Zscaler Q1 2022 Earnings Call – November 30, 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 second 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

Building on our incredible momentum from last year, we had an exceptionally strong start to fiscal 22. In Q1, we delivered 62% revenue growth and 71% billings growth, while generating record operating profits and free cash flow. We are again seeing strong revenue growth across all verticals, customer segments and geographies, with over half of our revenue coming from outside the U.S. We recently achieved a significant milestone of surpassing $1 billion in annual recurring revenue, while continuing rapid growth.

In my recent dialogues with 100s of CISOs and CIOs, 8 out 10 are looking to phase out legacy network security in favor of zero trust architecture, due to increasing cybersecurity risks and accelerating digital transformation initiatives. I'll highlight two main reasons why enterprises are selecting Zscaler over legacy solutions:

1. We saw a more than 300 percent year-over-year increase in sophisticated threats hidden in SSL-encrypted traffic. A large number of them are ransomware attacks and most would bypass next-gen firewalls, which aren't designed to inspect encrypted traffic at scale. We are the only cloud provider with a proxy architecture designed to inspect SSL-encrypted traffic at scale to deliver better security. This year, our cloud has blocked more than 20 billion threats hidden in encrypted traffic.
2. By connecting users only to applications, and not to the network—a core principle of zero trust architecture—we eliminate lateral threat movement, hence reducing ransomware attacks such as the Colonial Pipeline breach. In contrast, firewalls and VPNs connect users to the network, enabling lateral threat movement. It is clear from our growth and enterprise wins that architecture matters and Zero Trust security can't be built on legacy network security architecture. This gives us long term advantage.

Turning to the quarter, let me discuss 2 factors that drove our performance:

1. We saw continued strength in new and upsell bookings of over $1 million in annual value. We drove 87% year-over-year growth in customers exceeding $1 million in ARR, ending with over 220 of these customers.
2. The expansion down-market to Enterprise segment, organizations with 2,000 to 6,000 employees, is scaling and it remains our fastest growing segment. With increasing contribution from the Enterprise segment, the total number of customers who pay us more than $100,000 per year is up 53% year over year to over 1,600.

Our 71% billings growth this quarter speaks to the commitment that customers are making to our Zero Trust Exchange platform. As we have noted before, the purchase of ZIA is often the first step to adopting our platform. Let me share a couple of ZIA-driven deals.

- A Fortune 50 insurance company purchased ZIA transformation bundle with cloud firewall and sandbox plus DLP and CASB for data protection to secure 170,000 employees and affiliated agents working from anywhere. This customer wanted secure and fast access to Internet and SaaS applications, particularly Microsoft 365 and Teams. Connecting to Zscaler's nearest edge cloud where we have direct peering with 100's of application providers, their users are seeing a 75% improvement in response time.
- Next, a leading defense industry integrator purchased ZIA for 200,000 users, plus workload protection for internet traffic. Our ZIA platform – which recently achieved FedRAMP High Ready status – will help them meet many requirements for CMMC, a cybersecurity standard for defense contractors. Zscaler is consolidating their several point products, simplifying the network, enforcing consistent cyber policy across multiple business units while reducing operational costs.

We believe these large deals show that we are the only multi-tenant, zero trust platform meeting the needs of major enterprises to transform their legacy hub-and-spoke network and castle-and-moat security.

With customers shifting to the cloud, more 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 public cloud. Here are a few examples:

- A Fortune 500 banking customer signed a 4-year commitment for three key pillars of our platform. Their existing ZIA contract was upgraded to include cloud firewall, sandbox, DLP, CASB and browser isolation. They also purchased ZPA for all 100,000 employees to implement app segmentation without having to implement legacy network segmentation. In addition, ZDX was purchased to identify and help remediate application, network or end-point issues to ensure great user experience and employee productivity regardless of their location. This deal more than tripled the customer's annual spend with us. Having adopted our full portfolio for user protection, we are now discussing zero trust security for workloads with this customer.
- Next, in a new logo win, a Fortune 100 insurance customer purchased ZIA Transformation bundle and ZPA for all 30,000 employees to pursue their cloud-first strategy. With cyber protection as a major requirement, this customer only considered a proxy architecture to perform SSL inspection at scale and rejected firewall-based architectures. ZPA will eliminate their attack surface, hiding their thousands of private applications behind our Zero Trust Exchange, hence they can't be discovered, exploited or DDoS'd. We are consolidating at least 3 vendor point products, materially reducing complexity and operating cost. Our integration with CrowdStrike and Microsoft was also an important consideration for them.
- Next, one of the powerful use cases for ZIA and ZPA is to accelerate M&A integration with significant ROI. An existing European based Global 500 manufacturing customer purchased ZIA Transformation bundle for 30,000 employees of the newly acquired business, and ZPA for 50,000 users to accelerate the M&A integration. The legacy approach to providing access to private applications post acquisition requires integrating two complex corporate networks, which they expected to take 18 months or more. Without having to connect two corporate networks, Zscaler's approach provided secure access to SaaS or private applications across both companies in weeks, saving time and money.

After having disrupted perimeter-based security for users with our Zero Trust Exchange, we are bringing zero trust to workloads with Zscaler Cloud Protection. Let me highlight a few ZCP wins:

- An existing ZIA and ZPA State government customer purchased Workload Segmentation for over 4,500 workloads, along with ZDX and CASB for their 28,000 employees. This was a seven-figure annual contract value driven by our Emerging Products. Implementing Zero Trust for workloads will reduce their cyber risk by achieving micro-segmentation without doing legacy network segmentation.
- Moving on to our Workload Posture offering, we are seeing increased interest from customers in CSPM for configurations and CIEM for entitlements. During the quarter, a tech company bought CSPM for over 9,000 workloads and a software enterprise bought CIEM for 5,000 workloads.
- Our Workload Communication offerings, powered by ZIA and ZPA technology, is building momentum with additional customer wins in the quarter. For example, a healthcare customer purchased workload communication for 3,500 workloads and a Financial Services customer purchased it for 1,000 workloads.

When you look at these wins, our success starts with true zero trust architecture which is the opposite of firewalls and VPNs: our Zero Trust Exchange is the largest in-line cloud security platform in the world, processing over 200 billion transactions per day, which doubled in the last 18 months, and is preventing more than 7 billion security and policy violations per day. This massive amount of traffic provides us 300 trillion signals per day to feed our machine learning and AI engines, resulting in superior threat protection, and better detection of user and application traffic anomalies. This network effect is a big competitive advantage for us. Each of our 150-plus data centers receives a continuous stream of more than 200,000 unique security updates every day. This can't be done with a single-tenant VM-based architecture that legacy security vendors are running on public clouds and calling SASE; this is only possible with the purpose-built, highly scalable cloud that Zscaler built from day one.

I am very proud of our pace of innovation that delivers value to our customers. Let me share a few stats for the quarter:

- ZIA delivered 29 agile releases and ZPA delivered 44 agile releases. Each product pillar delivered scores of new features and enhancements.
- Our ThreatLabz security research team discovered and delivered over 495,000 new advanced threat indicators and signatures to our global cloud. In addition, our cutting-edge security research scientists discovered and reported 18 new zero-day vulnerabilities. These are testimonials of the sophistication and scale of our research team. A great platform combined with a great research team, enables us to deliver great cyber protection to our customers.

Let me highlight some of the significant features we delivered in Q1:

- We enhanced out-of-band CASB to support additional SaaS applications. We see more customers buying our CASB along with ZIA and replacing their existing CASB point product.
- We added optical character recognition technology to our DLP offering, addressing data loss problem for images in files like PDFs. This feature, combined with previously released Exact Data Match and Indexed Data Match technology, makes us the leading data protection platform.
- We integrated our recently acquired Smokescreen active defense technology with ZPA, making it easier for customers to deploy and manage it from a single console.
- The pace of innovation for our newer pillars like ZDX and ZCP is accelerating. For example, one of the most demanded ZDX features is real-time performance monitoring for Zoom and Microsoft Teams, which we delivered by working closely with Zoom and Microsoft through API-integration. We added over 150 features to ZDX in the past 12 months, delighting our customers. One customer said, and I quote, "We now have unprecedented visibility into the environment. We can respond faster and forecast where we may have issues and address those areas before they become a problem."

I want to highlight another increasingly important area – helping our customers achieve their ESG goals. Our highly efficient cloud replaces hundreds of thousands of on-prem appliances and eliminates the need to buy more in the future, resulting in the significant decrease in the energy, resources and carbon emissions associated with building, transporting, powering and cooling them. As you may have seen from a recent press release, our cloud platform now uses 100% renewable energy. As part of this effort, we have a cross-functional team with oversight from the Board to drive our sustainability strategy.

Zscaler has never been stronger, and I believe we have an incredible opportunity in front of us. We have our sights set on the next milestone: growing our ARR to $5 billion. I believe the key to sustained growth in our next stage is to accelerate the broader adoption of our platform.

- Our Zero Trust Exchange platform, with four major pillars, provides a comprehensive foundation for securing and improving application access in the world of cloud and mobility. With ZIA and ZPA, we have proven our success implementing zero trust for users. Our next immediate opportunity is to bring zero trust to workloads, powered by the same core ZIA and ZPA technology. As we shared in our deal highlights, we're seeing solid traction with ZDX and ZCP, the newest growth vectors for the company.

- We are seeing increasing average revenue per customer, and we estimate a 6x growth opportunity on upsell with our current customers. From presales to deployment and customer success, we have a sophisticated sales machine to sell value and deliver measurable outcomes at the CXO level.
- Over the next several years, our innovation engine will further build out the breadth and depth of our platform, extending our already substantial technology lead. We are also pursuing some very exciting opportunities to extend zero trust to operational technology or OT systems, with manufacturing leaders like Siemens.

In summary, we are very excited about our future, and we believe we are still in the early innings of a significant market opportunity to accelerate secure digital transformation.

CFO Commentary

We are pleased with the results for the first quarter of fiscal 2022. Revenue for the quarter was $231 million, up 17% sequentially and 62% year-over-year. On a year-over-year basis, revenue growth accelerated in the quarter driven by strong business activity. ZPA product revenue was 16% 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%. Our investments in APJ are bearing fruit with greater than 100% revenue growth in that region.

Our total calculated billings grew 71% year-over-year to $248 million, with billings duration at the high end of our 10-14 months range. We had several customers choosing to pay upfront for their multi-year contracts; as a reminder, our contract terms are typically one to three years and we do not offer any special incentives for upfront payments. We are also pleased to report 68% year-over-year growth in short-term billings. I would note that both billings and revenue benefited from a $1.5 million one-off deal in the quarter. Remaining performance obligations, or RPO, were $1.71 billion as of October 31st, up 97% from one year ago. The current RPO is 50% of the total RPO.

Our strong customer retention and ability to upsell the broader platform have resulted in a high dollar-based net retention rate, which was above 125% in the quarter and higher than the 128% we reported last quarter. As we have discussed before, this metric will vary quarter-to-quarter and it is not a metric we manage our business towards. We focus on growing our net new business without incentivizing differently between new or upsell. We have a strong base of large and growing enterprise customers, which provides us with a significant opportunity to upsell our broader platform. Considering these factors, we believe NRR above 125% is truly outstanding for us.

We had 224 customers paying us more than $1 million annually, up 87% from 120 in the prior year. The continued strength in this metric speaks to the strategic role we play in our customers' digital transformation initiatives. We also added over 550 customers paying us more than $100,000 annually, ending the quarter at 1,616 such customers.

Turning to the rest of our Q1 financial performance, total gross margin of 80.6% was approximately flat quarter over quarter and down 50 basis points year over year. Our total operating expenses increased 17% sequentially and 69% year-over-year to $162 million. Operating expenses as a percentage of revenue increased by approximately 3 percentage points from 67% a year ago to 70% in the quarter primarily due to increased hiring, higher compensation expenses, investments in SmokeScreen and Trustdome businesses we acquired in second half of last year, and a partial return of T&E. Operating margin was 10% and Free cash flow margin was 36%, which benefited from the timing of capex spend. We continue to expect capex as percent of revenue to be high-single digits for the full year. We ended the quarter with over $1.58 billion in cash, cash equivalents, and short-term investments.

Please note that Net Other Income includes an $800,000 loss primarily related to the change in value of our assets denominated in Euro and British Pound as the US dollar strengthened. To minimize such impact going forward, we recently implemented a hedging program for our balance sheet. As a reminder, we primarily transact sales globally in US dollars, and several quarters ago, we put in place a hedging program for our international operating expenses.

For income taxes, our tax expenses primarily represent international taxes paid to foreign jurisdictions we do business in. For several APJ countries, there is a withholding tax on sales made to customers in those countries. As our APJ business has grown significantly in recent quarters, the withholding taxes were $1.5 million in Q1.

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 second quarter of fiscal 2022, we expect:

- Revenue in the range of $240 million to $242 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 $20 million to $21 million
- Net loss on other income of $100 thousand
- Income taxes of $4 million.
- Earnings per share of approximately $0.11, assuming 150 million fully diluted shares.

For the full-year fiscal 2022 we are:

- Increasing our revenue to a range of $1.00 billion to $1.01 billion or year-over-year growth of 49% to 50%.
- Increasing calculated billings to a range of $1.300 billion to $1.305 billion or year-over-year growth of 39% to 40%. We now expect our first half mix to be approximately 43% to 44% of our full year billings.
- Increasing our operating profit to a range of $90 million to $93 million. Based on the return of in-person conferences and events, we expect operating margin to decline sequentially in Q3 before improving in Q4.
- Updating our earnings per share to a range of $0.50 to $0.52 assuming approximately 150 to 151 million fully diluted shares. Please note that our share count guidance now includes dilution from our convertible debentures.

With a large market opportunity and customers increasingly adopting the broader platform, we are committed to investing aggressively in our company. 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.