



Fortinet Q2 2024 Earnings Prepared Remarks

Aaron Ovadia, Director, Investor Relations

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

Joining me on today's call are Ken Xie, Fortinet's Founder, Chairman, and CEO, Keith Jensen, our CFO, and John Whittle, our COO. 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 second quarter of 2024 before providing guidance for the third 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 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, Aaron, and thank you to everyone for joining our call.

We are pleased with our strong execution in the second quarter as we successfully balanced growth and profitability.

- We achieved record operating margins, which increased 820 basis points to 35%,
- Managed to billings and revenue at the high end of the guidance range,
- Raised our full year 2024 revenue and operating margin guidance,
- And we continue to invest for growth, gaining market share in Secure Networking and investing in the fast-growing Unified SASE and Security Operations markets.

Secure Networking customers are increasingly recognizing our FortiOS and FortiASIC technologies offer 5x to 10x better performance than our competitors, while increasing security effectiveness and providing a lower total cost of ownership. For over 20-years, we have been leading the shift to network and security convergence, and industry projections now indicate secure networking will surpass traditional networking by 2026, four years earlier than previously anticipated.

In the second quarter, Unified SASE accounted for 23% of total billings, up 1 point. We expect our differentiated Unified SASE offering to become a leader in the SASE market.

We believe we are the only company that has built all the SASE functions organically in a single operating system. We have converged the networking and security stack including our market leading SD-WAN, ZTNA, Secure Web Gateway, CASB, Firewall and many other innovations.

Our SASE offering provides flexible enforcement, delivering a better user experience while securing access to applications on-premises and in the cloud. Furthermore, we continue to build our own SASE delivery infrastructure, including leveraging our FortiGate technology, providing us with a competitive long-term cost advantage.

As announced earlier today, we acquired Next DLP, a next generation, cloud native SaaS Data Protection platform extending from endpoint to cloud. This will allow us to enter the standalone enterprise DLP market as well as integrated markets with our FortiSASE solution.

We also recently improved our position in the Gartner Magic Quadrant for Single-Vendor SASE and are the only vendor included in all 5 of the major network security Magic Quadrants: Single-Vendor SASE, Network Firewall, SD-WAN, Security Service Edge (SSE), and Enterprise Wired and Wireless LAN Infrastructure. Each of these solutions run on our single unified operating system, FortiOS, with AI-powered FortiGuard Security Services and unified management.

AI-driven SecOps accounted for 10% of total billings in the second quarter, up 1 point. Our comprehensive SecOps portfolio, backed by over a decade of AI experience, offers the broadest range of sensors and advanced analytics to continuously assess activity to identify signs of cyberthreats.

FortiAI harnesses Generative AI to turbocharge our platform and helps security operations teams make better-informed decisions and respond to threats faster by

simplifying the most complex tasks. FortiAI is available in FortiAnalyzer, FortiSIEM, and FortiSOAR and will soon be available in other Fortinet products.

In addition, we are pleased to further expand our SecOps portfolio with the acquisition of Lacework and believe that together our solutions form one of the most comprehensive, full stack cloud security solutions available from a single vendor. Lacework's organically developed AI-driven cloud-native application protection platform will be combined with the power of Fortinet's Security Fabric platform, ensuring broad protection across the network, cloud, and endpoint.

This acquisition increases our total addressable market by \$10 billion and adds a team of talented engineers dedicated to cloud-native security while also expanding our salesforce that can sell the entire Fortinet portfolio of solutions.

Yesterday, we announced several enhancements to Fortinet's OT security platform, which already stands as the most comprehensive OT security platform on the market. Enhancements include new ruggedized appliances, advanced secure networking and security operations capabilities, and expanded partnerships with leading OT vendors, reflecting Fortinet's commitment to security for the growing cyber-physical systems market.

As further evidence of our innovation and commitment to excellence in OT, we recently earned the prestigious Red Dot Product Design Award for our FortiGate Rugged 70G with Dual 5G Modems. Fortinet was the only cybersecurity company to receive this recognition for an industrial next-generation firewall.

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

Keith Jensen, CFO

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

Let's start with the key highlights from the second quarter...

Overall, we are very pleased with our execution in the quarter. We achieved record gross and operating margins at 81.5% and 35.1%, respectively, while delivering topline numbers at the high end of our guidance range.

Revenue grew 11% as product revenue exceeded our expectations, driven by robust software revenue growth and sequential hardware growth that more closely aligned with historical norms.

We also added approximately 6,300 new logos as we continue to invest in our channel partners.

As you will hear in a moment, we believe we are on-pace for another 'Rule of 40' year.

At the same time, we accelerated our investments in the fast-growing Unified SASE and Security Operations markets with the acquisitions of Lacework and Next DLP. Lacework strengthens our position in the high-growth CNAPP market and expands our total addressable market by \$10 billion, while Next DLP improves our position in the standalone enterprise data loss prevention (DLP) market.

Combined, Fortinet will gain over 900 customers and talented sales and engineering teams. I'll pause here to offer a very warm welcome to both companies.

Continuing with Q2 highlights -- We have taken the lead in partnering with the U.S. Cybersecurity and Infrastructure Security Agency (CISA) through its Secure by Design Pledge and are leading with our responsible transparency practices.

We want to emphasize we understand customer trust is paramount to our business. Our continued success across all customer segments and each of our three pillars represents hundreds of thousands of end customers testing and buying Fortinet's

security solutions. Simply stated, this is a significant scale advantage – and a responsibility -- few others have, and also offers customer validation at a very robust level.

We are committed to responsible updates and deployment processes, supply chain controls, product security measures, and transparency. To understand more about the proactive measures we take to safeguard our customers and our reputation, please visit our Trust Website at fortinet.com/trust.

Looking at billings in more detail...

Total billings were consistent year over year at \$1.54 billion, overcoming the headwind from the drawdown in backlog in the comparable quarter. At the same time, total bookings increased year over year and more importantly, the sequential growth rate approached pre-covid, pre-supply chain norms.

Unified SASE and SecOps delivered strong growth along with software, while product sales recovered more than expected.

We continued to see significant progress from our investments in both pillars and saw strong pipeline growth of 45% for Unified SASE and 18% for SecOps.

Both pillars are gaining significant momentum within our install base as over 90% of Unified SASE and SecOps billings are coming from existing customers. Larger enterprises continue to be our largest customer segment, with large and mid-enterprises representing 86% and 82% of Unified SASE and SecOps, respectively.

Within Unified SASE, FortiSASE billings continued to grow at triple digit rates as existing customers can seamlessly integrate our solution within minutes to secure their hybrid workforce while FortiClient customers are able to use a single agent to secure internet, private, and SaaS applications. We have also integrated FortiAP with FortiSASE for securing thin edges and unmanaged devices.

Our Unified SASE solution continues to gain market recognition. For the second consecutive year, we have been recognized as a Challenger in the Gartner Magic

Quadrant for Single-Vendor SASE, with the third highest placement on the Ability to Execute axis.

And as mentioned earlier, we are further improving our FortiSASE solution by adding powerful data loss prevention capabilities from Next DLP.

Rounding out the billings commentary, SMB was again the top performing customer segment while International Emerging was again our best performing geography. On an industry vertical basis, technology and transportation grew at double-digit rates while service provider and manufacturing were more challenged.

Turning to revenue and margins....

Total revenue grew 11% to \$1.434 billion, driven by service revenue growth and software licenses.

Service revenue of \$982 million grew 20%, accounting for 68.5% of total revenue. Service revenue growth was led by 36% growth in SecOps and 27% growth in Unified SASE. As noted on slide 5, Unified SASE includes SSE and related technologies together with SD-WAN.

Product revenue decreased 4%, but better than expected, to \$452 million.

Excluding the impact of backlog, product sales growth improved 14 points quarter over quarter and a similar amount year over year.

Software license revenue growth continued to accelerate at 26% and represented a high teens percentage of product revenue, a nearly five-point increase in the software mix year over year.

Combined revenue from software licenses and software services such as cloud, and SaaS security solutions -- increased 32%, accelerating from 23% a year ago and providing an annual revenue run rate of over \$800 million.

Total gross margin *increased 360 basis points to a quarterly record of 81.5%* and exceeded the high end of the guidance range by 400 basis points, benefiting from

higher product and services gross margin as well as a 5-point mix shift to higher margin service revenues.

Product gross margin of *66.0% increased 250 basis* points year over year, mainly due to the increased software mix and lower indirect costs.

On a quarter-over-quarter basis, product gross margin *increased from 56% to 66%* as hardware demand increased and inventory levels and related inventory charges moved closer to historical norms.

Service gross margin of *88.6% increased 240 basis points* as service revenue growth outpaced labor cost increases and benefitted from the mix shift towards higher margin FortiGuard security subscription services.

Operating margin increased 820 basis points to a quarterly record of 35.1% and was 840 basis points *above* the high-end of our guidance range, reflecting the record gross margin as well as cost efficiencies within the business.

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

Free Cash Flow was \$319 million for the quarter and \$927 million for the first half of 2024, or \$1.1 billion, after adjusting for real estate and infrastructure investments.

Cash taxes in the quarter were \$252 million. As a reminder, last year's second quarter benefited from the deferral of approximately \$190 million in cash tax payments, which were ultimately paid in the fourth quarter of 2023.

Infrastructure investments totaled \$23 million.

The average contract term in the second quarter was 28 months, flat year-over-year and up 1 month quarter-over-quarter. DSO decreased 7 days year-over-year and increased 2 days quarter-over-quarter to 68 days.

While we did not repurchase shares in Q2, share buybacks have totaled \$5.3 billion over the past 4-plus years and the remaining buyback authorization is \$1 billion.

Now, I'd like to share a few significant wins from the second quarter...

In a 7-figure deal, an international government agency purchased 12 solutions across all 3 pillars, including 8 SecOps solutions. This new customer selected Fortinet because of our operating system's ability to consolidate over 30 networking and security functions into a single unified platform, covering SecOps, SASE, and Secure Networking. The customer was impressed with the integrated security, end-to-end visibility, and automated response features of our FortiOS operating system.

Next, in a 7-figure win, a large utility company expanded our partnership by signing their first Enterprise Agreement with us to safeguard their OT environment. This deal displaces 5 legacy vendors and includes ruggedized equipment deployed at the customer's power plants, control centers, and substations. Keys to this expansion win were our proven expertise in securing critical infrastructure and our price-for-performance advantage.

Lastly, in a competitive displacement win, a retail store chain purchased our FortiSASE solution in a 7-figure deal. This customer chose Fortinet because of our integrated FortiOS platform as they were able to seamlessly integrate FortiSASE with their existing Fortinet security solutions.

Now, I'd like to offer some comments on customer inventory digestion and the firewall refresh cycle...

Last quarter, we pointed to a 25% improvement in the number of days to register FortiGuard contracts from its peak and view this as an early, but soft indicator that 'inventory digestion' at end users appeared to be normalizing and the firewall market could start to show signs of recovery. To provide an update on this indicator and other signs of possible improvement in the firewall market, we can share that:

- As shown on slide 19, in the second quarter, the days to register security service contracts improved another 12 days and has now returned to 2020 pre-supply chain and pre-covid levels.

- Inventory commitments and levels are normalizing at our contract manufacturers and in the channel.
- And, as noted earlier, the sequential increase in hardware sales in the second quarter aligned more closely with historical norms.

While these indicators are positive, we believe customers are currently managing a tough macro environment in a key election year in the U.S., and we believe this is having an impact on some customers' purchasing decisions. As a result, we believe a full refresh cycle is unlikely to occur in 2024, but more likely in 2025.

Moving onto guidance...

As a reminder, our third quarter and full year outlook, which are summarized on slides 21 and 22, is subject to the disclaimers regarding forward-looking information that Aaron provided at the beginning of the call.

Before reviewing the outlook, I'd like to offer a few modeling notes in light of our Lacework and Next DLP acquisitions, covering estimates *included* in our Q3 and full year guidance:

- For billings, the acquisitions increase Q3 by approximately ½ point and full year growth by approximately 1/3 point.
- For total revenue, they increase Q3 and full year growth by 1 point and 1/2 point, respectively.
- For gross margin, they decrease Q3 and full year margins by less than ½ point for each period.
- For operating margin, they decrease Q3 and full year margins by 3.0 points and 1.5 points, respectively.

Inclusive of these acquisition related estimates, for the third quarter, we expect:

- *Billings* in the range of \$1 billion 530 million to \$1 billion 600 million, which at the midpoint represents growth of five percent,

- Revenue in the range of \$1 billion 445 million to \$1 billion \$505 million, which at the midpoint represents growth of 10.5% percent,
- Non-GAAP gross margin of 79.0% to 80.0%,
- Non-GAAP operating margin of 30.5% to 31.5%,
- Non-GAAP earnings per share of \$0.50 to \$0.52, which assumes a share count between 767 and 777 million,
- Capital expenditures of \$40 to \$60 million.
- A non-GAAP tax rate of 17%, and
- Cash taxes of \$125 to \$145 million.

For the year, we expect, inclusive of numbers gave a moment ago:

- *Billings* in the range of \$6 billion 400 million to \$6 billion 600 million,
- Revenue in the range of \$5 billion 800 million to \$5 billion 900 million, which at the midpoint represents growth of 10% percent,
- Service revenue in the range of \$3 billion \$975 million to \$4 billion \$25 million, which at the midpoint represents growth of 18%,
- Non-GAAP gross margin of 79.0% to 80.0%,
- Non-GAAP operating margin of 30.0% to 31.5%,
- Non-GAAP earnings per share of \$2.00 to \$2.04, which assumes a share count of between 767 and 777 million,
- Capital expenditures of \$320 to \$360 million,
- Non-GAAP tax rate of 17%, and
- Cash taxes of between \$525 million and \$575 million.

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

Before we begin the Q&A session, it is with deep sadness that we recognize the passing of our friend Peter Salkowski, our SVP of Finance and Investor Relations. Peter was an integral part of the Fortinet team for over six years and was renowned for his passion for mentoring and developing the next generation of leaders. We will miss Peter and fondly remember his commitment to fostering talent and nurturing potential within our company.

I know that Peter worked closely with many of you on this call, and the outpouring of condolences and heartfelt memories you've shared since his passing clearly shows the positive impact he had on so many people's lives. Peter took great pride in his contribution to Fortinet, and rightly so, having contributed to increasing shareholder value from \$8 billion to \$46 billion during his tenure at Fortinet. We'll miss you.

I'll now hand the call back over to Aaron.

Closing Remarks: Aaron Ovadia, Director, Investor Relations

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

Fortinet will be attending investor conferences hosted by Deutsche Bank, Goldman Sachs, and Oppenheimer during the third quarter.

We will also be holding an Analyst Day on November 18th, where we expect to update our medium-term financial model.

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!