Second Quarter 2017 Earnings Conference Call Script -–July 26, 2017

Kelly:

Thank you, operator, and thanks to everyone on the call for joining us this afternoon to discuss Fortinet's financial results for the second quarter of 2017. With me today are Ken Xie, Fortinet's Founder, Chairman and CEO, and Drew Del Matto, CFO.

Ken will begin our call by providing a high-level perspective on our business. Drew will then review our financial and operating results, and conclude with our forward guidance outlook before opening up the call for questions. During Q&A, we ask that you please be conscious of limited time on this call, and make your questions brief to allow for others to participate. As a reminder, today we're holding two calls. For those who have additional questions, we will hold a second conference call at 3:30 PM Pacific Time. Both calls will be webcast from our investor relations website.

Before we begin, I'd like to remind you that on the call today we will be making forward-looking statements. These forward-looking statements are subject to risks and uncertainties that could cause actual results to differ materially from those projected in these statements. Please refer to our SEC filings, in particular the risk factors in our most recent Form 10-K and Forms 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, please note that we will be discussing certain non-GAAP financial measures on this call. Our GAAP results and GAAP to non-GAAP reconciliations can be found in our earnings press release and on slides 11 and 12 of the presentation that accompany today's remarks. We also encourage you to refer to the Investor Relations section of our website for important information, including: our earnings press release issued a few minutes ago, the slides that accompany today's prepared remarks, and other important information about the company. A replay of this call will also be available on our website. I will now turn the call over to Ken.

Ken:

Thank you Kelly, and thanks to everyone for joining today's call to discuss our second quarter 2017 results. In the second quarter, Fortinet again demonstrated strong leadership in the security market. We continue to grow revenue and billings above market rates. Ongoing strength in subscription services is creating high-margin recurring revenue, and improving the predictability of our financial results. We are pleased that our operating margin and earnings per share well exceeded our guidance, and we remain committed to continued growth and operating margin improvement.

The second quarter offered an important test of Fortinet's technology leadership, as businesses and organizations small and large were hit with multiple ransomware attacks. The Fortinet Security Fabric provided customers with proactive and comprehensive protection, stopping the spread of Wannacry and Peyta through multiple, integrated, and automated lines of defense. At the first line of defense, FortiMail detected the malware from infected links, and if attachments were downloaded, FortiSandbox stopped the malware from entering the network. FortiGate blocked pfishing attempts, and FortiClient detected malware coming into organizations from external devices. FortiSwitch and FortiAP quarantined infected hosts, and stopped the ransomware from connecting to and encrypting file servers. Finally, FortiAnalyzer and FortiSIEM enable customers to monitor these and other security risks and react to them in real time.

Fortinet is taking the lead in providing actionable threat intelligence through the use of our new cloud-based Threat Intelligence Service . Fortinet is partnering with global intelligence organizations such as NATO, and Interpol to combat cybercrime. Recently, our collaboration with Interpol led to the identification and shut down of 8,800 Command and Control servers and compromised websites, including government portals.

We are proud to announce that Fortinet was recognized as a Leader in the July 2017 Gartner Magic Quadrant for Enterprise Network Firewalls. The report evaluated the completeness of

Fortinet's Security Fabric vision and our ability to execute as factors for the inclusion in the Magic Quadrant. FortiGate Enterprise Firewall customers provided three times more reviews on Gartner Peer Insights, as of July 21, 2017– than the nearest competitor. As a foundation of the Fortinet Security Fabric, the FortiGate Enterprise Firewall is the only solution that delivers the scale, automation, and performance needed to protect from the edge to the datacenter and from IoT to the Cloud.

We also retained our status as a Leader in the Magic Quadrant for Unified Threat Management. For the eighth year in a row, Fortinet was recognized by Gartner for vision and ability to execute in the UTM category. Fortinet UTM technology reduces IT complexity for SMBs providing advanced protection, network performance, and unified visibility and control offered by the Fortinet Security Fabric. This innovative technology has made Fortinet the leading security provider and the largest market share holder in the UTM space for SMB.

Additionally, IDC again named Fortinet the unit market share leader for security appliances shipped.

In the second quarter, Fortinet demonstrated commitment to and leadership in cloud security. In April we announced the extension of the Fortinet Security Fabric to the cloud as part of our FortiOS 5.6 release. We also launched FortiCASB, extending the core capabilities of our Security Fabric architecture to provide businesses the same level of cybersecurity and threat intelligence in cloud environments as they do on their physical networks. And we enhanced FortiGate SD-WAN capabilities to enable distributed enterprises to apply Security Fabric visibility and control to their software-defined environments. During the second quarter, Fortinet expanded cloud security capabilities for Microsoft Azure and AWS customers. While many of our competitors are talking about their cloud solutions, the Fortinet Security Fabric delivers performance, effective security, and management across private and public cloud environments.

More leading technology companies joined the Fortinet Security Fabric-Ready ecosystem in the second quarter. Microsoft joined the Fabric-Ready program to be able to deliver cloud security at scale for global enterprise corporations. To date, Fortinet has 27 Fabric-Ready Program Partners, representing a cross-section of leading information technology providers including the Cisco and

Hewlett Packard Enterprise, whose offerings can integrate with the Fortinet Security Fabric. Fortinet offers the most open program on the market today, even allowing competitor products to integrate with the Fortinet Security Fabric. Our open approach offers customers the management, visibility and control benefits of the Fortinet Security Fabric within their existing environments, whether on-premise, in private clouds or in the public cloud.

Fortinet is proud of the recognition by industry analysts of our market leadership and positioning in the Magic Quadrant for Enterprise Network Firewall and Unified Threat Management. We remain committed to maintaining this leadership position by investing in growth while making continued progress toward our profitability goals. I will now turn the call to Drew to review our second quarter financial results and forward guidance.

Drew:

Thank you, Ken. Let me now share our financial results for the second quarter, which can be seen on slide 3:

- Fortinet had another strong quarter. Billings increased 14% year over year to $427 million dollars.
- Revenue of $363 million dollars was up 17% year-over-year.
- Deferred revenue grew to $1 billion 161 million dollars, up 28% year over year, reflecting the ongoing business shift to more margin rich, recurring subscription and service revenue.
- Our non-GAAP gross margin was 75%.
- Non-GAAP operating margin was 18%, and non-GAAP earnings per share were 27 cents.
- We generated free cash flow of $58 million dollars during the quarter, an increase over the same period last year in spite of the impact of the $85 million dollar purchase in April of two buildings in the Vancouver area.
- Operating cash flow for the second quarter was $145 million dollars, an increase of 113% year-over-year.

We had another good quarter in large enterprise deals. Year over year, the number of deals over $100 thousand dollars grew 21%, deals over $250 thousand dollars grew 5%, deals over $500 thousand dollars grew 10%, and deals over $1 million dollars grew 25%.

The majority of our large deals were attributable to the key differentiators of the Fabric, particularly manageability, orchestration, and integration across the enterprise.

We again had a strong quarter in the government vertical, and we made some significant strides in the U.S. Federal space. Two of our seven-figure deals in the quarter were Fabric deals with U.S. government organizations. The breakdown of billings across our top 5 verticals was Service Provider at 18%; Government at 15%; Financial Services at 13%; Education at 10%; and Retail at 8%.

On a geographic basis, billings in the Americas grew 13%, EMEA billings grew 13%, and APAC billings grew 19%. North America again had a strong billings quarter, lending us continued confidence in the maturation of our sales model.

Now, turning to billings by product range on slide 4, high end products accounted for 39% of total product billings, our mid-range products accounted for 29%, and our entry-level products accounted for 32%.

Revenue was $363 million dollars in the quarter up 17% year-over-year.

As you can see on Slide 5, revenue performance was driven by the combination of 4% year-over-year product revenue growth, and 26% year-over-year services revenue growth. The continued shift to higher services growth reflects our ongoing success in driving higher-priced subscription bundles, metered model cloud business, and virtual solutions.

Global revenue diversification is a key strength of our business. Turning to slides 6 and 7, revenue from the Americas represented 44% of our business and grew 21% year over year; revenue from EMEA represented 36% of our business and grew 13% year over year; and revenue from APAC represented 20% of our business and grew 14% year over year.

During the second quarter, our non-GAAP gross margin was 75%. Non-GAAP services gross margin was 85%. Non-GAAP product gross margin was 58%, lower than recent quarters due to inventory reserves as we transition to our newer appliances.

We continue to focus on productivity and efficiency in our operating model, paying close attention to the growth in billings versus operating expenses. On a year-over-year basis in the second quarter, billings grew by 14%, while sales and marketing expense grew by just 1%. In all, we had $53 million dollars in incremental billings year-over-year, on just $12 million dollars in incremental operating expense.

As a percentage of revenue on a non-GAAP basis, sales and marketing expenses were 40%, down from 46% in the second quarter of last year, research and development expenses were

12%, flat from last year, and general and administrative expenses were 5%, up 1% from last year due to the ongoing implementation costs of the new revenue accounting standard.

Total non-GAAP operating expenses were $206 million dollars during the second quarter, resulting in non-GAAP operating income of $66 million dollars, or 18% of total revenue, up 600 basis points year over year.

Non-GAAP net income for the second quarter was $48 million dollars or 27 cents per share, based on approximately 180 million diluted shares outstanding. As expected, the annualized non-GAAP tax rate was 32%.

As seen on slides 8 and 9, we again ended the quarter with a strong balance sheet, including $1 billion, four hundred and sixty five million dollars in cash and investments. During the quarter we spent $33 million dollars to repurchase 849 thousand shares of our common stock at an average price of $39 dollars and 7 cents. As I mentioned earlier, cash from operations was $145 million dollars, representing growth of 113% over the same period last year, and free cash flow in the quarter was $58 million dollars.

Annualized inventory turns for Q2 were 2.2, an improvement over inventory turns of 1.6 in the first quarter of this year. Deferred revenue increased to $1 billion and 161 million dollars, an increase of $257 million dollars or 28% year-over-year. DSO was 68 days, down from 74 days in the second quarter of 2016.

Let me now finish with our guidance, which can be seen on slide 10. As a reminder, all forward-looking statements, including all of the guidance statements provided, are subject to Kelly's cautions at the start of this call.

Our business is more heavily weighted toward international markets than most of our competitors, and as such we are cautious that slower summer months, particularly in Europe, can sequentially affect our business, particularly when it comes to larger deals where more signatures are needed.

With this is mind, for the third quarter of 2017, we expect:

- Billings in the range of of $417 million dollars to $427 million dollars.
- Revenue in the range of of $367 million dollars to $373 million dollars.
- Non-GAAP gross margin of 75%.

We are pleased with the margin performance that we had in the second quarter, but are mindful that some of the profitability improvement came from not hiring as quickly as we had planned. For the third quarter we expect:

- Non-GAAP operating margin of 16-17%, and
- Non-GAAP earnings per share of 22-23 cents.

We are revising our guidance for the full year 2017, which is:

- Billings in the range of $1 billion seven hundred and seventy five million dollars to $1 billion seven hundred and ninety five million dollars.
- Revenue in the range of $1 billion four hundred and eighty-seven million dollars to $1 billion four hundred and ninety-five million dollars.
- Non-GAAP gross margin of 74.5%-75%
- Non-GAAP operating margin of 16.2%
- Non-GAAP earnings per share of 94-96 cents.

Additionally, the Board of Directors doubled our authorization for share repurchases to $600 million dollars through January of 2019. We expect to repurchase at least $150 million dollars worth of stock in 2017, including the $33 million dollars that we spent in the second quarter. I'll now hand the call back to Ken to close.

KEN: Thank you Drew. We are very pleased with our second quarter results and with the leadership that Fortinet is demonstrating in the market today. The Fortinet Security Fabric offers us a unique and strong competitive position, and we are gaining market share against our competitors and mindshare with customers around the world. In closing, I'd like to thank Fortinet employees, partners, customers, and shareholders for their continued confidence and support.

Kelly: Operator, you may start the Q&A.

Note: *Gartner does not endorse any vendor, product or service depicted in its research publications, and does not advise technology users to select only those vendors with the highest ratings or other designation. Gartner research publications consist of the opinions of Gartner's research organization and should not be construed as statements of fact. Gartner disclaims all warranties, expressed or implied, with respect to this research, including any warranties of merchantability or fitness for a particular purpose*.

Gartner Peer Insights reviews constitute the subjective opinions of individual end-users based on their own experiences, and do not represent the views of Gartner or its affiliates.]