Fortinet Q2 2023 Earnings Prepared Remarks

<u>Peter Salkowski, SVP Finance, Investor Relations</u>

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 second quarter of 2023.

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 of 2023 before providing guidance for the third quarter of 2023 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 second quarter 2023 results.

Total revenue in the second quarter increased 26%, driven by strong revenue growth in services which topped 30% for the second consecutive quarter, with 34% growth in security subscriptions, and non-FortiGate products grew over 45% which is nearing a $2 billion annual run rate.

Billings growth of 18%, led to more normalized product revenue growth of 18%. We believe our billing performance reflects large enterprises' concerns with the macro environment, in addition to some inventory digestion after two years of elevated 30%+ of product billing growth during the supply chain shortage.

According to IDC's latest Quarterly Security Tracker, in addition to having the #1-unit in the firewall category for 10 consecutive years with over 50% market share, Fortinet is now the market share leader in both units and revenue.

Based on the latest Westlands Advisory OT Security and Cybersecurity report, Fortinet was named as the only IT/OT Network Protection Platforms leader. We are currently one of the top and fastest growing OT security vendors in a market that Westlands Advisory expects to grow to $33 billion by 2030.

Fortinet's success lies in our broad integrated platform, our proprietary ASIC security processor, and our ability to converge networking and security both on-prem and in the cloud across a single FortiOS operating system. To leverage these advantages and drive future growth, in additional to our leading network security solution, we will increase our go to market investments in Universal SASE, SD-WAN, OT security, Cloud security, and Security Operations, and we will be dedicating more resources to support hybrid infrastructure and hybrid work.

Today, we announced the new FortiGate 90G, our first next-generation firewall and secure SD-WAN appliance with the new Security Processor 5 ASIC that delivers industry-leading security functions, performance, scalability, and power efficiency at a cost-effective price. The FortiGate 90G is fully integrated with our FortiGuard AI-powered Security Services and has secure compute ratings that are up to 16 times greater than the average of our competitors' similarly priced models while using over 90% less power than competing solutions.

We also announced two new SD-WAN services: Underlay performance monitoring service to simplify operations and enhance digital experience, as well overlay service to facilitate rapid deployment, redundancy and seamless inter-connection of locations with FortiSASE using SPA technology. These new SD-WAN services showcase our commitment to expanding our service leveraging our leading installation base for additional future growth. We see our single vendor SASE solution opening a large, new market and one where our sizeable SD-WAN installed base can be leveraged as a significant market access point, together with newly announced SD-WAN service, we plan to accelerate our global Point of Presence (PoP) deployment with a dual strategy of investing in our own PoPs as well as working with service providers.

Fortinet recently announced the results of an independent analysis by Forrester of the cost savings and business benefits of deploying FortiGate Next-Generation firewalls and FortiGuard AI-Powered Security Services within the enterprise data center, which included more than a 300% return on investment (ROI) over three years, payback in six months, and 90% reduction in time spent on manual updates.

In addition, an independent analysis by Enterprise Strategy Group established that customers who deployed Fortinet Security Operations solutions, such as FortiEDR and FortiNDR, reduced their time to detect and respond to incidents from an average of three weeks to one hour. This demonstrates the substantial impact that artificial intelligence, machine learning, and the integration of Fortinet SecOps Fabric products can have on an organization's ability to secure today's rapidly expanding attack surface.

Finally, new developments in AI such as generative engines show a lot of promise to various applications in cybersecurity. We believe AI technologies can help us significantly to improve productivity and can be scaled to our large customer base in areas such as malware detection, threat hunting, event correlation and automation, as well as assisting networking design and troubleshooting.

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 the key highlights from the second quarter…

Billings growth was 18% as was product revenue growth. Service revenue growth held firm at 30% resulting in total revenue growth of 26%.

OT and SD-WAN revenue continued to perform well as revenues from these products were up 60% and 40%, respectively.

In a sign of our strength in the small and mid-sized customer segments, we added a record 6,500 new logos.

Operating margin at 26.9% exceeded the high end of the guidance range by 140 basis points.

Free cash flow was strong at $438 million, representing a margin of 34%, benefiting from the deferral of certain cash tax payments to the fourth quarter.

Looking at billings in more detail…

Billings of $1.54 billion were led by non-FortiGate billings at over 30% growth, representing 34% of total billings. Non-FortiGate billings growth was driven by networking, FortiGateVM, NAC, and cloud: and, as Ken mentioned, Non-FortiGate is nearing a $2 billion annual revenue run rate.

In terms of industry verticals, government and manufacturing topped the list as a percentage of total billings, with manufacturing up almost 50%. Government and construction were up over 30%, while service provider and retail were up 1% and down 5%, respectively. Retail was impacted by a very difficult compare, as the industry vertical nearly doubled in the year earlier period.

Billings growth varied by geo's with International Emerging leading, followed by Europe and LATAM.

APAC and, to a lesser extent, US enterprise were challenged by difficult prior year comparisons.

Deals over $1 million dollars increased from 122 deals to 134 deals.

Turning to revenue and margins….

Total revenue grew 26% to $1.29 billion, driven by Non-FortiGate growth of over 45% and service revenue growth of 30%.

This was the second consecutive quarter of greater than 30% service revenue growth. Security subscriptions represent over 55% of all service revenue and continued their streak of strong growth increasing sequentially every quarter from 23% in Q1'22 to 34% in Q2'23.

Product revenue of $473 million increased 18%.

Product lead times and backlog are expected to approach normal levels in the third quarter.

Total gross margin of 77.9% was up 140 basis points driven by a 160 *basis point increase* in product gross margin to 63.5%. Product gross margins benefited from earlier pricing actions and easing cost pressures, and were partially offset by certain inventory charges.

Service revenues were 63% of total revenues and delivered gross margin of 86.2%. Higher service revenue offset higher labor costs and increased cloud delivery costs, as we continue to expand our cloud and SASE delivery models.

We see our single vendor SASE solution opening a large, new market and one where our sizeable SD-WAN installed base can be leveraged as a significant market access point. We plan to accelerate our Point of Presence (PoP) deployment with a dual strategy Ken mentioned of investing in our own PoPs as well as working with third party providers to accelerate our deployment.

Operating income of $348 million grew 36%, outpacing revenue growth by more than 10 points, as operating discipline resulted in significant operating leverage.

Operating margin of 26.9% exceeded the high end of the guidance range and was *up 210 basis points* due to the strong gross margin performance and operational efficiencies.

Earnings per share increased 58% to $0.38 per share and also exceeded the high end of guidance.

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

Free Cash Flow increased 55% to *$438 million. Adjusted* Free Cash Flow, which excludes real estate investments, was $498 million, representing a 38.5% adjusted free cash flow margin.

Free Cash Flow benefitted from the deferral of approximately $190 million in cash tax payments. As mentioned last quarter, these tax payments together with other deferred 2023 tax payments are due to be paid in the fourth quarter.

Capital expenditures were $77 million, including $59 million of real estate investments.

Cash taxes in the quarter were $38 million.

The Board recently increased the Company's share repurchase authorization by $500 million, and the total available share buyback authorization is now approximately $2.0 billion.

Now, I'd like to share a few significant wins from the quarter that exemplifies the strength of our broad and integrated platform…

First, a global pharmaceutical leader signed an 8-figure deal to adopt Fortinet's cybersecurity Fabric, investing in our OT-aware secure networking architecture as well as our AIOps and threat intelligence solutions. Recognizing the market shift to a platform-based approach to security, this company selected Fortinet to secure its highly regulated and sensitive medical data as it continues to drive global operational and financial efficiencies through our broad, integrated and automated platform approach to cybersecurity.

In another deal, one of the largest US school districts, which had recently refreshed its data center firewalls with FortiGates, was seeking to improve its network security posture with a NAC solution that offers better visibility to the devices connected to its network. Fortinet competed against multiple peers and was able to win due to FortiNAC's ease of implementation, centralized management capability, and superior risk remediation as well as the tight integration with the district's existing Fortinet Security Fabric. This high 7-figure deal was the largest NAC deal in Fortinet's history.

Finally, in a 7-figure displacement, and our largest FortiSASE deal ever, a large bank on its digital transformation journey was searching for a single vendor SASE solution for its hybrid workforce. It selected our FortiSASE solution for its 5,000 users as it integrates SD-WAN and SASE into a holistic solution and delivers comprehensive security both from the cloud and on-prem while ensuring consistent security policies for all users regardless of their location and wherever applications are being accessed.

These transactions illustrate how Fortinet's platform strategy, integrated operating systems and proprietary ASIC technology continue to resonate with customers.

That said, given the heightened interest in AI technology, we could not do this call without discussing Fortinet's investment and innovations in AI…

Fortinet has been at the forefront of AI and Machine Learning innovation for many years, leveraging deep learning and artificial neural networks to power our products and security services, enabling a faster, stronger, and more accurate defense for our customers.

One of our first AI-powered use cases was the introduction of the virtual FortiGuard threat analyst. FortiGuard addresses threats in real time with Machine Learning — coordinated protection and is extensively used in malware detection and threat hunting. Every time a threat is identified, FortiGuard generates threat intelligence that automatically updates defensive signatures across the Fabric. In cloud environments, where scale and speed are critical, AI and Machine Learning can help security teams keep pace with threats on multiple fronts. All of this happens seamlessly and behind the scenes — requiring no staff time from an organization's security analysts.

Today, our platform ingests and analyzes on average more than 100 billion events every day to deliver over 1 billion security updates daily across the Fortinet Security Fabric and ecosystem. While many of our competitors OEM their security from different security vendors, our AI-driven FortiGuard Threat Intelligence has been built in-house, which allows us to use AI across different sources.

Adversaries increasingly are using AI in their playbooks to drive cyber-attacks, which will only increase the rapidly evolving cyber security threat landscape. We continue to invest in AI and Machine Learning technologies across our products, including Generative AI, Natural Language Models, and other implementations to enhance, simplify and automate security for our customers.

Before moving to guidance, I'd like to offer some observations from the second quarter and about the industry...

Regarding the second quarter, we believe macro-uncertainty impacted our billings performance through average contract durations and, in the second half of June, an elevated level of enterprise deals pushing to future quarters.

We saw shorter contract duration with the average term decreasing 1.5 months to 28 months, creating a 4 to 5-point billings headwind year over year. Normalizing billings growth for the change in contract duration, yields billings growth in the low 20% range.

Having some level of enterprise deals push to future quarters is not unusual. In Q2'23, however, an unusually large volume of deals that we expected to close in June, instead pushed to future periods.

From a market perspective, CIOs continue to prioritize and invest in securing their organizations in the face of rising cyber threats.

We see new regulatory requirements such as the recently announced rules on cybersecurity disclosures by the SEC, and the EU Cyber Resilience Act announced earlier this year that will continue to provide market tailwinds as organizations further increase their cybersecurity investments to comply with new stringent cyber regulations.

The cybersecurity industry remains highly relevant as CIOs prioritize cyber spending within their overall IT budgets. As such, the longer-term demand drivers for Fortinet remain very solid.

That said, we do see a return to more normal seasonality for Fortinet in the back half of the year as tailwinds such as the supply chain driven growth subsides and we cycle prior period price increases.

Moving onto guidance…

As a reminder, our third quarter and full year outlook, which are summarized on slides 11 and 12, are subject to the disclaimers regarding forward-looking information that Peter provided at the beginning of the call.

For the third quarter, we expect:

- *Billings* in the range of $1 billion 560 million to $1 billion 620 million, which at the midpoint represents growth of 13%, and is consistent with our quarter over quarter seasonality prior to the pandemic of low single digit growth.
- Revenue in the range of $1 billion 315 million to $1 billion $375 million, which at the midpoint represents growth of 17%,
- Non-GAAP gross margin of 75.5% to 76.5%,
- Non-GAAP operating margin of 24.5% to 25.5%,
- Non-GAAP earnings per share of $0.35 to $0.37, which assumes a share count between 795 and 805 million,

- Capital expenditures of $100 to $130 million,
- A non-GAAP tax rate of 17%,
- Cash taxes of $25 million,
- As previously mentioned, backlog is expected to approach normal levels in Q3.

For the full year, we expect:

- *Billings* in the range of $6 billion 490 million to $6 billion 590 million, which at the midpoint represents growth of 17%, and implies slightly below normal seasonality in Q4,
- Revenue in the range of $5 billion 350 million to $5 billion 450 million, which at the midpoint represents growth of 22.3%,
- Service revenue in the range of $3 billion $350 million to $3 billion $410 million, which at the midpoint represents growth of 28.2%.
- The service revenue guidance implies product revenue growth of 13.5%.
- Non-GAAP gross margin of 75.25% to 76.25%,
- Non-GAAP operating margin of 25.25% to 26.25%,
- Non-GAAP earnings per share of $1.49 to $1.53, which assumes a share count of between 795 and 805 million,
- Capital expenditures of $335 to $385 million due to our continued cloud, data center, and facilities investments.
- Non-GAAP tax rate of 17%,
- Cash taxes of $460 million with approximately $380 million in the fourth quarter,

We continue to execute our long-term strategy and remain confident in the strategy and in our solutions. While it's a little early to be providing guidance for next year, we would expect our near-term performance to represent a short-term trough. Given our confidence in our solutions, our offerings, and taking into account that growth comparisons will ease as we move through 2024, at this early stage we would expect billings growth to approach high-teens by the fourth quarter of 2024.

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 Deutsche Bank, Goldman Sachs, Oppenheimer, Rosenblatt, and Stifel 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!