Zscaler Q4 2021 Earnings Call – September 9, 2021

Forward-Looking Statements

This document contains forward-looking statements that involve risks and uncertainties, including statements regarding our future financial and operating performance, including our financial outlook for the first quarter of fiscal 2022 and full year fiscal 2022. There are a significant number of factors that could cause actual results to differ materially from statements made in this press release, including but not limited to: the duration and global impact of COVID-19 on our business, operations and financial results and the economy in general; our ability as an organization to acquire and integrate other companies, products or technologies in a successful manner; 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, 2020 filed on September 17, 2020, 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 press release 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

We had a very strong quarter to close out a spectacular year. In Q4, we delivered growth of 57% in revenue and 70% in billings, as customers embraced our expanded cloud platform to accelerate their digital transformation. Let me share a few highlights of fiscal 21:

- Our full-year revenue grew 56% to $673 million and billings grew 70% to reach $934 million. We are seeing revenue growth across all verticals, customer segments and geographies. 51% of revenue was from outside the United States.
- I'm very excited to see our ARR approaching $1 billion, and pleased to note that our new annualized bookings and new logo acquisition accelerated throughout the year.
- All product pillars of our platform saw strong demand. Notably, ZPA revenue surpassed $100 million in fiscal 21, growing 166% year over year.

Increased cybersecurity risk and accelerating digital transformation have increased the need for our zero trust architecture. We are uniquely positioned to reduce business risk and make businesses agile and more competitive. We are the only cloud provider at scale with a proxy-based architecture to deliver true zero trust security. Firewall and VPN-based castle-and-moat security connects users to the corporate network which facilitates lateral movement of threats, increasing cyber risks. Zscaler connects users only to applications, not to the network, a core principle of zero trust architecture that reduces ransomware attacks and other cyber risks. Built from the start to enforce policy at the edge, as advocated by the SASE framework, the Zscaler cloud spans 150 data centers with 5-9's of availability, providing fast and secure access to all applications, whether in your data center or in a multi-cloud environment. Because of these architectural advantages and our proven ability to scale, the Zscaler Zero Trust Exchange has become the foundation for digital transformation.

- With a record number of 7-figure ACV deals in Q4, we now have over 200 customers with greater than $1 million in ARR. Over 5,600 enterprises, including 35% of the Fortune 500, trust Zscaler to secure their transformation journey. While the average Net Promoter Score of SaaS companies is 30, Zscaler's is 74, which is 2.5 times higher, proof of the value Zscaler delivers.

Now, I would like to discuss 3 market segments where we made significant progress during the quarter and the fiscal year:

1. First, the financial services sector has become our top vertical, as these companies are embracing the cloud and Office 365. Let me highlight 3 new customer wins in Q4 for the purchase of ZIA and ZPA together.
    - First is a global bank that is adopting a zero trust strategy to protect over 100,000 employees with our high-end ZIA and ZPA bundles. They purchased every module we offer in the ZIA pillar, including firewall, sandbox, CASB, DLP and browser isolation. Fast user experience and enhanced cybersecurity were the key factors for our win.
    - Our second new logo win is a Fortune 500 asset management company that purchased ZIA and ZPA to secure over 30,000 employees.
    - And third is a Fortune 500 insurance company that purchased ZIA and ZPA for 26,000 employees to enable work from anywhere.

    These wins illustrate, when companies are ready to embrace the cloud, Zscaler is the only cloud-native, multitenant platform that meets their needs. With security as a major requirement, these financial services customers only considered a proxy architecture that can provide SSL inspection at scale, and rejected firewall-based architecture. We now count 8 of the top 10 global banks and 7 of the top 10 insurance companies outside of China as our customers.

2. Next, let me highlight our progress in the Enterprise market segment, which includes organizations with 2,000 to 6,000 employees. We started focusing on this segment at the start of fiscal 21, and the results have exceeded our expectations. This segment includes over 12,000 organizations representing $8 billion of our serviceable market for user protection. Deal sizes in this segment are growing as customers adopt more of our platform. I am excited to see our first 7-figure upsell win in our Enterprise segment, where the customer is buying all 4 pillars of our platform: ZIA, ZPA and ZDX for 6,000 users, and ZCP workload segmentation for almost 3,000 servers. Our ARR with this customer now exceeds $1.5 million, validating the significant opportunity in this market segment. To further penetrate this segment, we are developing targeted marketing programs, significantly growing our sales team, and doubling down on our Summit Partner program to recruit and enable channel partners to drive further sales leverage.

3. Finally, we continue to invest to capture our large Federal opportunity. With a sizable Fed sales team and the highest FedRAMP certifications, we count well over 100 government agencies and federal integrators as customers. In Q4 alone, we added over 20 new Federal customers, including 4 with over $1 million in annual contract value, each purchasing ZIA and ZPA together. Driven by the President's recent Executive Order, we are seeing increased interest in our Zero Trust Exchange across all levels of the government. We are among a select group of companies chosen by NIST, a national standards body, to run a pilot program in support of the Executive Order. We are excited about this opportunity to help our country dramatically improve our security posture while significantly reducing legacy IT costs.

Next, let me highlight our technology innovations and emerging products which are expanding our opportunity. We started with a highly scalable, multi-tenant, globally distributed cloud capable of providing inline inspection of internet and SaaS traffic with ZIA and securing access to private applications with ZPA. Over the past year, we extended our platform to protect cloud workloads and to manage digital user experience. We're very excited about the early traction of our emerging products, the next growth engines for us. Our emerging products contributed high-single-digits percentage of our new and upsell business in fiscal 21, which is well ahead of our expectations.

ZDX is the fastest growing solution in our history, and a natural complement to ZIA and ZPA. With a single lightweight end-point agent, it is frictionless to turn on ZDX to provide end-to-end visibility to help resolve performance issues for every Zscaler user.

- In Q4, one of our largest ZDX deals came from a Fortune 500 tech company that purchased the entire ZIA portfolio as well as ZPA and ZDX for all 60,000 employees to support work from anywhere while embracing zero trust architecture.
- We were pleasantly surprised to see so many large enterprises adopt ZDX so rapidly. Other notable ZDX wins include a Fortune 500 pharma company for 70,000 users, a Fortune 50 energy company for 55,000 users, a Fortune 500 European bank for 39,000 users, an industrial manufacturing company for 28,000 users and a healthcare company for 25,000 users.

I believe that every ZIA and ZPA customer will embrace ZDX, as user experience is one of the highest priorities for a CIO. We are receiving very positive feedback from customers. A Fortune 600 healthcare executive indicated ZDX contributed to an 18-point gain in employee net promoter score for their IT service desk in 2 quarters.

After having disrupted perimeter-based security with our Zero Trust Exchange for users, our next big opportunity is to bring zero trust to workloads with Zscaler Cloud Protection or ZCP. Every organization is building their applications in the cloud and will look to implement zero trust security to protect workloads. Our Zero Trust Exchange securely connects workloads-to-workloads and process-to-process using business policies, eliminating the need for traditional networks and associated cyber risks. Solutions within our ZCP pillar include:

- Workload Posture, which includes CSPM and CIEM, ensures proper configuration and enforces least privileged access for multi-cloud environments.
- Workload Communication, powered by ZIA and ZPA technology, secures app-to-app and cloud-to-cloud communication, and
- Workload Segmentation achieves micro-segmentation without legacy network segmentation.

We have over 300 ZCP customers and are seeing increasingly strong interest from new and existing customers. Let me highlight a few ZCP wins during Q4:

- An existing ZIA and ZPA customer in the consumer goods sector with over 100,000 employees purchased workload communication for 25,000 workloads and workload segmentation for 10,000 workloads. This customer has a large server environment on a traditional network. Implementing our Zero Trust for workloads will reduce their cyber risk by minimizing lateral threat movement while securing their app migration to the cloud.
- We are also landing new logos with ZCP. For example, we landed a Fortune 500 professional services company where ZCP was the main driver. This customer purchased workload communication for 6,000 workloads, workload segmentation for 500 workloads as well as the entire ZIA bundle for 40,000 employees. Our team collaborated with CrowdStrike, our technology partner, and a Global SI, our channel partner, for this deal.

Let me conclude with some thoughts on our vision and strategy. We envision a world in which the exchange of information is always secure and seamless. In today's hyper-connected, digital world our Zero Trust Exchange secures any-to-any connectivity for users, applications, workloads and IoT and OT systems – regardless of their location. At our analyst day in January, we laid out our audacious goal of serving 200 million users and 100 million workloads. In order to achieve this goal, we are focused on attracting and developing talent and creating a culture of excellence. We hired over 1,100 employees over the past year and enabled them to be productive and successful, all during the pandemic. We are investing in our people through learning initiatives and building a culture where a global and diverse workforce can deliver excellence, powering our customers success. Our employees are engaged and completely aligned to our mission. Per our latest employee survey, 96% of employees understand and believe in the strategic direction of the company. I am proud that we are recognized as a Great Place to Work in the 2021 Glassdoor ratings.

We are focused on driving broad adoption of all four pillars of our platform. The breadth and depth of our platform is resonating with customers, and they are purchasing our higher-end bundles to consolidate their security and networking point products. I believe Zscaler is the go-to platform for vendor consolidation, cost savings, increased user productivity and better cyber protection. As we demonstrated over the last 12 months, we built a sophisticated go-to-market machine that delivers business value and measurable outcomes at the CXO level. I am extremely proud of our go-to-market team and how we executed our sales strategy this year. Even with significant growth in our salesforce, sales productivity has increased over the prior year, exceeding our expectations. Our Summit Partner channel program consists of hundreds of cloud-focused resellers, system integrators, and service providers that are contributing to our deal wins and increasing sales leverage. As our market share, reputation and brand awareness continue to strengthen, a growing number of cloud and SaaS providers are integrating with our platform, further strengthening our strategic position with our joint customers. Our expanding ecosystem is contributing to our sales velocity and broadening our reach.

I believe we are on the right track to capture a material share of our $72 billion serviceable market. We also see additional opportunities to bring zero trust to IoT and OT systems. Moreover, 5G—which pushes computing further to the edge—opens up additional opportunities for Zscaler. To pursue these markets, we have a two-pronged innovation strategy:

1. One, investing aggressively in internal R&D and scaling our world-class engineering organization, which continues to rapidly deliver new products and features. We recently opened a new R&D hub in Israel, and are expanding our R&D centers across the US, India, Canada, and Spain.
2. Two, making highly targeted acquisitions to enhance our platform and shrink time to market. During fiscal 21, we completed two acquisitions: Trustdome strengthens our ZCP pillar and positions us better to pursue our shift-left strategy. And SmokeScreen enhances our active defense capabilities with honeypot technology.

Through internal innovation and highly targeted acquisitions, we will further expand our leadership in the SASE and zero trust security markets.

In summary, with all these drivers and innovations ahead of us, you can see why we are very excited about our future.

CFO Commentary

We are pleased with the results for the fourth quarter and full year 2021. Revenue for the quarter was $197 million, up 12% sequentially and 57% year-over-year. ZPA product revenue was 17% of total revenue. From a geographic perspective, we had broad strength across our three major regions: Americas represented 51% of revenue, EMEA was 38% and APJ was 11%. For the full year, revenue was $673 million, up 56% year-over-year. This was an acceleration from the 42% growth we delivered in fiscal 2020.

Our total calculated billings grew 70% year-over-year to $332 million, with billing duration in the middle of our 10-14 months range. We are also pleased that year over year growth in short-term billings accelerated to 71% in the fourth quarter from 61% in the previous quarter. Our strong billings performance was driven by a record number of new 7-figure annualized contract value deals in the quarter, as we sold more of our platform offering. We saw strong growth in our top 5 verticals: Finance, Manufacturing, Services, Healthcare and Technology. Remaining performance obligations, or RPO, were $1.553 billion as of July 31, up 98% from one year ago. The current RPO is 49% of the total RPO.

Looking at our pillars, ZPA was 27% of our total new and upsell business in fiscal 2021. Emerging products, which include ZDX and ZCP, are tracking ahead of our expectations and contributed high-single digits of our total new and upsell. We are seeing strong customer interest and expect emerging products to contribute low teens percentage of our total new and upsell business in fiscal 2022. The adoption of our Emerging products is pacing ahead of ZPA in its early years. We have a large opportunity with all our pillars and we will continue to expand our portfolio to strengthen our leadership position in the zero trust security market.

Our strong customer retention and ability to upsell the broader platform have resulted in a consistently high dollar-based net retention rate, which was 128% compared to 126% last quarter and 120% a year ago. As we have highlighted, this metric will vary quarter-to-quarter. While good for our business, our increased success 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. Considering these factors, we feel that 128% is outstanding.

We have a strong base of large enterprise customers, which provides us with a significant opportunity to upsell our broader platform. We had 202 customers with ARR greater than $1 million, up 87% from 108 in the prior year. We also had 1,480 customers with ARR greater than $100,000, which compares with 973 customers last year. Our new customer adds accelerated in FY21. We organically added approximately 1,000 new logos in FY21 excluding acquisitions and we ended the year with over 5,600 customers. Expanding our field engagement with smaller enterprises with 2,000 to 6,000 employees and the increased investments in our partner program are contributing to higher new customer growth.

Turning to the rest of our Q4 financial performance, total gross margin of 80% declined by 1 percentage point quarter over quarter and improved by 1 percentage point year over year. Our total operating expenses increased 15% sequentially and 60% year-over-year to $138 million. Operating expenses as a percentage of revenue increased by 1 percentage point from 69% a year ago to 70% in the quarter primarily due to increased hiring and higher compensation expenses as well as $2 million in expenses related to Trustdome and SmokeScreen operations. Operating margin was 10% and Free cash flow margin was 14%. We ended the quarter with over $1.5 billion in cash, cash equivalents, and short-term investments.

Now, moving on to guidance. As a reminder, these numbers are all non-GAAP which excludes stock-based compensation expenses and related payroll taxes, amortization of debt discount and amortization of intangible assets. For the first quarter of fiscal 2022, we expect:

- Revenue in the range of $210 million to $212 million, reflecting a year-over-year growth of 47% to 49%
- Gross margins of 79%. I would like to remind investors that a number of our emerging products, including ZDX, Workload Segmentation and CSPM, will initially have lower gross margins than our core products, because we are more focused on time-to-market and growth than optimizing them for gross margins.
- Operating profit in the range of $18 million to $19 million
- Other income of $400 thousand, net of interest payments on the senior convertible notes
- Income taxes of $1.2 million.
- Earnings per share of approximately $0.12, assuming 148 million fully diluted shares.

For the full-year fiscal 2022 we expect:

- Revenue in the range of $940 million to $950 million or year-over-year growth of 40% to 41%.
- Calculated billings in the range of $1.23 billion to $1.25 billion or year-over-year growth of 32-34%. We expect our first half mix to be approximately 42% of our full year billings, which is in-line with the average of the last three to four years.
- Operating profit in the range of $85 million to $90 million.
- Earnings per share in the range of $0.52 to $0.56 assuming approximately 149 to 150 million fully diluted shares. Please note that our share count guidance now includes dilution from our convertible debentures. We have a capped call with a strike price of $246.76. Every $10 increase in our stock price above this strike price will add 250,000 to 300,000 shares to our fully diluted share count.

For your modeling purposes, I would like to discuss the anticipated T&E and M&A impact to fiscal 2022 operating expenses.

- In fiscal 2021, we saw a 280 basis point benefit to margins from lower T&E compared to fiscal 2020. With plans for in-person meetings and events in the second half of this year, including sales conferences in Q3 and ZenithLive in Q4, we expect T&E as a percentage of revenue to be approximately 250 to 300 basis points higher in fiscal 2022 as compared to fiscal 2021.
- As mentioned previously, the recent acquisitions of Trustdome and Smokescreen are expected to have an immaterial impact on revenue in fiscal 2022. We expect to incur approximately $13 million to $15 million in operating expenses to further invest in these products and incorporate their technologies into our platform. This is incorporated into our guidance.

Let me conclude with comments on our investment framework. We will balance growth and profitability based on how our business is growing. At our analyst day, with consensus estimates at that time reflecting approximately 30% revenue CAGR, we outlined our target of achieving 20-22% operating margins in fiscal 2024, which implied 300 basis points of margin expansion per year. Since then, we delivered outstanding results with revenue growth exceeding our expectations. If we continue to have high growth and strong unit economics, we will prioritize investing in the business, which would lead to lower than 300 basis points of margin expansion per year. To that point, our Fiscal 2022 guidance of 40% to 41% revenue growth and 9% to 9.5% operating margins reflects approximately 150-200 basis points of margin expansion after adjusting for the increased T&E and M&A expenses. We remain confident of reaching 20-22% operating margins in the long-term, but growth will continue to take priority considering our strong business momentum. With a huge market opportunity and customers increasingly adopting the broader platform, we are committed to investing aggressively in our company.