Zscaler Q4 2022 Earnings Call – September 8, 2022

Forward-Looking Statements

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 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 factors such as the duration and global impact of COVID-19, effects of inflation and international conflicts like the Russia-Ukraine crisis on our business, operations and financial results and the economy in general; 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 Quarterly Report on Form 10-Q for the three months ended April 30, 2022 filed on June 9, 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

I am very pleased to share our strong Q4 results to end another outstanding year. In the quarter, we delivered 61% revenue growth and 57% billings growth, as customers continued to embrace our Zero Trust Exchange platform to secure their digital transformation. We are delivering this strong growth while generating strong profitability. Our free cash flow margin was 24%, which was a record for Q4. While many Public SaaS companies are happy to get to Rule-of-40, we surpassed the Rule-of-80 for the quarter and for the full year. These outstanding results reflect the strong underlying unit economics of our business that has high-90% gross retention rate and over 80% gross margins. This is possible because of our differentiated service and purpose-built, multi-tenant cloud platform that scales efficiently.

For the full year, our revenue grew 62% to $1.1 billion and billings grew 59% to $1.5 billion. We are seeing revenue growth across all products, industry verticals, market segments and geographies. Our platform is securing over 34 million users for over 6,700 customers, and we're making great progress towards our goal of protecting 200 million users. To reach our goal, we will continue to invest aggressively in growing our business and driving innovation, while focusing on operational efficiencies to drive the bottom line.

Let me share with you some of my observations and how we plan to manage through the uncertain macro environment in fiscal 23.

- First, my conversations with hundreds of IT executives confirm that cybersecurity remains the #1 IT priority and a top Board level issue. Independent CIO surveys confirm Zero Trust security and SASE will continue to be a top priority. Zscaler's proxy-based cloud platform is the best solution for tackling sophisticated cybersecurity challenges. In addition, the rise of hybrid work and the need for secure digital transformation are driving the demand for Zscaler. We believe periods of macro uncertainty can accelerate adoption of disruptive technologies like ours, which offer better security and user experience while substantially reducing cost and IT complexity. As the pioneer and recognized leader in Security Service Edge, we are well positioned to capture this ongoing market shift towards Zero Trust.
- Second, we address a $72 billion market, with significant new customer and upsell opportunities. Our superior architecture and proven experience delivering measurable outcomes at the CXO level, elevate us above the competitive noise. We drove 62% year-over-year growth in customers with greater than $1 million in ARR, ending with over 320 of these customers, including over 20 customers exceeding $5 million in ARR. We have a blueprint for delivering great value, which drives strong upsell for us. Approximately 60% of our new business comes from existing customers, and our net retention rate has again exceeded 125%, now for 7 consecutive quarters. Happy customers buy more, and our net promoter score continues to exceed 70, which is more than 2 times the average NPS for SaaS companies. In addition, we expect our deep and wide platform together with our enviable customer base of large enterprises, to continue to drive upsells. As we have indicated before, we have a 6X upsell opportunity with our existing customers just for our core ZIA and ZPA product pillars.
- Lastly, our consultative sales process plays a major role in our success and enables us to maintain a high-level of engagement with our customers, especially at the c-level. As part of this process, we produce CFO-Ready business cases with ROI and payback periods calculated in collaboration with our customers. In Q4, as we saw more deals getting scrutinized, we delivered more of these business value assessments, which helped us close many large multi-year, multi-product pillar deals. We believe our adaptive sales process makes us resilient to changing business environment and will continue to drive our business.

Looking forward, I am excited about fiscal 23 as we continue to win opportunities with new and existing customers. Increasingly, customers are buying ZIA, ZPA and ZDX together to deliver a complete Zero Trust solution for users. This accelerates our customers' transformation journey and makes us a critical partner for them. Let me discuss two such deals in Q4:

- In a new logo win, a Fortune 50 pharmaceutical company purchased ZIA, ZPA and ZDX for all 145,000 employees. This deal started with a regional need to improve security without compromising user experience in China. With multiple data centers in China covering various regions with premium connectivity options, Zscaler has superior zero trust access for multi-nationals out of China. Next, this customer engaged us for global M&A IT integration and hybrid work use cases. Impressed with these results, they accelerated their company-wide zero trust adoption with us. They disqualified their incumbent next-gen firewall vendor who had no referenceable customer at the required scale for its SASE cloud VPN product. This customer understands that a VPN, either as an appliance or hosted in the cloud under any name, is not zero trust and is the biggest security risk. This customer also purchased Zscaler for Workloads for 10,000 workloads to enable multi-cloud, app-to-app connectivity to support their M&A strategy. This was a 3-year, 8-figure deal for all four pillars of our platform – ZIA, ZPA, ZDX and Zscaler for Workloads, or what we used to call Cloud Protection. We closed this deal with AWS marketplace, which is becoming a larger channel for us.
- Next, one of our largest deals in the quarter came from a delighted Fortune 500 tech customer who deployed the entire Zscaler for Users solution including ZIA, ZPA and ZDX. This provided fast and direct access for users working from anywhere to applications in the data center or in the cloud. With dramatic improvements in user experience, employees were buzzing about the change. One employee slacked, and I quote, "Every morning I log into my machine, I'm thankful for Zscaler!" This customer doubled their seats to 120,000 users and extended the commitment for another 3 years. Their journey with us started with a small M&A IT integration use case, which quickly expanded into a company-wide zero trust initiative. In less than 2 years, this customer's annual spend with Zscaler grew 13x to well over $10 million.

Next, from a product perspective, we saw strong performance across all pillars of our platform. Our core pillars, ZIA and ZPA, have never been stronger, and we are excited about the rapid adoption of our emerging products: ZDX to manage digital user experience, and Zscaler for Workloads to secure servers and workloads. Emerging products contributed 14% of our new business in fiscal 22, and we expect continued growth in fiscal 23.

We continue to innovate rapidly and expand our platform. At our Zenith Live conference in June, we launched Posture Control for public clouds as a fully integrated solution that correlates vulnerabilities and risks across CSPM, CIEM, and Infrastructure as Code scanning. In cooperation with AWS, we are extending our platform to protect cloud workloads against malware and data breaches as enterprises continue to migrate and refactor their applications and workloads on AWS. In addition, we integrated our recently acquired deception technology into our platform and saw great adoption by our customers. This is an example of our highly targeted early-stage acquisition strategy shortening our time to market for new innovations and expanding our market opportunity.

Let me highlight three deals that were driven by our emerging products:

- We won a seven-figure ACV deal with a government agency in Australia for ZIA, ZPA and ZDX, where ZDX accounted for approximately $1 million of the total ACV value. ZDX pinpoints and resolves performance issues in real-time by monitoring experience of every user, every network hop, and every application, regardless of their location. The customer said ZDX is a must-have, as it delivered immediate value by reducing troubleshooting time and improving employee productivity.

- In a seven-figure ACV upsell win, a Fortune 50 insurance company purchased ZPA Transformation bundle for Zero Trust Access to implement user-to-app segmentation. This customer understands that if a user connects to the network with an on-prem or cloud VPN, that is not zero trust. With this latest purchase, they plan to replace their legacy network security, including VPN, Network Access Control or NAC, network-based segmentation, and VDI infrastructure. They purchased Zscaler Deception to detect and intercept bad actors trying to infiltrate the network.
- Finally, a Global 500 financial services customer in APJ purchased Zscaler for Workloads for 36,000 workloads to complement their ZIA and ZPA services for users. With many apps running in AWS and Azure, they wanted to implement a Zero Trust architecture to prevent lateral threat movement and eliminate backhauling workload traffic through the data center for inspection. We reduced cost and complexity by eliminating the need for virtual firewalls and site-to-site VPN networks, while improving security and operational efficiency.

Next, let me discuss the progress we are making in Federal vertical. We now have FedRAMP High authorization for ZIA, which together with ZPA, makes us the only cloud security service to have two products at the highest level of FedRAMP certification. In addition, ZPA is the only Zero Trust solution with DoD IL5 certification. These certifications are driving our federal business. In Q4, we added over 25 new Federal customers and over half of them purchased ZIA and ZPA together. Now, we have landed 10 of the 15 Cabinet-level agencies as customers, with plenty of opportunities for upsell at these large organizations. I want to highlight one federal deal that I'm particularly excited about:

- We were awarded a 5-year, $46 million contract by a large cabinet agency with over 100,000 users. The value of this contract will be granted over time, based on deployment. Against this award, we received an initial low seven-figure ACV task order for ZIA and ZPA.

Next, let me comment on the increased leverage we're driving with our channel programs. We saw over 50% year-over-year growth in channel sourced-deal registrations. Working closely with our cloud-centric VAR partners, we are building momentum down-market in the Enterprise and Commercial segments, which is providing higher contribution to our new business. At RSA conference, you heard a key partner, Optiv, talk about their plans to grow with us and further invest in Zscaler certifications for their consultants. I'm also excited about the opportunities we can unlock together with the global SIs that are building large Zero Trust and SASE transformation practices.

Moving to cloud marketplaces - this channel is growing very well for us. We have made strategic investments in our collaboration with AWS and Azure, including deep technology integrations, co-selling opportunities and demand generation programs. In Q4, our new business through cloud marketplaces grew nearly 5x year over year. For example, we signed 5 greater-than-$1 million deals through the AWS marketplace, including 2 of our top 5 New and Upsell deals of the quarter. Our strengthening Azure and AWS partnerships also give us access to their customers' sizable cloud budgets which can streamline the deal close process.

I want to highlight another important area for our customers – their ESG goals. Our highly efficient cloud eliminates the need for on-prem appliances, which significantly decreases IT waste, energy usage, and carbon emissions. We are also committed to our own ESG goals. Since achieving 100% renewable energy last year, we are proud to be Carbon Neutral for calendar 22, covering relevant Scope 1, 2, and 3 categories, including travel, customer use, public cloud use, and procurement. I am excited to announce our goal to be Net Zero by 2025, joining our customers in a collective effort to transition to a low carbon economy.

In closing, even with uncertain macro conditions, we continue to see favorable demand for our Zero Trust Exchange platform, which makes businesses more agile and competitive, simplifies IT, consolidates point products and reduces cost. We believe customers trust Zscaler more than any other provider for securing their cloud journey. We have grown our global team to approximately 5,000 employees who share a mission to secure the hyperconnected world of cloud and mobility. I am extremely proud of the strong growth and profitability we delivered in 2022. I want to thank our employees and our partners for their tireless efforts and commitment to our customers' success. We will continue to invest aggressively to delight our customers and capture the large opportunity ahead of us, while delivering operational excellence.

CFO Commentary

We are pleased with the results for the fourth quarter and full year. Revenue for the quarter was $318 million, up 61% year-over-year and up 11% sequentially. ZPA product revenue was approximately 19% of total revenue, growing 80% year-over-year. From a geographic perspective, we had broad strength across our three major regions: Americas represented 52% of revenue, EMEA was 33% and APJ was 15%. APJ continues to be our fastest growing region with revenue growth of 88% year-over-year. For the full year, revenue was $1.09 billion, up 62% year-over-year. This is an acceleration from the 56% growth we delivered in fiscal 2021.

Our total calculated billings in Q4 grew 57% year-over-year to $520 million, with billing duration comparable to a year ago and slightly above the midpoint of our normal 10-14 months range. We saw strong growth in our top 5 verticals: Finance, Manufacturing, Healthcare, Technology and Services.

Our remaining performance obligations, or RPO, grew 68% from one year ago to $2.607 billion. The current RPO is 49% of the total RPO. As a point of clarification, the total contract value of the 5-year, $46 million award from a US Federal government agency that Jay mentioned is not included in our RPO. RPO for this contract will be recognized as the individual task orders are received, which are 12-months in term length as is typical for our federal customers.

Moving on to our product pillars, for the full year, Emerging products, which include ZDX and Zscaler for Workloads, or what we used to call Cloud Protection, met our targets and contributed 14% to our total new business. Including our new CNAPP and deception offerings in the Zscaler for Workloads pillar, we expect Emerging Products to contribute high-teens percentage of our total new business in fiscal 2023. ZPA was 27% of our total new business in fiscal 2022, and grew as a mix between the two core ZIA and ZPA pillars. We have a large opportunity with all our pillars, and we will continue to innovate and expand our portfolio to strengthen our leadership position in the Zero Trust security market.

Our strong customer retention rate and our ability to upsell the broader platform have resulted in a high dollar-based net retention rate, which was again above 125% for the last 7 quarters. We have a strong base of large enterprise customers, which provides us with a significant opportunity to upsell our broader platform. We had 327 customers paying us more than $1 million annually, up 62% from 202 in the prior year. The continued strength in this metric speaks to our large enterprise focus and the strategic role we play in our customers' digital transformation initiatives. We added 198 customers in the quarter paying us more than $100,000 annually, ending the year at 2,089 such customers. Expanding our field engagement with smaller enterprises with 2,000 to 6,000 employees and the increased investments in our Summit Partner program are contributing to overall customer growth.

Turning to the rest of our Q4 financial performance, total gross margin of 81.6% was up nearly 1 percentage point quarter-over-quarter and year-over-year. Our total operating expenses increased 8% sequentially and 60% year-over-year to $221 million. Operating margin was 12% and Free cash flow margin was 24%. We continue to expect data center capex to be around high-single digit percent of revenue for the full year. We ended the quarter with over $1.73 billion in cash, cash equivalents, and short-term investments.

Before providing our guidance, I would like to share a few thoughts about the framework for our business outlook in the current environment. Zscaler is operating from a position of strength. We are entering this fiscal year with a record pipeline and a large set of customer opportunities. We have confidence in the durability of our business model, with very high contribution margins after the initial land, and proven ability to retain and upsell to our enterprise customer base. With customers increasingly adopting the broader platform with long-term commitments, we plan to continue to invest in capturing our large market opportunity. As Jay mentioned, there was more deal scrutiny at the end of Q4, which resulted in business being more backend loaded. We think it's prudent to expect this higher level of review and scrutiny by our customers to continue given the uncertain macro-economic outlook. While demand for the Zscaler platform remains very strong, if the business environment changes, our business model allows us to adapt quickly and to deliver on our operating profit and margin goals. In fiscal 23, in our guidance, we intend to deliver operating margin expansion of approximately 150 basis points.

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, and amortization of intangible assets. For the first quarter of fiscal 2023, we expect:

- Revenue in the range of $339 million to $341 million, reflecting a year-over-year growth of 47% to 48%.
- Gross margins of approximately 80%. I would like to remind investors that a number of our emerging products 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 $37 million to $38 million.
- Net other income of $5 million
- Income taxes of $2.5 million.
- Earnings per share of approximately $0.26, assuming 155 million fully-diluted shares. Please note that starting in fiscal 2023, we adopted the new accounting standard which requires the use of if-converted method for calculating EPS. To account for our convertible notes, you will need to add back $360,000 in quarterly interest expense and include 7.63 million shares to the fully-diluted share count.

For the full-year fiscal 2023 we expect:

- Revenue in the range of $1.49 billion to $1.50 billion or year-over-year growth of approximately 37%.
- Calculated billings in the range of $1.92 billion to $1.94 billion or year-over-year growth of 30% to 31%. While we don’t normally guide to quarterly billings, I want to remind you that we will have a difficult year-over-year comparison in Q1. In the year ago quarter, we had a one-off deal and multi-year invoices that resulted in billings duration at the high-end of our normal 10 to 14 months range. With that in mind, we expect Q1’23 billings to grow approximately mid-30 percent year-over-year. We also expect our first half mix to be approximately 42% to 43% of our full year billings guide, which is higher than the first half mix in the last few years.
- Operating profit in the range of $173 million to $176 million.
- Income taxes of $14 million.
- Earnings per share in the range of $1.16 to $1.18, assuming approximately 157 million fully diluted shares. As noted earlier, to account for our convertible notes in EPS, you will need to add back $1.44 million in annual interest expense and include 7.63 million shares to the fully-diluted share count.

Let me conclude with comments on our investment framework. We will balance growth and profitability based on how our business is growing. If we continue to have high growth, we will prioritize investing in the business. As we have discussed, if we are growing revenue faster than 30%, you can expect less than 300 basis points of margin expansion in the year. We remain confident of reaching 20-22% operating margins in the long-term. With a huge market opportunity and customers increasingly adopting the broader platform, we are committed to investing aggressively in our company while balancing this with our operating profit goals. However, if we see a deteriorating global economic environment, we have the flexibility to place a higher priority on operating profitability.