



## Fortinet Q4 2022 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 full year and fourth 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 full year and fourth quarter of 2022 before providing guidance for the first quarter of 2023 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.

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 full year and fourth quarter 2022 results.

For the full year, revenue growth accelerated to 32%. We continue to gain market share in the cyber security industry with customers increasingly recognizing how Fortinet's integrated and single platform approach to security delivers a lower total cost of ownership and a greater return on investment than competing solutions.

Product revenue growth of 42% was very strong making Fortinet a leading product revenue company in the cyber security industry with total product revenue of \$1.8 billion. SD-WAN and OT bookings together accounted for over 25% of total bookings and our goal is to keep growing and achieve #1 market share in Network firewall, Secure SD-WAN, and OT security markets over the next couple of years.

For 20 years, Fortinet has led long-term strategies and investment around the convergence of networking and security. Yesterday, we announced our 5th generation FortiSecurity Processor, the FortiSP5. This new SoC based FortiASIC has secure compute power ratings for major network security functions like Firewall and VPN throughputs that are 17 to 32 times greater than the average of our competitors' similarly priced models using general purpose CPUs, and doubles

the ASIC chip acceleration of applications to 14, such as Zero Trust, SASE, 5G, and SD-Branch, with much better performance and efficiency. According to the most recent IDC data on unit shipments of firewall appliances, Fortinet holds the #1 units shipped market share position at 48%, providing Fortinet with an attractive economies of scale position as well as making it difficult for competitors to develop their own ASIC technology due to high entry barriers and the significant investment that is required.

FortiASIC's huge security computing power advantage enables FortiOS to integrate more security functions and applications than our competitors, with much better performance and much lower energy consumption, resulting in much lower total cost of ownership while offering easier operations for our customers. For example, a recent Forrester report highlighted that customers deploying Fortinet's Secure SD-WAN solution achieved a 300% return on investment over 3 years with a payback period of only 8 months.

Fortinet's substantial installed base of products with rich functions, enables us to offer additional security services, and upsell integrated and automated FortiFabric solutions. We recently announced several new and enhanced services that help SoC teams reduce their organizations' cyber risk while being more efficient at handling cyber security issues.

As networking and security continue to converge and consolidate, we believe we are well-positioned to achieve our 2025 Billings target of \$10 billion.

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.

As we look back at 2022, we see the success of our strategy to lead in convergence and consolidation as well as the combined power of our ASIC technology with our integrated operating system. Combined these efforts are driving our strong financial results.

There has been an explosion of devices that must be connected to the cloud, data center, and edge compute. As a result, the infrastructure has expanded to support secure connectivity via distributed firewalls. It is no longer feasible to overlay security on top of networking in the data center, they must be deployed as a converged solution. Firewalls need to work seamlessly with networking and security applications across a company's entire infrastructure.

Fortinet is leading the convergence trend with a wide range of technologies including Network Firewalls, Secure SD-WAN, 5G, and OT Security; all embedded in our single operating system, delivered as hardware, software, cloud, and "as a Service".

Traditional CPU-based solutions are very inefficient at supporting both networking and security. That's why Fortinet developed proprietary ASIC technology to build an application-specific solution. Yesterday, as Ken mentioned, we announced our next generation ASIC, the FortiSecurity Processor, or FortiSP5, which allows line speed convergence of Networking and Security at every network edge. The new 7 nanometer technology combines existing NP7 technology with new content processor capabilities.

Our Enhanced Platform suite of integrated products is delivering on customer demands for convergence, vendor consolidation, ease of management, and lower operating costs.

***The success of the strategy is evident in our full year 2022 results and I'll start there ...***

*Billings* passed the \$5 billion mark, totaling \$5.6 billion and growing 34%, while revenue totaled \$4.4 billion, with growth accelerating to 32% — the *fifth consecutive year of revenue growth of 20% or more*.

Driven by strong demand for our Fabric and Cloud security solutions, Enhanced Platform Technology *billings and revenue* both increased over 40% to \$1.8 billion and \$1.5 billion, respectively.

And, despite a challenging global supply chain environment, product revenue growth came in at 42% — our *highest annual product growth rate in over ten years*. Our product revenue growth was driven by the continued growth of our firewall use cases and the addition of over 23,000 new customers.

*Service revenue* was up 26% to \$2.6 billion, resulting in three consecutive years of accelerating service revenue growth rates.

*Gross margin* was strong at 76.3% and operating margin outpaced our initial expectations, increasing 110 basis points to a new Fortinet *record high of 27.3%*.

*Our GAAP operating margin of 22%* is *one of the highest in the industry* and we continued our streak of being GAAP profitable every year of our 14-year history as a public company.

*Earnings per share* increased 49% to \$1.19.

*Free Cash Flow* was a record at \$1.45 billion. Free Cash Flow margin was 33% and adjusted for real estate investments, the Free Cash Flow margin came in at 37%.

For the year, we repurchased approximately 36 million shares at a cost of \$2 billion.

*Total deferred revenue* increased 34% to \$4.6 billion. Short-term deferred revenue increased 32% to \$2.35 billion. Quarterly contract terms throughout the year were consistent with the year earlier periods, including the fourth quarter at 28 months.

***Before moving onto our Q4 results, I'd like to summarize our enterprise success and highlight a few seven-figure deals from 2022...***

We saw great success during the year with our strategy to expand further into the large enterprise segment as the number of deals over \$1 million increased over 55% to a *record* 546 deals and billings on these deals increased by over 70%.

*Let's look at a few of these large deals...*

In a competitive upsell deal, Fortinet displaced *11 different vendors* by consolidating the customer's network and security functions on our Security Fabric. This worldwide wholesaler previously purchased Secure SD-WAN and FortiProxy. Next on their list was a centralized network security solution that could be managed and deployed to its 400 global locations. The customer chose Fortinet's Security Fabric for its flexible and integrated solution across multiple scenarios including work-from-anywhere, perimeter security, and data center segmentation.

In another upsell deal, a leading global manufacturer was spun off and had to stand up their security and networking infrastructure separately. The newly created infrastructures included remote access, SD-WAN, Application Delivery Control, authentication, endpoint, e-mail protection, and switching. Keys to our win included our Zero Trust capabilities, a cloud first SD-WAN strategy, and the ease of integration and convergence across our platform suite.

Lastly, in a new logo win, a large US retailer with over 500 locations was struggling with the total cost of ownership of their legacy security architecture. Keys to this win included delivering a single pane of glass versus the multiple consoles they were using and replacing the competitor's firewalls with our FortiGates, delivering URL filtering, Wi-Fi security, and edge router replacement –

all on our unified and integrated FortiOS platform. This customer reported anticipated savings of \$29 million over 5 years.

***Turning to Q4 results...***

Both billings and revenue delivered new Fortinet records with billings of \$1.7 billion and revenue of \$1.3 billion, both metrics increased over 30%.

The strong fourth quarter revenue performance reflects solid customer demand across both our Core and Enhanced Platform Technologies.

In the fourth quarter, we added over 6,200 new logos – *another new Fortinet record* – reflecting the support of our channel partners, the leverage they bring, and the breadth of our worldwide customer base.

***Taking a closer look at the fourth quarter...***

Billings growth of 32% was driven by a 40% increase in Enhanced Platform Technology billings, which accounted for over one-third of total billings.

Total revenue growth of 33% was driven by strong demand for Core and Enhanced Platform Technologies, which increased 26% and 47%, respectively.

Product revenue grew 43% to \$540 million.

Service revenue was up 27% to \$743 million, driven by strong product revenue growth and strength in our security subscriptions.

Short-term deferred growth was 32% and represents *eight consecutive quarters of accelerating growth rates*.

Total gross margin of 77.6% was driven by a *310 basis point increase* in product gross margin to 65.2%. Several factors converged to drive our record high quarterly product gross margin including legacy pricing actions, easing supply chain cost pressures, and improved discounting.

Service gross margin of 86.7% ticked down 40 basis points due to increased labor cost and our expansion in cloud services and the related hosting costs.

Operating margin of 32.5% was up 400 basis points year-over-year due to the strong gross margin performance and Fx benefit.

***Looking to the Statement of Cash Flows summarized on slides 11 and 12...***

Free Cash Flow was \$497 million. Adjusted Free Cash Flow, which excludes real estate investments, was \$510 million, representing a 40% adjusted free cash flow margin.

Cash taxes were \$63 million.

Capital expenditures were \$31 million, including \$13 million for real estate investments.

DSO increased 14 days sequentially and year-over-year to 89 days, also impacting service revenue growth.

***Moving to guidance...***

We believe the continued innovations we've made in building our platform enables our customers' digital transformation journey.

And, as Ken noted, customers are increasingly recognizing how Fortinet's integrated and single platform approach to security can deliver a lower total cost of ownership and a greater return on investment than competing solutions.

Now, I'd like to review our outlook for 2023 summarized on slide 15, which 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 415 million to \$1 billion 465 million, which at the midpoint represents growth of 24%,
- Revenue in the range of \$1 billion 180 million to \$1 billion \$220 million, which at the midpoint represents growth of 26%,
- Non-GAAP gross margin of 75.0% to 76.0%,



- Non-GAAP operating margin of 23.0% to 24.0%, which at the midpoint represents an increase of 150 basis points,
- Non-GAAP earnings per share of \$0.27 to \$0.29, which assumes a share count between 795 and 805 million,
- Capital expenditures of \$80 to \$110 million,
- A non-GAAP tax rate of 17%.
- Cash taxes of \$20 million.
- We should note the first quarter guidance assumes backlog decreases slightly during the quarter.

For the full year, we expect:

- *Billings* in the range of \$6 billion 710 million to \$6 billion 790 million, which at the midpoint represents growth of 21%,
- Revenue in the range of \$5 billion 370 million to \$5 billion 430 million, which at the midpoint represents growth of 22%,
- Total service revenue in the range of \$3 billion \$335 million to \$3 billion \$365 million, which at the midpoint represents growth of 27% and implies a 4<sup>th</sup> consecutive year of accelerating service revenue growth.
- The service revenue guidance also implies product revenue growth of 15%.
- Non-GAAP gross margin of 75.0% to 76.0%,
- Non-GAAP operating margin of 25.0% to 26.0%,
- Non-GAAP earnings per share of \$1.39 to \$1.41, which assumes a share count of between 805 and 815 million,
- Capital expenditures of \$400 to \$450 million due to continued investment in cloud, data center, and facilities.
- Non-GAAP tax rate of 17%,

- Cash taxes of \$375 million, split somewhat evenly between the first and second half of the year. The increase in cash taxes reflects recently effective R&D capitalization and amortization requirements.
- The full year estimates assume backlog approaches historical levels by the end of the year.

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

And with a strong business model and a history of execution, we are confident that our market share gains will continue.

We remain on track to achieve our 2025 financial targets, which include:

- Billings of \$10 billion,
- Revenue of \$8 billion,
- Non-GAAP operating margin of at least 25% and,
- *Adjusted* Free Cash Flow margin in the mid-to-high 30% range in 2025.

And with that, 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 Baird and Morgan Stanley during the first quarter. A Fireside chat webcast link will be posted on the Events and Presentations section of Fortinet's investor relations website for the Morgan Stanley conference.

If you have any follow up questions, please feel free to contact me.

Have a great rest of your day!