Fortinet Q3 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 third 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 third quarter of 2023 before providing guidance for the fourth 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

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

In Q3, we exceeded Street expectations in operating margin and free cash flow; however, billings and product revenue fell below our expectations due to a slowdown in Secure Networking growth, along with challenges in sales execution and marketing efficiency.

In response to the slowdown in the Secure Networking market, we are shifting our marketing and sales team's focus towards the faster growing Security Operations and SASE markets over the next few quarters, all while maintaining our consistent focus on leading innovation in Secure Networking and the convergence of security and networking where we have been a leader for 23 years.

While we anticipate limited near-term growth in the Secure Networking market, it is very important for Fortinet as we believe it enables our platform strategy with our massive footprint as the market leader in both firewall revenue and units shipped.

The Secure Networking market is valued at $62 billion and is projected to increase high single digits annually to $86 billion by 2027. Our consistent focus on innovating our industry leading FortiOS, which supports over 30 networking and security applications, combined with our ASIC driven performance capabilities, which provide 5x to 10x better performance on average than competitors, continues to drive our market share gains. Secure Networking remains a vital part of our strategy and a market that we believe will return to double-digit annual growth over time.

We have been innovating for some time in the faster growing segments of Security Operations and SASE.

Security Operations, also known as SecOps, is a $46 billion market growing in the mid-teens annually to $78 billion by 2027. Fortinet's SecOps platform is comprehensive and integrated, offering EDR, SIEM, SOAR, NDR, and other integrated solutions. Consolidation in the security industry demands seamless integration of underlying security tools. Fortinet's strength lies in its innovation and its ability to enable automation through a high degree of product integration. Our AI and SecOps products empower automatic responses within seconds, all underpinned by a single consolidated management and analytics platform.

In addition to SecOps, we've continued to increase our focus on SASE, a $17 billion market expected to grow at a 20% compound annual growth rate to $36 billion by 2027. We believe Fortinet is the only company with a SASE service solution that can perform all functions in the Cloud or in an appliance, all with a common operating system, including full networking and security stack, market leading SD-WAN offering ZTNA and management console.

Our SASE service solution is supported by Google Cloud, with over 100 worldwide SASE Cloud locations, together with our own 30-plus points of presence and data centers.

For appliance-based use cases, we accelerate SASE service functions using our ASIC technology. For instance, we recently announced the FortiGate 120G, with the Security Processor 5, which supports our full SASE offering, which includes SD-WAN, Firewall, Secure Web Gateway, and Data Loss Prevention, and boasts secure compute ratings 6 to 54 times better than our competition.

We anticipate that success in the SASE market will first come from upselling SASE services to our installed base of tens of thousands of SD-WAN customers and from attracting new customers looking to leverage our single-vendor integrated SASE services solution. Our industry leadership in both firewall and SD-WAN, the two largest components of SASE, provides us with a significant competitive advantage.

We have a track record of successful execution and believe we are the only company with strong SASE services and SecOps solutions combined in the same operating system. This differentiation sets us apart and provides us with a significant competitive advantage over peers.

While we expect topline growth to be modest for the next few quarters due to challenging Secure Networking comparisons and our business transformation, realignment towards Security Operations and SASE, we anticipate growth returning to double-digit by the second half of 2024. We remain committed to generating healthy operating margins of 25% or greater in 2024 and 2025.

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 Ken mentioned, we are confident in our integrated FortiOS driven platform strategy which is summarized on slides 6 thru 10 of the earnings slide deck. As we look forward, we believe shifting our R&D and Go-to-Market investments to the faster growing SASE and SecOps markets is consistent with near-term market opportunities.

As shown on slide 10, SASE and SecOps account for 20% and 10%, respectively, of our business today. And, as shown on slide 7, these markets are expected to grow in the mid-to-high teens annually.

Secure Networking, which currently accounts for 70% of our business, is expected to experience slower growth, following two years of very robust growth. As a result, for the near term, we expect to deliver healthy profitability along with more modest growth.

With execution and continued investment in the SASE and SecOps markets, we believe we can return to delivering mid-to-high teens top line growth and while continuing to deliver operating margins of 25% or greater, in other words, a return to the balanced growth and profitability which has led us to achieve the Rule of 40 in 12 of 15 years as illustrated on slide 19.

In a moment, I'll expand on the strategic shift by sharing a few of the tactical steps and investments. First, I'd like to review some highlights from the quarter.

We continued to add new logos at an impressive rate and saw strong top line performance in Small Enterprise and software, while operating margin and free cash flow were above expectations.

We added over 6,400 new logos, supported by Small Enterprise customers which grew bookings by 19%.

Our efforts to manage personnel and other costs drove our operating margin to 27.8%, 230 basis points above the high end of the guidance range.

Free cash flow was strong at $481 million, representing a margin of 36%.

Looking at billings…

Starting from the third quarter of 2020, we saw a 3-year compound annual billings growth rate, or CAGR, of 26%, illustrating our ability to drive strong and sustained growth over an extended period. In Q3, however, billings of $1.49 billion represented growth of 6% as we experienced one-month shorter contract duration and importantly lackluster appliance demand resulting from elevated product growth in earlier periods.

In terms of industry verticals, education and government billings were strong, while service provider and retail billings were weak.

Small Enterprise billings growth was strong, while growth rates with larger enterprises disappointed.

Billings growth varied by geo with International Emerging showing strong growth while our much larger geos of Europe and the US were weaker.

Turning to revenue and margins….

Total revenue grew 16% to $1.33 billion, which compares to our 3-year CAGR of 27%. The 3-year CAGR is largely consistent with our 14-year CAGR illustrated on slide 18.

Product revenue of $466 million, representing a 3-year CAGR of 28%, was down 1%, reflecting product lead times, backlog aligning with historical levels, and the lighter levels of Network Security demand Ken referred to.

Service revenues of $869 million grew 28%, representing a 3-year CAGR of 27%. Service revenue accounted for 65% of total revenues, driven by 34% growth in higher margin security subscriptions, which represents 57% of total service revenue.

We mention the 3-year CAGRs to illustrate how consistent they are with these same CAGRs starting from our 2009 IPO which are illustrated on slide 18. Each of the 3-year CAGRs – billings, product, service and total revenue -- are within five points of the 14-year CAGRs for the same top line metrics; adding to our confidence in returning to higher growth levels.

Product gross margins were down 310 basis points as we saw margin pressure related to inventory levels.

Service gross margins were up 60 basis points as service revenue growth outpaced higher levels of cloud and hosting costs.

Total gross margin of 76.9% was up 70 basis points driven by the increase in service gross margins and the six-point mix shift from product revenue to service revenue.

Operating margin of 27.8% exceeded the high end of the guidance range and operating income of $371 million was $33 million higher than consensus and $20 million above the high end of our guidance range, reflecting our efforts to control spending.

Looking to the Statement of Cash Flows summarized on slides 15 thru 17…

Free Cash Flow increased 22% to $481 million, representing a free cash flow margin of 36%, or 9 points above consensus. Operating cash flow increased $68 million, to 41% of revenue.

Capital expenditures were $70 million, including $50 million of real estate investments.

Cash taxes paid in the third quarter were $26 million.

As a reminder, free cash flow benefited from regulatory relief in the form of deferred estimated and other tax payments in the second and third quarters totaling $192 million and $18 million, respectively. In the fourth quarter we expect cash taxes to total $345 million, including the $210 million of deferred tax payments.

We repurchased approximately 10.4 million shares of our common stock for an aggregate cost of $605 million in the third quarter. In October, we purchased an additional 7.7 million shares for $444 million and our remaining share repurchase authorization stood at approximately $980 million at the end of October.

Now, I'd like to share a couple key SASE wins for us in the quarter…

In a seven-figure upsell win, an existing financial services customer initiated their Single Vendor SASE solution for 50,000 users. Fortinet was able to displace another incumbent as the customer continued their consolidation journey with us, supplementing their earlier SecOps, Cloud, and Network Security purchases.

In a six-figure deal, an existing SD-WAN customer continued their strategic transition to SaaS and cloud-based applications by adding our SASE solution for 2,000 users. We believe existing SD-WAN customers such as this one, offer a rich cross sell opportunity for our SASE solution.

It's worth noting these deals closed before our recently announced partnership with Google Cloud, which significantly expands our PoP coverage by adding over 100 locations and prior to Gartner's release of the inaugural Single-Vendor SASE Magic Quadrant, where we were named a "Challenger." By 2025, one third of new SASE deployments are expected to be single vendor.

We should also note that Fortinet is recognized in 9 Gartner Magic Quadrants, as shown on slide 3.

Now I'd like to expand on Ken's strategic commentary with some of the tactical investments we are making to increasingly focus our efforts on SASE and SecOps…

In the areas of research and development and solution delivery, in addition to the new Google Cloud Partnership I just mentioned and our own data center investments, we are:

- Continuing to integrate Single Vendor SASE features into FortiOS,
- Continuing to expand our SecOps capabilities with AI technology and additional functions and enhanced integration, and
- Finalizing co-development agreements with existing large enterprise customers to accelerate continuous improvement of our integrated enterprise level SASE solution.

Our Go to Market strategy investments include:

- Actively promoting our Challenger position in Gartner's Single Vendor SASE Magic Quadrant, focusing on 3rd party certification of our broad and integrated solutions, including SSE and SD-WAN and aggressively marketing Fortinet's competitive advantages and the key components of SASE, SecOps and network security as summarized on slide 10,
- Certifying 5,500 Fortinet sales professionals in SecOps solutions after already certifying these same sellers in SASE, which is the largest sales enablement motion in company history.
- Investing in sales comp plans, to include incentives to sell SASE and SecOps capabilities to existing and new customers,
- Expanding partner rolls deeper into channel partners specializing in SASE and SecOps, and,
- Developing channel training that is focused on differentiating Fortinet's comprehensive and integrated SASE and SecOps capabilities.

We believe Fortinet remains well-positioned in the cybersecurity market and the market shift to platform strategies is in early stages. According to Gartner, 75% of companies are pursuing a vendor consolidation strategy, reflecting the evolving landscape of cybersecurity in a highly fragmented industry with thousands of vendors. As shown on slide 9, Fortinet brings consolidation across SecOps, SASE, and Networking Security – the three key growth drivers in our strategy

Organizations are recognizing that an integrated security solution with a single operating system is the best method to improve their security posture as this approach allows each security solution to share data and communicate with each other—reducing complexity and improving security effectiveness.

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

Moving to guidance…

We continue to see increased deal scrutiny and longer sales cycles which is constraining our near-term results. We expect these longer sales cycles to continue, along with the associated budgetary scrutiny, and our fourth quarter guidance takes this into consideration.

As a reminder, our fourth quarter and full year outlook, which are summarized on slides 20 and 21, is subject to the disclaimers regarding forward-looking information that Peter provided at the beginning of the call.

For the fourth quarter, we expect:

- *Billings* in the range of $1 billion 560 million to $1 billion 700 million, which at the midpoint represents a decline of 5%,
- Revenue in the range of $1 billion 380 million to $1 billion $440 million, which at the midpoint represents growth of 10%,
- Non-GAAP gross margin of 75.5% to 76.5%,
- Non-GAAP operating margin of 27.5% to 28.5%,
- Non-GAAP earnings per share of $0.42 to $0.44, which assumes a share count between 780 and 790 million,
- Capital expenditures of $40 to $60 million,
- A non-GAAP tax rate of 17%,
- Cash taxes of $345 million,

For the full year, we expect:

- *Billings* in the range of $6 billion 95 million to $6 billion 235 million, which at the midpoint represents growth of 10%,

- Revenue in the range of $5 billion 270 million to $5 billion 330 million, which at the midpoint represents growth of 20%,
- Service revenue in the range of $3 billion $355 million to $3 billion $375 million, which at the midpoint represents growth of 28%,
- The service revenue guidance implies product revenue growth of 9%,
- Non-GAAP gross margin of 76.0% to 77.0%,
- Non-GAAP operating margin of 26.5% to 27.5%,
- Non-GAAP earnings per share of $1.54 to $1.56, which assumes a share count of between 790 and 800 million,
- Capital expenditures of $220 to $240 million,
- Non-GAAP tax rate of 17%,
- Cash taxes of $430 million.

As we look forward to 2024 and transition from a period of elevated product growth we can offer a few thoughts looking forward.

- In the near term, we will continue to focus on improving profitability.
- We expect product gross margins to be pressured in 2024, nonetheless we expect healthy operating margins that are 25% or greater.
- We expect to gradually increase billings growth through the year and approach double digit growth by the second half of 2024, reflecting the progressively easier comps due to the easing of the headwind from the backlog drawdowns in the first half of 2023 and the benefit of our SASE and SecOps focus.
- We expect contract term to remain below our high-water marks in 2022.
- Consistent with prior years, we expect that the timing of service revenue growth trends will lag product growth trends.

- Longer term, we remain confident in our solutions and our ability to adopt our strategy to shifts in the market, taking market share as we increase our investments in SASE and SecOps, ultimately returning to balanced growth and profitability.

I look forward to updating you on our progress in the coming quarters.

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 Barclays, Stifel, and Wells Fargo during the fourth 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!