Zscaler Q3 2023 Earnings Call – June 1, 2023

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 fourth 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 influences and instability, including the ongoing effects of inflation, geopolitical events and the COVID-19 pandemic on our business, operations and financial results and the economy in general; the uncertainty about the raising of the U.S. federal government debt limit and 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 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 Securities and Exchange Commission (SEC), including our Quarterly Report on Form 10-Q for the fiscal quarter ended January 31, 2023 filed on March 8, 2023 and 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

We delivered strong third quarter results, with all financial metrics above the high end of the guidance we provided last quarter. On a year-over-year basis, revenue grew by 46%, billings grew by 40%, and current billings grew by 44%. Our new business grew significantly across various industry verticals, and we had approximately half of our revenue come from outside the U.S. We have a strong and loyal base of customers, with gross retention rates in the high 90s. We have a disciplined approach to growth, and once again, our operating income more than doubled on a year-over-year basis, with operating margins now exceeding 15%.

While we continue to operate under tighter economic conditions, I believe the comprehensive functionality of our Zero Trust Exchange platform, our strong execution and our customer-first approach will enable us to navigate this macro backdrop and deliver on our guidance. Our consultative sales process enables our account teams to adapt to the changing business environment and stay close to our customers, especially at the c-level. We are partnering earlier with CXOs to jointly create compelling CFO-ready business cases that have clear ROI and payback periods. As our Q3 results demonstrate, this high-touch engagement is helping get deals across the finish line. Our go-to-market engine enables us to close many large multi-year, multi-product deals. We are providing increased guidance for the full year, which we believe balances our business optimism and macroeconomic uncertainties.

A few quarters ago, we noted that customers were increasingly scrutinizing their projects and budgets due to macro conditions. We have seen this elevated level of scrutiny continue in Q3. Nevertheless, we see high-priority initiatives still moving forward. In my conversations with hundreds of IT executives, cybersecurity remains their #1 IT priority. Traditional network security based on firewalls and VPNs cannot handle the complexity of safeguarding enterprises in what has become a work-from-anywhere world. 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.

Moreover, C-level leaders from around the globe are telling me that the technical debt of their legacy network and security point products impedes progress and slows down business operations. Our business value message is resonating with customers: our Zero Trust Exchange offers better security and user experience while substantially reducing cost and IT complexity compared to legacy networking and security. By consolidating point products and embracing Zero Trust with Zscaler, our customers are modernizing their security and increasing productivity, which gives them the competitive edge they need to succeed in today's rapidly evolving business environment. We also partner with many tech leaders to deliver easy, jointly integrated solutions for customers, which increases our business value and creates go-to-market leverage for us. Our current marketing campaign called “Beyond the Perimeter” is a great example of the successful field collaboration with our tech partner CrowdStrike that is increasing our pipeline.

In today’s environment, our strategy is to double down on customer success. From presales to deployment and customer success management, we have built our organization to deliver measurable outcomes at the CXO level. We made a number of investments in Customer Success services, Technical Account Managers, Partner Services, and Certification of partners, which together will help our customers move faster towards realizing business value. We now have 400 customers with greater than $1 million in ARR, including over 35 customers exceeding $5 million in ARR. In Q3, our new logo business grew approximately 20% year-over-year. Our proven experience at scale makes us the partner of choice for customers pursuing their Zero Trust security journey. We have a blueprint for delivering greater value, which drives strong upsell. Approximately 60% of our new business came from existing customers, and our net retention rate has again exceeded 125%. Happy customers buy more, and our net promoter score of over 70 is a testament to our strong relationship with our customers. As we have indicated before, we have a 6x upsell opportunity with our existing customers for protecting their users.

Our engineering team is innovating at a rapid pace and has expanded our comprehensive platform from securing users, to securing workloads as well as securing IoT/OT. As I mentioned before, customers are increasingly buying Zscaler for Users, which bundles ZIA, ZPA, and ZDX together. Let me highlight one such platform deal in the quarter.

In an exciting upsell win, a fast-growing Global bank in APJ upgraded to Zscaler for Users bundle for 150,000 users after deploying ZIA last year. With this upgrade, this customer is significantly reducing time to open new branches by 50% and eliminating the need for firewalls and MPLS network services. We are now a strategic partner to them as they continue to expand their footprint and transform into a cloud-centric organization. This customer said it is the first time they have seen a security vendor that understands their business needs and aligns its solution to address them. With this latest purchase, this customer's ARR surpassed $10 million. This is also an example of the geographic diversity of our business outside the US. Today, we serve 8 out of the 10 largest Financial Services and Diversified Insurance companies in the world outside of China.

Over the past few quarters, I observed that analysts and investors often equate ZPA with VPN replacement. This is simply not true. ZPA replaces the entire in-bound DMZ. And ZPA is often purchased for all employees. In fact, over half of our ZPA customers have purchased ZPA services for all employees, hence delivering zero trust whether they work in the office or at home.

In Q3, ZPA was an area of strong growth and we saw large new logo deals that landed with ZPA. Let me highlight two such deals.

A Fortune 100 logistics company made a 4-year, multi-million ACV purchase of ZPA and ZDX for 100,000 users. ZPA provides Zero Trust application access architecture for their employees, partners, and suppliers as it consolidates multiple point products, including multiple VPNs, load balancers, VDIs, and dedicated private network services. As a result, ZPA is expected to generate a 300% ROI for this customer.

In another ZPA land deal, a Global 300 tech manufacturing company made a 3-year, 7-figure ACV commitment for ZPA and ZDX for all 30,000 employees. Cybersecurity was their top priority as their IP in software development and manufacturing was being actively targeted by nation state actors and hackers.

Another aspect of our market not well understood by investors is that scale and performance are paramount considerations to customers in the real world. When you are providing inline inspection you cannot have a trade off between performance and security. Given our large opportunity and our success in the market, it is not surprising to see a number of vendors claiming that they have the same capabilities as we do. They built their products using something known as service function chaining in order to reduce their time to market. The reality is service chaining for in-line traffic inspection using microservices results in poor performance. They are effectively trying to scale low performance. Our unique architecture with our patented single-scan, multi-action technology enables us to deliver comprehensive security at high performance and scale. We secure over 40 million users from some of the largest global brands and we surpassed 300 billion transactions daily. We are the largest inline security cloud and no one comes close to us. Customers cannot afford to risk their mission-critical operations with immature offerings from unproven vendors.

Let me highlight a deal which showcases the scale of our platform. In a large SSE win, a global 30 healthcare insurance company purchased ZPA and ZDX for 450,000 users and ZIA for 430,000 users. Their incumbent

CASB provider could not scale to even 5% of the employees when TLS inspection was turned on. At this customer, we are consolidating dozens of point products from a handful of vendors, including DLP, CASB, web proxies, firewalls and VPNs. Our integration with Microsoft E5 suite across ZIA, ZPA and ZDX was also an important decision factor for them. In addition, the customer will use Zscaler to rapidly integrate new acquisitions in weeks rather than months that are required by legacy network security architecture.

Next, let me highlight a deal that was led by data protection. In our largest win in the transportation vertical, a Global 50 company purchased the ZIA Transformation bundle plus ZDX and Advanced Data Protection suite for 165,000 users. Zscaler was chosen over a CASB vendor because of our best-in-class capabilities in DLP, CASB, browser isolation, SSPM and SaaS supply chain security. And of course, our proven cloud scale and resilience was a big factor. This deal started with data protection, and quickly expanded to include web proxy, firewall and sandbox and to implement direct-to-cloud architecture across their 6,500 locations. We see more customers buying our data protection along with ZIA and replacing their existing CASB point products.

As these deals show, customers are embracing our expanded platform including our two emerging product pillars: ZDX for digital user experience, and Zscaler for Workloads. These emerging products are on track to meet our full-year target of high-teens percentage of new business. This quarter, we had an upsell deal with a Global 200 bank headquartered in APJ that purchased Zscaler for Workloads for 70,000 workloads in a multi-cloud environment. As an existing ZIA customer, it was easy and seamless for them to roll out workload protection, which increased their annual spend with us by 35%.

We are also starting to close larger deals with our Federal government customers, as their Zero Trust deployments move beyond the initial land deals. A cabinet-level agency purchased ZIA and ZPA for 110,000 users to cover all of its sub-agencies. After a thorough evaluation, they are standardizing on Zscaler to consolidate multiple point products across the agency and to comply with the President's Executive Order which mandates federal agencies to adopt Zero Trust principles. Our highly scalable and reliable platform and our highest FedRAMP authorizations for both ZIA and ZPA have been key differentiators in this win. Having landed 12 of the 15 cabinet level agencies, we have plenty of opportunity to expand further with these very large organizations.

To take our customer-centric innovations to the next level, we welcomed Syam Nair as our new CTO who will lead our R&D teams. Syam has extensive experience in leading and scaling engineering and product development teams that accelerated innovation cycles at Salesforce and Microsoft. He was a driving force in scaling the AI-powered customer engagement platform at Salesforce, which is critical to the next phase of our AI journey.

Let me highlight a few examples of how we are leveraging AI/ML to deliver better cyber protection today.

- Our first acquisition in 2018 was an AI/ML company. We leveraged their technology together with Zscaler data to deliver far better detection for zero day attacks. This resulted in reducing the number of files being sent to our sandboxing engine by 80 percent, reducing time-to-detection and improving user experience.
- ZDX, our digital experience service, was launched 3 years ago. It was built from the ground up to leverage AI/ML to not just show where performance is degraded, but what caused the issue.
- The data protection advancements we launched in October 2022, leveraged AI/ML to classify unstructured documents for policy enforcement.
- And, after the launch of ChatGPT, Zscaler delivered policy-based access control to ensure that customers can use AI applications safely. If their employees submit sensitive data to ChatGPT-like applications, our DLP technology detects it and blocks it.

While plenty of AI apps like ChatGPT, GPT4, Bard and Bedrock use public data, AI-powered cyber security for enterprises requires their own private data. Based on a proxy architecture, Zscaler Zero Trust Exchange is like a private switchboard for all communication for users, workloads and devices that captures all communication logs – a whopping 300 billion logs per day. These are not DNS logs that have little information beyond the domain, these are not firewall logs that cannot often see SSL traffic, these are complete logs that have structured and unstructured data, including the full URL, providing trillions of signals per day.

Zscaler has AI experts and data scientists and the most valuable anonymized private data to customize and effectively train LLM models for the security domain. Imagine a world where our customers will know that they are about to be breached before they are breached, so they can proactively prevent the attack. Using AI, I believe Zscaler has the opportunity to predict most of today's ransomware and other sophisticated attacks on our customers.

We plan to launch a number of innovations, including many for AI/ML at Zenith Live, our annual cloud summit in mid-June in Las Vegas. I invite you to join us.

In closing, we believe that we're still in the early stages of a significant market opportunity to disrupt 30-years of traditional network security and capture a large share of our $72 billion addressable market. Our Zero Trust Exchange is built on a unique architecture that securely connects users, devices, and applications using business policies, regardless of their location. We believe our 10-plus-year track record of running a massive, inline cloud that has to be highly reliable and available makes Zscaler the go-to platform for vendor consolidation, cost savings, increased user productivity and better cyber protection. We remain focused on creating shareholder value by driving customer-centric innovation, new business growth, and increased profitability.

CFO Commentary

Revenue in Q3 was $419 million, up 46% year-over-year and up 8% sequentially. ZPA product revenue was approximately 20% of total revenue, growing 66% year-over-year. From a geographic perspective, Americas represented 54% of revenue, EMEA was 31% and APJ was 15%.

Our total calculated billings in Q3 grew 40% year-over-year to $482 million. Until we get more certainty around the macro environment, we believe looking at total billings on a sequential basis can be a relevant measure of our billings performance in the near-term. On a sequential basis, billings declined 2% quarter over quarter, which was better than our normal seasonality. Our calculated current billings grew 44% year-over-year.

Our remaining performance obligations, or RPO, grew 36% from a year ago to $3.023 billion. The current RPO is approximately 50% of the total RPO.

Our dollar-based net retention rate was once again above 125%. 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. This is not a metric we try to optimize quarter-to-quarter, which could lead to variability on a quarterly basis.

At the end of Q3, we had 400 customers with greater than $1 million in ARR, up 39% from a year ago. The continued strength of this metric speaks to the strategic role we play in our customers' digital transformation initiatives. We also ended the quarter with 2,432 customers with greater than $100,000 in ARR.

Turning to the rest of our Q3 financial performance. Total gross margin of 80.2% compares to 80.4% in the prior quarter and 80.6% in the year ago quarter. Higher public cloud usage for our emerging products drove the year-over-year change in gross margins. Our total operating expenses increased 3% sequentially and 33% year-over-year to $272 million, primarily due to higher compensation expenses. Operating margin of 15.3% increased approximately 600 basis points year-over-year. Following our optimization efforts in Q2, we are seeing higher efficiency in supporting roles across the departments. Our free cash flow margin was 18%. We continue to expect our data center capex to be around the high single-digit percentage of revenue for the full year. We ended the quarter with over $1.97 billion in cash, cash equivalents and short-term investments.

Next, let me share some observations about the macro environment and our framework for guidance. From our perspective, the global macro environment remains uncertain and customers continue to scrutinize large deals. 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. While good for our business, larger deals take longer to close as customers introduce more checks and reviews. In addition, in select instances, we enable new strategic customers to ramp into larger subscription commitments. Typically, these ramped deals reduce our first-year billings, but will grow into a higher annual run-rate level in the second year. We are entering Q4 with a record pipeline and our customer engagements remain strong. However, predicting close rates in any 90-day period has become more challenging in this environment. Our guidance assumes that new business will take longer to close over the remainder of the fiscal year in view of the macro. As a result, we are assuming a slightly lower close rate in Q4 compared to Q3. We will continue to balance growth and profitability. In our outlook for Q4, we intend to deliver operating margin expansion of more than 400 basis points year over year.

With that in mind, let me provide our guidance for Q4 and fiscal 23. As a reminder, these numbers are all non-GAAP. For the fourth quarter of fiscal 2023:

- We expect revenue in the range of $429 million to $431 million, reflecting a year-over-year growth of 35% to 36%.
- Gross margins of approximately 80%. I would like to remind investors that a number of our emerging products, including ZDX and Zscaler for Workloads, will initially have lower gross margins than our core products. We are currently managing the emerging products for time-to-market and growth, not optimizing them for gross margins. In addition, we will continue to invest in our cloud infrastructure, as we scale with the growing demand.
- Operating profit in the range of $69 million to $70 million.
- Net other income of $13 million
- Income taxes of $6 million
- Earnings per share of approximately $0.49, assuming 157 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.

For the full year fiscal 2023:

- We expect revenue in the range of $1.591 billion to $1.593 billion or year-over-year growth of approximately 46%.
- Calculated billings in the range of $1.974 billion to $1.978 billion or year-over-year growth of 33% to 34%.
- Operating profit in the range of $224 million to $225 million. Our guidance reflects approximately 400 basis points of operating margin improvement compared to last year.
- Income taxes of $21 million.
- Earnings per share in the range of $1.63 to $1.64, assuming approximately 156 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.

We remain confident in our ability to capture our large market opportunity while increasing profitability. We will balance growth and profitability based on how our business is growing. 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 to deliver on our operating profit and margin goals. With a large market opportunity and customers increasingly adopting the broader platform, we'll continue to make disciplined investments to position us for long-term growth.