Fortinet Q1 2023 Earnings Prepared Remarks

Peter Salkowski, SVP Finance, Investor Relations

Thank you. 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 first 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 first quarter of 2023 before providing guidance for the second 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 outstanding first quarter 2023 results.

For the first quarter, revenue growth was 32% due to strong growth in both product and service revenue. With 35% product revenue growth, we continue to gain market share while being a leading product revenue company in the cyber security industry. This strong product revenue growth will help drive future service revenue growth.

Quarterly service revenue grew over 30% for the first time in 6 years. We believe we have a significant opportunity to upsell value-added security services to our large installed base. In the first quarter, SD-WAN and OT bookings together continued to account for over 25% of total bookings, and our goal is to become the #1 in Network firewall, Secure SD-WAN, and OT security markets over the next couple of years.

Fortinet is leading the trend of network and security convergence and cyber security consolidation. Gartner expects that by the year 2030 the secure networking market will be larger than traditional networking. Traditional networking lacks awareness and control of content, applications, users, devices, and location and is still using the same network protocol that was developed 50 years ago. Fortinet's secure networking solution has expanded from Next Generation Firewalls to SD-WAN, SD-Branch, 5G, internal segmentation, ZTNA and Universal SASE, and we believe, the secure networking market can achieve double-digit growth annually for the foreseeable future.

In today's environment, organizations are looking to consolidate their multiple security vendors and functions that are deployed across their expanding attack surface to lower their TCO and management costs while improving visibility and automating real time threat detection and response. Fortinet's latest release of FortiOS 7.4 together with the FortiSP5 ASIC leads the industry with better integration and automation as well as faster acceleration while lowering TCO. FortiOS enables organizations to deploy the Fortinet Security Fabric to every edge, allowing security to dynamically scale and adapt as the network evolves.

Last month, we announced Universal SASE, which supports hybrid infrastructure and enables the same networking and security features that are available in our appliances to be delivered as-a-service, all within a single console. Many of our service provider partners are collaborating with us on this offering. Also, we announced enhancements to several of our Fortinet Security Fabric solutions, including endpoint security, cloud security, SoC, and SOAR.

As networking and security continue to converge and customers look to consolidate vendors and point products, we believe we are well positioned to achieve our 2025 billings target of $10 billion while generating an annual Non-GAAP operating margin of at least 25% for each of the next three years.

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…

<u>Keith Jensen, CFO</u>

Thank you, Ken, and good afternoon everyone.

Let's start with the key highlights from our strong first quarter performance…

Our strong first quarter results reflect a continued demand for our broad portfolio of cybersecurity and networking solutions and the demand for consolidation and convergence that is delivered by our integrated, single platform strategy.

Total revenue growth of 32% was led by strong product revenue growth and service revenue *growth accelerating to over 30%.*

Billings increased 30%, *our eighth consecutive quarter of at least 30% billings* growth.

Secure SD-WAN and OT bookings once again accounted for over 25% of total bookings.

Our strong top-line results reflect continued customer demand across both Core and Enhanced Platform Technologies and highlights the diversification of our business model – by solutions, geographies, customer segments, and industry verticals.

We continued to deliver balanced growth and profitability with better than industry average top-line growth and strong profitability despite the continued economic uncertainty.

The first quarter operating margin of 26.5% represents the highest first quarter operating margin in our 14-year history as a publicly traded company.

Free cash flow was $647 million, representing a margin of 51%, up 23 percentage points. Both the quarterly free cash flow and free cash flow margin are Fortinet post-IPO records.

Last month we hosted nearly 3,000 customers and partners at our very successful Accelerate conference and I'd like to recap 3 key themes:

1. Expanding firewall deployments environment
2. Convergence
3. Consolidation

First, today's rapidly evolving threat landscape and connectivity demands a comprehensive approach to firewalls and network security, including a combination of hardware, virtualized software, and security services.

In fact, Gartner anticipates that:

> *…by 2026, more than 60 percent of organizations will have more than one type of firewall deployment, which will prompt adoption of hybrid mesh firewalls.*

Fortinet is well-positioned to capitalize on this expansion of firewall deployments and form factors as we have been delivering hybrid mesh firewalls for years on a single operating system.

Second, the company was founded over 20 years ago on the belief that the convergence of security and networking will become an industry standard.

Gartner shares this belief noting they:

> *…expect the size of the secure networking market to overtake the traditional networking market by 2030.*

We believe secure networking at scale works most effectively on ASIC technologies.

Since its inception Fortinet has been developing proprietary ASIC technologies to build application-specific solutions to support convergence as traditional CPU-based solutions are less efficient at supporting both networking and security.

Third, vendor and product functionality consolidation strategies continue to become more commonplace. Looking to Gartner here again, they note:

> *…75% of organizations were pursuing a cybersecurity vendor consolidation strategy in 2022, up from 29% in 2020.*

Our integrated FortiOS platform allows customers to converge networking functionality with security capabilities, while consolidating cybersecurity products and functionality. With FortiASIC's significant computing power advantage, FortiOS can consolidate more security functions and solutions while maintaining our performance and cost advantage.

Specifically, FortiOS supports many security applications, including network firewall, SD-WAN, SASE, 5G, WiFi security, ZTNA, VPN, and SSL with a variety of use cases for each security application. For example, firewall use cases include data center, branches, edges, virtual, cloud native, micro-segmentation – both East/West and North/South – and firewall-as-a-service.

Our convergence and consolidation strategy provides security across our customers' entire digital infrastructure, while lowering their operating costs.

Let's now take a closer look at the first quarter…

Billings grew 30% to $1.50 billion, driven by Enhanced Platform Technology solutions.

In terms of industry verticals, government and financial services top the list as a percentage of total billings, with financial services up over 40%. Construction, media, and utilities were all up at least 50%.

Billings growth benefited from a better-than-expected backlog contribution. While the backlog cancellation rate increased quarter-over-quarter, it was lower than we had forecasted in our model.

We continue to believe there is an elevated cancellation risk in future periods for networking equipment backlog.

Bookings grew double digits in the quarter, off a challenging comparison of 50% growth in the first quarter of last year.

We continue to see success with our strategy to expand further into the large enterprise segment with the number of deals over $1 million increasing 38% to 124 deals and billings on these deals increasing 50%.

One of these deals was an 8-figure expansion and upsell opportunity at a Fortune 50 retailer. The retailer was looking to replace their firewall point solutions with a holistic cybersecurity solution.

After purchasing FortiManager and FortiAnalyzer in the fourth quarter of last year, this customer selected FortiGate VMs after a very competitive process for their 2,000 store locations as part of our new FortiFlex program. FortiFlex is a new points-based consumption program supporting hybrid mesh firewall deployments as well as a variety of other security solutions. The customer selected Fortinet due to the substantial value offered by our unified platform and their significant technical requirements.

In the first quarter, we added approximately *6,100 new logos* – reflecting the support of our channel partners through their investments and the investments we've made in them.

Average contract term was flat year-over-year at 27 months and down 1 month quarter-over-quarter.

Turning now to revenue….

Total revenue grew 32% to $1.26 billion, driven by strong demand for Core and Enhanced Platform Technologies, increasing 23% and 50%, respectively.

Product revenue of $501 million increased 35%, despite the very difficult comparison to last year's first quarter at 54% with its very strong contribution from acquisitions.

Product revenue growth was driven by strong growth in Enhanced Platform Technologies, improving supply chain dynamics, and our earlier pricing actions.

Service revenue was up over 30% to $762 million – the highest growth rate in services since 2016.

The average number of days between when a customer purchases and subsequently activates a security service contract declined slightly sequentially and remained elevated on a year-over-year basis.

Service revenue growth was closely aligned with our short-term deferred revenue growth rate in recent periods. Short-term deferred revenue growth was over 30% for the fourth consecutive quarter.

Total gross margin of 76.3% was up 190 basis points including a *440 basis point increase* in product gross margin to 61.8%. Product gross margins benefited from earlier pricing actions, improved discounting, and easing cost pressures.

Service gross margin of 85.9% ticked up 70 basis points as price increases offset increased investments in data centers and Points of Presence, or PoPs.

Operating margin of 26.5% was *up 450 basis points* due to the strong gross margin performance, a foreign exchange benefit, and revenue growth that was 10 points higher than our 22% headcount growth. As previously noted, 26.5% is our highest ever first quarter operating margin as a public company.

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

Free Cash Flow was *a quarterly Fortinet record at $647 million* and benefited from elevated receivables in the fourth quarter of last year and the subsequent cash collections, as well as the record-setting operating margin, and the timing of CapEx projects.

Adjusted Free Cash Flow, which excludes the real estate investments, was $662 million, representing a 52% adjusted free cash flow margin and our highest margin since our 2009 IPO.

We have come to expect some quarterly variances in our Free Cash Flow results with the first quarter often stronger due to the seasonally stronger fourth quarter billings.

Capital expenditures were $30 million, including $15 million of real estate investments. This was lower than expected due to the timing of real estate activities.

Cash taxes were $21 million.

The Board increased the Company's share repurchase authorization by $1 billion, and the total available share buyback authorization is now approximately $1.5 billion for repurchases through February 2024.

Looking forward, we are excited about the growth drivers that we have discussed previously as well as our new single-vendor Universal SASE offering. Our Universal SASE offering delivers a comprehensive solution that extends the convergence of networking and security from the edge to remote users while helping teams drive operational efficiency and reducing complexity and costs by consolidating vendors. In fact, Gartner predicts that:

> *by 2025, one-third of new SASE deployments will be based on a single-vendor SASE offering, up from 10% in 2022.*

As we bring Universal SASE to market, we expect to make various investments including increasing our PoPs. Our guidance reflects the impact of these investments to both our gross margin and capital expenditure estimates.

Moving to guidance…

I’d like to review our outlook for the second quarter and full year summarized on slides 10 and 11, which is subject to the disclaimers regarding forward-looking information that Peter provided at the beginning of the call.

For the second quarter, we expect:

- *Billings* in the range of $1 billion 560 million to $1 billion 600 million, which at the midpoint represents growth of 21%,
- Revenue in the range of $1 billion 280 million to $1 billion $320 million, which at the midpoint represents growth of 26%,
- 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 $0.33 to $0.35, which assumes a share count between 790 and 800 million,
- Capital expenditures of $80 to $110 million,
- A non-GAAP tax rate of 17%.
- Cash taxes of $35 million, which is lower than our prior expectation as the deadline for certain tax payments has been extended to the fourth quarter.

The second quarter guidance assumes backlog decreases during the quarter.

For the full year, we expect:

- *Billings* in the range of $6 billion 750 million to $6 billion 810 million, which at the midpoint represents growth of 21%, this guidance assumes a low-single digit impact on billings growth from backlog.

- Revenue in the range of $5 billion 425 million to $5 billion 485 million, which at the midpoint represents growth of 23.5%,
- Service revenue in the range of $3 billion $370 million to $3 billion $400 million, which at the midpoint represents growth of 28%.
- The service revenue guidance implies product revenue growth of 16%.
- Non-GAAP gross margin of 75% to 76%,
- Non-GAAP operating margin of 25% to 26%,
- Non-GAAP earnings per share of $1.44 to $1.48, which assumes a share count of between 795 and 805 million,
- Capital expenditures of $400 to $450 million due to our continued cloud, data center, and facilities investments.
- Non-GAAP tax rate of 17%,
- Cash taxes of $390 million with approximately $300 million in the fourth quarter,
- The full year estimates assume backlog returns to historical levels later this year.

As we wrap up the prepared remarks, maybe one additional observation:

Over many years the Fortinet team and its partners have offered a very solid and consistent level of execution across a wide range of economic cycles and other challenges. Like many others, we see a level of economic uncertainty in front of us and we look forward to this possible challenge and delivering on our goals.

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 J.P. Morgan and Bank of America during the second 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.