Zscaler Q3 2021 Earnings Call – May 25, 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 fourth quarter of fiscal 2021 and full year fiscal 2021. 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, 2020 filed on September 17, 2020, 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

As you saw in our earnings release, we delivered outstanding results for the third quarter, with accelerating growth at scale while increasing adoption of our broader platform. We drove 60% growth in revenue and 71% growth in billings. We also generated strong growth in operating profits and delivered record free cash flow. Enterprises are looking to Zscaler to secure their digital transformation and architect for the work-from-anywhere economy, which we believe is the new normal. Our results exceeded our expectations, and we are again increasing our guidance for fiscal 21.

Our business is firing on all cylinders: our superior architecture and optimized go-to-market engine is elevating us above the competitive noise. Our Zero Trust Exchange platform connects users, devices and applications, which is fundamentally different from firewall-based castle-and-moat security. Our platform prevents lateral threat movement and eliminates the attack surface by making applications invisible from the internet, hence reducing business risk. Furthermore, our proxy architecture, designed to inspect SSL-encrypted traffic, blocks sophisticated threats and prevents loss of sensitive data. Faced with the latest news-making ransomware and other cyberattacks, CISOs and CIOs are turning to Zscaler to dramatically improve their security posture while reducing their legacy IT costs.

As you have heard me say before, architecture matters. Zscaler purpose-built the right high-performance, multi-tenant proxy architecture from day one, whereas many vendors are trying to retrofit their existing solutions, which inevitably fails. Built from the start to enforce policy at the edge, as advocated by SASE framework, we are deployed across 150 data centers with 5-9's of availability. We are processing more than 160 billion transactions daily, preventing up to 7 billion security incidents and policy violations. This unmatched network effect provides better security and user experience.

Let me highlight 3 factors that drove our strong performance in the quarter:

1) First, building on our strength with large enterprises, we closed a record number of seven-figure ACV deals across a broad range of industries. Most of these wins are 3-year commitments to provide our customers the foundation for application, network and security transformation.
2) Second, an increasing share of our sales is coming from broader platform purchases by new and existing customers. Strong platform upsells drove our 126% dollar-based net retention rate in the quarter. Our newer solutions like out-of-band CASB, Zscaler Digital Experience or ZDX and Zscaler Cloud Protection or ZCP, are increasingly contributing to our wins. The breadth and depth of our platform is resonating with customers, and I believe Zscaler is the go-to platform for vendor consolidation, cost savings, increased user productivity and better cyber protection.
3) Third, our strategic decision last year to increase our investments in go-to-market is yielding fantastic results. I am very pleased with our performance and momentum across all geos, all market segments and all products. Earlier this year, we expanded our investment in the enterprise segment, which consists of organizations with 2,000 to 6,000 employees. This quarter, we saw a higher mix of new business from this segment.

Now let me highlight key wins in the quarter, starting with ZIA.

- Because of the pandemic, a Global 500 technology company in Asia was routing internet traffic of their employees working from home over VPN through the corporate data center. This created a poor user experience for SaaS applications like Office 365 and overwhelmed their security appliances. To power their workplace modernization initiative for their 80,000 employees, the customer purchased ZIA Transformation Edition including SSL inspection, cloud firewall, and sandboxing as well as ZDX. ZDX improves productivity by identifying and helping resolve user performance issues over the entire cloud network path, in real-time before users complain.

- In another new logo win, a global business services company facing challenges supporting work-from-anywhere purchased our Business Edition plus cloud firewall, CASB, DLP and ZDX for all 46,000 employees to directly access SaaS applications to reduce business risk and improve user experience. In addition, they replaced their legacy VPN with ZPA to provide zero trust access to private applications for their 29,000 call center employees. With the purchase of 3 of our 4 platform pillars, this customer is accelerating their digital transformation from a 5-year goal into a 6-month reality.

Next, let me share two significant deals that show our growing momentum in the financial services vertical and our increasing success working with our tech partners:

- A top tier global investment bank is pursuing a zero-trust strategy by rebuilding its security architecture for the modern, hybrid work environment. They purchased our ZIA Business Edition plus DLP, cloud sandbox and ZDX for 50,000 users. With security as a major requirement, only a proxy architecture with SSL inspection at scale was considered. Our 10-year track record of running a massive, highly reliable and available inline security cloud made us the best choice. Taking advantage of the breadth of our platform, this customer also started limited deployments of additional products, including browser isolation, CASB, workload segmentation and ZPA. This deal is a great example of the successful field sales collaboration between Zscaler and our tech partner CrowdStrike.
- In another financial services win, a multi-national company embracing cloud transformation purchased the entire ZIA portfolio including CASB, advanced DLP and CSPM for Microsoft Office 365, plus ZDX for 30,000 employees. Like the prior deal, this customer only considered a proxy architecture and firewall architectures were disqualified. Their Zscaler platform purchase consolidated 4 vendors, streamlined their operations and reduced IT costs. This is another great example of field sales engagement with another important tech partner, in this case, Microsoft.

As these new customer wins show, the attach rate of our data protection products—including DLP, out-of-band CASB, browser isolation and CSPM for SaaS—is growing.

- Now, let me discuss an upsell deal that was primarily driven by data protection. An existing Global 200 pharma customer with headquarters in Europe purchased CASB, advanced DLP and Sandbox for all 79,000 employees to up-level their security. We displaced the incumbent out-of-band CASB point product, a trend we are increasingly seeing as customers are standardizing on Zscaler's integrated platform. In addition, to access private applications, they bought 3,000 ZPA seats, the first step to eliminate their legacy VPN. This latest purchase was a seven-figure ACV deal, which doubled the customer's ARR.

As we look forward to a post-pandemic world, in which employees unwittingly bring infected laptops back to the office, organizations need a true zero-trust platform to eliminate the risk of lateral threat movement. Secondly, we're also seeing SD-WAN projects restarting, with companies moving to direct-to-cloud architecture from their legacy hub-and-spoke network and castle-and-moat security.

- In the quarter, an existing Global 200 manufacturing customer with headquarters in Europe upgraded their 120,000-user subscription from Business to Transformation bundle to secure local breakouts at their 1,000 locations worldwide, some with SD-WAN and some without SD-WAN. The Transformation bundle added cloud sandbox and cloud firewall, which doubled this customer's ARR.
- And finally, I'll highlight an upsell win with a global pharma company that previously purchased the Transformation bundle and ZPA for 15,000 users. Their SD-WAN deployment was delayed last year, and now they are accelerating their network and application transformation with a 5-year commitment to Zscaler. This quarter, they purchased an additional 50,000 ZIA and ZPA seats to cover all 65,000 employees, while also adding DLP for all users. They also purchased our new ZPA Private Service Edge,

to enable zero trust access for their employees returning to the office. This demonstrates customers are implementing ZPA for all employees, not just for remote users.

In addition to our ongoing success in protecting users, our next big opportunity is protecting workloads with Zscaler Cloud Protection. We are rapidly expanding our ZCP portfolio, through organic innovation and targeted acquisitions. Let me highlight our recent M&A activity.

- As announced last month, we acquired Trustdome, a leading provider of cloud infrastructure and entitlement management or CIEM, to complement our CSPM solution. CIEM and CSPM together, properly integrated, can correlate identity information with configuration data and enforce least privileged access for cloud environments, hence reducing business risk. This further expands our market opportunity for workload security.
- In addition, today, we announced a definitive agreement to acquire Smokescreen Technologies, which provides us with a deception technology to detect active attacks and lateral threat movement. We plan to integrate Smokescreen with our ZIA and ZPA solutions to enhance our active defense capabilities.

You will hear more about these solutions at our Zenith Live Cloud Summit next month.

As we look forward to the next few years, we are focused on driving broader adoption of our four platform pillars, which together maximize the success of digital transformation. Our core ZIA and ZPA business has never been stronger. And we're excited about the early traction of ZDX and ZCP, the next growth engines for the company.

Now I will highlight three points about our go-to-market machine which is scaling very well.

- Our field organization continues to scale and is executing on all cylinders.
- Moving to our partners. As I mentioned in our deal wins, we have strong and growing technology partnerships. In addition to incremental product integrations, we continue to grow our go-to-market partnership with CrowdStrike, who also became a customer this quarter. I am proud that Zscaler was named the Zero Trust Champion at Microsoft's 20/20 Partner Awards. Further expanding our technology relationships, we recently partnered with IBM to add Zscaler services to their zero trust security offerings. This partnership includes integrating with their identity, MDM and SIEM solutions, and joint go-to-market initiatives. On the channel front, we are expanding our Summit Partner program and adding VARs that are building cloud transformation practices. Our service provider relationships are strong and we're building joint engagements with system integrators.
- On the marketing front, we are aggressively investing in thought leadership for Zero Trust security and expanding demand generation programs.

In summary, we are making tremendous progress across all three areas – sales organization, marketing and channel partners – and delivering strong results quarter after quarter. I believe we are on track to capture a material share of our $72 billion serviceable market.

CFO Commentary

Thank you, Jay. As Jay mentioned, we are pleased with the results for the third quarter of 2021. Revenue for the quarter was $176.4 million, up 12% sequentially and 60% year-over-year. 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 38% and APJ was 11%.

Turning to calculated billings, which we define as the change in deferred revenue for the quarter plus total revenue recognized in that quarter. Billings grew 71% year-over-year to $225 million, with billing duration towards the upper-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. With that in mind, we are also pleased that short-term billings, which are calculated based on the change in short-term deferred revenue plus reported revenue for the period, grew 61% over the prior year.

Remaining performance obligations, or RPO, which represent our total committed non-cancelable future revenue, were $1.2 billion as of April 30th. RPO grew 85% from one year ago. The current RPO is 51% of the total RPO.

Our strong customer retention and ability to upsell the broader platform have resulted in a consistently high dollar-based net retention rate, which was 126% compared to 127% last quarter and 119% a year ago. As we have highlighted, this metric will vary quarter-to-quarter. 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. Considering these factors, we feel that 126% is outstanding.

Total gross margin of 81% was flat quarter over quarter and improved by 1 percentage point year over year. As a reminder, gross margins in the second half of last fiscal year were pressured by the augmented use of public cloud to meet the 10x surge in ZPA traffic as pandemic lockdowns began.

Turning to operating expenses. Our total operating expenses increased 6% sequentially and 53% year-over-year to $119.7 million. Operating expenses as a percentage of revenue declined by 3 percentage points from 71% a year ago to 68% in the quarter primarily due to lower T&E, which was partially offset by increased hiring and M&A expenses.

- Sales and marketing expense increased 6% sequentially and 56% year-over-year to $80.9 million. The year-over-year increase was due to higher compensation expenses and investments in building our teams and go-to-market initiatives.
- R&D expenses increased 8% sequentially and 55% year-over-year to $25.9 million. The increase is primarily due to continued investments in our engineering teams.
- G&A expenses increased 4% sequentially and 33% year-over-year to $12.9 million. The growth in G&A includes investments in building our teams, compensation-related expenses and professional fees.

Our third quarter operating margin was 13% compared to 9% in the same quarter last year, and T&E spending had a positive 270 basis point benefit. Operating margin was better than our guidance range due to stronger than expected performance in the business and due to timing of certain sales and marketing spend. Net income in the quarter was $21.4 million or a non-GAAP earnings per share of $0.15. We ended the quarter with over $1.4 billion in cash, cash equivalents, and short-term investments. Free cash flow was positive $56 million in the quarter, which compares to $9 million during the same quarter last year. This increase was driven by our strong billings growth, receivables collection and operating performance.

Now, moving on to guidance. As a reminder, these numbers are all non-GAAP which excludes stock-based compensation expenses and related payroll taxes, amortization of debt discount, amortization of intangible assets and any associated tax effects.

For the fourth quarter of fiscal 2021, we expect:

- Revenue in the range of $185 million to $187 million, reflecting a year-over-year growth of 47% to 49%
- 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. We are currently managing the emerging products for time-to-market and growth, not optimizing them for gross margins. With this in mind, we believe 79-80% is a good range for us in the near-term.
- Operating profit in the range of $13.5 million to $14.5 million
- Other income of $300 thousand, net of interest payments on the senior convertible notes
- Income taxes of $1.7 million.
- Earnings per share of $0.08 to $0.09, assuming approximately 146 million fully diluted shares.

For the full-year fiscal 2021 we now expect:

- Revenue in the range of $660 million to $664 million or year-over-year growth of 53% to 54%.
- Calculated billings in the range of $878 million to $880 million or year-over-year growth of approximately 60%.
- Operating profit in the range of $71 million to $72 million.
- Earnings per share of $0.47 assuming approximately 145 million fully diluted shares.

The acquisitions of Trustdome and Smokescreen are expected to have an immaterial impact on revenue in Q4 and in fiscal 2022, as they are early stage companies. Our plan is to further develop these products and incorporate their technologies into our platform. We expect to incur $2.5 million to $3.0 million in additional operating expenses in Q4 related to the acquisitions, including a new R&D center of excellence in Israel. This is incorporated into our Q4 guidance. For your modeling purposes, we expect to incur approximately $13 million to $15 million in operating expenses related to the acquisitions in fiscal 2022.

With a huge market opportunity, we remain committed to investing aggressively in our company behind the growth in our business. We have a highly efficient business model and are making investments across the organization today in order to capitalize on the large opportunity ahead of us. While we will balance growth and profitability, growth will continue to take priority considering our strong business momentum.