Fortinet Q4 2023 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 fourth quarter of 2023.

Joining me on today's call are Ken Xie, Fortinet's Founder, Chairman and CEO, Keith Jensen, CFO and John Whittle, 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 full year and fourth quarter of 2023 before providing guidance for the first quarter of 2024 and 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 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

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

In Q4, total billings grew 8.5% to $1.9 billion, driven by our increased focus on SecOps, SASE and improved execution from our sales teams. We closed six 8-figure deals across 5 industry verticals. All six of these transactions include all 3 of our SASE, SecOps and Secure Networking solutions, illustrating the value of our integrated platform that spans across on-premises and cloud as well as our FortiASIC technology advantages.

Fortinet's total addressable market across SecOps, SASE and Secure Networking is expected to increase from $150 billion in 2024 to $208 billion by 2027. Our customer base consists of 76% of the Fortune 100, including 9 of the top 10 technology companies, 9 of the top 10 manufacturers and 9 of the top 10 healthcare.

Our SecOps billings grew 44%, accounted for 11% of total billings with strong performance from several solutions including EDR, SIEM, Email Security, and NDR, to automatically detect, investigate, and respond to threats.

Unified SASE billings grew 19%, accounting for 21% of our total billings.

We believe Fortinet is the only company with a unified SASE solution all integrated into a single FortiOS that includes a full networking and security stack consisting of market leading SD-WAN, ZTNA, Secure Web Gateway, CASB, and Firewall-as-a-Service designed for on-premises and cloud. Our FortiSASE solution is gaining momentum quickly, as we closed our first 8-figure SASE deal for 350,000 seats.

In Q4, we added 40 new features to our SASE solution, including support for over 150 PoP locations worldwide and the ability to protect thin edge devices. We see a huge opportunity to attach FortiSASE to our tens of thousands of SD-WAN customers.

Secure Networking accounted for 68% of billings and represents our largest addressable market. Gartner expects the Secure Networking market to overtake the traditional networking market by 2030. Fortinet is the #1 network security vendor with over half of the global firewall deployment. In addition to physical firewalls, we offer virtual, cloud native and Firewall-as-a-service solutions, all based on our FortiOS operating system that consolidates over 30 networking and security functions together.

Converged security and networking require more specialized computing power than traditional networking. Our FortiASIC powered FortiGate delivers 3x to 10x more performance as indicated by the security compute rating with every new FortiGate product release. The latest FortiASIC SP5 based FortiGate70G with Dual 5G in ruggedized format secures devices within operational technology environments, it is off to a great start as a Fortune 50 company signed an 8-figure operational technology deal featuring this new FortiGate in the fourth quarter. Also included within our FortiOS operating system is a fully featured Access Point controller. Recently we announced a new secure access point product, making us the first vendor to announce a business-grade WiFi 7 product.

Fortinet has consistently been an innovative cyber security company and this earnings call wouldn't be complete without a few words about our AI.

We have invested heavily in AI across every function and product. For over a decade, Fortinet has used machine learning and AI to provide advanced threat intelligence across more than 40 products from network, end point and application security. Our solutions apply AI and ML across the expanded digital attack surface automatically containing and remediating incidents within seconds, where the industry averages for detection and remediations takes several days. We have also been applying Gen AI technology across our entire product line, allowing customers to optimize the security effectiveness and operational efficiency. FortiAI is already available on FortiSIEM and FortiSOAR, and more products will be adding this functionality in the coming months.

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 Jensen, CFO

Thank you, Ken, and good afternoon everyone.

As Ken mentioned, billings grew 8.5% driven by improved sales execution and early returns on our SASE and SecOps investments. The quarter benefited from what we saw as a muted seasonal budget flush and certain deals that had pushed from earlier quarters closing in the fourth quarter driving a record six transactions, each over $10 million.

For these exceptionally large transactions, Secure Networking was 75% of the billings mix while SecOps and SASE combined for another 20% plus, illustrating these companies' long-term commitment to both firewall and consolidation strategies.

Taking a closer look at three of these 8-figure deals…

One of these deals included mid-seven figures for SecOps and another mid-seven figures for SASE. The SASE solution covers a planned 350,000 user deployment at a top U.S. school district to provide a safe learning environment for students regardless of their physical location. We won this deal because of our operating system's ability to integrate 30-plus networking and security functions across SecOps, SASE and Secure Networking into a single, unified platform providing consistent policies, and automated responses.

Our vision encompasses creating a secure foundation for our customers, allowing them to navigate today's evolving digital landscape with confidence while empowering them to embrace innovation without compromising security.

Illustrating this vision, in another 8-figure deal, a large U.S. enterprise selected Fortinet to support their hybrid cloud architecture as they transition more of their workloads to the cloud. This competitive displacement reduced complexity and the customer's total cost of ownership while showcasing our ability to consolidate security functions onto our FortiOS platform.

In a third 8-figure win, a large financial institution in the U.S. expanded our partnership with their first Enterprise Agreement with Fortinet. This EA includes the recently announced FortiGate Rugged 70G to secure their remote working and ATM environments.

Built with AI-powered security, the Rugged 70G brings our customers the latest secure networking innovations while at the same time simplifying infrastructure and driving efficiencies.

In addition to exceeding the customer's performance expectations in a multi-vendor bake-off, we were successful by demonstrating the versatility of our single operating system and FortiOS platform across multiple use cases.

Over the past several years, we have successfully addressed large customer buying preferences by increasing our investments in EA programs. In the fourth quarter, these contracts represented nearly 10% of our billings with a three-year CAGR of over 80%.

Today, with over 35% of our billings beyond traditional, and sometimes cyclical, firewalls, Fortinet has become an increasingly diversified business over the past decade. Most recently, the diversification has included prioritizing investments in SASE, SecOps and other software and cloud-based solutions.

A key element of the diversification is our single operating system strategy. FortiOS is the foundation of our comprehensive and innovative solutions that drive the convergence of networking and security while also consolidating multiple security capabilities.

Attempting to piece together best-of-breed solutions from multiple vendors can result in significant security gaps, slower AI-driven technology adoption, and a slower pace of identifying, reporting, and resolving security incidents.

Organizations increasingly recognize that an integrated security solution run by a single operating system is the best way to improve their security posture. Consolidation allows security solutions to share data and communicate with each other - reducing complexity, improving security effectiveness, easing the need for skilled labor, and lowering the total cost of ownership.

Consolidation drove our SecOps business to 44% growth with strong growth from EDR, SIEM, email security, and NDR. Importantly, 94% of our SecOps business was from existing customers, as companies look to execute their vendor consolidation strategy with Fortinet.

Digging a little deeper into the 11% of billings that SecOps contributed to our business, the mid-enterprise segment is growing the fastest, as these companies respond to the cybersecurity labor shortage and look to reduce complexity.

Geographically, International Emerging is leading the way for SecOps, likely reflecting stronger economic conditions and extending the success of their 2022 pilot project.

Extending the single operating system and consolidation strategy further, our single vendor SASE solution billings increased 19% and accounted for 21% of total billings. Our SASE pipeline is up over 150% as more of our sales reps are building pipeline.

As expected, the SMB segment was the largest mix of SASE customers at 55%, increasing 8 points quarter over quarter. Fortinet has one of the least complex and most customer friendly SASE pricing models. Our one bundle – and one operating system solution – provides all the standard capabilities, including:

- Secure Web Gateway and Firewall-as-a-Service for secure internet access,
- Zero Trust Network Access and SD-WAN from our Points of Presence providing secure private access, as well as
- CASB and Data Loss Protection.

Our single vendor SASE solution also includes integration to SOC-as-a-service and FortiClient, which provides the customer with endpoint protection and vulnerability scanning.

Regarding our focus and investments in SASE and SecOps…

- SD-WAN customers represented 37% of new SASE customers.
- Over 90% of our global sales force has completed mandatory sales training for both SASE and SecOps.
- In 2023, 60,000 customers and partners attended at least one of our 27 training workshops.
- Lastly, we've increased our worldwide points of presence coverage to over 150 locations.

Turning now to the quarterly financial results…

Total billings were $1.86 billion, up 8.5% driven by improved sales execution and the strong rebound in the large enterprise segment, together with 6,400 new logos.

On a billings by geo basis, the U.S. led the way with mid-teens growth, driven by strong performance in the U.S. enterprise.

In terms of industry verticals, government and financial services, each with growth of approximately 25%, were our top two industry verticals while service provider and retail remained under pressure.

The average contract term was 30 months, up 2 months year over year and sequentially. Adjusting for the six 8-figure deals, the normalized contract term was consistent year over year and sequentially at 28 months.

Turning to revenue and margins….

Total revenue grew 10% to $1.42 billion, driven by strong services revenue growth.

Service revenue of $927 million grew 25%, accounting for 66% of total revenue - a mix shift of 8 points. Service revenue growth was driven by strength in SecOps, SASE and other security subscriptions.

Product bookings were up, however, product revenue decreased 10% to $488 million due to a tough compare. Product revenue grew 43% in the prior year period, benefitting from the drawdown of backlog.

Total gross margin of 78.5% was up 90 basis points and exceeded the high end of the guidance range by 200 basis points, driven by the increase in service gross margins and the 8-point mix shift from product revenue to service revenue.

Service gross margins were up 140 basis points as service revenue growth outpaced labor costs and benefitted from the mix shift towards higher margin security subscription services.

Product gross margins were down 510 basis points as we continued to see margin pressure related to inventory levels and product transitions.

Operating margin was very strong at 32%, three and a half points above the high end of our guidance range and operating income of $454 million was $40 million above the high end of the implied guidance range, reflecting aggressive cost management.

Looking to the Statement of Cash Flows summarized on slides 17 thru 19…

Total cash taxes paid in the fourth quarter were $341 million, including $210 million in estimated tax payments that were deferred from earlier quarters in accordance with U.S. and California one-time regulatory relief, resulting in Free Cash Flow of $165 million.

Capital expenditures were $27 million.

We repurchased approximately 16.8 million shares at a cost of $895 million for an average cost per share of $53.29.

Moving to an overview of our 2023 full year results…

Billings surpassed the $6 billion mark, totaling $6.4 billion, up 14%.

Total revenue grew 20% to $5.3 billion and we added over 25,000 new customers.

Service revenue grew 28% to $3.4 billion, driven by a 33% increase in security subscriptions.

Product revenue grew 8% to $1.9 billion on a very tough compare after growing 42% in 2022.

Gross margin was up 110 basis points to 77.4%, benefiting from the revenue mix shift to service revenue.

Operating margin also increased 110 basis points to a calendar year record of 28.4% resulting in operating income of over $1.5 billion.

The GAAP operating margin of over 23% continues to be one of the highest in the industry.

Earnings per share increased 37% to $1.63.

Free Cash Flow was a record at over $1.7 billion. Free Cash Flow margin was 33%. Excluding real estate investments, the Adjusted Free Cash Flow margin came in at 35%.

For the year, we repurchased approximately 27 million shares at a cost of $1.5 billion for an average cost per share of $55.25. And, as summarized on slide 20, Fortinet has returned $5.3 billion to shareholders via share repurchases in the past three years.

Earlier this year the Board increased the share repurchase authorization by an additional $500 million, bringing our remaining share repurchase authorization to approximately $1 billion.

Moving onto guidance…

As we look to 2024, several factors impact guidance including the firewall industry cycle, remnants of 2022 and 2023 supply chain activity, and customer buying behavior.

- Prior firewall product cycles have lasted approximately 4 years, with 8 quarters of higher growth followed by 8 quarters of slower growth. Looking at our bookings, the current product cycle decline started approximately 4 quarters ago in Q1'23, suggesting that we should experience the bottom of the cycle in early 2024.
- Worldwide supply chain challenges resulted in elevated purchasing and record backlog, distorting year-over-year growth comparisons and creating a period of project and product digestion.
    - The backlog drawdown in the first half of 2023 provided a mid-to-high single digit percentage tailwind to billings and low double-digit tailwind to product revenue growth for that period. The year over year product revenue comparisons in the first half of 2024 will be the most challenged, while we expect service revenues to grow sequentially in

the low single digits in the first quarter and to grow sequentially in the low- to mid-single digits for the remainder of 2024.

- In addition, we expect product revenue growth will continue to be impacted by project and product digestion in 2024.

- And, we believe the selling environment should improve in the second half of 2024 and into 2025.

As a reminder, our first quarter and full year outlook, which are summarized on slides 23 and 24, is subject to the disclaimers regarding forward-looking information that Peter provided at the beginning of the call.

For the first quarter, we expect:

- *Billings* in the range of $1 billion 390 million to $1 billion 450 million, which at the midpoint represents a decline of 5.5%,
- Revenue in the range of $1 billion 300 million to $1 billion $360 million, which at the midpoint represents growth of 5.4%,
- Non-GAAP gross margin of 76.5% to 77.5%,
- Non-GAAP operating margin of 25.5% to 26.5%,
- Non-GAAP earnings per share of $0.37 to $0.39, which assumes a share count between 775 and 785 million,
- Capital expenditures of $220 to $250 million, including a real estate transaction that closed earlier in the quarter.
- A non-GAAP tax rate of 17%, and
- Cash taxes of $30 million.

For the full year, we expect:

- *Billings* in the range of $6 billion 400 million to $6 billion 600 million,

- Revenue in the range of $5 billion 715 million to $5 billion 815 million, which at the midpoint represents growth of 9%,
- Service revenue in the range of $3 billion $920 million to $3 billion $970 million, which at the midpoint represents growth of 17%,
- Non-GAAP gross margin of 76.0% to 78.0%,
- Non-GAAP operating margin of 25.5% to 27.5%,
- Non-GAAP earnings per share of $1.65 to $1.70, which assumes a share count of between 785 and 795 million,
- Capital expenditures of $370 to $420 million,
- Non-GAAP tax rate of 17%, and
- Cash taxes of $520 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 an investor conference hosted by Morgan Stanley during the first quarter. The fireside chat webcast link 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!