

Zscaler, Inc. (ZS)

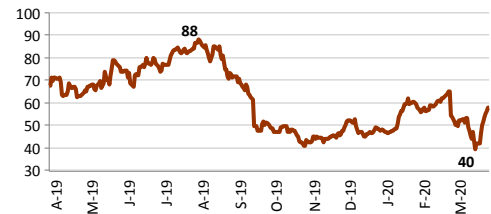
Notes from Call with Management on Work at Home Trends

We hosted a call with Zscaler CEO Jay Chaudhry and CFO Remo Canessa yesterday focusing on the work from home trend and how it relates to Zscaler. Overall, we remain confident in our belief that Zscaler is positioned to benefit from this rapid shift to work from home due to the coronavirus as this shift places a spotlight on the flaws of traditional VPNs. We believe this shift to work from home helps highlight Zscaler's ability to deliver customers security efficacy alongside a superior user experience.

- **Customer demand for Zscaler's solutions strong.** Management commentary around demand trends given the shift to work from home was positive. For potential new customers, the company is seeing interest in both ZIA and ZPA as companies look for ways to secure remote access while maintaining user performance. Additionally, the company has seen existing customers expand their Zscaler deployments, add ZPA to an existing ZIA deployment, and/or accelerate ZPA testing/deployment.
- **VPNs an untenable solution.** We went into more detail on why we believe Zscaler is poised to benefit from work from home [in this note](#). In brief, we believe the rapid shift to work from home is forcing companies to realize the negatives of VPN use.
- **Pace of deployment a key differentiator.** Zscaler's architecture enables customers to roll out the company's solutions with relative speed, a key point of discussion as companies have to rapidly shift to having their users work from home. Management pointed to examples of deployments at large organizations taking only weeks or even days. Additionally, while ZPA is architected to allow users to connect to specific applications (rather than the entire company network), the company indicated it has seen customers skipping the process of assigning access to specific applications (therefore providing a more like to like solution vs. VPNs in terms of access) to enable more rapid deployment.
- **ZPA pricing/ARR contribution.** Management indicated ZPA is priced similarly to ZIA and follows a similar pattern of uplift for the company's different bundles (i.e., Professional = 1x, Business = ~1.5x, Transformation = ~3x). In FY19, ZPA contributed 14% of the company's new and upsell business, and we expect ZPA contribution to continue to increase.
- **Mobile workforce/sales processes.** As Zscaler was built for the world of cloud, management indicated that getting used to the company's own distributed workforce was straightforward from a technology perspective. Commentary was positive around the company's ability to handle customer engagements and sign deals despite the shift to remote work. Overall, we believe management commentary pointed to healthy demand trends.
- **C-level focus.** Management indicated the shift to work from home is being driven by the C-level, whose focus has shifted from transformative cloud projects to allowing users to work remotely with performance and security.

RAISING PRICE TARGET

1-Year Price Chart



Stock Data

Rating:	Outperform
Suitability:	Higher Risk
Price Target/Previous:	▲\$70/\$60
Price (3/24/20):	\$62.14
Market Cap (mil):	\$8,495
Shares Out (mil):	136.7
Average Daily Vol (mil):	2.60
Dividend Yield:	0.0%

Estimates

FY Jul	2019A	2020E	2021E
Q1	0.01 A	0.03 A	0.06 E
Q2	0.09 A	0.09 A	0.09 E
Q3	0.05 A	0.02 E	0.06 E
Q4	0.07 A	0.02 E	0.06 E
Fiscal EPS	0.22 A	0.15 E	0.27 E
Fiscal P/E	NM	NM	NM

Chart/Table Sources: FactSet and Baird Data. Price chart reflects most recent closing price.

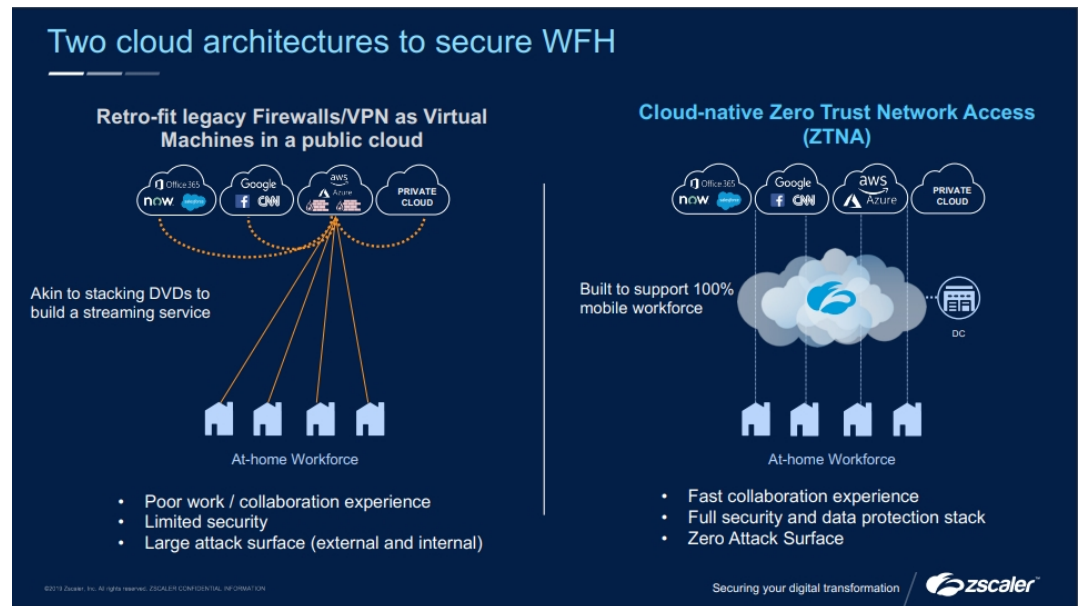
Please refer to Appendix
- Important Disclosures
and Analyst Certification

Zscaler offers a cloud-native security platform in a subscription model.

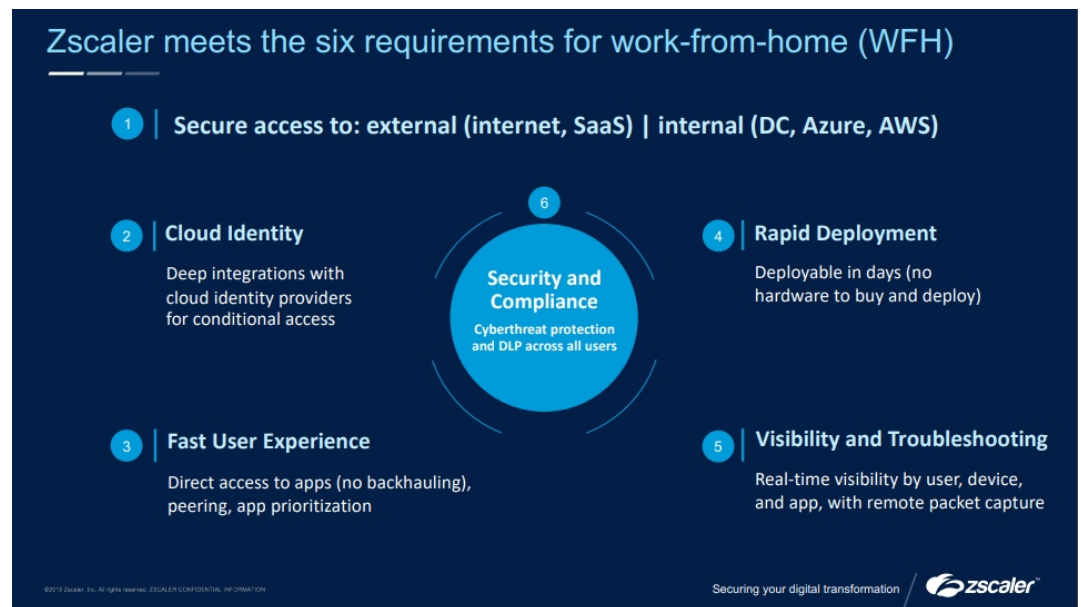
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Details



Source: Company Presentation



Source: Company Presentation

Investment Thesis

Who is Zscaler? Based in San Jose CA, Zscaler offers a cloud-native security platform in a subscription model. The company was founded in 2008 as an alternative to on-premise security solutions in parallel with the shift to SaaS applications. The Zscaler globally distributed cloud resides in over 150 data centers and is updated over 120K times per day.

Large potential TAM. Management details their total addressable market as ~\$20 billion comprised of categories such as URL filtering, branch firewall, DLP, sandboxing, and VPN. Zscaler provides customers an actual ROI given their ability to reduce WAN costs, branch office infrastructure, and improve user experience.

Competitive landscape. Zscaler competes most frequently with Symantec BlueCoat, Cisco Umbrella, and Raytheon Forcepoint (Websense). These competitors offer cloud-based solutions but channel checks indicate these offerings can be less robust, provide less granularity, and sometimes require on-premise hardware.

Cloud-based architecture. Zscaler deploys proprietary software on top of commodity hardware at ISPs and colocations around the world (e.g., Equinix). The company makes use of some third-party providers such as Arista, Juniper, and Super Micro. Cost of revenue includes colocation costs, bandwidth costs and asset depreciation.

Go-to-market. The company utilizes a combination of Service Providers and Integrators and Value-Added Resellers. We view incremental go-to-market resources as an opportunity since some channel partners know the company well and some don't know the company at all.

Pricing. Zscaler charges on a subscription model per user per month ranging from roughly \$1-\$6. Customers typically sign a multi-year deal upfront. Per Gartner, the typical discount from list price is 35-40% which we view as industry norm. It's increasingly common for a customer to attach every employee to the Zscaler cloud.

A controlled company. Executive officers, directors, and shareholders owning greater than 5% and their affiliates own approximately 50% of outstanding ZS common stock, with CEO Jay Chaudhry and entities associated with Mr. Chaudhry owning about 20% of the outstanding ZS equity. Management does not currently intend to take advantage of corporate governance exceptions afforded to a "controlled company."

Valuation. Our \$70 price target is calculated using a DCF analysis assuming: 1) ~9.7% cost of equity; 2) terminal growth of 3.0%; and 3) ~30% 10-year CAGR for top line starting in F18; and 4) our estimated long-term terminal EBIT margins at 35%.

Risks & Caveats

Competition. Competition in the network security market is intense, and Zscaler faces competition from both legacy players and start-ups. Many competitors have better name recognition, larger install bases, broader product portfolios, and larger sales and marketing budgets. Additionally, Zscaler competes in the same labor markets as these competitors for scarce cybersecurity talent.

History of losses. Zscaler has incurred net losses and negative cash flow or only minimal non-GAAP income/cash flow in all periods of the company's history. The company is expected to continue to achieve minimal cash flow and non-GAAP profitability for the foreseeable future. In order to further grow the business, the company will continue to invest heavily in both sales and research and development.

Macroeconomic risk. Zscaler is susceptible to macroeconomic risks, as IT customers tend to delay new investments during economic downturns.

Company Description

Zscaler, founded in 2008, and headquartered in San Jose, California, is a cybersecurity vendor seeking to mitigate the risk of cyber threats facing enterprises in a cloud-first world. Through its multi-tenant platform, distributed across more than 150 data centers globally, Zscaler enables customers to offload web security to the internet backbone—reducing the need for sprawling on-prem appliance infrastructure or cumbersome MPLS backhauling. Continued innovation over the last several years has allowed the company to expand from a sole cloud-based proxy offering to a cloud-based platform with solutions that span sandboxing, outbound firewall, private access, and data loss prevention.



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Zscaler, Inc.

\$ in thousands, except per share data

Income Statement

FYE in July	2018	2019	Q120	Q220	Q320E	Q420E	2020E	Q121E	Q221E	Q321E	Q421E	2021E	2022E
Revenue	\$190,174	\$302,836	\$93,590	\$101,268	\$105,825	\$114,631	\$415,314	\$124,018	\$134,192	\$136,876	\$144,844	\$539,931	\$678,154
QoQ			8.7%	8.2%	4.5%	8.3%		8.2%	8.2%	2.0%	5.8%		
YoY	51.3%	59.2%	47.9%	36.3%	33.7%	33.1%	37.1%	32.5%	32.5%	29.3%	26.4%	30.0%	25.6%
Gross Profit	153,056	246,605	75,618	82,815	85,718	92,829	336,981	100,203	108,398	110,870	117,296	436,767	548,579
Gross Margin %	80.5%	81.4%	80.8%	81.8%	81.0%	81.0%	81.1%	80.8%	80.8%	81.0%	81.0%	80.9%	80.9%
S&M	111,365	146,785	49,364	49,670	57,226	61,418	217,678	61,693	65,754	67,891	73,260	268,598	311,177
S&M-% of revenue	58.6%	48.5%	52.7%	49.0%	54.1%	53.6%	52.4%	49.7%	49.0%	49.6%	50.6%	49.7%	45.9%
R&D	36,334	46,588	14,831	14,200	16,986	18,744	64,761	19,033	17,810	21,627	22,960	81,431	103,964
R&D-% of revenue	19.1%	15.4%	15.8%	14.0%	16.1%	16.4%	15.6%	15.3%	13.3%	15.8%	15.9%	15.1%	15.3%
G&A	20,718	28,135	8,536	8,067	9,488	11,255	37,346	11,557	11,406	12,182	12,746	47,891	58,561
G&A-% of revenue	10.9%	9.3%	9.1%	8.0%	9.0%	9.8%	9.0%	9.3%	8.5%	8.9%	8.8%	8.9%	8.6%
Operating Expenses	168,417	221,508	72,731	71,937	83,700	91,417	319,785	92,282	94,971	101,700	108,967	397,920	473,702
QoQ			16.9%	(1.1%)	16.4%	9.2%		0.9%	2.9%	7.1%	7.1%		
YoY	42.8%	31.5%	44.0%	44.3%	42.0%	46.9%	44.4%	26.9%	32.0%	21.5%	19.2%	24.4%	19.0%
Operating Profit	(15,361)	25,097	2,887	10,878	2,018	1,413	17,196	7,921	13,427	9,170	8,330	38,847	74,877
Operating Margin %	(8.1%)	8.3%	3.1%	10.7%	1.9%	1.2%	4.1%	6.4%	10.0%	6.7%	5.8%	7.2%	11.0%
Interest / Other	2,315	7,401	1,993	1,842	1,842	1,842	7,519	1,842	1,842	1,842	1,842	7,368	7,368
Pretax	(13,046)	32,498	4,880	12,720	3,860	3,255	24,715	9,763	15,269	11,012	10,172	46,215	82,245
Tax expense	1,337	2,426	794	716	950	1,050	3,510	1,200	1,200	1,200	1,200	4,800	6,400
Tax rate	-10%	7%	16%	6%	25%	32%	14%	12%	8%	11%	12%	10%	8%
Net Income	(14,383)	30,072	4,086	12,004	2,910	2,205	21,205	8,563	14,069	9,812	8,972	41,415	75,845
EPS (basic)	(\$0.13)	\$0.22	\$0.03	\$0.09	\$0.02	\$0.02	\$0.15	\$0.06	\$0.09	\$0.06	\$0.06	\$0.27	\$0.45
Fully diluted shares	109,634	135,544	136,860	136,663	139,000	143,477	139,000	150,651	155,170	158,274	159,857	155,988	170,485

Source: Company documents, Baird estimates

Research disclosures can be accessed at <http://www.rwbaird.com/research-insights/research/coverage/research-disclosure.aspx>.

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Billings													
FYE in July	2018	2019	Q120	Q220	Q320E	Q420E	2020E	Q121E	Q221E	Q321E	Q421E	2021E	2022E
Deferred Revenued:													
Current	\$140,670	\$221,387	\$218,191	\$251,221	\$256,733	\$312,014	\$312,014	\$297,357	\$329,956	\$333,251	\$395,306	\$395,306	\$469,160
Noncurrent	<u>23,353</u>	<u>29,815</u>	<u>27,678</u>	<u>28,801</u>	<u>35,009</u>	<u>38,564</u>	<u>38,564</u>	<u>36,752</u>	<u>36,662</u>	<u>41,188</u>	<u>46,377</u>	<u>46,377</u>	<u>55,041</u>
Total deferred revenue	164,023	251,202	245,869	280,022	291,742	350,578	350,578	334,109	366,618	374,439	441,683	441,683	524,202
QoQ			(2.1%)	13.9%	4.2%	20.2%		(4.7%)	9.7%	2.1%	18.0%		
YoY	69.8%	53.2%	48.8%	35.9%	37.9%	39.6%	39.6%	35.9%	30.9%	28.3%	26.0%	26.0%	18.7%
Current-% total	86%	88%	89%	90%	88.0%	89.0%	89%	89.0%	90.0%	89.0%	89.5%	90%	90%
Billings													
Revenue	\$190,174	\$302,836	\$93,590	\$101,268	\$105,825	\$114,631	\$415,314	\$124,018	\$134,192	\$136,876	\$144,844	\$539,931	\$678,154
Plus: Change in deferred	<u>67,404</u>	<u>87,179</u>	<u>(5,333)</u>	<u>34,153</u>	<u>11,720</u>	<u>58,836</u>	<u>99,376</u>	<u>(16,469)</u>	<u>32,509</u>	<u>7,821</u>	<u>67,244</u>	<u>91,105</u>	<u>82,519</u>
Billings	257,578	390,015	88,257	135,421	117,545	173,467	514,690	107,549	166,701	144,697	212,088	631,036	760,673
QoQ			(29.8%)	53.4%	(13.2%)	47.6%		(38.0%)	55.0%	(13.2%)	46.6%		
YoY	64.7%	51.4%	36.7%	17.7%	38.9%	37.9%	32.0%	21.9%	23.1%	23.1%	22.3%	22.6%	20.5%
Seasonality			17%	26%	23%	34%		17%	26%	23%	34%		
Current Billings	245,376	383,553	90,394	134,298									
QoQ			(27.0%)	48.6%									
YoY	60.7%	56.3%	34.7%	26.5%									
RPO	397,900	554,200	554,700	608,500									
QoQ			0.1%	9.7%									
YoY	80.9%	39.3%	34.9%	32.0%									
Net Retention Rate (TTM)			120%	116%									

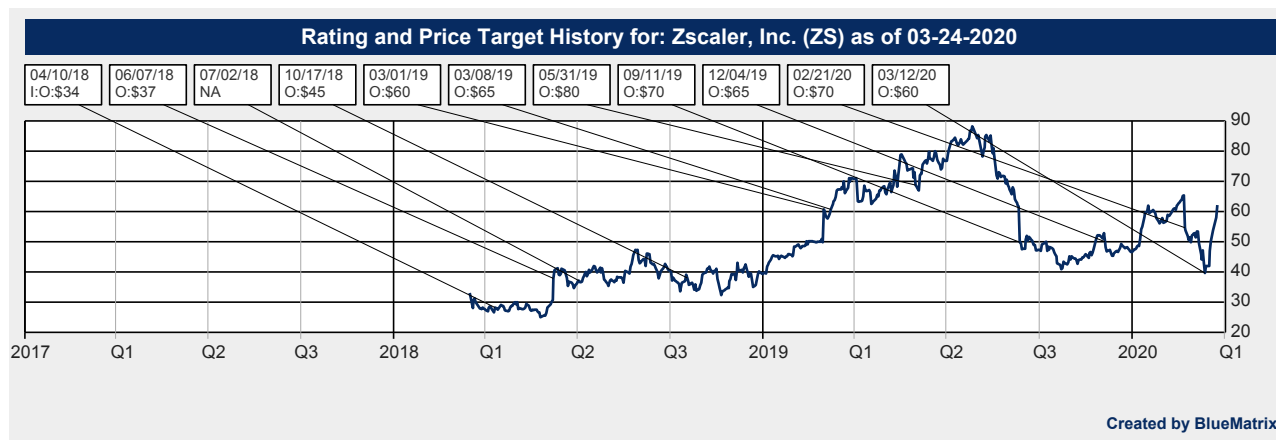
Source: Company documents, Baird estimates

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Appendix - Important Disclosures and Analyst Certification

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1 Robert W. Baird & Co. Incorporated makes a market in the securities of ZS.

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