Fortinet Q3 2024 Earnings Prepared Remarks

Aaron Ovadia, Senior Director, Investor Relations

Thank you and good afternoon everyone. This is Aaron Ovadia, Senior Director of Investor Relations at Fortinet. I am pleased to welcome everyone to our call to discuss Fortinet's financial results for the third quarter of 2024.

Joining me on today's call are Ken Xie, Fortinet's Founder, Chairman, and CEO, Keith Jensen, our CFO, John Whittle, our COO, and Christiane Ohlgart, our CAO and Sales Operations Leader. 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 2024 before providing guidance for the fourth quarter of 2024 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.

The prepared remarks for today's earnings call will be posted on the Quarterly Earnings section of our investor relations website 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, Aaron, and thank you to everyone for joining our call.

We are pleased to report another quarter of strong execution and continued growth momentum including:

- Record gross margin and operating margin, with the operating margin increasing by 830 basis points to over 36%,
- Total revenue growth of 13% as we return to positive billings and product revenue growth,
- Unified SASE billings growth of 14%, Security Operations billings growth of 32%, and Secure Networking returned to positive growth, all driven by our continued share gains in our total addressable market of $284 billion.

As highlighted on slide 11 of the investor presentation, Fortinet continues to be the only vendor to leverage a single operating system, FortiOS, delivering solutions in five secure networking Gartner Magic Quadrant reports — Security Service Edge, SD-WAN, Single-Vendor SASE, Network Firewall, and Enterprise Wired and Wireless LAN Infrastructure.

FortiOS, combined with our proprietary FortiASIC technology, significantly boosts secure computing power, delivering 5x to 10x better performance than our competitors, while lowering customers' total cost of ownership and energy consumption.

In the third quarter, Unified SASE billings were 23% of our business, up one and a half points, driven by security service edge (SSE) billings growth of 220% with pipeline up 130%.

Fortinet is the only vendor offering all SASE functions in a single operating system and providing a unified networking and security stack on-premise and in the cloud. This allows FortiSASE to be deployed within minutes for our SD-WAN customers.

Our single OS based FortiSASE also enables Sovereign SASE for service providers and large enterprises to deploy FortiSASE within their own data center for data privacy.

In addition, we were recently recognized as a clear Leader in the 2024 Gartner Magic Quadrant for SD-WAN for the fifth consecutive year and notably, are positioned highest of all vendors in Ability to Execute for the fourth year in a row. Leveraging Fortinet's leading position in Firewall and SD-WAN and our integrated FortiSASE within the same FortiOS, Fortinet provides the easiest and most secure path for migrating from a traditional firewall to Secure SD-WAN and Unified SASE.

We continue to invest in our global infrastructure, owning over 3 million square feet across office spaces, executive briefing centers, operational facilities, and data centers. Our own hosting capabilities will give us a long-term cost advantage while allowing us to use our own FortiStack for better security and management.

AI-driven Security Operations was our fastest growing pillar, outpacing the overall market with 32% billings growth, accounting for 10.5% of our total business, up 2 points.

We have expanded our Security Operations portfolio with the launch of Lacework FortiCNAPP and FortiDLP, which together represent a new $20 billion market opportunity, and we expect to cross-sell both solutions to our large installed base of customers.

Our commitment to innovation and investment in R&D has enabled us to rapidly expand FortiAI, our GenAI assistant, into seven key solutions: FortiAnalyzer, FortiManager, FortiSIEM, FortiSOAR, FortiDLP, and the recently announced FortiNDR and FortiCNAPP. More GenAI-enabled FortiAI products will be announced in early 2025, as Fortinet's AI-based Security Operations business accelerates.

Before turning the call over to Keith, I would like to thank our employees, customers, partners, and suppliers worldwide for their continued support and hard work.

Keith Jensen, CFO

Thank you, Ken, thank you Aaron, and good afternoon everyone.

Let's start with the key highlights from the third quarter…

We are very pleased with our strong execution and financial performance in the third quarter, repeating our second quarter performance by again achieving record gross margins and record operating margins, while delivering top-line results at the top of our guidance range.

Total revenue grew 13%, driven by strong growth in services revenue and product revenue's return to growth.

We again added over 6,000 new logos, driven by the resilience of small enterprise customers and the strength of our robust channel partner ecosystem.

As you will hear in a moment, we are pleased to again raise our revenue and operating margin guidance for the full year and believe we are on track to achieve our seventh consecutive year of exceeding the 'Rule of 40'.

Looking at billings in more detail…

RPO grew 15% to $6.1 billion and total billings grew 6% to $1.58 billion, driven by robust growth in Security Operations at 32% and Unified SASE at 14%. SSE and related cloud technologies were again the fastest growers in Unified SASE, benefiting from our large SD-WAN customer base.

Our Unified SASE and Security Operations pillars are gaining considerable traction, with over 90% of their billings coming from our Secure Networking install base and combining to drive our SaaS solution *organic ARR* growth rate of 74%.

The "customer buying journey" from FortiGate to SD-WAN to SASE supports our customers' drive towards consolidation and is gaining traction.

This consolidation journey first begins with a firewall and FortiOS and typically expands to SD-WAN and next to SASE. I should share that, two-thirds of our large and mid-enterprise customers have deployed our SD-WAN technology providing them with a gateway to FortiSASE. Of these large customers, our first year of SASE delivered high mid single digit penetration rates highlighting both the dramatic expansion opportunity as well as customer demand for vendor consolidation.

Including all elements of Unified SASE, pipeline growth was over 30%, while the SSE technologies are seeing pipeline and ARR growth of over 130% and 500%, respectively.

Larger enterprises continued to drive our expansion into Unified SASE and SecOps markets, with large and mid-enterprises representing 91% and 76% of SASE and SecOps billings, respectively.

As we worked through the wind down of last year's backlog and the related year over year headwind to growth, Secure Networking has returned to growth, as expected.

Rounding out the billings commentary, SMB and large enterprise were our top two performing customer segments, while EMEA was our best performing geography with double-digit growth.

Among our top 5 verticals, manufacturing billings grew by over 20%, driven by OT billings growth of 19%. Retail returned to growth for the first time in six quarters, up 9%, while the service provider vertical reached its highest growth rate over the same six quarter period.

Turning to revenue and margins….

Total revenue grew 13% to $1.508 billion, driven by 19% service revenue growth and product revenue's return to growth.

Service revenue of $1.034 billion grew 19%, accounting for 69% of total revenue. Service revenue growth was driven by growth in our SaaS solutions, including 50% services growth in SecOps and 27% services growth in Unified SASE.

Product revenue returned to growth for the first time in 5 quarters, increasing 2% to $474 million. Excluding the impact of backlog, product revenue grew sequentially at double-digit rates outpacing historical norms for Q2 to Q3 and following a similar story line to what we saw in Q2 when sequential growth also outpaced historical norms.

A moment ago we talked about solution consolidation and described the customers' journey around firewalls to SD-WAN and onto SASE. A second customer buying journey is supporting customers' convergence of security and networking. Their journey begins with Fortinet's firewalls and expands to leverage our FortiLink technology to manage Fortinet switches and access points. It's worth noting that, over 95% of our larger enterprise switch customers previously, or simultaneously, purchased FortiGate firewalls. At the same time, our switch penetration rate here at large customers is around 50%, highlighting both our success and future opportunity.

Software license revenue continued its double-digit growth, driven by SecOps solutions, and represented a mid-to-high teens percentage of total product revenue.

Combined revenue from software licenses and software services such as cloud and SaaS security solutions -- increased 33%, accelerating from 32% in the second quarter, and providing an annual revenue run rate of over $900 million.

Total gross margin *increased 630 basis points to a quarterly record of 83.2%* and exceeded the high end of the guidance range by 320 basis points. Gross margins benefitted from higher product and services gross margins as well as a 4-point mix shift to higher margin service revenues.

Product gross margin of *71.6%* was also a quarterly record and increased *1,370 basis* points, which includes a 320 basis point benefit related to the renegotiation of supplier contractual commitments. Excluding this one-time benefit, the product gross margin would have been 68.4%.

Services gross margin of 88.5% *increased 130 basis points a*s services revenue growth outpaced labor cost increases and benefitted from the mix shift towards higher margin FortiGuard security subscription services.

Operating margin increased 830 basis points to a quarterly record of 36.1% and was 460 basis points *above* the high-end of our guidance range. Excluding the one-time benefit to product gross margins, operating margins would have been 35.1%.

Taken together with our reported Q2 margins, the Q3 margins, excluding the one-time benefit, provide directional insights to our financial performance.

Before moving onto the statement of cash flows, I'd like to provide a few details related to the impact from the Lacework and NextDLP acquisitions. These acquisitions increased Q3 billings and revenue by approximately 60 and 90 basis points, respectively, and decreased gross and operating margins by about 30 and 220 basis points, respectively.

Looking to the Statement of Cash Flows summarized on slides 16 and 17…

Free Cash Flow was $572 million, representing a margin of 38%, and adjusted for real estate investments the margin came in at 40%.

In the first nine months of the year, free cash flow was $1.5 billion, or $1.75 billion, after adjusting for real estate investments.

Cash taxes were $140 million, up $114 million, reflecting the prior year's regulatory extensions of estimated tax payments.

Infrastructure investments totaled $36 million.

The average contract term in the third quarter was 28 months, flat year-over-year and quarter-over-quarter.

DSO decreased 6 days year-over-year and quarter-over-quarter to 62 days, reflecting stronger than usual linearity.

The $106 million *gain o*n bargain purchase from the Lacework acquisition relates to NOL carryforwards and the related recognition of the deferred tax assets. The gain is excluded from our non-GAAP financials, but is included in the GAAP financials, adding 14 cents per share to our GAAP EPS.

Share buybacks totaled $600,000and last month, the Board increased the share repurchase authorization by an additional $1.0 billion, bringing our remaining share repurchase authorization to approximately $2.0 billion.

Now, I'd like to share a few significant wins from the third quarter…

First, in a 7-figure upsell deal, an existing SD-WAN customer in the retail industry continued on their consolidation journey, adding FortiSASE for 16,000 users. This customer selected our FortiSASE solution for its simplicity, ease of management, and consistent security enforcement across their infrastructure. We outperformed the competition by leveraging our FortiOS operating system, streamlining operations and reducing cost of ownership, while showcasing our ability to consolidate multiple security functions onto a single platform.

In another 7-figure win, a medical device company purchased FortiSASE to replace their existing solution. This customer chose Fortinet for its simplified and consistent security management, significant cost savings, and FortiSASE's enhanced functionality, particularly the bi-directional connectivity between their datacenter and remote users, enabling them to push policies more effectively.

In an 8-figure competitive displacement win, a multinational bank commenced their partnership with us by selecting our FortiGate firewalls and multiple SecOps solutions to secure their hybrid architecture. This customer was particularly impressed with our integrated security, end-to-end visibility, and automated response capabilities of our FortiOS operating system.

Before discussing our guidance, I'd like to offer a couple comments on the firewall recovery and refresh opportunity. During last quarter's remarks, we mentioned that the continued improvement in the days-to-register FortiGuard contracts indicated 'inventory digestion' at end users returned to normal. In the third quarter, this metric was stable, further validating our view that the firewall market is recovering. Today, we would like to add to this commentary by noting that in 2026 a record number of FortiGates will reach the end of their support lifecycle and we expect these customers to start the refresh cycle for these products sometime in 2025.

Moving onto guidance…

As a reminder, our fourth quarter and full year outlook, which are summarized on slides 19 and 20, is subject to the disclaimers regarding forward-looking information Aaron provided at the beginning of the call.

Before reviewing our outlook, I should note we expect the Lacework and NextDLP acquisitions to increase Q4 billings and revenue growth by 75 and 135 basis points, respectively, and decrease operating margin by 230 basis points.

For the fourth quarter, we expect:

- *Billings* between $1.9 billion and $2 billion, which at the midpoint represents growth of 5%,
- Revenue in the range of $1 billion 560 million to $1 billion $620 million, which at the midpoint represents growth of 12% percent,
- Non-GAAP gross margin of 79.5% to 80.5%,
- Non-GAAP operating margin of 33% to 34%,
- Non-GAAP earnings per share of $0.58 to $0.62, which assumes a share count between 768 and 778 million,
- Capital expenditures of $100 to $120 million.
- A non-GAAP tax rate of 17%, and
- Cash taxes of $127 to $177 million.

For the full year, we expect:

- *Billings* in the range of $6 billion 430 million to $6 billion 530 million,
- Revenue in the range of $5 billion 856 million to $5 billion 916 million, which at the midpoint represents growth of 11% percent,
- Service revenue in the range of $4 billion $15 million to $4 billion $45 million, which at the midpoint represents growth of 19%,
- Non-GAAP gross margin of 80.3% to 81.3%,
- Non-GAAP operating margin of 32.9% to 33.9%,
- Non-GAAP earnings per share of $2.20 to $2.28, which assumes a share count of between 766 and 776 million,
- Capital expenditures of $380 to $400 million,
- Non-GAAP tax rate of 17%, and
- Cash taxes of between $550 million and $600 million.

I look forward to seeing you at our Analyst Day later this month and updating you on our progress in the coming quarters.

I'll now hand the callback over to Aaron to begin the Q&A session.

<u>Closing Remarks: Aaron Ovadia, Senior Director, Investor Relations</u>

Thank you. I'd like to thank everyone for joining today's call.

As a reminder, we will be holding an Analyst Day on November 18th, marking our 15-year IPO anniversary, where we will share the company's vision for the future of cybersecurity and provide an update on our strategy and mid-term financial model.

We will also be attending investor conferences hosted by Barclays, Needham, Scotiabank, and Wells Fargo during the fourth quarter.

The 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!