Fortinet Q4 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 fourth quarter and full year 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 fourth quarter and full year of 2024 before providing guidance for the first quarter and full year of 2025. 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 with our strong performance in the fourth quarter, successfully balancing growth and profitability, including:

- Record operating margin of 39%,
- Total revenue growth of 17%, including product revenue growth of 18%, our highest growth rate in 6 quarters, as we further strengthen our market leadership in secure networking,
- And strong growth in Unified SASE and Security Operations with security service edge billings growth of 85%, which drove our Unified SASE billings growth to 13%, accounting for 23% of our business.

The strong Unified SASE growth highlights the value that our customers see in our single-vendor SASE strategy. We are the only vendor to organically develop the key SASE functionality into a single operating system, FortiOS, which integrates market-leading next gen Firewall, SD-WAN, ZTNA, Secure Web Gateway, CASB, DLP, and other innovations, seamlessly unifying networking and security, delivering an enhanced user experience and securing access to applications across on-premises and cloud environments.

Existing firewall and SD-WAN customers can deploy FortiSASE in the cloud or on premise within minutes. We also enable Sovereign SASE for service providers and large enterprises to host FortiSASE within their own data centers, enabling tighter control of their data and greater connectivity, while leveraging our FortiASIC technology to accelerate SASE functions for superior performance. Additionally, Fortinet's AI-powered security, unified management, and single agent approach provide consistent protection across all locations and devices, ensuring full control, visibility, and simplified deployment, while also offering the industry's simplest licensing at 3x to 5x better performance per user.

AI-driven Security Operations accounted for 11% of total billings while ARR grew 32%. We recently enhanced our Security Operations portfolio by acquiring Perception Point, a leader in advanced email and collaboration security. This acquisition strengthens our end-to-end cybersecurity by extending protection beyond email to the entire modern workspace, addressing the growing advanced threat risks in today's elevated threat environment.

In Secure Networking, we continue to lead the industry with our convergence and consolidation strategy, a vision we have been driving for 25 years. Industry forecasts predict that secure networking will surpass traditional networking by 2026. As the #1 secure networking vendor, Fortinet secures over half of all global firewalls and leads the convergence trend.

Also, as shown on slide 4, Fortinet continues to be the only vendor to leverage a single operating system, FortiOS, across five secure networking Gartner Magic Quadrants. Customers are increasingly recognizing that our FortiOS and FortiASIC technologies deliver 5x to 10x better performance than competitors, while enhancing security effectiveness and reducing total cost of ownership. This is especially evident in Operational Technology, where OT sales approached $1 billion in 2024.

Today, we introduced the FortiGate 30G, 50G, and 70G next generation firewalls and unified SASE solution designed for SMB and distributed enterprises, with cutting-edge performance and enhanced security delivering up to 5x to 10x faster throughput and better threat protection than industry averages, and support a wide range of secure network interfaces for remote access.

In addition, we recently acquired the remaining share in Linksys, a leading provider of connectivity solutions, to expand our enterprise-grade security to employees working remotely, home businesses, and consumers.

Lastly, I'm very proud to share that Fortinet was recently recognized on Forbes' Most Trusted Companies in America list, ranking #7 overall and the only cybersecurity company in the top 50 list, highlighting our transparency and commitment to our customers as the most trusted cybersecurity company.

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

Keith Jensen, CFO

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

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

We delivered strong execution and financial performance with top-line results above the high-end of guidance, together with *record* operating margins at 39%.

Total revenue grew 17%, driven by strong product and service revenues as product revenue growth pushed up to 18%.

In addition, we added a *record* 6,900 new logos, driven by close alignment with our channel partners.

Looking at our financial results in more detail…

Total billings grew 7% to $2.0 billion, including double digit Security Operations and Unified SASE growth. RPO grew 12% to $6.4 billion.

ARR growth was very strong as SecOps grew 32% and Unified SASE grew 28% to a combined total of over $1.5 billion.

Within Unified SASE, SSE continues to gain traction with ARR growth of 96% as we continue to see early success upselling FortiSASE to our large SD-WAN customer base. FortiSASE deals increased over 60% and the pipeline was up 90%.

The typical FortiSASE journey starts with the customer's first purchase of our ASIC-based, market leading, FortiGate firewall, followed by an expansion to SD-WAN and then to our single-vendor SASE solution. The expansion journey is particularly significant as over 70% of our large enterprise customers have adopted our SD-WAN functionality and are poised to expand to FortiSASE. Our large enterprise FortiSASE penetration rate increased to 10%, that's up 2 points since our November Analyst Day reporting.

Rounding out the billings commentary…

- Deals between $5 million and $10 million increased over 90%,
- SMB was our top performing customer segment with growth of over 30%,
- And EMEA was our best performing geography, driven by growth of over 25% from International Emerging.

Among our top 5 verticals, worldwide government and service provider both grew over 20%, while financial services saw the expected challenge from the difficult year-over-year comparison, driven by several seven and eight-figure deals in the fourth quarter of 2023.

Turning to revenue and margins….

Total revenue grew 17% to $1.66 billion.

Product revenue increased 18% to $574 million, our highest growth rate in 6 quarters, driven by hardware revenue growth of 19%. On a sequential basis, product revenue increased 21% and represents the third quarter in a row with elevated sequential growth.

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

Service revenue of $1.09 billion grew 17% to 65% of total revenue. Service revenue growth was driven by SaaS solutions at 130%, which includes Lacework, as well as strong organic services growth in Unified SASE and SecOps.

Combined revenue from software licenses and software services such as cloud, Lacework and other SaaS security solutions -- increased 41%, and provides an annual revenue run rate of over $1 billion.

Total gross margin *increased 340 basis points to 81.9%* and exceeded the high end of the guidance range by 140 basis points.

Product gross margin of *69.3%* increased *920 basis* points as inventory related charges normalized from last year's highly elevated levels, adding 840 basis points to product gross margin and 290 basis points to total gross margin.

Service gross margin of 88.6% *increased 50 basis points to a quarterly record a*s services revenue growth outpaced labor and hosting cost increases while benefitting from the mix shift towards higher margin FortiGuard security subscription services as well as some early AI related savings.

Operating margin *increased 720 basis points to a record* 39.2% and was 520 basis points *above* the high-end of our guidance range, reflecting the strong gross margin, a Fx tailwind of 110 basis points, as well as the top line over performance that flowed through to the bottom line.

Before moving onto the statement of cash flows, I'd like to summarize the financial impact from the Lacework, NextDLP, and Perception Point acquisitions. These acquisitions increased fourth quarter billings growth by 115 basis points versus our expectation of 75 basis points and decreased operating margin by 190 basis points versus our expectation of a decrease of 230 basis points.

Looking to the Statement of Cash Flows summarized on slides 18 thru 21…

Free Cash Flow was $380 million and free cash flow margin was 23%, up 11 points. Adjusted Free Cash Flow was $459 million, representing a margin of 28%, up 16 points.

Cash taxes were $156 million, down $186 million, reflecting the prior year's regulatory extensions of estimated tax payments while infrastructure investments were $98 million, or up $71 million.

The average contract term in the fourth quarter was 29 months, down 1 month year-over-year and up 1 month quarter-over-quarter.

DSO decreased 10 days, reflecting improved linearity year over year.

The remaining share buyback authorization is $2.0 billion.

Moving to an overview of our 2024 full year results…

Billings exceeded $6.5 billion while total revenue grew 12% to $5.96 billion, driven by revenue growth of around 25% for both Unified SASE and SecOps.

Service revenue grew 20% to $4.05 billion, driven by a 22% increase in security subscriptions and 33% growth in Unified SASE services.

Gross margin was up 390 basis points to 81.3%, benefiting from the revenue mix shift to service revenue and a 140 basis point tailwind as inventory related charges normalized during the year.

Operating margin increased *660 basis points to a record* of 35.0% resulting in operating income of $2.1 billion, which was up 38%.

Our GAAP operating margin of 30.3% continues to be one of the highest in the industry.

Earnings per share increased 45% to $2.37.

Free Cash Flow was a *record* at $1.9 billion, representing a margin of 32%. Adjusted Free Cash Flow was $2.2 billion, representing a margin of 37%.

To sum up 2024, I think it's important to note that we met or exceeded the 'Rule of 45' for the 5th consecutive year.

Now, I'd like to share a few significant fourth quarter wins showcasing our SASE expansion and our leadership in Operational Technology…

In a 7-figure new customer win, a healthcare provider strategically included FortiSASE in its first Fortinet purchase, alongside SD-WAN, while replacing a competitor's firewalls. With a new leadership team focused on vendor consolidation, reducing operating costs and complexity, and addressing technological debt, FortiOS consolidated multiple security functions onto a single platform, modernized an outdated firewall infrastructure, and replaced VPN technologies with a 5,000-seat SASE solution that relies on Fortinet's PoPs.

In another 7-figure SASE deal, an existing Fortune 500 SD-WAN retail customer purchased FortiSASE for 2,000 users, with the potential to scale up to 12,000. They chose Fortinet for its flexible and consistent security enforcement, which enhances user experience while securing access to both on-prem and cloud applications. Additionally, they valued our strategy of building our own SASE delivery infrastructure powered by our proprietary ASIC technology.

Lastly, in a high seven-figure deal, a large energy company expanded its partnership with us by signing its first Enterprise Agreement to protect its global critical infrastructure. This customer secures its infrastructure using FortiGates across approximately 1,000 sites, spanning branch locations, data centers, and cloud environments. Key factors in this win included our ability to support their global critical infrastructure both technically and through world-class support programs, our leadership in OT infrastructure capabilities, and the automation and seamless integration of our FortiOS system.

With Fortinet supplying over 50% of the firewalls worldwide, Fortinet security solutions themselves have become critical infrastructure protecting the critical infrastructure, in a threat landscape where there has been a step level increase in sophistication and risk. Given our scale, innovation and broad adoption, we and national cybersecurity agencies around the world view our partnership as key to protecting the most important customers and entities in this dynamic landscape

Next, I'd like to review some of our key AI solutions for threat intelligence, networking, NOC and SOC, and LLM leakage…

- For *threat intelligence*, FortiGuard AI-powered security services combined with real-time threat intelligence, help organizations combat known, unknown, zero-day, and emerging AI-based threats.
- For *networking*, FortiAIOps reduces the time needed to diagnose networking issues. By monitoring trends in the network and with full access to logs across the Fortinet Security Fabric, our AI engine uses machine learning to understand the optimal conditions for the network and highlight potential issues.
- For the *NOC and SOC*, FortiAI uses natural language and generative AI to guide, simplify, and automate analyst activities. FortiAI is integrated into 7 different network and security operations products with additional products to be added.
- For *LLM leakage*, our AI-based DLP services actively identify and block sensitive information from being uploaded or shared with AI systems.

Before discussing our guidance, I'll offer a few updates on the record level firewall upgrade opportunity that we shared during our November Analyst Day. In the fourth quarter, we saw early upgrade movement with larger enterprises, both on buying plans and actual purchases. We expect the momentum to build as we move into the second half of 2025 as we get closer to the 2026 end of service dates.

The 2026 and 2027 cohorts present a substantial upsell opportunity for SASE, Switches, access points, and SecOps solutions. To maximize our upgrade and cross-sell potential, we are implementing several initiatives, including:

- Creating sales plays for each customer segment and key vertical

- Expanding our account plans for larger enterprises to more specifically target the upgrade and expansion opportunities
- Collaborating with channel partners on SMB opportunities, incentive programs, end user data, and developing targeted bundle offerings for these customers.

Moving onto guidance…

As a reminder, our first quarter and full year outlooks, which are summarized on slides 23 and 24, are subject to the disclaimers regarding forward-looking information that Aaron provided at the beginning of the call.

I should note we expect Linksys and Perception Point to increase first quarter billings and revenue growth by approximately 90 basis points and decrease operating margin by around 40 basis points. For the full year, we expect Linksys and Perception Point to increase billings and revenue growth by approximately 125 basis points and decrease operating margin by around 50 basis points.

Alright, for the first quarter, we expect:

- *Billings* in the range of $1 billion 520 million to $1 billion 600 million, which at the midpoint represents growth of 11%,
- Revenue in the range of $1 billion 500 million to $1 billion $560 million, which at the midpoint represents growth of 13%,
- Non-GAAP gross margin of 80.0% to 81.0%,
- Non-GAAP operating margin of 30.0% to 31.0%,
- Non-GAAP earnings per share of $0.52 to $0.54, which assumes a share count between 774 and 780 million,
- Infrastructure investments of $80 to $100 million.
- A non-GAAP tax rate of 18%, and
- Cash taxes of $30 to $35 million.

For the full year, we expect:

- *Billings* in the range of $7 billion 200 million to $7 billion 400 million, which at the midpoint represents growth of 12%,
- Revenue in the range of $6 billion 650 million to $6 billion 850 million, which at the midpoint represents growth of 13%,
- Service revenue in the range of $4 billion $575 million to $4 billion $725 million, which at the midpoint represents growth of 15%,
- Non-GAAP gross margin of 79.0% to 81.0%,
- Non-GAAP operating margin of 31.0% to 33.0%,
- Non-GAAP earnings per share of $2.41 to $2.47, which assumes a share count of between 773 and 783 million,
- Infrastructure investments of $380 to $430 million,
- Non-GAAP tax rate of 18%, and
- Cash taxes of between $525 million and $575 million.

And on a personal note, as you may have read in today's 8-k filing that after a 4-decade career in finance, including 11 years at Fortinet, it's time for me to enjoy retirement. I'll continue to serve through the next quarterly earnings call and up to May 15th, and plan to stay at Fortinet to help with the transition through June 30th.

Most importantly, I'm leaving Fortinet in very good hands: pursuant to our succession plan, Christiane Ohlgart, who, as discussed in the 8-K has served in various roles at Fortinet for almost 6 years, will take over as CFO when I step down in May.

I'd like to thank Ken, Michael, the Fortinet team, and all of you for making this chapter in my life so rewarding. I very much appreciate the time I've had at Fortinet, working with Ken, Michael and the entire team, and certainly with the investors and financial analysts. I know I'll miss Fortinet, its people, customers and its noble mission to protect and serve important customers and entities around the world.

Ken Xie, Founder, Chairman and CEO

Thank you, Keith, for your great service on behalf of Fortinet, and Christiane, we look forward to working with you in your new role to continue to drive success at Fortinet. I'll now hand the call over to Aaron to begin the Q&A session.

Closing Remarks: Aaron Ovadia, Senior Director, Investor Relations

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

We will be attending an investor conference hosted by Morgan Stanley during the first quarter. The fireside chat webcast link 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!