Fortinet Q3 2022 Earnings Prepared Remarks

Peter Salkowski, VP of Investor Relations

Good afternoon everyone. This is Peter Salkowski, vice president of investor relations at Fortinet. I am pleased to welcome everyone to our call to discuss Fortinet's financial results for the third quarter of 2022.

Speakers on today's call are Ken Xie, Fortinet's Founder, Chairman and CEO and Keith Jensen, CFO. 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 third quarter before providing guidance for the fourth quarter 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.

Ken and Keith's prepared remarks for today's earnings call will be posted on the Quarterly Earnings section of our investor relations website immediately following today's 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

Thanks Peter and thank you to everyone for joining today's call to review our outstanding third quarter 2022 results.

Revenue for the quarter grew 33%, significantly outpacing the industry growth rate. We believe that customer recognition of the exceptional value proposition provided by our high performance Forti-ASIC technology and integrated FortiOS operating system is driving our ability to take cyber security market share.

Product revenue growth was very strong at 39%, extending our position as a product revenue leader in the cyber security industry. Our product revenue performance reflects the strong demand we've built over the past 18 months across our security solutions along with the successful execution of our internal teams in managing the supply chain challenges.

Three growth drivers, the heightened threat environment, the convergence of security and networking, and the consolidation of security functionality and the vendors, together with the opportunity to upsell additional security services to our significant installed base, are expected to drive future growth.

First, the threat landscape, including ransomware, continues to expand and evolve targeting companies of all sizes, locations and industries. To counter the threat landscape, we are implementing our unique Universal ZTNA across a wide range of customers, driving triple digit growth for this product and delivering a comprehensive approach to zero trust that is consistent for any user, anywhere, on any device and supports today's hybrid workforce.

Second, for years Fortinet has led strategies around the convergence of networking and security. We estimate the total addressable market for networking and security will increase from $54 billion today to $73 billion in 2026. Convergence accelerates digital transformation and substantially reduces operational costs by combining network modernization with dynamic security that seamlessly spans every part of the network, especially now that many companies are merging SOC and NOC operations together.

Fortinet is leading the convergence trend with a wide range of technologies including Network Firewall and Segmentation, Secure SD-WAN, OT Security, and 5G in a single operating system which can be deployed as hardware, software, cloud, and As a Service.

Fortinet continues to gain Secure SD-WAN market share as our integrated Secure SD-WAN solution delivers better security, performance and efficiencies over more traditional offerings. In the quarter, SD-WAN and OT bookings grew over 45% and 75%, respectively, and together accounted for over 25% of total bookings. We believe we can achieve #1 market share in SD-WAN in the next couple of years.

Today, we announced the FortiGate 1000F, our latest innovation in converging networking and security. Powered by our NP7 SPU, the 1000F delivers 5 to 10 times higher performance across six major network security functions while consuming 80% less power versus competitive solutions. The lower power consumption was a contributing factor in our top 2 percent ranking in S&P Global's Corporate Sustainability Assessment.

Our third growth driver is the consolidation of vendors and product functionality. With Forti-ASIC's huge security computing power advantage, FortiOS can integrate more security functions than our competitors, together with over 30 key products ranging from endpoint to network to cloud security. Fortinet provides our customers with easier operation while lowering management costs and the total cost of ownership.

Additionally, we are very focused on upselling value-added security services to our significant customer base. According to IDC's second quarter unit share data, Fortinet holds the #1 market share position for units shipped at 43%, up 210 basis points. We expect to reach 50%-unit market share in the next few years. This leadership position and the substantial installed base creates attractive economies of scale and the opportunity to upsell additional security services.

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

Keith…

Keith Jensen, CFO

Thank you, Ken, and good afternoon everyone.

Let's start with an overview of our strong third quarter performance…

Revenue of $1.15 billion was another quarterly record for Fortinet, increasing 33% year-over-year and 12% sequentially; *our highest third quarter sequential growth rate in eleven years.*

We continue to deliver better than industry average top-line growth and generate strong profitability.

Our operating margin exceeded guidance at over 28%, driving the *adjusted* free cash flow margin to 40%.

Our history as a public company has revolved around the Rule of 40, measured as the combined total of revenue growth and operating margin. Impressively, the Q3 total came in at over 60.

We continue to see success in our strategy to expand further into the large enterprise segment:

- The number of deals over $1 million increased over 80% to 153 deals,
- The total billings value of deals over $1 million more than doubled driven by a record number of deals over $5 million, and
- G2000 bookings increased over 40%.

Our strong third quarter results reflect solid customer demand across both our Core and Enhanced Platform Technologies and the exceptional performance of the team in a challenging supply chain environment.

We believe the investments we've made in building our platform and our go to market engine enables our customers' digital transformation journey. Our platform strategy allows customers to converge networking functionality with security capabilities while consolidating cybersecurity products, providing security across their entire digital infrastructure while lowering their operating costs.

Recently, the Forrester Wave Enterprise Firewalls report acknowledged the success of our investment strategy, placing Fortinet as a Leader for the first time in its history.

According to Forrester, quote:

> *"Fortinet excels at performance for value and offers a wide array of adjacent services. Long known for its bang-for-the-buck approach to network security, Fortinet has built a flexible and capable platform with its flagship product, the FortiGate Firewall."*

Taking a closer look at the income statement…

Product revenue grew 39%. Product revenue growth for our Core and Enhanced Platform Technology products increased 29% and 51%, respectively.

The product revenue growth rate accelerated over four points sequentially, especially impressive given it was our *toughest year-over-year comparison in over ten years.*

Service revenue was up 28% accelerating 3 points sequentially, driven by strong product revenue growth and *seven consecutive quarters of increasing short-term deferred revenue growth rates.*

Support and related service revenue was up 28%, accelerating over two points sequentially to $311 million, while security subscriptions service revenue was up 29%, accelerating four points sequentially, to $370 million.

Total revenue in the Americas increased 34%, EMEA revenue increased 37%, and APAC posted revenue growth of 23%.

Total gross margin at 76.2% exceeded the high-end of our guidance range.

Product gross margin of 61.0% was up 30 basis points year-over-year.

Service gross margin of 86.6% was flat year-over year, but up 70 basis points sequentially.

Operating margin of 28.3% was up 250 basis points, benefiting from Fx and the operating margin leverage that comes with higher revenues.

Shifting to Billings…

Billings of $1.4 billion were up 33%, representing the *6th consecutive quarter of billings growth in excess of 30%.*

Core Platform billings were up 27% and accounted for 67% of total billings.

As shown on slide 6, entry level FortiGates posted very strong billings growth with the mix shifting 16 points in their favor driven by demand and, as we expected, improved supply.

Enhanced Platform Technology billings were up 45% and accounted for 33% of total billings, a positive mix shift of three points.

Average contract term was flat year-over-year at 29 months.

Looking to the Statement of Cash Flows summarized on slides 7 and 8…

Free Cash Flow was *$395 million. Adjusted* Free Cash Flow, which excludes real estate investments, was $464 million, representing a 40% adjusted free cash flow margin.

DSOs were down 5 days sequentially, while increasing 12 days year-over-year to 75 days.

Cash taxes were $69 million.

Capital expenditures were $88 million, including $69 million for real estate investments.

We repurchased 10.2 million shares of our common stock for a cost of $500 million, bringing the year-to-date totals to 36 million shares at a total cost of $2 billion. The remaining repurchase authorization totals $530 million.

Regarding backlog…

The backlog at the end of the third quarter was up slightly from the end of the prior quarter with FortiGate firewalls accounting for just one third of total backlog. We expect fourth quarter ending backlog to be relatively consistent with the third quarter backlog as we are seeing early signs of a transition back to more normalized customer buying behaviors.

Moving to guidance…

The current environment favors a Fortinet style platform that offers integrated solutions and strong security capabilities at an attractive cost of ownership. To enhance our ability to capture our share of the large market opportunity, we plan to continue to invest in innovation across our integrated platform offerings.

Now, I'd like to review our outlook for the fourth quarter summarized on slide 9, which is subject to the disclaimers regarding forward-looking information that Peter provided at the beginning of the call.

And to start, as part of the Q4 guidance setting process, we considered several factors, including:

- The greater macro uncertainty today, and with it, the increased risk to forecasting the timing for larger transactions.
- The transition to more normalized customer buying behaviors means there is less of an emphasis on 'ordering to get a place in line'. For comparison, in the fourth quarter of 2021 when supply was tighter, backlog increased over $120 million and contributed to 49% bookings growth.
- And lastly, elevated year-earlier top line comparisons that include certain one-time items adding a couple of points of service revenue growth, and fully cycling the Alaxala acquisition.

In response, we have slightly widened top line guidance ranges.

For the fourth quarter, we expect to again reach the Rule of 60, and with that the key metrics include:

- *Billings* in the range of $1 billion 665 million to $1 billion 720 million, which at the midpoint represents growth of 30%,
- Revenue in the range of $1 billion 275 million to $1 billion $315 million, which represents growth of 34%,

- Non-GAAP gross margin of 75% to 76%,
- Non-GAAP operating margin of 30.0% to 31%,
- Non-GAAP earnings per share of $0.38 to $0.40, which assumes a share count between 795 and 805 million,
- We expect capital expenditures of $75 to $85 million,
- We expect a non-GAAP tax rate of 17%.

For the full year, we expect billings and revenue growth to exceed 30% for the second consecutive year.

- *Billings* in the range of $5 billion 540 million to $5 billion 595 million, which at the midpoint represents growth of 33%,
- Revenue in the range of $4 billion 410 million to $4 billion 450 million, which represents growth of 33%,
- For context, at the midpoints these full year billings and revenue growth rates are 3 points higher than the initial growth rates we provided in early February, despite the start of the war in Ukraine in late February, a significant increase in interest rates, an increasingly uncertain macroeconomic environment and importantly, full year backlog that is expected to be above the February estimate of $350 million.
- Total service revenue in the range of $2 billion $645 million to $2 billion $655 million, which represents growth of 27% and implies full year product revenue growth of 42%,
- Non-GAAP gross margin of 75% to 76%,
- Non-GAAP operating margin of 26.0% to 27.0%, at the midpoint a year-over-year increase of 30 basis point
- Again for context, at the midpoint gross and operating margin expectations are 50 and 100 basis points above the February guide, respectively.

- Non-GAAP earnings per share of $1.13 to $1.15, which assumes a share count of between 800 and 810 million,
- We expect full year capital expenditures of $325 to $335 million,
- We expect our Non-GAAP tax rate to be 17%,
- We expect cash taxes to be $265 million

Before wrapping up, I would like to offer some preliminary thoughts on 2023 and our mid-term targets, on the heels of very strong growth in 2021 and 2022.

We continue to successfully balance growth and profitability while investing in longer term innovation and go to market initiatives to fuel future growth.

The strength of our business model includes its diversification, margins that provide capacity for future investment, and a rich mix of higher margin recurring service revenues.

- As we saw in the height of the pandemic, this diversification helps mitigate the risk of economic slowdowns. Specifically, in 2020 we delivered operating margins of nearly 27%, adjusted free cash flow margin of over 38% and top line growth of 20%.
- During the past 12 months we have readily exceeded our operating margin targets while increasing our engineering headcount by about 20% and significantly increasing our future sales capacity by over 25%, including a greater than 50% increase in new, non-tenured, salespeople.
- While we will provide more detailed 2023 guidance when we report our fourth quarter results, it's worth noting that service revenue accounts for 60% of total revenue with gross margins hovering above 85%. We see continued service revenue growth driven by two years of very strong product revenue growth and *seven consecutive quarters of accelerating short-term deferred revenue growth*.

With a strong business model and a history of being able to execute, we are confident that our momentum will continue and point to our key growth drivers including strategic investments, the heightened threat environment, the convergence of networking and security, and cybersecurity consolidation.

Cybersecurity, though not immune to economic slowdowns, is expected to remain a comparatively safer harbor.

As such, we remain on track to achieve *all* of the medium-term financial targets from our May 2022 Analyst Day including $10 billion in billings and $8 billion in revenue in 2025, each representing a 22% three-year CAGR from the midpoints of our 2022 guidance.

The targets also include an *average* Non-GAAP operating margin of *at least* 25% for the four years from 2022 to 2025 and a 2025 *Adjusted* Free Cash Flow margin in the mid-to-high 30% range. Illustrating our long-term focus for balancing growth with profitability, our targets remain committed to the Rule of 40, or better.

I'll now hand the call back over to Peter to begin the Q&A session.

Closing Remarks: Peter Salkowski, VP of Investor Relations

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

Fortinet will be attending investor conferences hosted by Barclays, Stifel, and Wells Fargo during the fourth quarter. 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!