

## Zscaler

# 2Q Preview: Expecting a solid 2Q, but we flag risks for the remainder of the year

Reiterate Rating: BUY | PO: 265.00 USD | Price: 242.80 USD

## What to expect heading into 2Q earnings

Zscaler is scheduled to report 2Q earnings on 2/29 and we forecast strong results. The Street is modeling 25% billings growth for 2Q24, slightly above our 24%, however [our partner discussions point to a few potential sources of upside](#) including year-end budget flush, strong federal cycle, and accelerating SASE adoption. Our 2Q revenue forecast of 31% growth is in-line with Street and slightly above the 30% guidance. We model OM to contract by -118bps sequentially to 16%, driven by normal seasonality, and expect FCFm of 16%, above Street's 14%, supported by improving cash flow generation. We maintain our Buy and increase our PO from \$255 to \$265 still based on 13x CY25E EV/Sales versus 12x prior.

## What could drive upside to 2Q growth?

2Q billings tends to be a seasonally weaker, yet we see a few offsetting factors. Per channel partners, year-end budget flush, which was noticeably absent in CY22, benefitted cloud-based solutions including SASE. Market awareness of SASE also continues to mature, and Zscaler continues to be a market leader, especially in the Enterprise segment. Finally, management's guidance baked in precautionary conservative factors including worsening macro and sales disruption as a result of a new CRO, which might prove better than expected given the strong SASE tailwinds.

## Where are the risks?

SASE competition continues to evolve, with new products from security and CDN vendors. Channel checks indicate that Palo Alto remains the top competitor in the Enterprise segment, while Cloudflare has seen recent success in SMB. While customer retention remains strong, competitive offerings could pressure customer renewal rates and pricing. Second, RPO growth was down -300bps in 1Q, and Management attributed this to a strong federal quarter. However, RPO is a leading indicator of contract duration, and another weak quarter could signal underlying weakness.

## Expect tough comps to pressure growth for 3Q

Last quarter we cautioned that Zscaler's impressive FY23 performance could create some headwinds to growth for FY24. For example, the company implicitly guided billings growth to decline from 34% in 1Q24 to 21% in 4Q24, yet this is driven by a large \$20mn contract recorded in 4Q23. As a result, we expect the company to guide to 3Q billings growth of 25%, versus 40% last year, which we believe is transitional.

Estimates (Jul) (US\$)	2022A	2023A	2024E	2025E	2026E
EPS	0.69	1.79	2.48	3.12	3.93
GAAP EPS	(2.77)	(1.40)	(0.90)	(0.64)	(0.50)
EPS Change (YoY)	32.7%	159.4%	38.5%	25.8%	26.0%
Consensus EPS (Bloomberg)			2.48	3.00	3.73
DPS	0	0	0	0	0
Valuation (Jul)					
P/E	351.9x	135.6x	97.9x	77.8x	61.8x
EV / EBITDA*	235.1x	120.5x	83.3x	59.4x	50.8x
Free Cash Flow Yield*	0.7%	1.0%	1.5%	1.4%	1.7%

\* For full definitions of *IQmethod*<sup>SM</sup> measures, see page 5.

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### Equity

#### Key Changes

(US\$)	Previous	Current
Price Obj.	255.00	265.00

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### Stock Data

Price	242.80 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
Mkt Val (mn) / Shares Out (mn)	36,015 USD / 148.3
Free Float	60.9%
Average Daily Value (mn)	436.22 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 <sup>TM</sup>	Medium

ESGMeter is not indicative of a company's future stock price performance and is not an investment recommendation or rating. ESGMeter is independent of BofA Global Research's equity investment rating, volatility risk rating, income rating, and price objective for that company. For full details, refer to "[BofA ESGMeter Methodology](#)".

SASE: Secure Access Service Edge

RPO: Remaining Performance Obligations

CDN: Content Delivery Network

# iQprofile<sup>SM</sup> Zscaler

## iQmethod<sup>SM</sup> – Bus Performance\*

(US\$ Millions)	2022A	2023A	2024E	2025E	2026E
Return on Capital Employed	6.2%	11.5%	14.2%	14.5%	15.3%
Return on Equity	18.4%	42.7%	42.6%	36.0%	31.9%
Operating Margin	10.2%	14.9%	17.3%	19.4%	20.8%
Free Cash Flow	253	365	544	492	617

## iQmethod<sup>SM</sup> – Quality of Earnings\*

(US\$ Millions)	2022A	2023A	2024E	2025E	2026E
Cash Realization Ratio	3.2x	1.7x	1.8x	1.3x	1.2x
Asset Replacement Ratio	1.7x	1.7x	2.5x	2.0x	1.8x
Tax Rate	NM	NM	4.9%	18.3%	19.6%
Net Debt-to-Equity Ratio	-7.8%	-17.7%	-47.1%	-59.1%	-65.5%
Interest Cover	NA	NA	NA	NA	NA

## Income Statement Data (Jul)

(US\$ Millions)	2022A	2023A	2024E	2025E	2026E
Sales	1,091	1,617	2,102	2,642	3,307
% Change	62.1%	48.2%	30.0%	25.7%	25.2%
Gross Profit	882	1,304	1,691	2,124	2,659
% Change	62.0%	47.9%	29.7%	25.6%	25.2%
EBITDA	152	297	429	602	703
% Change	41.3%	95.0%	44.7%	40.3%	16.9%
Net Interest & Other Income	(1)	56	71	64	64
<b>Net Income (Adjusted)</b>	<b>102</b>	<b>277</b>	<b>398</b>	<b>521</b>	<b>680</b>
<b>% Change</b>	<b>34.3%</b>	<b>172.8%</b>	<b>43.7%</b>	<b>30.8%</b>	<b>30.5%</b>

## Free Cash Flow Data (Jul)

(US\$ Millions)	2022A	2023A	2024E	2025E	2026E
Net Income from Cont Operations (GAAP)	(390)	(202)	(135)	(100)	(81)
Depreciation & Amortization	40	56	65	89	108
Change in Working Capital	97	29	279	126	68
Deferred Taxation Charge	NA	NA	NA	NA	NA
Other Adjustments, Net	574	580	498	555	721
Capital Expenditure	(69)	(97)	(162)	(177)	(198)
<b>Free Cash Flow</b>	<b>253</b>	<b>365</b>	<b>544</b>	<b>492</b>	<b>617</b>
<b>% Change</b>	<b>64.2%</b>	<b>44.5%</b>	<b>49.0%</b>	<b>-9.5%</b>	<b>25.4%</b>
Share / Issue Repurchase	42	46	46	0	0
Cost of Dividends Paid	0	0	0	0	0
Change in Debt	0	0	0	0	0

## Balance Sheet Data (Jul)

(US\$ Millions)	2022A	2023A	2024E	2025E	2026E
Cash & Equivalents	1,013	1,262	1,674	2,166	2,784
Trade Receivables	400	583	567	882	1,272
Other Current Assets	844	1,045	1,249	1,319	1,396
Property, Plant & Equipment	161	242	349	437	527
Other Non-Current Assets	415	476	658	883	1,115
<b>Total Assets</b>	<b>2,833</b>	<b>3,608</b>	<b>4,497</b>	<b>5,687</b>	<b>7,094</b>
Short-Term Debt	0	0	0	0	0
Other Current Liabilities	1,134	1,536	1,943	2,477	3,047
Long-Term Debt	969	1,134	1,134	1,134	1,134
Other Non-Current Liabilities	156	213	273	331	394
<b>Total Liabilities</b>	<b>2,259</b>	<b>2,883</b>	<b>3,350</b>	<b>3,941</b>	<b>4,576</b>
<b>Total Equity</b>	<b>573</b>	<b>725</b>	<b>1,146</b>	<b>1,746</b>	<b>2,518</b>
<b>Total Equity &amp; Liabilities</b>	<b>2,833</b>	<b>3,608</b>	<b>4,497</b>	<b>5,687</b>	<b>7,094</b>

\* For full definitions of iQmethod<sup>SM</sup> measures, see page 5.

## Company Sector

Cyber Security

## Company Description

Zscaler is a leader in cloud-based Security solutions, which helps protect enterprise traffic. Zscaler benefits from a material market shift from legacy appliance-based approaches to cloud services. The Company's products are uniquely architected to address the higher-growth cloud or software-as-a-service (SaaS) portion of the market and Zscaler's platform is designed to add additional features and solutions that grow the total addressable market.

## Investment Rationale

We believe Zscaler is positioned to gain share in the market's migration to cloud-based security solutions. Zscaler offers a differentiated, next-gen cloud architecture to address growing network complexity. The company's scalable, purpose-built software platform also enables Zscaler to move into new security markets. We expect the company's SaaS model and new offerings to deliver sustainable high growth as the company invests to gain market share.

## Stock Data

Average Daily Volume 1,796,622

## Quarterly Earnings Estimates

	2023	2024
Q1	0.29A	0.67A
Q2	0.37A	0.58E
Q3	0.48A	0.57E
Q4	0.64A	0.66E

# BofA Expectations vs Consensus

## Exhibit 1: BofA vs Consensus estimates

Our estimates are mostly inline with Street; we believe improving cash flow generation should boost FCFm

	F2Q24 Expectations			F3Q24 Expectations			FY24 Expectations		
	BofA	Consensus	Delta	BofA	Consensus	Delta	BofA	Consensus	Delta
<b>Billings</b>	<b>\$609,887.7</b>	<b>\$614,660.0</b>	<b>-0.8%</b>	<b>\$612,002.5</b>	<b>\$600,830.0</b>	<b>1.9%</b>	<b>\$2,545,748.0</b>	<b>\$2,552,480.0</b>	<b>-0.3%</b>
YoY growth (%)	23.5%	24.5%		26.9%	24.6%		25.1%	25.4%	
<b>Revenue</b>	<b>\$509,120.6</b>	<b>\$508,320.0</b>	<b>0.2%</b>	<b>\$529,485.4</b>	<b>\$532,050.0</b>	<b>-0.5%</b>	<b>\$2,101,858.3</b>	<b>\$2,099,110.0</b>	<b>0.1%</b>
YoY growth (%)	31.4%	31.2%		26.4%	27.0%		30.0%	29.8%	
<b>Gross margin (%)</b>	<b>80.2%</b>	<b>80.0%</b>	<b>0.2bps</b>	<b>80.3%</b>	<b>80.4%</b>	<b>-0.1bps</b>	<b>80.5%</b>	<b>80.4%</b>	<b>0.0bps</b>
<b>Operating margin (%)</b>	<b>16.9%</b>	<b>16.9%</b>	<b>0.0bps</b>	<b>16.2%</b>	<b>16.9%</b>	<b>-0.6bps</b>	<b>17.3%</b>	<b>17.4%</b>	<b>-0.1bps</b>
<b>EPS</b>	<b>\$0.58</b>	<b>\$0.58</b>	<b>-0.8%</b>	<b>\$0.57</b>	<b>\$0.59</b>	<b>-3.4%</b>	<b>\$2.48</b>	<b>\$2.48</b>	<b>0.0%</b>
<b>Free cash flow</b>	<b>\$83,289.63</b>	<b>\$69,820.00</b>	<b>19.3%</b>	<b>\$98,601.13</b>	<b>\$81,540.00</b>	<b>20.9%</b>	<b>\$508,349.21</b>	<b>\$479,800.00</b>	<b>6.0%</b>
FCF margin (%)	16.4%	13.7%		18.6%	15.3%		24.2%	22.4%	

Source: BofA Global Research estimates, company report

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## Partner Commentary - SASE

“SASE is one of the largest growth drivers for us this year. It also helps that we have been getting better terms from a margin perspective on SASE deals lately.” – **Global Partner**

“From our view, Zscaler is mainly the leader in SASE, though deal flow with Palo Alto has been pretty steady within the space. We also expect Cloudflare to have a good 2024 in the space.” – **North American Partner**

“SASE has stayed relatively consistent with our expectations on both vendor side and overall deployments. People are starting to understand the SASE market much more and deployments have been strong.” – **North American Partner**

“More of the enterprises we work with already had SASE than did the mid-market and SMBs. Starting to see more new deployments down market.” – **North American Partner**

“Saw ramping of deals with Cloudflare in 4Q as they continue to engage with more partners and improve relationships in the channel.” – **Global Partner**

“We saw a solid budget flush for Palo Alto within SASE in 4Q. For us, it’s mainly a bundled sell with other Palo products and we don’t expect pipeline to fall off in 2024.” – **North American Partner**



## 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.

## Analyst Certification

I, Tal Liani, hereby certify that the views expressed in this research report accurately reflect my personal views about the subject securities and issuers. I also certify that no part of my compensation was, is, or will be, directly or indirectly, related to the specific recommendations or view expressed in this research report.

### US - Telecom and Data Networking Equipment Coverage Cluster

Investment rating	Company	BofA Ticker	Bloomberg symbol	Analyst
<b>BUY</b>				
	Akamai	AKAM	AKAM US	Madeline Brooks
	Amdocs	DOX	DOX US	Tal Liani
	Arista Networks	ANET	ANET US	Tal Liani
	Check Point Software Technologies	CHKP	CHKP US	Tal Liani
	Ciena	CIEN	CIEN US	Tal Liani
	CrowdStrike Holdings Inc.	CRWD	CRWD US	Tal Liani
	CyberArk	CYBR	CYBR US	Tal Liani
	Fastly	FSLY	FSLY US	Madeline Brooks
	Fortinet	FTNT	FTNT US	Tal Liani
	Gen Digital, Inc.	GEN	GEN US	Jonathan Eisenson
	InterDigital, Inc.	IDCC	IDCC US	Tal Liani
	Motorola Solutions	MSI	MSI US	Tomer Zilberman
	Qualcomm	QCOM	QCOM US	Tal Liani
	Zscaler	ZS	ZS US	Tal Liani
<b>NEUTRAL</b>				
	Cellebrite	CLBT	CLBT US	Tal Liani
	Cisco Systems	CSCO	CSCO US	Tal Liani
	Palo Alto Networks	PANW	PANW US	Tal Liani
	SentinelOne, Inc.	S	S US	Tal Liani
<b>UNDERPERFORM</b>				
	Cloudflare	NET	NET US	Madeline Brooks
	CommScope	COMM	COMM US	Tal Liani
	F5 Inc	FFIV	FFIV US	Tal Liani
	Okta Inc	OKTA	OKTA US	Madeline Brooks
	SecureWorks	SCWX	SCWX US	Tal Liani

## iQmethod<sup>SM</sup> Measures Definitions

### Business Performance

Return On Capital Employed

Return On Equity

Operating Margin

Earnings Growth

Free Cash Flow

### Quality of Earnings

Cash Realization Ratio

Asset Replacement Ratio

Tax Rate

Net Debt-To-Equity Ratio

Interest Cover

### Valuation Toolkit

Price / Earnings Ratio

Price / Book Value

Dividend Yield

Free Cash Flow Yield

Enterprise Value / Sales

EV / EBITDA

### Numerator

$\text{NOPAT} = (\text{EBIT} + \text{Interest Income}) \times (1 - \text{Tax Rate}) + \text{Goodwill Amortization}$

Net Income

Operating Profit

Expected 5 Year CAGR From Latest Actual

Cash Flow From Operations – Total Capex

### Numerator

Cash Flow From Operations

Capex

Tax Charge

Net Debt = Total Debt – Cash & Equivalents

EBIT

### Numerator

Current Share Price

Current Share Price

Annualised Declared Cash Dividend

Cash Flow From Operations – Total Capex

$\text{EV} = \text{Current Share Price} \times \text{Current Shares} + \text{Minority Equity} + \text{Net Debt} +$

Other LT Liabilities

Enterprise Value

### Denominator

$\text{Total Assets} - \text{Current Liabilities} + \text{ST Debt} + \text{Accumulated Goodwill}$

Amortization

Shareholders' Equity

Sales

N/A

N/A

### Denominator

Net Income

Depreciation

Pre-Tax Income

Total Equity

Interest Expense

### Denominator

Diluted Earnings Per Share (Basis As Specified)

Shareholders' Equity / Current Basic Shares

Current Share Price

$\text{Market Cap} = \text{Current Share Price} \times \text{Current Basic Shares}$

Sales

Basic EBIT + Depreciation + Amortization

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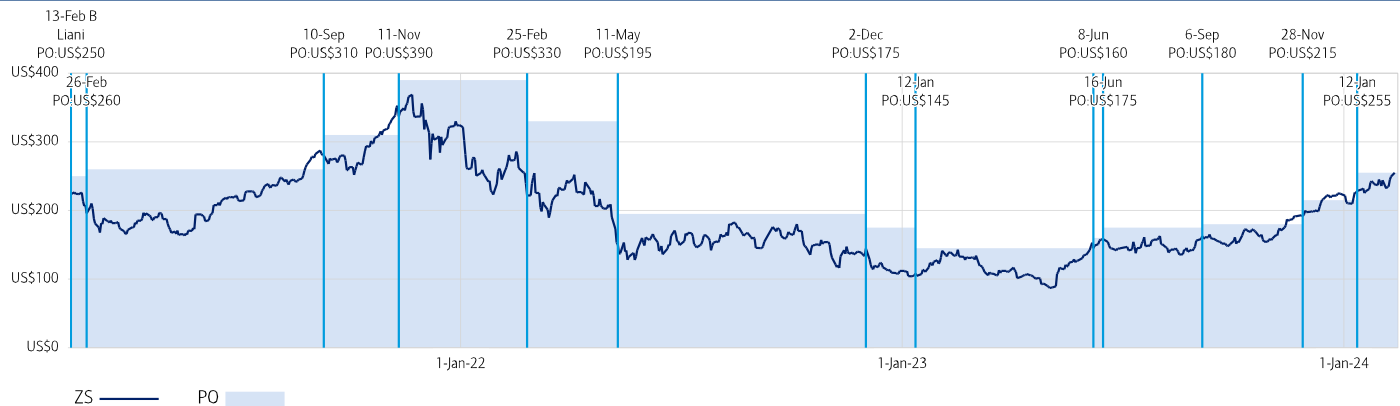
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# Disclosures

## Important Disclosures

### Zscaler (ZS) Price Chart



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

The Investment Opinion System is contained at the end of the report under the heading "Fundamental Equity Opinion Key". Dark grey shading indicates the security is restricted with the opinion suspended. Medium grey shading indicates the security is under review with the opinion withdrawn. Light grey shading indicates the security is not covered. Chart is current as of a date no more than one trading day prior to the date of the report.

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

Coverage Universe	Count	Percent	Inv. Banking Relationships <sup>R1</sup>	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)

Coverage Universe	Count	Percent	Inv. Banking Relationships <sup>R1</sup>	Count	Percent
Buy	1895	53.62%	Buy	1083	57.15%
Hold	832	23.54%	Hold	454	54.57%
Sell	807	22.84%	Sell	383	47.46%

<sup>R1</sup> Issuers that were investment banking clients of BofA Securities or one of its affiliates within the past 12 months. For purposes of this Investment Rating Distribution, the coverage universe includes only stocks. A stock rated Neutral is included as a Hold, and a stock rated Underperform is included as a Sell.

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Investment rating	Total return expectation (within 12-month period of date of initial rating)	Ratings dispersion guidelines for coverage cluster <sup>R2</sup>
Buy	≥ 10%	≤ 70%
Neutral	≥ 0%	≤ 30%
Underperform	N/A	≥ 20%

<sup>R2</sup> Ratings dispersions may vary from time to time where BofA Global Research believes it better reflects the investment prospects of stocks in a Coverage Cluster.

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