Zscaler Q3 2024 Earnings Call – May 30, 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 fourth 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 January 31, 2024, filed on March 6, 2024, 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

We delivered an outstanding quarter with all metrics exceeding our guidance, and I'm very pleased to increase our full year guidance, based on our strong performance. Revenue in Q3 grew by 32% year-over-year, and billings grew by 30%. Our $1 million-plus ARR customers increased 31% year-over-year to 523, and we ended the quarter with over 50 customers with $5 million-plus in ARR. Our disciplined approach to growth is reflected in our operating profit, which nearly doubled year-over-year, and our operating margin reached a record 22%. I am also pleased to report that we had our first quarter of GAAP profitability on a net income basis for Q3.

Our strong performance was driven by continued demand for our Zero Trust Exchange platform, which we purpose built to secure communication among users, workloads, and devices. We expect demand to remain strong as an increasing number of enterprises are planning to adopt our platform for better cyber and data protection. Zero Trust security remains a top initiative for IT teams, as legacy castle-and-moat, firewall-based security is ineffective in the new world of cloud and AI. Our Zero Trust Exchange, processing over 400 billion transactions and preventing billions of security and policy violations per day, provides superior security to our customers. For example, last calendar year, our platform prevented over 2 billion phishing attempts, up 60% year-over-year.

The cyber and data protection capabilities of our platform are resonating with customers, and we are accelerating the expansion of our core platform with innovations across multiple pillars.
- We recently introduced the industry's first AI-powered Co-pilot for ZDX, our digital experience monitoring solution. This helps simplify and automate detection and resolution of performance issues.
- We added two significant products to our Data Protection pillar: 1) Data Security Posture Management, or DSPM, to discover, classify, and protect sensitive data in public clouds, and 2) GenAI App Security to provide deep visibility and granular controls for GenAI apps.
- We introduced Zero Trust Network Segmentation, which expands our platform to local area networks inside branches, campuses, and factories.
- We expanded our AI Cloud solutions by introducing Unified Vulnerability Management to enable customers to proactively identify critical vulnerabilities.

We will continue our rapid platform expansion with organic innovations, as well as strategic acquisitions. We recently acquired two early-stage innovators - Avalor and Airgap Networks. Avalor's Data Fabric ingests, normalizes, and unifies data across enterprise security and business systems, to dynamically prioritize vulnerabilities based on holistic risk. This innovative Data Fabric will combine data from our 400 billion daily transactions with over 150 third party data sources to add various contexts to provide better understanding of risk for timely mitigation. As a result, customers can get real-time actionable insights and operational efficiencies, improving their overall security posture.

For securing customer branches, campuses, and factories, we continue to innovate. Our Zero Trust Branch solution, released last year, enables each branch office, campus, and factory to be treated like a Starbucks, which means there is no lateral threat movement, as the branches are not on the corporate network, and there is no need for firewalls, as branches are no longer exposed to the internet. With the Airgap acquisition, we are taking branch security to the next level, as we are introducing the industry-first Zero Trust segmentation inside branches, campuses, and factories for servers and IoT/OT devices. This eliminates the need for legacy firewall-based segmentation for east-west traffic.

We talked about our $72 billion market opportunity in the past. Our recent acquisitions and other innovations increase our market opportunity by several billion dollars, as they extend our platform into new adjacent markets, including vulnerability management, security operations, and branch security.

Moving on to our AI innovations, we are developing multiple AI-powered applications, including Risk360, Business Insights, Unified Vulnerability Management, and more. We are training our AI security models with the vast amounts of data generated by over 400 billion daily transactions on our platform to deliver superior threat detection. We are leveraging AI to automatically classify data and enforce policies for better data loss prevention. We have delivered GenAI App Security to enable secure use of AI apps by our customers. Our GenAI App Security delivers: 1) visibility into the AI services used by employees, 2) policy control, which allows different user groups to access only approved AI services from the thousands of such services, and 3) enforcement of data protection policies, to prevent sensitive data from leaking to public AI services.

We will be showcasing these and other innovations that combine the power of Zero Trust with AI at our Zenith Live user conference in June.

Organizations are relying on Zscaler to continue to innovate as threat actors are evolving and posing new challenges by frequently exploiting firewall- and VPN-based security architecture. Recently, hackers exploited a zero-day vulnerability of a leading next gen firewall and a vulnerability of a leading VPN. Such exploits put organizations at risk, as attackers can move laterally on the flat networks created by legacy firewalls. These shortfalls in legacy security will continue to be exploited until enterprises embrace Zero Trust architecture and phase out firewalls and VPNs.

Zscaler's Zero Trust architecture eliminates lateral threat movement, which dramatically improves security posture of organizations. Our differentiated Zero Trust and proxy-based architecture is foundational to delivering superior security. Let me give you a few examples.

After experiencing a catastrophic cyberattack last year, a large financial services new logo customer purchased our ZIA, Data Protection, and ZDX pillars for 25,000 users in a 7-figure ACV, multi-year deal. This customer wanted Zero Trust architecture, and hence excluded their current firewall vendors from consideration. Our superior architecture and strong data protection capabilities were key to winning this deal, as the customer said: Zscaler's CASB, EDM & OCR technologies are amazing. Zscaler just works.

In another example, an existing global manufacturing customer, after learning about a major VPN vulnerability, rolled out Zscaler to 100,000 devices in just 3 days. Subsequently, the customer increased their purchase of Zscaler for Users, including ZIA, ZPA, ZDX, and Data Protection in a 7-figure ACV deal, increasing their ARR by over $5 million. This customer also made an initial purchase of Zero Trust for Branch and our advanced Privileged Remote Access solution, which speaks to the customers' growing interest in our broader platform.

Customers are also purchasing more of our platform to eliminate legacy tech debt and consolidate multiple point products, while simplifying IT operations and improving user experience. Let me highlight two upsell deals that illustrate this.

After making an initial purchase last year, a Global 100 Financial Services customer significantly expanded the purchase of Zscaler for Users in a 7-figure ACV deal for over 64,000 users. Despite having years of relationships with their legacy firewall security vendor, they chose Zscaler. This customer is consolidating multiple point

products, including Secure Web Gateway, VPN, and VDI. We worked closely with one of our GSI partners on this large project. This deal is an example of us working with GSI partners to expand our market opportunity.

In another upsell win, a large APJ-based financial services customer signed a 7-figure ACV multi-year deal for 10,000 users, buying most of our platform services. In addition to expanding their purchase of Zscaler for Users, they purchased our Zero Trust for Workloads, Zero Trust for Branch, and AI Cloud solutions. Our emerging products contributed nearly a third of the ACV value of the deal.

I'm very pleased to share that we are seeing strong customer interest in our emerging products, which contributed nearly a quarter of our new and upsell business this quarter. Here are a few examples.

In an 8-figure ACV deal, a Fortune 500 technology customer expanded their purchase of Zscaler for Users, and made their first purchase of Zero Trust for Workloads, and our AI Cloud solutions. With this purchase, the customer's total ARR increased over 5x to more than $10 million. This was also our largest workload protection deal to date, representing 7-figures in ACV. I'm thrilled to see our recent innovations in workload protection receiving increased traction.

We closed several deals for our AI Cloud solutions, including Risk360 and Business Insights, with customers across multiple verticals, including broadcasting, consulting, insurance and many more. CISOs get inundated with lots of security alerts and signals that don't help them take specific actions based on risk. Customers are buying Risk360 as it provides them with the overall risk score of their organizations, the factors contributing to risk, and actionable recommendations to reduce risk.

For Zero Trust Branch, one of the largest retailers in Europe, who initially adopted ZIA, ZDX, and Data Protection last year, expanded their deployment in a 7-figure upsell deal to include the full suite of Zscaler for Users and Zero Trust SD-WAN. Zero Trust SD-WAN, which will be deployed at their regional locations, contributed about a quarter of the ACV value of this deal.

Next, in the federal vertical, we are proud to be serving 12 of the 15 cabinet level agencies, and we continue to pursue new and upsell business opportunities across the federal market to help them adopt Zero Trust architecture, as mandated by the President's Executive Order. To give an example, in a 7-figure upsell win, an existing cabinet level agency increased their purchase of ZIA and ZPA by over 50%, significantly increasing the ARR of this already $10 million-plus customer.

Next, let me give you an update of our progress in the Department of Defense, or DoD, segment. DoD has a requirement to implement Zero Trust with the technologies and solutions that work best for individual military services and departments. I'm thrilled to share that we signed a 7-figure ACV deal with a DoD branch this quarter. In this land deal, the customer made an initial purchase of Zscaler for Users to protect 50,000 users. With our proven Zero Trust architecture, this latest DoD deal demonstrates that we are well positioned to capture the large cyber security opportunity at the DoD.

Next, let me give you an update on our go-to-market organization, where we continue to make great progress.

First, to capture the strong demand for our platform and to scale our business to $5 billion in ARR and beyond, we appointed Mike Rich as our Chief Revenue Officer in Q2. Mike hired key leaders in Q3, and he now has his full management team in place. The quality and caliber of Mike's leadership team is exceptional. I'm very pleased with the progress of our sales hiring, particularly at the leadership level. With the right leaders in place, we are now focused on increasing the pace of hiring quota-carrying reps.

Second, as I mentioned last quarter, we are evolving our sales motion from opportunity-centric to account-centric. The 8-figure ACV deal with a Fortune 500 technology company that I called out earlier is an example of the success of this new sales motion. We engaged closely with this customer to recommend the best solution for now and the future. We look forward to working with them as they are fully embracing digital transformation and Zero Trust security.

In conclusion, we are on a mission to take our platform everywhere, so customers can benefit from better security, simplified IT operations, and improved user productivity. We are one of the few vendors that deliver tangible cost savings, as we eliminate multiple legacy point products. The last three decades of the security industry have been centered around firewalls, which are no longer effective in today's cloud, mobile, and AI world. I believe the next three decades will be defined by Zero Trust architecture. We have the right platform and the right team to delight our customers and capture our large and growing market opportunity. I am excited about the journey ahead and look forward to sharing at Zenith Live how Zscaler is combining the power of Zero Trust with AI to power the future of secure digital transformation.

CFO Commentary

Our Q3 results exceeded our guidance on growth and profitability, even with ongoing customer scrutiny of large deals, the changes in our sales organization, and higher than expected sales attrition in the quarter. Revenue was $553 million, up 32% year-over-year and up 5% sequentially. From a geographic perspective, Americas represented 54% of revenue, EMEA was 31%, and APJ was 15%.

Our total calculated billings in Q3 grew 30% year-over-year and remained flat sequentially at $628 million. Our calculated current billings grew 29% year-over-year. Our remaining performance obligations, or RPO, grew 27% from a year ago to $3.824 billion. Current RPO was approximately 51% of the total RPO.

We ended Q3 with 523 customers with greater than $1 million in ARR, and 2,922 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 116%. 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 Q3 financial performance, total gross margin of 81.4% compares to 80.8% in the prior quarter and 80.2% 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 in 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 2% sequentially and 21% year-over-year to $328 million. We continue to generate significant leverage in our financial model, with operating margin reaching 22%, an increase of approximately 680 basis points year-over-year. Our free cash flow margin was 22%, including data center CapEx of approximately 6% of revenue. We ended the quarter with over $2.2 billion in cash, cash equivalents and short-term investments.

Moving on to guidance for Q4 and full year fiscal 2024. As a reminder, these numbers are all non-GAAP.

For the fourth quarter:
- We expect revenue in the range of $565 million to $567 million, reflecting a year-over-year growth of 24% to 25%.
- Gross margins of 80%.
- Operating profit in the range of $107 million to $109 million.
- Net other income of $17 million.
- Income taxes of $11 million.
- Earnings per share in the range of $0.69 to $0.70, assuming 165 million fully diluted shares.

For the full year fiscal 2024, we're increasing our guidance as follows:
- Revenue in the range of $2.140 billion to $2.142 billion, reflecting a year-over-year growth of approximately 32%.
- Calculated billings in the range of $2.603 billion to $2.606 billion or year-over-year growth of approximately 28%.

- Operating profit in the range of $422 million to $424 million, which reflects up to 490 basis points of operating margin improvement compared to last year.
- Income taxes of approximately $32 million.
- Earnings per share in the range of $2.99 to $3.01, assuming approximately 161 million fully diluted shares. We expect our free cash flow margin to be in the low-to-mid 20% range.

We will give specific Fiscal 25 guidance on the next earnings call, but I would like to mention that the increased spend on data center CapEx which we had originally planned for Fiscal 24 is now planned for Fiscal 25.

Q3 was a transitional quarter for our go-to-market team, and I believe we did an outstanding job navigating through it. Although our attrition was higher than we expected, as Jay mentioned we had a strong quarter hiring, particularly at the sales leadership level. We are now focused on increasing the pace of hiring quota-carrying reps. We believe the combination of our existing sales team with these new hires will result in a much stronger go-to-market organization. That said new hires will take time to ramp to full productivity, which we believe will result in a few points of headwind to our total billings growth in Fiscal 25.

With our customer obsession, expanding platform, and strengthening sales teams, we are well positioned to continue to gain share in a large and growing market for us.