Fortinet Q1 2022 Earnings Prepared Remarks

Peter Salkowski, VP of Investor Relations

Good afternoon everyone. This is Peter Salkowski, vice president of investor relations at Fortinet. I am pleased to welcome everyone to our call to discuss Fortinet's financial results for the first quarter of 2022.

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 first quarter before providing guidance for the second quarter and updating the full year. We will then open the call for questions.

During the Q&A session, we ask that you please keep your questions brief and limit yourself to one 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

Thanks Peter and thank you to everyone for joining today’s call to review our outstanding first quarter 2022 results.

Our better than expected first quarter results demonstrate the strong demand for our cyber security innovation. Total revenue growth of 34% was driven by record product revenue growth of 54%. Total billings increased 36%. Our strong results reflect new orders that were significantly greater than anticipated, partially offset by an increase in backlog.

As a result, bookings increased 50% year over year to $1 billion 276 million, which included bookings growth for SD-WAN of 54%, Global 2000 growth of 61%, and OT growth of 76%. For the quarter, net new backlog was 9% of bookings, as we continued to navigate a challenging supply-chain environment.

We believe that hybrid networks are here for the foreseeable future and Fortinet is pushing the boundaries of what is possible, with innovation to enable customers to successfully operate in today’s elevated threat environment. Our solid performance and market share gains are being driven by our efforts to make our customers’ entire infrastructure more secure and integrated in a zero-trust network.

Fortinet’s Security-driven networking approach converges networking functionality with security capabilities fueled by our powerful FortiASIC SPUs to provide the best performance and rich functionality. The new FortiOS 7.2 offers multiple new and enhanced services across FortiGuard, FortiCare and FortiTrust such as ZTNA, identity, inline Sandboxing, Advanced Device Protection for OT and IoT environments, SOC-as-a-Service, and inline CASB. And Fortinet provides one of the broadest security services offerings at an average of half the cost, compared with our main competitors. In addition, we have prioritized our mostly organic research and development efforts on integrating security products into our centralized FortiOS fabric platform which Gartner refers to as a Cybersecurity MESH architecture.

Today we announced a new suite of FortiGates powered by our FortiASIC SPU. The FortiGates 3700F, 600F and 70F deliver high-performance converged networking and security with Security Compute Ratings of 5x on average, better performance than competitive offerings.

During the quarter, we were pleased to receive the Gartner Peer Insights Customer Choice Awards for both WAN Edge Infrastructure and Next-Generation Firewalls for 3 Years in a row. Our innovations position Fortinet as one of the most influential cybersecurity leaders. These growth drivers and organic innovations are accelerating our growth potential to new levels.

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. It is their collective efforts and trust that are contributing to Fortinet’s strong growth and market share gains.

Keith Jensen, CFO

Thank you Ken and good afternoon everyone.

Before adding to Ken's comments and going into more detail on our Q1 financial results, I'd like to briefly discuss a *wording* change in how we describe our business.

FortiGate is now referred to as the "Core Platform" and Non-FortiGate is now referred to as "Platform Extension."

This change helps to emphasize the importance of our FortiOS operating system. FortiOS drives our entire security platform across multiple Platform Extension use cases including Zero Trust Access, Cloud Security, Security Operations, and Secure Networking.

With that in mind, let's start the more detailed Q1 discussion…

Customer demand was again strong and broad-based -- across geographies, customer sizes, industries, use cases, and security solutions – reflecting three key demand drivers.

1. The elevated threat environment.
2. Convergence of security and networking, and
3. Customers consolidating across our platform offerings

These key growth drivers are contributing to our strong results and *accelerating* pipeline growth rates. In short, we believe we are in a period of sustained high growth for the cybersecurity industry, and Fortinet.

Moving to the Q1 financial results…

Total revenue of $955 million was up 34%, driven by *record* product revenue growth of 54%. Taking into account an $80 million sequential increase in product backlog, product *bookings growth* was *87%.*

Product revenue growth was broad-based with Core Platform and Platform Extension product revenue growth at 50% and 59%, respectively.

While we continued to see robust product growth from Secure SD-WAN and Operational Technology, or OT, the Core Platform product revenue growth was mainly driven by the wide range of *other* use cases embedded in our operating system.

Service revenue was up 24% to $584 million.

Support and related services revenue was up 26% to $271 million, while security subscriptions services revenue was up 23% to $313 million.

To offer one observation about how customers may be responding to the supply chain challenges, we are seeing indications that a subset of customers placed product orders further in advance and may have delayed purchases or registrations of the related service contracts. This, together with the timing differences related to product and service revenue recognition, creates a lag between product and service revenue growth. We expect quarterly service revenue growth to accelerate throughout the rest of the year.

As summarized on Slide 6, total revenue in the Americas increased 32%, EMEA revenue increased 25%, and APAC posted revenue growth of 57%, which includes the contribution from AlaxalA.

EMEA's growth includes the impact of suspending operations in Russia; nonetheless EMEA easily exceeded our internal targets.

Looking forward, EMEA's pipeline growth indicates continued strength in our EMEA business, despite the situation in Eastern Europe and its potential impact on European economies.

Platform Extension revenue grew 49% and accounted for 34% of total revenue, *up 3 percentage points*.

Moving to bookings, backlog and billings…

We are experiencing *exceptionally* strong demand; demand that continues to exceed supply by more than historical norms.

Bookings were up 50% to $1.3 billion reflecting exceptional demand and a $116 million quarter-over-quarter increase in total backlog, bringing backlog to $278 million.

Larger enterprises continue to favor Fortinet's industry leading cost for performance advantage and are increasingly more appreciative of our integrated platform strategy. The platform strategy allows customers to converge networking functionality with security capabilities and consolidate multiple point products.

The following key metrics illustrate growing demand from enterprise customers:

- Global 2000 bookings were up over 60%,
- Large enterprise bookings were up over 65%

Secure SD-WAN bookings grew 54% reflecting the convergence of networking and security as well as a strong economic case. OT bookings were up 76% illustrating the continued response to the elevated threat environment.

As a reminder, backlog is excluded from the current quarter billings and revenue, however, it is expected to provide increased visibility and a topline tailwind in future quarters.

At $1.2 billion, billings were up 36%.

Core Platform billings were up 30% and accounted for 67% of total billings. As shown on slide 7, high-end FortiGates posted very strong billings growth with the mix shifting 6 points towards high-end appliances.

Platform Extension billings were up over 50% and accounted for 33% of total billings, up 3 percentage points.

Average contract term was consistent year-over-year and down 1 month sequentially at 27 months.

Moving back to the income statement…

Total gross margin was 74.4%, as the revenue mix tilted 5 percentage points to product revenue from higher margin services.

Product gross margin of 57.4% reflects the impact of component and freight cost increases as well as higher, less predictable component expedite fee expenses, and the impact of consolidating AlaxalA's results.

Service gross margin of 85.2% was impacted by AlaxalA, costs associated with the expansion of our data center footprint, and increased labor costs.

Operating margin of 22.0%, exceeded the midpoint of the guidance range by 200 basis points due to increased sales productivity and efficiencies in other Opex areas, offsetting the gross margin decline.

Headcount increased 26% to 10,860.

Moving to the Statement of Cash Flows summarized on slides 8 and 9…

Free Cash Flow was *$273 million*, representing a margin of 29%.

Capital expenditures for the quarter were $123 million, including $93 million for real estate investments. Adjusted for real estate purchases, our free cash flow margin was 38%. Our capital expenditure strategy includes investing in cloud and data center infrastructure as well as our office and warehouse capacity to support our higher levels of growth.

We repurchased approximately 2.3 million shares of our common stock for a cost of $691 million.

At end of the first quarter, the remaining share repurchase authorization was approximately $830 million with the authorization set to expire in February 2023.

Inventory turns of 3.5 times were up nearly one and a half turns year-over-year.

Now I'd like to spend some time reviewing backlog in more detail…

As I mentioned earlier, very strong demand drove a $116 million increase in total backlog to $278 million. To put this in perspective, total backlog at the end of the first quarter was approximately 6% of our trailing twelve months total billings. We shipped 60% of the Q4 ending hardware backlog in the quarter.

Consistent with the prior quarter, 73% of the backlog relates to expected future product shipments, while the remaining 27% relates to various services.

We believe our backlog is very strong and should provide a billings and revenue tailwind to growth in future periods. There are several reasons that support our view, including:

- Existing customers account for 93% of our backlog and no single end customer accounts for more than a low single digit percentage of backlog.
- There are 10 deals in the backlog – nine are from existing customers -- with a remaining balance of over $1 million that together account for less than 10% of total backlog. Remaining balance is defined as original order amounts less partial shipment amounts.
- Just 5% of Q4 backlog was canceled in Q1, suggesting that double-ordering is not a significant contributor to our backlog.
- We do not believe customers are meaningfully pivoting to software form factors from hardware as software is frequently a more costly option and may require:
    - Architectural redesign and investment, and
    - Changes in form factors and other equipment beyond just firewalls
- We believe our competitors are similarly impacted by the supply chain.
- And, finally, more customers are accepting the supply chain challenges and working with us to mitigate the issues by switching products, adjusting deployment schedules, and accelerating evaluations of new products.

Similar to others, we are experiencing ongoing supply chain challenges. Our responses to these challenges include:

- Significantly increasing inventory purchase commitments
- Redesigning products
- Qualifying additional suppliers, and
- Working closely with our suppliers to further enhance our resiliency and mitigate the effects of disruptions.

We expect supply chain constraints to be challenging throughout the remainder of the year. As a result, we expect component and logistics costs to remain elevated and backlog to increase through the course of the year.

As we balance our pricing actions with the opportunity for continued market share gains, we have passed along most, but not all cost increases. As such, we expect ongoing pressure to gross margins.

While the situation is very dynamic, we believe we will have access to sufficient inventory to meet our guidance.

The outlook is also subject to the disclaimers regarding forward-looking information that Peter provided at the beginning of the call.

For the second quarter, we anticipate *bookings* in the range of $1 billion $325 million to $1 billion 385 million, which at the midpoint represents bookings growth of 40%, and we expect:

- *Billings* in the range of $1 billion 225 million to $1 billion 265 million, which at the midpoint represents growth of 30%
- Revenue in the range of $1 billion 5 million to $1 billion $35 million
- Non-GAAP gross margin of 74.5% to 76.0%,
- Non-GAAP operating margin of 22.0% to 23.5%,

- Non-GAAP earnings per share of $1.05 to $1.10, which assumes a share count between 165 and 167 million.
- We estimate second quarter capital expenditures to be between $75 and $85 million.
- We expect a non-GAAP tax rate of 17%.

For the full year, we anticipate backlog could approach or possibly exceed $500 million, and expect:

- *Billings* in the range of $5 billion 500 million to $5 billion 580 million, which at the midpoint represents growth of 32.5%.
- Revenue in the range of $4 billion 350 million to $4 billion 400 million, which at the midpoint represents growth of 31%. This assumes the current supply chain environment remains constrained throughout the year.
- Total service revenue in the range of $2 billion $640 million to $2 billion $700 million, which represents growth of approximately 28% and implies full-year product revenue growth of approximately 36%.
- Given our current view of component cost and other supply chain pressures, we expect Non-GAAP gross margin of 74% to 76%.
- Non-GAAP operating margin of 24% to 26%.
- Non-GAAP earnings per share of $5.00 to $5.15, which assumes a share count of between 166 and 168 million.
- We estimate full year capital expenditures to be between $270 and $300 million.
- We expect our Non-GAAP tax rate to be 17%.
- We expect cash taxes to be approximately $260 million.

Lastly, I want to remind everyone that we will be holding an Analyst Day on May 10th coinciding with Accelerate 2022. A link to register for the webcast is located on the Events and Presentation page of Fortinet's investor relations website.

Along with Ken, I would like to thank our partners, customers, suppliers, and all members of the Fortinet team for all of their hard work, execution and success.

I'll now hand the call back over to Peter to begin the Q&A session.

Closing Remarks: Peter Salkowski, VP of Investor Relations

I'd like to thank everyone for joining the call today. As a reminder, Fortinet will be hosting an Analyst Day on Tuesday May 10th, a link to register for the webcast can be found on the Events and Presentations page of the Company's investor relations website.

We will also be attending the J.P. Morgan Global TMT conference in Boston on May 23rd and the Bank of America Global Technology Conference in San Francisco on June 7th. The Fireside Chats at these conferences will be webcast and a link to the webcast will be available 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!