Zscaler Q1 2025 Earnings Call – December 2, 2024

<u>Forward-Looking Statements</u>

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 second quarter of fiscal 2025 and full year fiscal 2025. 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, geopolitical events, operations and financial results and the economy in general; risks related to the use of AI in our platform; 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 Annual Report on Form 10-K for the fiscal year ended July 31, 2024, filed on September 12, 2024, 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.

<u>**CEO Commentary**</u>
We delivered a strong Q1 with all metrics once again exceeding the high end of our guidance. Revenue grew 26% year-over-year, and bookings growth accelerated to over 30% driven by increasing customer commitments to our Zero Trust Exchange platform and growing interest in our AI solutions. Our billings growth of 13% far exceeded the recent average growth rate of publicly-traded legacy network security vendors by over 10 percentage points, demonstrating our continued market share gains in cybersecurity. We are making tremendous progress executing on our go-to-market plans and driving innovations that our customers are relying on us for. With continued strong demand, I'm very pleased to increase our full year billings and revenue guidance.

Q1 was a solid quarter for profitability as well. With our operating discipline, we grew operating profit by 50% year-over-year and delivered new Q1 records for operating margin of 21% and free cash flow margin of 46%. While many successful SaaS companies strive for Rule-of-40 results, our revenue growth and free cash flow margin makes us a rare SaaS company that operates at Rule-of-70 or better. This places us in the top handful of the 145 largest public SaaS companies.

In my scores of customer conversations, CXOs are prioritizing Zero Trust security and AI for their IT spending. We are fighting AI with AI. We recently delivered several AI innovations and are continuing to expand our AI-portfolio in the following 3 areas of high customer interest:
- **First**, Securing use of AI applications for faster and safer adoption of Public and Private AI applications.
  - We enable customers to securely adopt public-AI apps, such as ChatGPT, Microsoft Copilot and GitHub Copilot, with "Zscaler for Copilots". Zscaler for Copilots provides granular visibility to find and classify on-prem or cloud data, gives access control for only the right users to access data, limits Copilots' discovery of data, fixes Copilot misconfigurations, and enforces policies to stop sensitive data from leaking. Our industry leading capabilities in this area are driving large customer wins. For example, in a new logo win, a Global 2000 technology services customer purchased our AI-powered Data Protection solution, which accounted for 50% of this 7-figure ACV deal. Data Protection enables this customer to securely roll out Microsoft Copilot. The secure use of Office 365 was a huge opportunity for us, and I believe the secure use of Microsoft Copilot is a huge opportunity as well.
  In addition to enabling secure adoption of Copilots, we provide visibility and control into public-AI apps used by employees, score the risk levels of AI-apps, and store prompt queries for logging or auditing purposes. With the widespread adoption of public-AI apps, we are seeing growing demand for their security.
  - Our innovations are expanding beyond securing public-AI apps to customers' private-AI apps, including chatbots, LLM and SLM models, and inference engines. We are expanding the functionality of our inline, proxy based Zero Trust Exchange with an LLM proxy to analyze prompt queries and results, to detect and prevent prompt injections and other malicious activities.
- **Second**, AI-powered Automated Digital Experience for operational efficiency and faster resolution of end-to-end user performance issues. Our already available automated digital experience products, including ZDX Copilot, are contributing to large deal wins. For example, in a 7-figure ACV upsell deal, a large healthcare provider doubled their ZIA subscription to 60,000 seats and purchased ZDX Advanced Plus, which includes ZDX Copilot, for all 60,000 seats. This customer plans to use ZDX Copilot to automate IT operations and reduce resolution time for service tickets. With this deal, this customer's annual spend more than doubled with us.

We are taking ZDX Copilot to the next level with ZDX AI-Agent to automate root cause analysis, resulting in further reduction in resolution time, and provide automated recommendations to fix user performance issues.

- **Third**, AI-powered security products for better cyber and data protection, and SecOps automation.
  - o We have delivered several AI-powered innovations for Data and Cyber protection, such as Automated data classification, Gen-AI based image classification, zero-day vulnerability detection and prevention, AI-powered App segmentation, and ML-based IoT/OT device discovery.
  - o For increased productivity and efficiency of security operations, we have introduced several innovations, including Risk360 and Unified Vulnerability Management, by extending our Zero Trust platform with data fabric technology. We are developing other AI-powered innovations, including Breach Prediction, Threat Hunting and more.

Our AI-powered solutions leverage the vast amount of proprietary enterprise data generated by 500 billion transactions per day processed by our Zero Trust Exchange. We will continue to leverage our data and combine it with new agent-based technologies to rapidly expand our AI-portfolio. The combination of Zero Trust and AI is creating exciting new opportunities, which we are well positioned to capture with our large and expanding platform.

Moving on, hackers are finding new ways to exploit the limitations of legacy castle and moat security to launch an increasing number of sophisticated attacks. Such attacks often start with exploitation of firewall or VPN architecture. These traditional security solutions enable threat actors to move laterally on the corporate network and compromise the entire organization. To make up for their flawed architecture, legacy security vendors are offering disjointed point products under the pretext of a platform. This increases cost and complexity for customers. A Fortune 50 retail customer recently told me that a legacy firewall vendor sold them a so-called platform, and when they tried to implement it, they found that it was nothing more than "consolidated billings".

Complexity is the enemy of security and resilience. No wonder so many enterprises are getting breached despite spending billions of dollars on so-called SASE security, which is nothing more than virtual firewalls and VPNs in the cloud. The sooner organizations move away from these disjointed security solutions to Zero Trust, the sooner they will become secure and resilient.

Zscaler customers modernize and future-proof their security with our platform for better security, operational simplicity and cost reduction. Today, we proudly secure over 35% of the Global 2000 and about 45% of the Fortune 500, and we are seeing more and more large enterprises adopt our platform. To give you an example,

- in a new logo 7-figure ACV deal, a Global 2000 Aerospace & Defense company, purchased ZIA for 100,000 users and Workload Protection for 5,000 workloads. This customer initiated a strategic shift towards a cloud first architecture and chose Zscaler as their partner for their security transformation.

Additionally, we see significant opportunity for ZPA upsells. Let me share an example:

- An existing Fortune 500 insurance customer expanded their ZIA subscription from 45,000 to 70,000 users and purchased ZPA for all 70,000 users. In addition to securing access to private applications, rapid M&A integration for faster time to value realization was a key objective for this customer. ZPA expedites M&A integration by securely providing Zero Trust access to applications for the acquired entity's employees without having to connect the networks of two companies. This is not possible with a firewall-based SASE solution. With this upsell, this customer's annual spend with us almost doubled to over $5 million dollars.

We expect ZPA to continue to be one of our biggest growth drivers in fiscal 25.

Moving on to Data protection - At Zenith Live, we outlined our broader vision of our Data Protection solution that our customers are increasingly adopting. For example,

- in a 7-figure ACV deal, a Fortune 500 pharma company purchased our Data Protection solution for over 23,000 users to eliminate multiple point products, including legacy data loss prevention, insider threat management, email data security and more. This purchase nearly doubled the annual spend of this customer with Zscaler.

I'm thrilled with the innovations we are bringing to our Data Protection solution. For example, we recently introduced a unique offering which combines the capabilities of ZPA with our Cloud Browser product to bring Zero Trust access to third party suppliers and partners. Traditionally, third-party application access was addressed either by VDIs that are expensive and complex, or by third-party enterprise browsers that require yet another agent to be deployed on the endpoint. Third-party enterprise browsers are complex to deploy and manage, and their vulnerabilities are being exploited by attackers. Our solution uses standard browsers, like Chrome, and provides superior security, while eliminating VDIs and third-party browsers. To give you a few examples:

- A Global 2000 IT services company for 20,000 users, a US based shipping and packaging company for 7,000 users, a Global 2000 Insurance company for over 5,000 users, each purchased our Cloud Browser solution to eliminate legacy third-party access products.

We will continue to invest to accelerate innovations in this area.

Next, our Emerging Products, including ZDX, Zero Trust for Branch & Cloud and AI-Analytics, are increasingly contributing to our success. I'm excited to share that Emerging Products ARR is growing twice as fast as our core products. Combined with our account-centric go-to-market motion, our Emerging Products are driving large 7-figure deals. Let me share two examples:

- **First**, in a 7-figure upsell deal, a Fortune 500 transportation customer purchased ZIA for Workloads, eliminating virtual firewalls from their cloud environments. This upsell drove approximately 40% increase in the annual spend of this existing $5-million-dollars plus ARR customer.
  Driven by our continued innovations for Workload Protection and our account-centric go-to-market strategy, we are securing large workload footprints for increasing number of customers, which has accelerated Workload Protection ARR over the past couple of quarters.
- **Second**, in a new logo 7-figure ACV win, a large US automotive supplier purchased our Zero Trust SD-WAN for all 45 of their branches and Zero Trust Device Segmentation for their 37 factories. The combination of Zero Trust SD-WAN with Zero Trust Device Segmentation will eliminate lateral threat movement among branches and factories, which is not possible to achieve with traditional SD-WAN. I believe with our solutions we will accelerate the decline of north-south and east-west firewalls. This deal is an example of a Global System Integrator or GSI working closely with Zscaler to transform customers' legacy networks and security to Zero Trust architecture.

Next, in the Federal vertical, we added a new cabinet-level agency this quarter and now we proudly serve 14 of the 15 cabinet-level agencies, including the DoD. Federal agencies are adopting the Zscaler platform to improve their security posture and reduce cost and complexity by eliminating firewalls and VPNs. Having landed these cabinet-level agencies, we see significant upsell opportunities to grow ARR over time. We are also continuing expansion into other federal agencies. For example, in a new logo win, a large Federal agency purchased ZPA and ZDX for 22,000 users in a 7-figure ACV deal.

Government investigations by multiple countries, including Australia, the European Union, Japan, Singapore, the United Kingdom and the United States, concluded that nation-state cyber attackers are successfully breaching the moat created by firewall-based solutions and as a result these Governments are planning to adopt Zero Trust architecture. We see this as a huge opportunity, and we will leverage our success in US Federal to grow our business in these and other countries.

Next, let me share a few highlights of the progress we are making to uplevel our go-to-market engine. I'm pleased to share that we are making solid progress on hiring and attrition plans. We had a strong quarter of hiring highly experienced quota-carrying account executives and had lower attrition. We expect these trends to continue in Q2, strengthening our sales capacity heading into the second half of fiscal 25.

Last year, we made the strategic decision to shift our sales motion from opportunity-based selling to account-centric selling. Our CRO Mike Rich and his team are executing on this strategy, and we are already seeing stronger customer engagements, higher quality pipeline, better close rates, and more business with customers. Strong customer engagement and sales execution contributed to over 20% year-over-year growth in Unscheduled Billings in Q1. As a reminder, Unscheduled Billings is comprised of new, upsell and renewal billings. We also grew $1-million-dollar-plus ARR customers by 25% year-over-year to 585. We ended Q1 with over 65 customers spending $5-million-dollars-plus annually with us.

Moving on to the channel, we are working closely with our strategic partners, including GSIs, Strategic National and Regional Partners, and Hyperscalers, to drive faster value realization for customers. An increasing number of strategic partners are embedding Zscaler's platform in their solutions for their customers. Our joint partner offerings are expanding beyond ZIA, ZPA, and ZDX, to now include our Emerging Products.

Overall, with strong execution in our account-centric sales motion, we expect to continue to grow the number of $1-million-dollar-plus and $5-million-dollars-plus customers at a strong pace. With a more mature pipeline, a stronger sales team, and growing partner engagements, I believe we remain on track to increase sales productivity and achieve strong growth.

In conclusion, our expanding portfolio that combines the power of Zero Trust and AI is resonating with customers. Our customer engagements are getting stronger as demonstrated by our Net Promoter Score or NPS of over 70, which is well over 2x the SaaS company average. I'm proud of the progress we made in our go-to-market initiatives this quarter, and we will continue to make further progress towards achieving our next goal of $5 billion dollars in ARR.

Now, I'd like to turn over the call to Remo for our financial results.

CFO Commentary

Thank you, Jay. Our Q1 results exceeded our guidance on growth and profitability, even with ongoing customer scrutiny of large deals. Revenue was $628 million, up 26% year-over-year and up 6% sequentially. From a geographic perspective, Americas represented 54% of revenue, EMEA was 30%, and APJ was 16%.

Our total calculated billings in Q1 grew 13% year-over-year to $517 million. As Jay mentioned, our Unscheduled Billings, comprised of new, upsell and renewal billings, grew over 20% year-over-year. Our calculated current billings grew 12% year-over-year.

Our remaining performance obligations, or RPO, grew 26% from a year ago to $4.411 billion. Current RPO was approximately 49% of the total RPO.

We ended Q1 with 585 customers with over $1 million in ARR, and 3,165 customers with over $100,000 in ARR. This continued strong growth of large customers speaks to the strategic role we play in our customers' digital transformation journeys. Our 12-month trailing dollar-based net retention rate was 114%. 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 Q1 financial performance, total gross margin of 80.6% compares to 80.7% in the year-ago quarter. Our total operating expenses increased 5% sequentially and 19% year-over-year to $372 million. We continue to generate significant leverage in our financial model, with operating margin of approximately 21%, an increase of about 330 basis points year-over-year. Our free cash flow margin was 46%, including data center CapEx of approximately 3% of revenue. We ended the quarter with over $2.7 billion in cash, cash equivalents and short-term investments.

Now, let me provide our guidance for Q2 and full year fiscal 2025. As a reminder, these numbers are all non-GAAP.
For the second quarter:
- We expect revenue in the range of $633 million to $635 million, reflecting a year-over-year growth of approximately 21%.
- Gross margins of approximately 80%. I would like to remind investors that we are introducing new products that are experiencing strong growth and are optimized for faster go-to-market rather than margins. This will continue to influence our gross margins. We plan to optimize new products for margins over time as they scale.
- Operating profit in the range of $126 million to $128 million.
- Net other income of $18 million.
- Earnings per share in the range of $0.68 to $0.69, assuming a 23% tax rate and 163 million fully diluted shares.

For the full year fiscal 2025:
- We expect billings in the range of $3.124 billion to $3.149 billion, reflecting a year-over-year growth of 19% to 20%. We expect our first half mix to be approximately 39.3% to 39.5% of our full-year billings guide.
- Revenue in the range of $2.623 billion to $2.643 billion, reflecting a year-over-year growth of 21% to 22%.
- Operating profit in the range of $549 million to $559 million.

- Earnings per share in the range of $2.94 to $2.99, assuming a 23% tax rate and approximately 164 million fully diluted shares
- We expect our free cash flow margin to be approximately 23.5% to 24%. We expect our data center capex to be approximately 3 points higher as a percentage of revenue compared to fiscal 2024 as we invest in upgrades to our cloud and AI Infrastructure.

With a large market opportunity and customers increasingly adopting the broader platform, we will invest aggressively to position us for long-term growth and profitability.

Conclusion
CFO
On a personal note, I 'd like to share that after 8 amazing years, I have decided to retire as Chief Financial Officer of Zscaler. It has been my greatest pleasure to be a part of Zscaler's journey from less than $250 million to over $2.5 billion ARR.

I'd like to thank Jay for his confidence in me. It has been a true partnership, which for me personally has been very special. I'd also like to thank the employees of Zscaler and our Board of Directors for their support through the years, and also thank our customers, partners, investors, and analysts.

I'm confident that Zscaler will continue to shape the next several decades in cybersecurity with its Zero Trust Exchange platform, and I look forward to following Zscaler's progress.

Now, I will turn the call over to Jay.

CEO
I want to personally thank Remo for all his contributions to Zscaler. Remo has been a friend and a trusted business partner whose wisdom and judgement helped us make many critical decisions as we scaled our business at an unprecedented pace. He will be dearly missed. Remo will remain as CFO until his successor is appointed.