FORTINET FIRST QUARTER 2017 EARNINGS CONFERENCE CALL SCRIPT

APRIL 27, 2017

Kelly:

Thank you, operator, and thanks to everyone on the call for joining us on this busy afternoon to discuss Fortinet's financial results for the first quarter of 2017. With me today are Ken Xie, Fortinet's Founder, Chairman and CEO, and Drew Del Matto, CFO.

Ken will begin our call by providing a high-level perspective on our business. Drew will then review our financial and operating results, and conclude with our forward guidance outlook before opening up the call for questions. During Q&A, we ask that you please be conscious of limited time on this call, and make your questions brief to allow for others to participate. As a reminder, today we're holding two calls. For those who have additional questions, we will hold a second conference call at 3:30 PM Pacific Time. Both calls will be webcast from our investor relations website.

Before we begin, I'd like to remind you that on the call today we will be making forward-looking statements. These forward-looking statements are subject to risks and uncertainties that could cause actual results to differ materially from those projected in these statements. Please refer to our SEC filings, in particular the risk factors in our most recent Form 10-K and Forms 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, please note that we will be discussing certain non-GAAP financial measures on this call. Our GAAP results and GAAP to non-GAAP reconciliations can be found in our earnings press release and on slides 11 and 12 of the presentation that accompany today's remarks. We also encourage you to refer to the Investor Relations section of our website at investor.fortinet.com for important information, including our earnings press release issued a few minutes ago, the slides that accompany today's prepared remarks, and other important information about the company. A replay of this call will also be available on our website. I will now turn the call over to Ken.

Ken:

Thank you Kelly, and thanks to everyone for joining today's call to discuss our first quarter 2017 results. In the first quarter, Fortinet delivered billings and revenue growth that exceeded our guidance **and continued to surpass market growth rates**. We continue to improve our profitability, and as we have discussed in the past, we plan to steadily increase our operating margins to create additional value for our shareholders.

In the first quarter we saw strength in large, multi-product deals, demonstrating that the security fabric architecture is continuing to gain **mind share and market share** for Fortinet. Our customer and partners recognize that our competitors' multiple point products and loosely integrated solutions do not provide the breadth, depth, performance, and orchestration necessary to address the demands of today's digital economy. The Fortinet Security Fabric is a cohesive, multi-product platform that works together to detect, monitor, block and remediate attacks against the **entire enterprise surface area**, responding to our customers' need for a seamless, tightly-integrated approach to security that protects **all points in the network**.

Enterprises do not have to sacrifice their network performance to ensure that their networks are secure in this highly competitive and evolving landscape. Our latest next generation firewalls, the FortiGate 7000 series with the 7030E, 7040E and 7060E deliver ultra-high speed Next Generation Firewall and advanced threat protection in a flexible chassis-based form factor, based on the latest CP9 security processor. Many security vendors **detect** threats, some can **prevent** them with integrated solutions, but only Fortinet excels in **all five stages** of network security: detection, prevention, integration, **performance and value**.

As we continue to land and expand into some of the largest enterprise corporations and government organizations in the world, we again added more than 10,000 new customers during the quarter. This brings the total to more than 310,000 customers worldwide. Broader adoption of the Security Fabric also resulted in increased sales in the quarter of non-FortiGate solutions.

During the quarter we were pleased to announce that **several leading** technology companies joined the Fortinet Security Fabric-Ready ecosystem, including Cisco, Hewlett Packard, Nuage Networks from Nokia and more. To date, Fortinet has 22 Fabric-Ready Program Partners, representing a cross-section of leading information technology providers whose offerings are tightly integrated with the Fortinet Security Fabric. This open approach enables multiple vendors' security solutions to share actionable threat intelligence and mitigation information in real-time.

We were also pleased to announce earlier this month that Fortinet has extended the core capabilities of our Security Fabric architecture to enable businesses to experience **the same level** of cybersecurity and threat intelligence **in cloud environments** as they do on their physical networks. The latest enhancements to the FortiOS 5.6 offers customers the ability to manage security capabilities across their private, public cloud and software-defined wide area networking (SD-WAN) environments.

Earlier this month, Fortinet and Vodafone announced **a new global relationship** to provide next generation security solutions to enterprise customers by embedding Fortinet's high-performance virtualized security solutions and integrated Security Fabric architecture within Vodafone's core network products.

Our strength in cloud offerings is **driving demand for on-premises implementation** of the Fortinet Security Fabric. By providing the highest performance, most complete and well-integrated solutions, the Fortinet Security Fabric has positioned Fortinet as **an innovator and** a market leader.

I will now turn the call to Drew to review our first quarter financial results and forward guidance.

Drew:

Thank you, Ken. Let me now share our financial results for the first quarter, which can be seen on slide 3.

- Fortinet had a strong start to 2017 with billings and revenue exceeding the high end of our guidance ranges.
- Billings increased 22% year-over-year to $403 million. Reflected in this number is approximately $12 million from a single deal closed in the quarter. Approximately 70% of the revenue from this multi-year contract was deferred into future periods.
- Revenue of $341 million was up 20% year-over-year.
- Revenue growth was driven by strong performance in North America, particularly in enterprise, demonstrating ongoing improvement in sales productivity.
- As Ken mentioned, we saw success in large deals and in multiple product deployments, demonstrating adoption of the Fortinet Security Fabric.
- Deferred revenue grew strongly again to $1.98 billion, up 31% year over year, reflecting the business shift to more margin rich, recurring subscription and service revenue. Sales of enterprise bundles were again strong in the first quarter, driving higher-priced and higher-margin recurring revenue over time.

- Our non-GAAP gross margin was 75%. Our strategic focus on driving sales of higher value, higher price, and higher-margin recurring revenue streams, such as services and virtualized product offerings contributed to our improved gross margin in the quarter.
- Non-GAAP operating margin was 13%, and non-GAAP earnings per share were $0.17.
- Finally, we generated $116 million of free cash flow during the quarter, an increase of 65% over the first quarter of 2016.

Our first quarter results benefited from customers' recognition of the value, performance, and comprehensive security coverage provided by Fortinet's Security Fabric. This was evidenced in the first quarter by continuing strength in large, multi-product deals, and sales of non-FortiGate products to enterprises. The number of deals over $100K grew 20%, deals over $250K grew 15%, and deals over $500K grew 31%.

The majority of our large deals were attributable to the key differentiators of the Fabric, particularly manageability, orchestration, and integration across the enterprise. For example, in the aforementioned multi-million-dollar, multi-product contract with a large educational institution, Fortinet's technology beat out the incumbent and other competitors not only due to performance, but also to the manageability and integration capabilities that the Fabric provides.

In another first quarter deal, Fortinet is being deployed in a large European financial institution whose incumbent security solution was not scalable, powerful, or manageable enough to respond to its growing business and larger attack footprint. The customer chose the Fortinet Security Fabric for our ability to provide internal segmentation and advanced threat protection in the context of a scalable, well-orchestrated, high-performance solution.

Cloud solutions are a critical component of the Fortinet Security Fabric, and represent a significant expansion opportunity and long-term driver of our growth. Fortinet delivers security <u>to</u> the cloud and <u>for</u> the cloud. The latest enhancements to the FortiOS enable customers to manage security capabilities across their cloud assets and software-defined wireless access networks. We also announced this month the launch of FortiCASB, a cloud access security brokerage providing customers and partners with an interface to gain visibility and control over SaaS applications through the Fortinet Security Fabric.

Turning to our quarterly sales results, the breakdown of billings across our top 5 verticals was Service Provider at 21%; Government at 15%; Education at 13%; Financial Services at 11%; and Retail at 9%.

On a geographic basis, billings in the Americas grew 27%, led by the United States which outpaced all other regions in the first quarter, validating the changes that we made to our sales structure just a year ago. EMEA billings grew 17%, and APAC billings grew 22%.

Now, turning to billings by product portfolio on slide 4, high end products accounted for 36% of total product billings, our mid-range products accounted for 31%, and our entry-level products accounted for 33%.

Revenue was $341 million in the quarter up 20% year-over-year.

As you can see on Slide 5, revenue performance was driven by the combination of 9% year-over-year product revenue growth, and 28% year-over-year services revenue growth. The continued shift to higher services growth reflects our ongoing success in driving higher-priced subscription bundles, metered model business, and virtual solutions.

On a geographic basis, from a revenue standpoint, you can see on slides 6 and 7, that revenue continues to be diversified globally, which remains a key strength of our business. Revenue from the Americas represented 43% of our business and grew 22% year over year; revenue from EMEA represented 37% of our business and grew 20% year over year; and revenue from APAC represented 20% of our business and grew 15% year over year.

During the first quarter, our non-GAAP gross margin was 75%. Non-GAAP services gross margin was 84%. Non-GAAP product gross margin was 60%.

We continue to focus on productivity and efficiency in our operating model, paying close attention to the growth in billings versus operating expenses. On a year-over-year basis in the first quarter, billings grew by 22%, while sales and marketing expense grew by just 16%. As expected, general and administrative expenses were elevated in the first quarter due in part to preparations for our implementation of the new revenue accounting standard. In all, year over year we had $73 million in incremental billings, on just $31 million in incremental operating expense.

As a percentage of revenue on a non-GAAP basis, sales and marketing expenses were 44%, down from 46% in the first quarter of last year, research and development expenses were 13%, flat from last year, and general and administrative expenses were 5%, also flat from last year.

Total non-GAAP operating expenses were $211 million during the first quarter, resulting in non-GAAP operating income of $43 million, or 13% of total revenue, up 200 basis points year over year.

Non-GAAP net income for the first quarter was $31 million or $0.17 per share, based on approximately 178 million diluted shares outstanding. As expected, the annualized non-GAAP tax rate declined to 32%.

As seen on slides 8 and 9, we ended the first quarter with a strong balance sheet, including $1.44 billion in cash and investments. Free cash flow in the quarter was $116 million, an increase of 65% over the first quarter of 2016.

Annualized inventory turns for Q1 were 1.6. Inventory turns were lower than expected in the first quarter due to early receipt of $8 million of inventory that was scheduled for Q2 delivery, and due to a ramp in inventory for our transition from the D to the E series of appliances. We expect to normalize our inventory turns to 2 or better over the next several quarters. Deferred revenue increased to $1.098 billion, an increase of $261 million or 31% year-over-year. DSO was 71 days.

Before I discuss guidance for the second quarter, I want to provide an update on our real estate plans. As I mentioned on our fourth quarter call, we are addressing our facilities requirements over the next several years both at headquarters in California as well as in Vancouver.

At the beginning of the year, we guided $140-150 million in capex for 2017, including approximately $120 million on real estate. Earlier this month, we concluded the purchase of the Vancouver building, so the vast majority of the real estate capex for 2017 will occur in the second quarter, affecting our Q2 free cash flow. We expect to return to strong free cash flow generation in the second half of the year.

Let me now finish with our guidance for the second quarter, and updates to our previously-issued guidance for the full year, which can be seen on slide 10. I will also address our plans for longer-term operating margin expansion. As a reminder, all forward-looking statements, including all of the guidance statements provided, are subject to Kelly's cautions at the start of this call.

Fortinet's market opportunity and competitive advantage is significant. Our investments have helped lay the foundation for our future growth, share gains, increasing profitability, and shareholder value creation. As I have mentioned, our model is shifting toward more margin-rich services revenue, which tends to have a higher ratio of deferral. These factors, along with typical seasonality of the business and our expense structure, are carefully factored into our near-term outlook.

For the second quarter of 2017, we expect:

- Billings in the range of of $425 million to $432 million.
- Revenue in the range of of $357 million to $363 million.

- Non-GAAP gross margin of 74%-75%.
- Non-GAAP operating margin of 14%-15%, and
- Non-GAAP earnings per share of 19 to 20 cents.

We are updating our guidance for the full year 2017 to reflect the first quarter's performance. For 2017 we now expect:

- Billings in the range of $1.770 billion to $1.792 billion.
- Revenue in the range of $1.485 billion to $1.495 billion.
- Non-GAAP gross margin of 74%-75%, and
- Non-GAAP earnings per share of 89 to 91 cents.

We had approximately $2 million of overachievement in non-GAAP operating income in the first quarter, which equates to approximately 10-20 basis points of operating margin on the full year at the middle of the range. We are adding that to our non-GAAP operating margin expectation for the year.

I'd like to conclude with some commentary on our longer-term operating model. As you know, over the last couple of years Fortinet has carefully considered our investment strategy to find an appropriate balance between high revenue growth and profitability. We made critical investments in Sales and Marketing to broaden our go to market capabilities, and focused on driving higher margin recurring revenue streams. In 2016, these efforts delivered non-GAAP operating margin improvements of approximately 200 basis points, exceeding our operating margin guidance despite the dilution from the acquisition of AccelOps. We remain focused on driving higher sales productivity, and maintaining a flat organization. We also have made a number of model and productivity improvements and changes to our operating structure to increase profitability. As our Q1 results illustrate, we are seeing the benefits of our focus, efforts and strategy.

We meet with shareholders frequently, and have heard from many of you that you would like more clarity and definition related to our path to operating margin improvement. In response to this feedback, and recognizing the importance of increased profitability to our business and our shareholders, we are updating our margin targets as well as the milestones we expect to achieve to get there. We plan to add 150-200 basis points to operating margins **each year** following 2017, reaching a minimum non-GAAP operating margin of 25% by 2022 and remaining thereafter in the 25%-30% range.

We appreciate our shareholders' feedback, and we welcome an ongoing dialogue with you on how to improve our business and increase shareholder value.

Now I'll hand the call back to Ken to close.

KEN: Thank you Drew. We are very pleased with our first quarter results and with the progress that Fortinet is making. The Fortinet Security Fabric is winning in the market place, and we are gaining market share against our competitors. We believe that the long-term operating model that Drew just outlined will bring the best value to our shareholders. Our first quarter results illustrate that our strategy to expand operating margin is working, and our model will continue to offer **improved profitability and value to our shareholders** while allowing Fortinet to remain an industry leader. In closing, I'd like to thank Fortinet employees, partners, customers, and shareholders for their continued confidence and support.

Kelly: Operator, you may start the Q&A.

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