

Zscaler Q2 2022 Earnings Call – February 24, 2022

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 third 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, 2021 filed on September 16, 2021, 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

I am pleased to share our strong results for fiscal Q2. We continue to see strong demand for our Zero Trust Exchange platform, as our customers embrace the cloud. We delivered 63% year-over-year revenue growth and 59% billings growth, while also generating over 50% growth in operating profits and free cash flow. Public SaaS companies are happy to get to Rule-of-40¹, while we have been exceeding the Rule-of-70 for the last 12 months, validating our strong execution in pursuing our large market opportunity. Our continued investment in scaling our engineering and go-to-market machines is yielding the best revenue growth we have had in 3 years, even as we surpassed \$1 billion in annualized revenue. We plan to keep on making substantial investments across the company to continue our rapid pace of innovation and growth. What we deliver with our platform is critical to our customers' highest priorities. This is reflected in our deal sizes, which are increasing due to our success with large enterprises who are buying more of our expanding platform. With a significant growth in the number of new logo and upsell customers for orders with over \$1 million in annual value, we now have over 250 customers exceeding \$1 million in ARR, an increase of 85% year-over-year.

Business momentum for our Zero Trust Exchange is strong, due to the market need for our modern security architecture in the world of cloud and mobility. Our flagship ZIA offering has been growing very well, as we continue to expand our cyber and data protection services. ZPA has now emerged as our second flagship offering, supporting millions of users and the majority of our Global 2000 customers. We are the clear market leader in Zero Trust application access with proven maturity and scalability. With ZIA and ZPA, we have demonstrated our success implementing zero trust for users. Our next immediate big opportunity is to bring zero trust to workloads in our ZCP pillar, powered by the same core ZIA and ZPA technology. In addition, our ZDX pillar is enabling a highly productive workforce, and it is seeing strong demand.

In a single integrated cloud platform, our Zero Trust Exchange provides secure, any-to-any connectivity for users, applications, workloads and IoT and OT systems – regardless of their location. While many vendors claim to offer a platform because they bought a bunch of point products that are very hard to integrate, no one comes close to the capabilities of our cloud-native, extensible platform. We will continue to invest in engineering, customer support, marketing and sales to accelerate the growth of our new products, while keeping the strong momentum on our flagship products.

We believe we are in a sustained, high-demand environment. We have a large and expanding market opportunity, powered by our customers' digital transformation journeys, which continue at a pace never seen before. According to IDG's recent *State of the CIO* report, the top CEO mandate for IT in 2022 is to upgrade cybersecurity to reduce business risk. Whether it is supporting remote work or enabling new digital customer and employee experiences, IT leaders must ensure that business operations are agile, resilient, and secure. Given the explosion in ransomware and high-profile data breaches, IT leaders are looking to phase out castle-and-moat security to adopt zero-trust architecture to unlock the full promise of digital transformation.

It is clear from our growth and our large enterprise wins that architecture matters. Despite legacy vendors' marketing claims, true Zero Trust security can't be built on legacy network security architecture. As I have highlighted before, there are two reasons why enterprises are selecting Zscaler:

1. We are the only proven cloud security provider with a proxy architecture that inspects TLS-encrypted traffic at scale to deliver superior security.
2. We connect users to applications and not to the network, eliminating lateral threat movement. This is a core principle of zero trust architecture that can't be achieved by next gen firewalls or cloud VPNs.

¹ Rule-of-40 is calculated as year-over-year revenue growth percentage plus free cash flow margin.

Let me discuss some of our Q2 deal wins that highlight the advantages of our Zero Trust Exchange.

- I'll start with a big ZIA win. A Fortune 100 professional services customer initially purchased our ZIA Transformation bundle, plus CASB and DLP, and ZDX for 125,000 employees working from anywhere. This quarter, they added 175,000 ZIA seats to secure all 300,000 employees. With a Cloud-First strategy and mission-critical client-facing data at stake, they selected our proven, scalable platform with the global footprint needed to support their business in over 150 countries. With 93% of their internet traffic encrypted, TLS inspection was a major requirement, and the customer only considered a proxy architecture.
- Next is a new logo customer that started with ZPA. As part of a strategic initiative to transform their IT infrastructure, this global 50 manufacturer, headquartered in Europe, purchased ZPA for 200,000 users to implement zero trust security. ZPA will eliminate their attack surface, protecting thousands of private applications behind our Zero Trust Exchange, hence their apps can't be discovered, exploited or DDoS'd. We are replacing their firewall-based VPNs that allow lateral threat movement. A global systems integrator partner, who is implementing the overall transformation project, played a major role in driving the Zscaler win - an example of the channel leverage we are creating with our investments in our SI partners.

As the shift to the cloud accelerates, customers are buying ZIA and ZPA together, enabling a true transformation with direct and seamless access to SaaS and private applications, whether on-prem or in the public cloud. Let me highlight several such deals:

- In a new logo win, a Fortune 50 insurance customer signed a 4-year commitment for ZIA, ZPA and ZDX to securely enable 65,000 employees working from anywhere. For comprehensive cyber and data protection, they purchased the high-end Transformation bundle plus CASB, advanced DLP and SSPM, or SaaS security posture management, which is like CSPM for SaaS. Fast user experience and superior cybersecurity were the key factors for our win.
- In another new customer win, a Fortune 500 fin-tech company that had grown through acquisitions signed a nearly 5-year commitment to up-level security and simplify IT. They purchased ZIA Transformation plus CASB and DLP as well as ZPA and ZDX for 60,000 employees. This consolidates 7 different security point products and accelerates the closure of their 24 data centers. Moreover, ZPA also shortens new employee onboarding to a few days from two-and-a-half months. It also eliminated the need many of their employees had for two laptops to access two separate networks.
- I am also excited about our success selling security transformation in new countries. A Global 500 manufacturer headquartered in Mexico purchased ZIA and ZDX for over 18,000 users and ZPA for 14,000 users. This is our first 7-figure annual deal in Latin America, a region where we recently started making investments.
- Next, M&A is an elegant use case for the Zscaler platform. In an upsell deal, a diversified industrial conglomerate with over 20 operating companies that previously purchased ZIA Transformation bundle, added ZPA for 16,000 users to accelerate M&A integration and reduce business risk. Without having to connect two corporate networks with legacy firewalls, which could have taken 14 months or more, our Zero Trust Exchange provided secure access to applications across both companies in weeks, saving time and money. This customer purchased our high-end ZPA bundle with integrated browser isolation to enhance data protection. They also bought our deception technology to intercept bad actors who may have infiltrated their network. This latest purchase more than doubled their annual spend with us.

Next, let me highlight customers purchasing all four pillars of our platform. In a new logo win, a Global 2000 leader in technology products purchased ZIA Transformation with DLP and CASB, ZPA and ZDX for 11,000 employees and ZCP workload posture for 6,000 workloads in multi-cloud environment. As they accelerated their digital transformation, the CIO's top priority was to eliminate the risk of legacy VPNs and lateral threat movement while ensuring the best user experience. They put ZDX to the test by asking us to troubleshoot poor Microsoft 365 experience of an executive traveling in Europe. ZDX mapped the entire network path over the internet in real-time, isolating specific issues and allowing the customer to quickly resolve the issue and improve the user experience. This proof of value led to their quick ZDX purchase. I believe that over time, every ZIA and ZPA customer will embrace ZDX, as workforce productivity is one of the highest priorities for a CIO.

Lastly, I'm very happy with our early success in expanding our routes to market via cloud marketplaces, first with AWS and now with Azure. Let me highlight two Azure marketplace deals:

- First, an existing Global 200 pharma customer with headquarters in Europe, purchased ZPA for all 87,000 employees, enabling zero-trust access to their private apps hosted in hybrid cloud environments. This purchase was done with just a couple of mouse clicks, and it doubled their annual spend with us.
- Second, a new Fortune 500 customer in the energy industry made a 3-year, 8-figure commitment for ZIA, ZPA and ZDX for all 23,000 employees.

We will continue to invest in cloud marketplaces as a new channel to revenue.

Enterprises trust Zscaler over cloud imitators and new entrants because we have a true zero-trust architecture and have over 10 years of operational experience running the largest security cloud in the world. Our Zero Trust Exchange processes over 210 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. To flawlessly run the world's largest security cloud with 5-9's of availability requires more than security expertise, it requires networking expertise and the ability to control the traffic paths. As Zscaler was born as a cloud company and has been operating an in-line cloud since 2008, we have gained this expertise over time. There is no compression algorithm for years of experience. This expertise will become even more important as we address hundreds of millions of workloads and billions of OT/IoT devices.

Let me share an example of our cloud operations differentiation. Microsoft extended direct fiber connectivity from their major data centers to ours because of the volume of traffic that flows between Zscaler and Microsoft. This direct connectivity enables us to deliver higher reliability and performance than the traditional internet exchange peering approach. This is a validation of our scale and the criticality of our services to our mutual customers. Another example of delivering great availability and high-performance is our integrations with Microsoft and Zoom. With API-based integration for Teams and Zoom, we proactively identify and resolve performance issues for these latency-sensitive apps, without which, user collaboration is disrupted, and business productivity is lost. Our proven track record running the world's largest inline security cloud makes Zscaler the obvious and trusted partner of choice when enterprises need to securely access mission-critical applications.

Let me also talk about our recognized market and innovation leadership. Zscaler pioneered the zero trust architecture, and over time, our platform subsumed functionality of multiple point-products into our secure web gateway foundation. As the market evolved and customers migrated toward a platform approach such as Zscaler, Gartner expanded the scope of their secure web gateway MQ to include functionality such as CASB, ZTNA, digital experience monitoring and browser isolation, and renamed it SSE or Security Service Edge. After

10 consecutive years of being named a Leader in Gartner's MQ for Secure Web Gateway, we were again named a market Leader for SSE.

Many of you are aware of SASE – so how are SASE and SSE related? SASE framework is the combination of SSE and WAN-Edge. SSE has all the security capabilities built on zero trust architecture and is independent of the type of network. WAN-Edge, which is generally SD-WAN, provides connectivity to an SSE cloud. Importantly, Zero Trust security is implemented in the SSE cloud, not in the WAN-Edge. As the category leader in SSE with the widest and deepest offerings, Zscaler is the go-to platform for vendor consolidation, cost savings, increased user productivity and better cyber protection.

As our market opportunities expand, we are promoting two strong leaders to continue scaling Zscaler.

- We are expanding Amit Sinha's role to President of the company. Amit will continue to lead our engineering and cloud operations teams while also assuming broad responsibilities for expansion of our platform into new areas.
- We are also promoting Dali Rajic to Chief Operating Officer. Dali will continue to lead our global sales organization, while also assuming broader responsibilities for interlocking among sales, marketing, business development and transformation teams to further enhance the customer's lifecycle journey.

In their new roles, Amit and Dali will be responsible for driving further growth, operational excellence, and collaboration across Zscaler, as we continue the path towards our next milestone of \$5 billion in ARR.

To enable our customer's ever-growing digital transformation aspirations and extend our market leadership, our entire organization is focused on attracting and developing talent and creating a culture that rewards innovation at all levels. We added approximately 1,000 employees globally in the last 6 months and have over 4,000 employees who are energized by our shared mission to create a hyperconnected digital world in which the exchange of information is always secure and seamless. In today's competitive hiring market, Zscaler is a destination for top talent. We are proud of our Glassdoor rating, which is among the highest in the industry.

Zscaler has never been stronger, and I believe we have a large and growing opportunity in front of us.

CFO Commentary

We are pleased with the results for the second quarter of fiscal 2022. Revenue for the quarter was \$256 million, up 11% sequentially and 63% year-over-year. On a year-over-year basis, revenue growth accelerated in the quarter driven by strong business activity. 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 35% and APJ was 14%. APJ continues to be our fastest growing region, with revenue growth of 116%.

Our total calculated billings grew 59% year-over-year to \$368 million, with billings duration near the midpoint of our 10-14 months range. We are also pleased to report 61% year-over-year growth in short-term billings. Remaining performance obligations, or RPO, were \$1.95 billion as of January 31st, growing 90% from one year ago. 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 again above 125%.

We had 251 customers paying us more than \$1 million annually, up 85% from 136 in the prior year. The continued strength in this metric speaks to the strategic role we play in our customers' digital transformation initiatives. We added over 560 customers in the past 12 months paying us more than \$100,000 annually, ending the quarter at 1,751 such customers.

Turning to the rest of our Q2 financial performance, total gross margin of 80.4% was approximately flat quarter over quarter and down 90 basis points year over year. Our total operating expenses increased 13% sequentially and 62% year-over-year to \$183 million. Operating expenses as a percentage of revenue of 72% were similar to a year ago, even as we made ongoing investments in the SmokeScreen and Trustdome businesses we acquired in the second half of last year and with a partial return of T&E. Operating margin was 9% and Free cash flow margin was 12%. We continue to expect capex as percent of revenue to be in the high-single digits for the full year. We ended the quarter with over \$1.61 billion in cash, cash equivalents, and short-term investments.

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, amortization of debt discount and amortization of intangible assets.

For the third quarter of fiscal 2022, we expect:

- Revenue in the range of \$270 million to \$272 million, reflecting a year-over-year growth of 53% to 54%
- 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 rather than optimizing them for gross margins.
- Operating profit in the range of \$19 million to \$20 million. As we noted before, we have more in-person events starting this quarter, including customer events, conferences and our internal mid-year sales events.
- Net loss on other income of \$100 thousand
- Income taxes of \$4 million.
- Earnings per share of \$0.10 to \$0.11, assuming 149 to 150 million fully diluted shares.

For the full-year fiscal 2022 we are:

- Increasing our revenue guidance to a range of \$1.045 billion to \$1.05 billion or year-over-year growth of 55% to 56%.
- Increasing calculated billings to a range of \$1.365 billion to \$1.37 billion or year-over-year growth of 46% to 47%.
- Increasing our operating profit to a range of \$95 million to \$98 million.
- Increasing our earnings per share to a range of \$0.54 to \$0.56 assuming approximately 149 to 150 million fully diluted shares. Please note that our share count guidance includes dilution from our convertible debentures based on the existing treasury method of accounting.

With a large market opportunity and customers increasingly adopting the broader platform, we are committed to investing aggressively in our company. We see a window of opportunity to extend our first-mover advantages in this fast-growing market, which will have positive long-term impacts. We will balance growth and profitability based on how our business is growing, but we will continue to prioritize growth which we believe is in the best interest of our shareholders, employees, and customers.