Fortinet Q2 2022 Earnings Prepared Remarks

<u>Peter Salkowski, VP of Investor Relations</u>

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 second 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 second quarter before providing guidance for the third 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 second quarter 2022 results.

Total billings increased 36%; the fifth consecutive quarter of at least 35% year-over-year billings growth. Revenue grew 29% driven by 34% product revenue growth. SD-WAN and OT bookings grew over 60% and 75%, which together accounted for 25% of total second quarter bookings. Our better-than-expected performance demonstrates the strong demand for our cyber security innovation.

Fortinet is at the forefront of networking and security convergence, enabling our customers to reduce complexity, while securing and connecting hybrid and remote users to advanced security with superior performance.

Today we announced the FortiGate 4800F, our latest innovation in converged Network Security. The 4800F is the world's fastest compact Firewall for hyperscale data centers and 5G networks. Powered by Fortinet's NP7 SPU, the 4800F delivers Security Compute Ratings of on average 5-10 times better performance than competitive solutions, across the 6 most common and important functions.

A leader in the Gartner Magic Quadrant for WAN Edge Infrastructure[1], Fortinet continues to take market share for Secure SD-WAN. Our integrated secure SD-WAN solution, powered by Fortinet's SPU SOC4, delivers huge performance, security and efficiencies over traditional offerings.

In addition to convergence, consolidation of vendors and product functionality is another major trend, particularly in Network Security. In a recent CISO survey, Gartner found the percentage of companies surveyed who want fewer security providers increased to 75% from only 29% in 2020.[2] With over 30 products lines built mostly by our inhouse strong engineering and development innovation, Fortinet is benefiting from this consolidation with our Security Fabric MESH offering. The Fortinet Security MESH platform delivers unparalleled protection with broad, integrated and automated protection across multiple edges, from endpoint, to data center, and hybrid cloud environments. These two major trends – convergence and consolidation position Fortinet well for long-term growth.

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, that are contributing to Fortinet's strong growth.

Keith Jensen, CFO

Thank you Ken and good afternoon everyone.

Let's start the more detailed quarterly discussion…

Second quarter results were solid and broad-based – across geographies, customer sizes, industries, and use cases – driving market share gains and demonstrating the strong support from our 3 key growth drivers…

- First, an elevated threat environment
- Second, the convergence of security and networking, and
- Third, the consolidation of security products across our platform offerings

Total revenue of $1 billion $30 million was up 29%, *passing the $1 billion dollar milestone in quarterly revenue for the first time in our history.*

Total product revenue growth was up 34%. Core Platform and Platform Extension product revenue growth was up 35% and 33%, respectively.

We continued to see robust product revenue growth from a wide range of security use cases, including Secure SD-WAN and Operational Technology, or OT.

Total service revenue growth rate increased sequentially to 25%, resulting in service revenue of $629 million.

Support and related service revenue was up 26% to $289 million, while security subscriptions service revenue was up 25%, or two points sequentially, to $340 million.

Service billings, defined as total billings minus product revenue*, were up 36%.*

The year-over-year growth rate for short-term deferred revenue has increased for six quarters in a row – from just under 21% in Q4'2020 to just over 31% in Q2'2022 – *the highest short-term deferred revenue growth rate in over six years*.

The accelerating growth rates for service billings and short-term deferred revenue reflect the earlier pricing actions that quickly appeared in product revenue and that are now beginning to appear in service revenue.

The pricing benefit more than offset various service revenue headwinds, including:

- suspending services in Russia,
- an increase in the average number of days between when a customer purchases and subsequently activates a security service contract, and
- the impact of contract manufacturers delaying deliveries to later in the quarter, limiting service revenue on new sales recognized in the quarter.

With growth and pricing benefits more than offsetting headwinds, we expect service revenue *growth will continue to accelerate through 2022* and into next year.

As summarized on Slide 6, total revenue in the Americas increased 23%, EMEA revenue increased 28%, and APAC posted revenue growth of 42%.

Despite macro conditions that may be more readily impacting other industries, our pipeline growth remains strong. In particular, EMEA's pipeline growth indicates continued strength in our European business.

Moving to a summary of our success with large enterprises…

Large enterprises continue to favor Fortinet's leading cost for performance advantage and are increasingly more appreciative of our integrated platform. The platform strategy allows customers to converge networking functionality with security capabilities and consolidate multiple point products.

Our success with large enterprise customers includes:

- Global 2000 bookings growth of *over 65%* year-over-year and on a rolling 4 quarter basis
- Large enterprise bookings growth of *over 55%* year-over-year and on a rolling 4 quarter basis, and
- The number of deals over $1 million increased over 50% to 122 deals and the total billings value of these transactions doubled.

Secure SD-WAN bookings grew over 60% reflecting the convergence of networking and security as well as a strong ROI for our customers. OT bookings were up over 75% reflecting the continued response to the elevated threat environment.

Shifting to Billings…

Billings of $1.3 billion were up 36%, representing the *5th consecutive quarter of billings growth in excess of 30%.*

I'll pause here to offer thoughts on product refresh cycles and their impact on our financial results. Specifically, we do not believe new product releases drive a near term spike in our top-line growth; rather, we believe the continual nature of our product releases drives long-term growth.

- For example, each new ASIC is included in a series of products released over several years.
  - Our most recent ASIC chip, the NP7 Security Processing Unit, was introduced in Q1 2020. Including the 4800F announced today, we have released 9 high-end Core Platform products with the NP7 chip. Over the next several quarters we will release several additional mid-range and high-end products with the NP7.
- Lastly, since the start of 2019, we have released 23 new FortiGate models.

While some of our competitors with much shorter product SKU lists may have shown clear signs of product refresh cycles, our strong long-term performance illustrates an extended series of overlapping product maturity curves.

Core Platform billings were up 32% and accounted for 69% of total billings. As shown on slide 7, mid-range FortiGates posted very strong billings growth with the mix shifting 5 points in their favor driven by demand as well as supply availability.

Platform Extension billings were up 44% and accounted for 31% of total billings, a mix shift of over one and a half points.

Average contract term was up one month year-over-year at 29 months, driven by the strength from large enterprise customers and the 50% plus increase in the number of deals greater than $1 million.

Worldwide government billings grabbed the largest share of the mix at 15% and were up 45%. The top 5 verticals accounted for 60% of total billings.

Moving back to the income statement…

Total gross margin of 76.5% exceeded the midpoint of the guidance range by approximately *125 basis points*, even as component, labor and freight costs increased, and the year-over-year revenue mix shifted 2 points to product revenue from higher margin services.

Product gross margin of 61.9% was up 20 basis points year-over-year – *and 450 basis points sequentially* – as pricing actions, product mix, and lower discounting offset higher component and other costs.

Service gross margin of 85.9% was down 100 basis points due to increased costs associated with the expansion of our data center footprint as well as labor cost and other costs; partially offset by benefits from Fx and earlier pricing actions.

Operating margin of 24.8% exceeded the midpoint of the guidance range by *approximately 200 basis points*. The year-over-year comparison saw the Fx benefit offset by lower gross margins, increased travel and marketing costs and other costs.

Headcount increased 27% to 11,508.

Looking to the Statement of Cash Flows summarized on slides 8 and 9…

Free Cash Flow was *$284 million and* was impacted by increases in DSO and cash taxes.

DSO increased 14 days year-over-year and 5 days sequentially to 80 days due to the change in billings linearity driven by the timing of inventory deliveries from contract manufacturers.

New R&D capitalization rules increased second quarter cash taxes by $85 million to $110 million. Second half cash taxes of approximately $135 million are expected to be more evenly spread across the third and fourth quarters.

For the first half of the year, our Adjusted Free Cash Flow margin, which excludes real estate spending, was 34%.

Capital expenditures for the quarter were $39 million, including $21 million for real estate investments.

We repurchased approximately 14.4 million shares of our common stock for a cost of $800 million, bringing the total year-to-date shares repurchased to 25.8 million for a total cost of $1.5 billion.

The Board increased the share repurchase authorization by $1 billion. The remaining repurchase authorization is now $1 billion $30 million.

Inventory turns of 3.1 times were up a half turn year-over-year and down a half turn sequentially.

Moving to bookings and backlog…

As a reminder, backlog is excluded from the current quarter billings and revenue; however, it is expected to provide increased visibility and a top-line tailwind in future quarters.

Bookings were up 42% to $1.4 billion.

Total backlog of $350 million is up $72 million sequentially and reflects very strong demand. Of the total backlog, networking equipment accounted for about 50%, while FortiGates accounted for 40%.

We believe our backlog is very strong as…

- Existing customers account for over 95% of total backlog and no single end-customer accounts for more than a low-single-digit percentage of backlog.
- There are 4 deals in backlog, all from previously existing customers, with a remaining balance of over $2 million that together account for 6% of total backlog.

- Just 4% of ending Q1 backlog was canceled in Q2 and about half of the deals in backlog have been partially fulfilled – suggesting that double ordering is not a significant contributor to backlog.

Consistent with the first quarter, we shipped approximately 60% of the prior quarter's backlog in the current quarter, as our team did an excellent job navigating the tough supply chain environment.

Nonetheless, we still expect supply chain constraints to be challenging throughout the remainder of the year.

We are continuing to address the supply chain challenges in a number of ways, including by increasing inventory purchase commitments, redesigning products, qualifying additional suppliers, and certain pricing actions.

We believe that even with these actions, demand will continue to outstrip supply. As a result, we expect backlog to continue to increase in 2022; and while the situation is very dynamic, we believe we will have access to sufficient inventory to meet our guidance.

As we balance our pricing actions with the opportunity for continued market share gains, we have passed along most, but not all cost increases. As such, we expect ongoing gross margin volatility from these increases as well as from shifts in our product mix related to inventory availability.

Before reviewing our guidance, let's offer a few Fortinet specific observations in areas you may have heard discussed elsewhere. In Q2,

- We noted certain larger transactions with increased negotiating cycles.

- Also, linearity pushed to later in the quarter, and later in the last month of the quarter, due mainly to supply constraints.

- Lastly, close rates were strong and, importantly, the aggregate value of deals that pushed out were within our historical norms.

Now, I'd like to review our outlook for the third quarter summarized on slide 10, which is subject to the disclaimers regarding forward-looking information that Peter provided at the beginning of the call.

For the third quarter, we anticipate our solid third quarter pipeline growth across deal types, sizes and geographies to support the following:

- *Bookings* in the range of $1 billion $455 million to $1 billion 485 million, which at the midpoint represents bookings growth of 36%,
- *Billings* in the range of $1 billion 385 million to $1 billion 415 million, which represents growth of 32%,
- Revenue in the range of $1 billion 105 million to $1 billion $135 million, which represents growth of 29%,
- Non-GAAP gross margin of 75% to 76%,
- Non-GAAP operating margin of 25% to 26%,
- Non-GAAP earnings per share of $0.26 to $0.28, which assumes a share count between 810 and 820 million,
- We estimate third quarter capital expenditures to be between $105 and $115 million,
- We expect a non-GAAP tax rate of 17%.

For the full year, we anticipate backlog that could approach or possibly exceed $500 million, will be offset by robust industry growth, pipeline strength, and market share gains fueling our growth and support the following:

- *Billings* in the range of $5 billion 560 million to $5 billion 640 million, which at the midpoint represents growth of 34%,
- Revenue in the range of $4 billion 350 million to $4 billion 400 million, which represents growth of 31%,

- Total service revenue in the range of $2 billion $620 million to $2 billion $670 million, which represents growth of 27% and implies full-year product revenue growth of 38%,
- We expect Non-GAAP gross margin of 75% to 76%,
- Non-GAAP operating margin of 25% to 26%,
- Non-GAAP earnings per share of $1.01 to $1.06, which assumes a share count of between 810 and 820 million,
- We estimate full year capital expenditures to be between $300 and $330 million,
- We expect our Non-GAAP tax rate to be 17%,
- We expect cash taxes for the year to be $265 million, as I mentioned earlier, cash taxes paid are higher in 2022 due to the new R&D capitalization rule in the US.

Along with Ken, I would like to thank our partners, customers, suppliers, and all members of the Fortinet team for all of their hard work, execution and success.

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 KeyBanc, Citibank, Evercore, Stifel, and Goldman Sachs during the third 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!

[1] – *Gartner, Magic Quadrant for WAN Edge Infrastructure, Jonathan Forest | Naresh Singh | Andrew Lerner | Evan Zheng, September 2022*

[2] - *Gartner, Gartner Tech Growth & Innovation Conference, Trend and Technologies That Will Reshape the Security Market and What to Do About Them, Neil MacDonald, July 2022*