

Zscaler

2Q First Take: Healthy results, but mixed signals under the surface

Maintain Rating: BUY | PO: 265.00 USD | Price: 241.97 USD

Healthy 2Q results, however billings guidance carries risk

Zscaler reported 1Q billings/revenue of 27%/35% YoY, above Street's 25%/31% supported by strong federal upsell and healthy new logo growth. Gross margin stayed stable at 81%, and topline outperformance combined with lower-than-expected OpEx led to +700bps OM expansion. Despite a solid quarter, management guided sequential billings deceleration of -7% next quarter (vs Street's -4%), implying reacceleration of 53% in 4Q (vs Street's 46%), which we believe could prove to be too aggressive given normal seasonality of 50% at the top end of the historical range. We maintain Buy on healthy 2Q results.

Positives: Strength in new logo adds, federal upsells

We highlight multiple bright spots from the quarter: 2Q marked a record number of new logo additions with roughly 50% of net new bookings attributed to new logos, with most customers adopting the full Zscaler for Users bundle upfront. Customers with over \$100k in ACV grew +21% and customers with over \$1mn in ACV grew 31% YoY, signaling strong demand for broader platform adoption. Lastly, while Federal was not the sole reason for strong performance, Zscaler benefitted from strong upsell, specifically among the large cabinets.

Concerns: Potential pricing pressure, billing weakness

A key question that remains is will Zscaler be able to maintain leadership and pricing stability in the SASE market given increasing competitive pressure? At the lower end of the market, Fortinet and Microsoft are offering steep pricing discounts, while at the higher end of the market, Palo Alto has aggressively increased bundling efforts to target existing firewall customers. While the company noted that pricing has not felt any impacts from the evolving competitive landscape, we suspect over time price will become an issue. We also flag potential downside risk to FY25 estimates as ST billings sequentially decelerated -700bps to 26% despite easing comps, and implied billings guidance forecasts growth of 24% exiting FY24 leaving limited room for upside compared to Street's FY25 billings growth of 23%.

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Stock Data

Price	241.97 USD
Price Objective	265.00 USD
Date Established	14-Feb-2024
Investment Opinion	C-1-9
52-Week Range	84.93 USD - 259.61 USD
Mrkt Val (mn) / Shares Out (mn)	35,892 USD / 148.3
Free Float	60.9%
Average Daily Value (mn)	545.35 USD
BofA Ticker / Exchange	ZS / NAS
Bloomberg / Reuters	ZS US / ZS.OQ
ROE (2024E)	42.6%
Net Dbt to Eqty (Jul-2023A)	-17.7%
ESGMeter™	Medium

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Timestamp: 29 February 2024 09:43PM EST

Price objective basis & risk

Zscaler (ZS)

Our PO of \$265 is based on roughly 13x CY25E EV/Sales. The multiple is a premium versus high-growth software peers (7-10x), which we justify by the higher growth profile. We believe a premium is warranted due to Zscaler's higher growth profile and potential to take meaningful share in new markets that would increase the TAM and potentially accelerate growth.

Upside risks to our PO are 1) faster-than-expected adoption of Zscaler's new products, such as Zscaler Private Access, 2) higher ASP uplift due to adoption of high-end offerings like the Cloud Next-generation firewall and Cloud Sandbox, and 3) a more significant shift to cloud-based security across enterprises of all sizes.

Downside risks to our PO are 1) a lower take-rate of new offerings, 2) material slowdown in new customer adoption and expansion deals, 3) risk of network outages or security breaches, and 4) an increase in competition from incumbent vendors and newer start-ups.

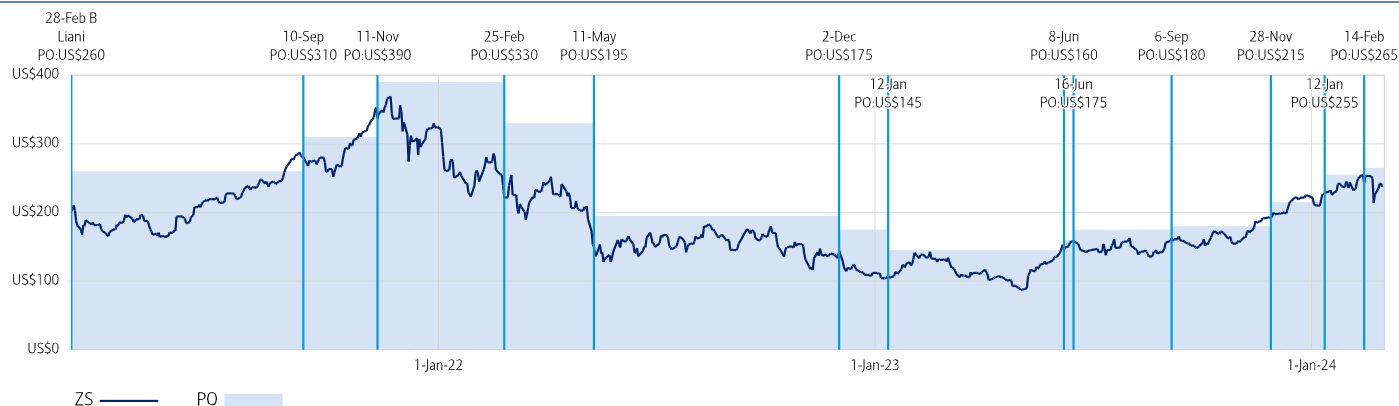
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Zscaler (ZS) Price Chart



B: Buy, N: Neutral, U: Underperform, PO: Price Objective, NA: No longer valid, NR: No Rating

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Coverage Universe	Count	Percent	Inv. Banking Relationships ^{R1}	Count	Percent
Buy	57	51.82%	Buy	43	75.44%
Hold	27	24.55%	Hold	17	62.96%
Sell	26	23.64%	Sell	12	46.15%

Equity Investment Rating Distribution: Global Group (as of 31 Dec 2023)

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Sell	807	22.84%	Sell	383	47.46%

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