Zscaler Q4 2024 Earnings Call – September 3, 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 first 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 Quarterly Report on Form 10-Q for the fiscal quarter ended April 30, 2024, filed on June 7, 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.

CEO Commentary

We delivered a strong Q4, with all metrics exceeding the high end of our guidance. Revenue grew 30% year-over-year, billings grew 27%, and profitability reached new records - with operating margin of approximately 22% and free cash flow margin of 23%. We also achieved a new milestone of $1 billion in quarterly bookings in Q4, driven by an acceleration in new and upsell business in the quarter. For the full year, revenue grew 34%, and free cash flow grew 75%, resulting in free cash flow margin of 27%, a new record for the company. With another year of strong top- and bottom-line performance, we exceeded the Rule-of-60 for the fourth consecutive year. Despite the recent changes in our go-to-market organization, we delivered these outstanding results driven by strong customer demand for our Zero Trust Exchange platform. I'm very pleased with the progress we are making in go-to-market execution, the pace of innovation and customer adoption of our expanded platform. I'm also pleased to share we crossed $2.5 billion in ARR in Q4, and we expect to achieve a new milestone of $3 billion or more in ARR in Fiscal 25.

Before getting into further details of the quarter, let me share a few observations on the demand environment.

First, customer adoption of our Zero Trust platform is stronger than ever, with Q4 setting a record for new and upsell business. Our platform secures 47 million users across nearly 8,700 customers. While other vendors are still struggling to deliver cloud security for users, we expanded our platform beyond users to deliver Zero Trust security for applications, workloads, and IoT/OT devices. Customers are consolidating their disjointed legacy security products by adopting our comprehensive platform.

Second, the increasing use of AI is creating new avenues of growth for us. For example, the rising adoption of GenAI is exposing new gaps in organizations' security posture. To help our customers address these risks, earlier this year we launched "GenAI Security", which enables customers to realize the productivity benefits of GenAI without compromising data security. Using our GenAI Security, customers can gain visibility, apply access control, and enforce data protection policies to prevent their sensitive data from leaking.

Third, I'm thrilled to share that we have achieved a major milestone with our cloud platform surpassing over half a trillion transactions daily - that is T as in Trillion. This further demonstrates our widening market leadership position. These transactions generate a vast quantity of proprietary logs that feed our massive data lake. These are not firewall logs that often can't inspect SSL traffic for cyber threat detection. These are complete logs that have structured and unstructured data, including the full URL. We leverage this proprietary data to train AI models that power innovations throughout our platform. Our AI-Analytics solution - including Unified Vulnerability Management, Risk360, Business Insights - are seeing strong traction. AI-Analytics contributed nearly three points to new and upsell business growth in Q4 and two points for the entire Fiscal 24, even though some of these products were only available for a part of the year. I'm pleased with the contribution of AI-Analytics in Fiscal 24, and with continued expansion of this solution, I expect its contribution to continue to grow.

With an addressable market of $96 billion, we believe we are in the very early stages of our opportunity with Zero Trust and AI.

The cyber threat environment continues to worsen as the limitations of firewall and VPN based architecture are exploited by threat actors to launch an increasing volume of sophisticated attacks. Over the last year, we saw an 18% increase in ransomware attacks blocked by the Zscaler cloud. Our seasoned ThreatLabZ research team is tracking 391 of the most sophisticated ransomware families, including many that were uncovered by Zscaler in the past year.

Driven by the increased number of cyber breaches, more customers are adopting our Zero Trust platform. For example, in a new logo win, a top 10 Fortune 500 industry machinery company purchased Zscaler for Users for 100,000 users in a multi-year, 7-figure ACV deal. The customer previously purchased a firewall-based SASE solution to consolidate firewalls, secure web gateways and MPLS network spend. Subsequently, they realized this so-called SASE solution allows lateral threat movement and does not deliver Zero Trust security. They chose Zscaler to replace their firewall-based SASE. Our purpose built, proxy-based cloud platform makes our customers' branches and data centers invisible to threat actors, hence, they can't be discovered, and they can't be attacked.

In addition to landing new logo platform purchases, we are also upselling our platform. Our land-and-expand motion creates a flywheel of continuous engagement and upsells. To give you an example, in a 7-figure upsell deal, a Fortune 200 financial services customer bought ZPA and ZDX, after their successful ZIA deployment, for 68,000 users. After securing internet and SaaS access with Zscaler, it was natural for them to expand to our broader platform: ZPA for Zero Trust access to private applications and for user-to-application segmentation to eliminate lateral threat propagation; and ZDX to quickly identify and resolve end-to-end performance issues. With this purchase, the customer's ARR more than doubled to nearly $10 million.

Next, I'm happy to share that customers continue to adopt the advanced features of our Data Protection pillar, making it one of our fastest growing pillars. For example, in a new logo win, an American healthcare provider purchased multiple pillars of our platform, including ZIA Transformation, Data Protection Advanced, and ZDX for 124,000 users in a multi-year, 8-figure TCV deal. Our Data protection pillar was critical to this win due to its comprehensive capabilities, which include securing all types of data - whether structured or unstructured; data in motion or data at rest; and data across all channels, including web, email, endpoint, SaaS, cloud workloads, and more.

Next, let me discuss our Emerging Products, including ZDX, Zero Trust for Branch and Cloud, and AI-Analytics. I'm delighted to share that Emerging Products contributed approximately 22% of new and upsell business in Fiscal 24, up from 18% in Fiscal 23. We expect this contribution to grow to mid-20s in Fiscal 25.

Our Zero Trust for Branch and Cloud solution - including Zero Trust for Workloads, Zero Trust SD-WAN and Zero Trust Segmentation - is driving more and more meaningful wins. Let me share two examples.

In an upsell win, a Fortune 500 financial services customer purchased Zero Trust for Workloads to protect their on-prem applications. Zero Trust for Workloads contributed approximately one-third of this 7-figure upsell ACV deal, which doubled the annual spend of this existing million ARR customer.

In another upsell win, a top 10 pharmaceutical company, purchased our Zero Trust SD-WAN solution to protect over 30 manufacturing sites, eliminating the need for firewalls and making each site like a Starbucks. Zero Trust SD-WAN was nearly 50% of this 7-figure ACV deal.

Our expanding portfolio of Emerging Products, further strengthened by our acquisitions of Avalor and Airgap, is opening doors for sales to new customers. With the addition of Airgap, Zscaler is expanding to provide Zero Trust security inside branches, factories and campuses, where customers traditionally relied on east-west firewalls and network access control, or NAC. By combining Airgap with our Zero Trust SD-WAN, we can not only replace firewalls at the edge, but also eliminate firewalls inside these sites.

We are also seeing strong traction for the Unified Vulnerability Management solution we acquired through Avalor. By combining our customers' enterprise security and business systems data with our proprietary log data from half-a-trillion daily transactions, Avalor delivers real-time actionable insights and operational efficiencies for customers to improve their overall security posture.

We expect new logo conversations that start with Airgap or Avalor or other Emerging Products to expand into broader platform opportunities. We will continue to invest in our platform expansion.

Moving to the Federal vertical, I'm excited to share we landed a new cabinet-level agency, increasing our count of cabinet-level agencies to 13. In a 7-figure ACV deal, this customer purchased Zscaler for Users for 5,000 users. With over 100,000 employees, this customer presents a significant 20x upsell opportunity.

Having landed in 13 of the 15 cabinet-level agencies, including the DoD, we see large upsell opportunities in the Federal vertical with the increasing adoption of Zero Trust. Building upon our success in the U.S., we are accelerating our public sector go-to-market investments in other nations that are modeling their Zero Trust security initiatives similarly to the U.S. This is a large opportunity for us, but like many government initiatives, this will take time.

Now, let me share some updates on our sales organization.

First, we had lower-than-expected attrition, and we had a strong hiring quarter. In Fiscal 25, we plan to continue hiring reps at a strong pace and expect attrition to further improve.

Second, I'm pleased to report that sales productivity was better than expected during the quarter, driven by acceleration in new and upsell business. In Fiscal 25, we expect sales productivity to continue to improve, with the second half stronger than the first.

Third, we increased investment in the Global System Integrators, or GSI, channel by hiring leaders experienced in building GSI programs for large enterprises. These hires are driving significant progress in developing mutual go-to-market plans with GSIs that integrate the Zscaler platform with their customers' digital transformation projects. Most large GSIs are already Zscaler customers, and that enables them to showcase to their customers the value Zscaler's Zero Trust platform delivers. This quarter we added another large GSI end user customer, making 8 of the top 10 GSIs by revenue Zscaler customers. This GSI purchased Zscaler for Users for over 300,000 users in our largest ever TCV deal in the services vertical. This GSI is consolidating multiple point products, including secure web gateways, load balancers, VPNs, firewalls and MPLS network, which is expected to deliver 200% ROI to this customer.

I'm pleased with the progress we are making in transforming our go-to-market engine to an account centric sales motion, which is contributing to growth of our large customers. We added nearly double the number of Global 2000 logos in Fiscal 24 as compared to Fiscal 23. We ended Fiscal 24 with approximately 35% of Global 2000 companies and more than 40% of Fortune 500 companies as our customers. Our customer base spending $1 million-plus annually grew by 26% year-over-year to 567, and we ended the quarter with over 60 customers spending $5 million-plus annually. We expect this large customer momentum to continue in Fiscal 25.

Finally, I want to address the topic of cloud resilience that has come to the forefront due to the recent cloud outages of Microsoft and CrowdStrike. When customers rely on a mission critical cyber security service, there is no room for service interruptions. From inception, Zscaler has built a cloud security platform that has been seamlessly scaling with high reliability and resilience. Operating such a service is no trivial task and it requires years of experience. Unproven vendors, including new entrants and legacy firewall companies, do not have this experience. By operating the world's largest security cloud with superior resilience for over a decade, we have earned the trust of the largest enterprises. This is a clear differentiator for us and is driving the growth of our business. As an innovator and a market leader, in January 2023, we became the first cloud security company to introduce a Business Continuity service that enables customers to continue their operations, even during catastrophic events.

In conclusion, we are uniquely positioned to benefit from the confluence of two large secular growth drivers: Zero Trust security and AI. We enter Fiscal 25 with a stronger go-to-market machine, increased pace of R&D innovation, strong adoption of our emerging products, and high levels of customer satisfaction, with an NPS score of over 70. With our customer obsession, expanding platform, and a large addressable market, I expect another strong year, which will move us closer to our goal of $5 billion in ARR.

CFO Commentary

Our Q4 results exceeded our guidance on growth and profitability, even with ongoing customer scrutiny of large deals. Revenue was $593 million, up 30% year-over-year and up 7% sequentially. From a geographic perspective, Americas represented 55% of revenue, EMEA was 30%, and APJ was 15%. For the full year, revenue was $2.17 billion, up 34% year-over-year.

Our total calculated billings in Q4 grew 27% year-over-year and 45% sequentially to $911 million. Our calculated current billings grew 27% year-over-year. Like last year, some customers paid us upfront on multi-year deals, and the percentage of total calculated billings coming from such upfront payments was relatively unchanged year-over-year.

Our remaining performance obligations, or RPO, grew 26% from a year ago to $4.418 billion. Current RPO was approximately 48% of the total RPO.

We ended Q4 with 567 customers with over $1 million in ARR, and 3,100 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 115%. 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 Q4 financial performance, total gross margin of 81.1% compared to 81.4% in the prior quarter and 80.7% in the year-ago quarter. On a year-over-year basis, gross margin benefited by approximately 60 basis points from a change in our accounting attributed to the longer useful life of our cloud infrastructure.

Moving on, our total operating expenses increased 8% sequentially and 26% year-over-year to $353 million. We continue to generate significant leverage in our financial model, with operating margin of approximately 22%, an increase of about 260 basis points year-over-year. Our free cash flow margin was 23%, including data center CapEx of approximately 8% of revenue. We ended the quarter with over $2.4 billion in cash, cash equivalents and short-term investments.

Before getting into the details of Q1 and full year fiscal 2025 guidance, I want to share additional context about our framework for billings guidance. We expect full-year fiscal 25 calculated billings of $3.110 billion to $3.135 billion or year-over-year growth of approximately 19% to 20%. We expect first half billings to be in the range of 39% to 39.5% of full-year billings guide, with Q1 to be approximately 16.2% of full-year billings guide. The mid-point of our guidance implies year-over-year billings growth of approximately 13% in the first half, accelerating to 23% growth in the second half. In no particular order, I'd like to share three key factors that are driving this acceleration:

One, as Jay mentioned, we expect sales productivity to continue to improve, with the second half stronger than the first. We expect this to contribute to strong new, upsell and renewal activity in the year

Two, our strong and growing pipeline supports second half acceleration; and

Three, from a timing perspective, our contracted, non-cancellable billings from prior years' active contracts are scheduled to grow 7% in the first half and 23% in the second half. This naturally implies a stronger second half in billings growth, giving us strong visibility into total billings growth in the second half.

Moving on to taxes, please note that we expect to continue to be a modest cash tax payer in fiscal 2025, with an estimated cash tax of approximately $45 million to $50 million. For Non-GAAP P&L reporting, I'd like to call your attention to a change we are making to our non-GAAP tax calculations. Starting Fiscal 2025 and going forward, we are establishing a non-GAAP tax rate of 23%, which is reflected in our non-GAAP earnings per share guidance for fiscal 2025. Please refer to our earnings release and financial supplemental for fiscal 23 and fiscal 24 comparisons reflecting this new non-GAAP tax rate.

Turning to the rest of the guidance. As a reminder, these numbers are all non-GAAP.

For the first quarter:

- We expect revenue in the range of $604 million to $606 million, reflecting a year-over-year growth of approximately 22%.
- Gross margins of 80%. I would also like to remind investors that a number of our emerging products, including newer products like ZDX, Zero Trust for Branch and Cloud and AI-Analytics, 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 and AI infrastructure to scale with the growing demand.
- Operating profit in the range of $114 million to $116 million.
- Net other income of $18 million.
- Income taxes of $31 million.
- Earnings per share in the range of $0.62 to $0.63, assuming 164 million fully diluted shares.

For the full year fiscal 2025:

- Revenue in the range of $2.60 billion to $2.62 billion, reflecting a year-over-year growth of 20% to 21%.
- Operating profit in the range of $530 million to $540 million.
- Income taxes of approximately $140 million.
- Earnings per share in the range of $2.81 to $2.87, assuming approximately 164 million fully diluted shares.
- We expect our free cash flow margin to be approximately 23.5% to 24%, including higher CapEx this year. We expect our data center CapEx to be approximately 3 points higher as percent 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.