FORTINET

Fortinet Q1 2024 Earnings Prepared Remarks

Peter Salkowski, SVP Finance & Investor Relations

Good afternoon everyone. This is Peter Salkowski, Senior Vice President of Finance and Investor Relations at Fortinet. I am pleased to welcome everyone to our call to discuss Fortinet's financial results for the first quarter of 2024.

Joining me on today's call are Ken Xie, Fortinet's Founder, Chairman and CEO, Keith Jensen, our CFO and John Whittle, our Chief Operating Officer. This is a live call that will be available for replay via webcast on our investor relations website.

Ken will begin our call today by providing a high-level perspective on our business. Keith will then review our financial and operating results for the first quarter of 2024 before providing guidance for the second quarter of 2024 and updating the full year. We will then open the call for questions.

During the Q&A session, we ask that you please limit yourself to one question and one follow up question to allow others to participate.

Before we begin, I'd like to remind everyone that on today's call we will be making forward-looking statements and these forward-looking statements are subject to risks and uncertainties which could cause actual results to differ materially from those projected.

Please refer to our SEC filings, in particular the risk factors in our most recent Form 10-K and Form 10-Q, for more information.

All forward-looking statements reflect our opinions only as of the date of this presentation and we undertake no obligation, and specifically disclaim any obligation, to update forward-looking statements.

Also, all references to financial metrics that we make on today's call are non-GAAP, unless stated otherwise. Our GAAP results and GAAP to non-GAAP reconciliations are located in our earnings press release and in the presentation that accompany today's remarks, both of which are posted on our investor relations website.

The prepared remarks for today’s earnings call will be posted on the Quarterly Earnings section of our investor relations website immediately following the call.

Lastly, all references to growth are on a year-over-year basis, unless noted otherwise.

I will now turn the call over to Ken.

Ken Xie, Founder, Chairman and CEO

Thank you, Peter, and thank you to everyone for joining our call.

In Q1, we managed the business with strong spending discipline and increased our operating margin 200 basis points to a first quarter record of 28.5%. We also generated record cash flow from operations of $830 million and our adjusted free cash flow margin was 61%.

We remain focused on investing in the faster-growing unified SASE and Security Operations markets, which combined accounted for one-third of first quarter billings. We continue to gain Secure Networking market share leveraging our advanced and differentiated FortiOS and FortiASIC technologies, with an increasing number of large customers adopting our industry-leading secure networking solutions.

Last month, attendance at our annual Accelerate conference increased 25% year-over-year to nearly 5,000 participants. Our Unified SASE and new AI offerings dominated the discussions with our partners and customers.

For the first quarter, Unified SASE accounted for 24% of total billings. To introduce customers and prospects to our Unified SASE solutions we plan to run attractive promotions in 2024.

For several reasons, we believe no cybersecurity company comes close to our differentiated Unified SASE solutions.

First, we have developed all Unified SASE functionality into one single operating system, FortiOS. This includes a full networking and security stack comprised of ZTNA, Secure Web Gateway, CASB, and our market leading SD-WAN and Firewall technologies providing content, application, user, device and location awareness to reduce attacks.

Second, our Unified SASE solution can be deployed on-premise, in the cloud or both. Peer solutions send traffic to a cloud-based PoP, increasing security risks and latency and is less efficient.

Last, Fortinet's Unified SASE offers both traditional software endpoint agents and hardware agents such as FortiWiFi access points and FortiSwitch for customers, with easier deployment and more broad use cases, such as Unified SASE for OT and IoT devices.

We expect our differentiated Unified SASE offering to emerge as the SASE leader.

Fortinet's advanced platform approach has been earning third party awards for many years. Last month, we entered Gartner's Magic Quadrant for Security Service Edge. As shown on slide 12 of the investor presentation, Fortinet is the only vendor recognized in the Gartner® Magic Quadrant™ reports for Security Service Edge, SD-WAN, Single-Vendor SASE, Network Firewall, and Enterprise Wired and Wireless LAN Infrastructure. All five security and network offerings from Fortinet are uniquely built on one operating system, FortiOS, and leverage our FortiASIC to increase secure computing power for more functions and better performance while lowering the cost and energy consumption.

Fortinet's SecOps solutions, which are better integrated and automated together than competitors, accounted for 9% of total billings. Initially launched as a part of FortiSIEM and FortiSOAR, our GenAI technology, FortiAI, is being deployed across both networking and security products, and today we announced the industry’s first IoT Security Generative AI Assistant. Customers can ask FortiAI to help in 30+ languages.

Fortinet is also a market leader in OT security solutions, the fastest growing space in network security, with billions of devices connecting online. Most OT devices have limited computing power making network security the most effective means of securing them.

Today we announced the FortiGate 200G, a mid-range firewall powered by our new SP5 FortiASIC, with secure compute ratings of 3x to 10x better performance than our competitors and the industry average, reinforcing our leading secure networking and Unified SASE advantage, that provides customers with industry-leading security functions, performance, and power efficiency.

Before turning the call over to Keith, I wish to thank our employees, customers, partners, and suppliers worldwide for their continued support and hard work.

Keith Jensen, CFO

Thank you, Ken, and good afternoon everyone.

Let’s start with the key highlights from the first quarter…

As Ken mentioned, we continue to manage the business through the macro uncertainty and successfully drove operating margin to a first quarter record of 28.5%, exceeding the high end of the guidance range by 200 basis points.

Free cash flow of $609 million, represented a 45% free cash flow margin benefiting from strong Q4'23 billings and their subsequent collection in Q1'24.

Billings of $1.41 billion and revenue of $1.35 billion were within their respective guidance ranges.

Looking at billings in more detail…

While Unified SASE and SecOps delivered strong billings growth, total billings declined 6%, as expected. The billings performance was driven by the difficult year-earlier comparison created by the backlog contributions to billings that occurred in last year's first quarter.

Total bookings were down just slightly.

Unified SASE and SecOps had outstanding growth across a variety of benchmarks in the first quarter. In addition, we saw significant progress from our investments in Unified SASE and SecOps. These include:

- Cross-selling into our large install base:
  - Existing customers delivered over 90% of SecOps and Unified SASE billings.
  - On an even more targeted basis, existing SD-WAN customers delivered 81% of Unified SASE billings.
- Larger enterprises are proving to be our largest customer segment, with large and mid-enterprises representing 78% and 84% of SecOps and Unified SASE billings, respectively.
- Even with increasing scale, both pillars have strong pipeline growth -- 30% for SecOps and over 45% for Unified SASE. More importantly, within SASE, the SSE pipeline growth was over 150%.
- Our investment in SASE is being recognized by 3rd party agencies. We recently scored the *"trifecta"* with Gartner's SASE Magic Quadrants -- SSE, SD-WAN and Single Vendor SASE. And as Ken noted, with last month's addition of SSE, Fortinet now appears in five network security Gartner Magic Quadrants; again, all running on a single operating system.
- With the SASE Magic Quadrant "*trifecta*", customers have shown increased interest in learning more about our unique SASE platform that runs on the one operating system, with one unified agent, one management system, and one data lake.

- To offer an example of customer interest, at our Accelerate conference early last month, the SASE demo booth was our most active, as customers surveyed SASE's new features and functions, including end-to-end Digital Experience Monitoring (DEM), Remote Browser Isolation (RBI), advanced Data Loss Prevention (DLP), and third-party SD-WAN connectivity.
- As a second example, nearly 25% of the Accelerate attendees joined our CMO for the SASE breakout session. The attendee number for this breakout session would have been even higher, if it wasn't for the fire marshal's regulations which forced us to turn away customer and partners who were eager to hear more about our SASE offering.
- And to offer one final example, the customer and partner SASE *"FAST TRACK"* training, which launched in January, is already the number two most attended technical training session, trailing only its Single Vendor SASE partner, SD-WAN.

- We're committed to driving more effective security solutions worldwide and welcome greater partnership with our industry peers. The new 3rd party SD-WAN connectivity technology is designed to support consolidation not only *ON* Fortinet, but *WITH* Fortinet.
- In terms of scale, we continue to open new Google and Fortinet PoPs in sync with our customers expanding footprint and driving the deployment scale demanded by large enterprises.
- And a quick update on the 7-figure 300,000 seat education deal that we mentioned last quarter -- the full production environment was activated in March and we are on track to have their 300,000 plus seats onboard to start the new school year.

To expand on Ken's earlier comment about today's AI related announcement, Fortinet's GenAI Assistant follows our FortiAI launch last year by supporting and guiding SOC and NOC teams as they configure and manage changes to their network and investigate and remediate threats. Its intuitive interface allows individuals to engage using 30 different natural languages, bridging the industry's skills shortage. I encourage everyone to visit Fortinet.com to learn more about the GenAI Assistant.

Rounding out the billings commentary, SMB was the top performing customer segment. International Emerging was our best performing geography and our three largest industry verticals continued to be worldwide government, service providers, and financial services.

Service provider and worldwide government experienced the highest growth, while retail and financial services were a bit more challenged.

As noted in our prior call, the six 8-figure deals in Q4'23 pushed our average contract term and DSO to elevated levels. The average contract term in the first quarter was 27 months, down just under one month year-over-year and three and-a-half months quarter-over-quarter. The DSO decreased 12 days year-over-year and 23 days quarter-over-quarter to 66 days.

Turning to revenue and margins….

Total revenue grew 7% to $1.35 billion, driven by service revenue growth.

Service revenue of $944 million grew 24%, accounting for 70% of total revenue – a revenue mix shift to services of 10 points. Service revenue growth was led by over 30% growth from Unified SASE and SecOps.

Product revenue decreased 18%, as expected, to $409 million, coming off a challenging 35% year-earlier compare impacted by backlog fulfillment in the prior year. Software license revenue increased 20% and represented a mid-to-high teens mix of product revenue.

Total net product bookings were down just slightly.

Combined revenue from software licenses and software services – such as cloud, and SaaS security solutions -- increased 29%, and represented an annual revenue run rate approaching $750 million.

Total gross margin of 78.1% was up 180 basis points and exceeded the high end of our guidance range, benefiting from the mix shift to higher margin service revenues.

Service gross margins of 87.9% were up 200 basis points as service revenue growth outpaced labor cost increases and benefitted from the mix shift towards higher margin FortiGuard security subscriptions.

Product gross margins were 55.7% as we saw margin pressure related to inventory levels and the transition to a more normalized demand environment.

Operating margin of 28.5% was 200 basis points *above* the high-end of our guidance range, reflecting the strong gross margins and prudent cost management.

Looking to the Statement of Cash Flows summarized on slides 16 and 17…

Free Cash Flow was *$609 million. Adjusted* Free Cash Flow, which excludes real estate investments, was $821 million, representing a 61% adjusted free cash flow margin.

Infrastructure investments totaled $222 million, including $212 million of real estate investments.

Cash taxes in the quarter were $31 million.

While we did not repurchase shares in Q1, share buybacks have totaled $5.3 billion over the past 4-plus years and the remaining buyback authorization is $1 billion.

Now, I'd like to share a few significant wins from the first quarter…

I'll start with the one 8-figure deal in the quarter, a competitive displacement and new logo win. This large U.S. financial institution selected Fortinet as part of their data center update and consolidation project.

- Keys to this win included our experience in this highly regulated, customer data sensitive industry, and our ability to lower the total cost of ownership and exceed their low latency performance requirements. Similar to other large financial institutions separating from their incumbent, this customer is expanding their Fortinet footprint by adding our SD-Branch solution and planning to consolidate additional technologies.

Next, in a competitive 7-figure win, a hospitality company that serves over 5 million guests annually updated their various Fortinet solutions including their FortiGate firewall footprint and FortiNAC solutions.

- Keys to expanding our relationship included our price-to-performance advantage on the firewalls and the NAC solution's proven ability to discover and lock-down devices that attempt to join their network, together with the operational simplicity and integration of the dozen different Fortinet solutions the customer uses.

In another 7-figure deal, a hotel and restaurant chain purchased our SD-Branch solution for 800 locations as well as our data center FortiGates for centralized management and enhanced security. This solution from our Network Security pillar included firewalls, switches, and access points as well as a variety of software products. The SD-Branch solutions bring improved efficiency and security over their branches and IoT devices.

- Key to this win, and in other retail opportunities, is enabling retailers to deploy, expand, and deliver a growing array of in-store digital solutions to support their customers' experience and increase their top line performance.

As these three customer wins illustrate, our Security Fabric platform includes each of our security pillars -- Unified SASE, AI-driven SecOps, and Secure Networking, making it the most integrated, most open portfolio of products in the industry, backed by one operating system (FortiOS), one unified agent (FortiClient), one management console (FortiManager), one data lake (FortiAnalyzer), open APIs, and integration with over 500 competitor and other third-party products. This integration allows customers to consolidate security solutions thereby reducing operational costs while increasing security effectiveness.

Moving onto guidance…

As a reminder, our first quarter and full year outlook, which are summarized on slides 21 and 22, is subject to the disclaimers regarding forward-looking information that Peter provided at the beginning of the call.

For the second quarter, we expect:

- *Billings* in the range of $1 billion 490 million to $1 billion 550 million, which at the midpoint represents a decline of one percent,
- Revenue in the range of $1 billion 375 million to $1 billion $435 million, which at the midpoint represents growth of nine percent,
- Non-GAAP gross margin of 76.5% to 77.5%,
- Non-GAAP operating margin of 25.75% to 26.75%,
- Non-GAAP earnings per share of $0.39 to $0.41, which assumes a share count between 775 and 785 million,
- Capital expenditures of $30 to $40 million.
- A non-GAAP tax rate of 17%, and
- Cash taxes of $240 to $270 million.

Before updating the full year guidance, I would like to elaborate on the backlog headwinds easing in the second half of 2024 and share that we believe we are starting to see early signs that the firewall digestion cycle is nearing completion.

The billings headwind from last year's backlog drawdown is over $150 million in 2024 and gradually diminishes throughout the year with no headwind in the fourth quarter.

When looking for early signs of a more normalized firewall market, one metric we watch is the average days to register security service contracts as shown on slide 19. In 2022, we noted that the days to register had increased about 50%, which was consistent with the customers' buying and stocking behaviors at the time. More recently, this metric decreased by about 25% from its peak and is now consistent with late 2021 levels and is on a pace to return to normal levels in the second half of 2024.

A reasonable read through on the data is that customers are completing the inventory digestion process and are on the path to a more normalized firewall buying behavior.

And with that, for the year, we expect:

- *Billings* in the range of $6 billion 400 million to $6 billion 600 million,
- Revenue in the range of $5 billion 745 million to $5 billion 845 million, which at the midpoint represents growth of nine percent,
- Service revenue in the range of $3 billion $940 million to $3 billion $990 million, which at the midpoint represents growth of 17%,
- Non-GAAP gross margin of 76.5% to 78.0%,
- Non-GAAP operating margin of 26.5% to 28.0%,
- Non-GAAP earnings per share of $1.73 to $1.79, which assumes a share count of between 780 and 790 million,
- Capital expenditures of $350 to $400 million,
- Non-GAAP tax rate of 17%, and
- Cash taxes of between $500 million and $550 million.

I look forward to updating you on our progress in the coming quarters and I'll now hand the call back over to Peter to begin the Q&A session.

Closing Remarks: Peter Salkowski, SVP Finance & Investor Relations

I'd like to thank everyone for joining the call today.

Fortinet will be attending investor conferences hosted by J.P. Morgan and Bank of America during the second quarter. The fireside chat webcast links will be posted on the Events and Presentations section of Fortinet's investor relations website.

If you have any follow up questions, please feel free to contact me.

Have a great rest of your day!