanti Pulse Secure VPNs within 48 hours. This is yet another example of why customers are increasingly realizing that their security posture remains vulnerable and are motivated to transform their firewall-based security to our Zero Trust architecture.

Spinning up firewalls and VPNs in the cloud, and calling it a SASE solution, doesn't solve cybersecurity challenges. While customers want to consolidate point products, they are looking for a fully integrated platform that delivers zero trust architecture. Cyber is so mission critical that customers will invest in the industry leading solutions rather than rely on cheaper or less effective products that are included as part of their ELAs. They want best-of-breed platforms with the best functionality that integrate with other platforms, thus eliminating dozens of point products. Zscaler Zero Trust platform is an integrated and purpose-built solution that delivers comprehensive security, and provides a compelling user experience, while reducing cost.

Strong customer interest in our platform drove a record first half total bookings, with nearly half of net new bookings coming from new logo customers. We added a record number of new logos for a Q2. This demonstrates the momentum in our business, and we are increasing our outlook for revenue and billings for fiscal 2024.

We are operating in a strong demand environment for Zero Trust architecture. To capture this demand and scale our business to $5 billion ARR and beyond, we appointed Mike Rich as our Chief Revenue Officer last quarter. Mike joined us from ServiceNow where he established a scalable go-to-market engine to drive deeper engagements with large enterprises. Going forward, Mike and his team are focusing on three key areas:

1. Our existing opportunity-led sales engine has helped us deliver strong growth over the years enabling us to surpass $2 billion in ARR. To drive our next phase of growth, we are evolving from an opportunity-centric to an account-centric sales motion, leveraging Mike's experience in building such plans. As we grow our sales organization, we are adding more experienced leaders and strategic sellers with the right level of experience working with CXOs and global system integrators. As we begin our planning for FY25, we are developing account plans that are aligned with our customers' long-term strategic initiatives, and we are partnering with our customers to build transformation roadmaps to modernize their security and IT infrastructure.

2. We launched our top accounts pilot program a couple of quarters ago which is successfully driving deeper platform engagements and adoption. Building upon our initial success and leveraging Mike's experience, we are scaling this program across more top accounts.
3. We are increasing our focus on vertical selling. We introduced a vertical-specific sales motion a few years ago, starting with the Public Sector, and expanded it to the Healthcare vertical last year. Based upon the successful growth in these verticals, we plan to continue to expand the program into more verticals, by adding domain experts who can drive vertical-specific strategies to better align with our customers' strategic initiatives.

We now have a double-digit number of customers spending more than $10 million with us annually. With our expanded platform and these go-to-market initiatives, I believe we will see more and more of our large enterprise customers reach $10 million ARR levels over time.

Now, let me highlight three factors that drove our performance in Q2.

1. We are seeing continued success in selling our broader platform, including ZPA, Data Protection, ZDX, Zero Trust for Workloads, Zero Trust for Branch, and AI-powered solutions. Driven by upsells, our $1 million ARR customer count grew by 31% year-over-year, ending the quarter with nearly 500 such customers.
2. We had a strong Federal quarter, with particular strength in upsells to cabinet level agencies. We have plenty of opportunity to expand further in the federal market.
3. We achieved a Q2 record for new logo additions, reflecting early success with our channel investments. Our $100,000 or more ARR customer base grew 21% year-over-year, ending the quarter with over 2,800 such customers.

Let me highlight two new logo deals from the quarter.

- A Fortune 100 healthcare customer purchased ZIA, ZPA, ZDX and advanced Data Protection for 10,000 users in a 7-figure ACV deal. ZPA will greatly enhance their security and user experience while eliminating legacy security gateways, by consolidating their VPN and VDI appliances. Protecting patient health care records is of paramount importance to this customer, which made data protection a crucial consideration for this deal. For the next phase, they are planning to expand to over 100,000 users, representing a significant upsell opportunity for us.
- In another new logo deal, after suffering repeated ransomware attacks, a technology company purchased 20,000 seats of ZIA, ZPA, ZDX and advanced Data Protection. They are phasing out their legacy castle-and-moat firewall-based security which failed to protect them against ransomware attacks. This customer excluded their incumbent firewall-based SASE vendor from consideration as they wanted a true Zero Trust architecture. This is a multi-year, 8-figure TCV deal, which is expected to generate over 100% ROI for the customer by eliminating their multiple firewalls, VPNs and VDI systems.

Now, let me highlight two upsell deals that highlight broader adoption of our comprehensive platform.

- In a 7-figure ACV deal, an existing Fortune 500 Financial services enterprise, currently using ZIA, ZPA and Data Protection, upgraded to our high-end ZPA Transformation bundle and added Endpoint DLP for 73,000 users. This also marks our largest Endpoint DLP deal since the introduction of this module just two quarters ago in our Data Protection solution. By moving to the high-end of our ZPA and Data

Protection packages, this customer increased their annual spend with us by over 60% to over $10 million annually.

- In another 7-figure ACV deal, a major global mining company increased their ZIA and ZDX purchases to 48,000 users and purchased ZPA transformation for 30,000 users. With the ZPA purchase, the customer is eliminating their VPN appliances and providing Zero Trust access for their workforce spread across remote locations worldwide. With this expanded purchase of our platform, the customer's annual spend with us nearly doubled to approximately $5 million.

Next, let me discuss our opportunities in the Federal market. As I mentioned earlier, we saw strong growth in net new ACV from the Federal vertical in Q2. After our initial lands at 12 of the 15 cabinet level agencies, we continue to win additional awards as agencies are increasingly adopting Zero Trust architecture to meet the President's Executive Order.

- For example, in a seven-figure upsell deal, an agency customer expanded their seats with ZIA, ZPA and Data Protection purchases, nearly doubling their annual spend with us. With this upsell, the customer is already approaching $5 million in annual spend, even though we are still less than 15% penetrated in terms of the number of users, representing a significant upsell opportunity in this agency.

With the highest levels of FedRAMP certifications for both ZIA and ZPA, we are very well positioned to benefit from continued growth with our federal customers. Building upon our success in the US, we are investing in building public sector programs for half a dozen nations that have adopted FedRAMP like certification programs. This is a significant opportunity for us, but like any government initiative this will take time.

Moving on, our R&D engine continues to deliver innovations, rapidly expanding our platform and providing larger upsell opportunities. Given our strategic position, we are interacting with more CXOs than ever before and having much deeper engagements.

For example, we recently hosted a CXO summit in India, attended by over 200 senior IT leaders, including over 100 CXOs. At the summit, one CXO said and I quote, "The velocity of features that Zscaler releases every time we meet is extremely impressive."

Our comprehensive platform protects not just users, but also workloads, and IoT/OT devices. While still early, we are seeing growing traction in our emerging platform solutions, including Zero Trust for Workloads, Zero Trust for Branch and Zero Trust for B2B, as well as our AI/ML powered solutions.

Zero Trust for Workloads continues to gain wider adoption.

- For example, in an upsell win, a financial technology company purchased Zero Trust for Workloads for 25,000 workloads, which contributed to nearly doubling their annual spend with us to over $1 million.
- A large aerospace company more than tripled their Zero Trust for Workloads purchase, contributing to a 60% increase in their annual spend with us to over $1 million.

In January, we launched Zero Trust for Branch which enables one-to-one connectivity between branch devices and applications, thus securing branch IoT/OT devices and eliminating the risk of lateral threat movement. Our Zscaler plug-and-play appliance would be the only solution customers will need at the branch, as it eliminates the need for legacy SD-WAN appliances, routers, and firewalls, thus dramatically simplifying branch networking and security.

Zero Trust for branch is a key component of our Zero Trust SASE solution, which is the industry's first single-vendor SASE solution built on Zero Trust. Zero Trust SASE pairs Zscaler's leading SSE with our new Zero Trust SD-WAN. We have seen early adoption of our Zero Trust SASE from customers across a range of industries including:

- A U.S. based Energy and Retail company
- A Europe based Fortune 500 manufacturing company
- A U.S. based Financial Services company, and many more

Moving to our AI cloud - within this portfolio, our newest products Risk360 and Business Insights are growing rapidly.

- Business Insights is helping CIOs and CFOs optimize cost of their SaaS applications, office locations, and more. For example, an existing Global 2000 consumer products customer purchased Business Insights for 97,000 users to replace their home-grown solution that cost over $500,000 annually.
- Recently adopted SEC disclosure requirements and Board level interest in understanding cyber risk are driving demand for Risk360. For example, A Global 2000 manufacturing customer purchased Risk360 for nearly 16,000 users to automate the process of risk quantification and take proactive measures to reduce cyber risk.

We have already delivered several AI innovations, including ML-based data classification, ML-based policy recommendations, Risk360, Business Insights, and more. In addition, one of the AI products I'm particularly excited about is "Breach Predictor". Breach predictor is our vision to leverage the power of our platform to predict breaches before customers get breached. We are working relentlessly to bring this and more industry leading AI innovations to our customers this year.

With our innovation engine humming and delivering cutting-edge products, and our go-to-market organization focused on scaling and growth, I'm more excited than ever about the opportunities ahead of us, and our ability to capitalize on those opportunities.

CFO Commentary

Our Q2 results exceeded our guidance on growth and profitability, even with ongoing customer scrutiny of large deals. Revenue was $525 million, up 35% year-over-year and up 6% sequentially. From a geographic perspective, Americas represented 54% of revenue, EMEA was 31%, and APJ was 15%.

Our total calculated billings in Q2 grew 27% year-over-year to $628 million. On a sequential basis, total billings increased 37% quarter-over-quarter. Our calculated current billings grew 26% year-over-year. Our remaining performance obligations, or RPO, grew 29% from a year ago to $3.613 billion. The current RPO is approximately 51% of the total RPO.

We ended Q2 with 497 customers with greater than $1 million in ARR, adding 29 such customers in the quarter. We also saw strength in $100,000 ARR customers this quarter, which grew to 2,820, adding 112 customers sequentially. This continued strong growth of large customers speaks to the strategic role we play in our customers' digital transformation initiatives. Our 12-month trailing dollar-based net retention rate was 117%. While good for our business, our increased success in selling bigger bundles, selling multiple pillars from the start, and faster upsells within a year, can reduce our dollar-based net retention rate in the future. There could be variability in this metric on a quarterly basis due to the factors I just mentioned.

Turning to the rest of our Q2 financial performance, total gross margin of 80.8% compares to 80.7% in the prior quarter and 80.4% in the year-ago quarter. On a year-over-year basis, gross margin benefited by approximately 60 basis points from a change in accounting attributed to the longer useful life of our cloud infrastructure. As mentioned on our previous earnings call, beginning fiscal 2024, we extended the depreciable useful life of our servers and network equipment in our cloud infrastructure from four to five years.

Moving on, our total operating expenses increased 3% sequentially and 22% year-over-year to $321 million. We continue to generate significant leverage in our financial model, with operating margin reaching 19.6%, an increase of approximately 700 basis points year-over-year. Our free cash flow margin was 19%, including data center CapEx of approximately 6% of revenue. We ended the quarter with over $2.4 billion in cash, cash equivalents and short-term investments.

Next, let me share some observations about the macro environment and our framework for guidance for the rest of the fiscal year. We believe we are still operating in a challenging macro environment and customers continue to scrutinize large deals. Customer interest in our platform remains strong, and we are adding experienced sales leaders to our already strong sales team to position us well for sustainable growth in the long-term. In our outlook for fiscal 2024, we're balancing our business optimism with ongoing macro-economic uncertainties and sales leadership changes.

Moving on to guidance for Q3 and full year fiscal 2024. As a reminder, these numbers are all non-GAAP.

For the third quarter:

- We expect revenue in the range of $534 million to $536 million, reflecting a year-over-year growth of approximately 28%
- Gross margins of 80%. I would like to remind investors that a number of our emerging products, including newer products like ZDX and Zscaler for Workloads, will initially have lower gross margins

than our core products. We're currently managing the emerging products for time to market and growth, not optimizing them for gross margins.

- Operating profit in the range of $98 million to $100 million
- Net other income of $15 million
- Income taxes of $10 million
- Earnings per share in the range of $0.64 to $0.65, assuming 161 million fully diluted shares.

For the full year fiscal 2024, we're increasing our guidance as follows:

- Revenue in the range of $2.118 billion to $2.122 billion, reflecting a year-over-year growth of approximately 31%
- Calculated billings in the range of $2.55 billion to $2.57 billion or year-over-year growth of 25% to 26%. From a modeling perspective, Q3 is typically our seasonally weaker quarter. Consistent with our historical seasonal patterns, we expect billings to decline sequentially by approximately 7% in Q3.
- Operating profit in the range of $395 million to $400 million, which reflects up to 400 basis points of operating margin improvement compared to last year.
- Income taxes of approximately $35 million
- Earnings per share in the range of $2.73 to $2.77, assuming approximately 161 million fully diluted shares. We expect our free cash flow margin to be up year-over-year and in the low-20% range. We continue to expect our data center CapEx to be high-single-digit percentage of revenue for the full year, reflecting the 3-percentage points to 4-percentage points of headwind to free cash flow margins. We expect the timing of CapEx spend to be more towards the later part of the second half of the year as we invest in upgrades to our cloud and AI infrastructure.

With a large market opportunity and customers increasingly adopting the broader platform, we plan to continue to invest significantly to drive long-term growth while increasing profitability.

Before moving on to Q&A, I would like to note that Bill Choi, our Senior Vice President of Strategic Finance and Investors Relations, will be leaving us in a couple of weeks. This is a bittersweet moment for me, as Bill has been instrumental in building the finance practice here, but happy for him as he is moving to pursue his first CFO opportunity at an AI networking company. We wish him great success in his next endeavor.