

Zscaler, Inc. (ZS)

\$118.24 (As of 08/11/20)

Price Target (6-12 Months): **\$135.00**

Long Term: 6-12 Months

Zacks Recommendation: Outperform

(Since: 06/08/20)

Prior Recommendation: Neutral

Short Term: 1-3 Months

Zacks Rank: (1-5)

2-Buy

Zacks Style Scores:

VGM:C

Value: F

Growth: A

Momentum: C

Summary

Zscaler is benefiting from the rising demand for cyber-security solutions owing to the slew of data breaches. Increasing demand for privileged access security on digital transformation and cloud-migration strategies is a key growth driver. Zscaler's portfolio strength boosts its competitive edge and helps add users. Moreover, a strong presence across verticals, such as banking, insurance, healthcare, public sector, pharmaceuticals, telecommunications services and education, is safeguarding Zscaler from the coronavirus pandemic's negative impact. Also, Zscaler's acquisitions of two start-ups, Cloudneeti and Edgewise, are expected to enhance its portfolio. However, intensifying competition in the security application market poses a concern. Moreover, elevated S&M and R&D spends remain overhangs on the margin.

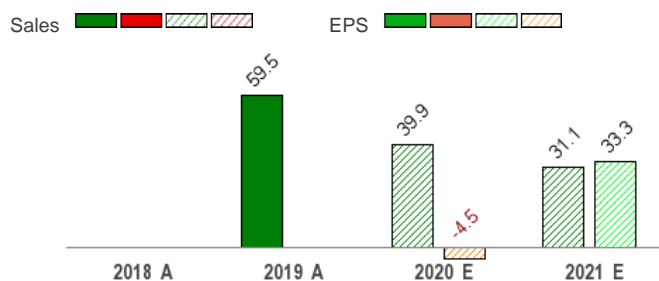
Price, Consensus & Surprise



Data Overview

52 Week High-Low	\$135.85 - \$35.00
20 Day Average Volume (sh)	2,121,532
Market Cap	\$15.2 B
YTD Price Change	152.7%
Beta	0.77
Dividend / Div Yld	\$0.00 / 0.0%
Industry	Internet - Services
Zacks Industry Rank	Top 47% (118 out of 253)

Sales and EPS Growth Rates (Y/Y %)



Last EPS Surprise	250.0%
Last Sales Surprise	3.9%
EPS F1 Est- 4 week change	0.0%
Expected Report Date	09/09/2020
Earnings ESP	0.0%
P/E TTM	452.0
P/E F1	422.3
PEG F1	NA
P/S TTM	38.8

Sales Estimates (millions of \$)

	Q1	Q2	Q3	Q4	Annual*
2021	127 E	133 E	141 E	149 E	556 E
2020	94 A	101 A	111 A	118 E	424 E
2019	63 A	74 A	79 A	86 A	303 A

EPS Estimates

	Q1	Q2	Q3	Q4	Annual*
2021	\$0.04 E	\$0.06 E	\$0.07 E	\$0.09 E	\$0.28 E
2020	\$0.03 A	\$0.09 A	\$0.07 A	\$0.03 E	\$0.21 E
2019	\$0.01 A	\$0.09 A	\$0.05 A	\$0.07 A	\$0.22 A

*Quarterly figures may not add up to annual.

The data in the charts and tables, including the Zacks Consensus EPS and Sales estimates, is as of 08/11/2020. The reports text is as of 08/12/2020.

Overview

Zscaler was founded in September 2007 as SafeChannel Inc., and the company's name was changed to Zscaler in August 2008. The company is one of the world's leading providers of cloud-based security solutions.

Zscaler offers a full range of enterprise network security services including web security, internet security, antivirus, vulnerability management, firewalls, and control over user activity in mobile, cloud computing, and Internet of things environments.

As a result of its wide-scale offerings, Zscaler is one shop for almost all types of security solutions. This provides a competitive advantage over other rivals that have mostly limited types of solutions, such as Proofpoint, which is specialized in identity theft protection, FireEye and F5 Networks, which offer cloud-based proxy, firewall, sandboxing and advanced threat protection.

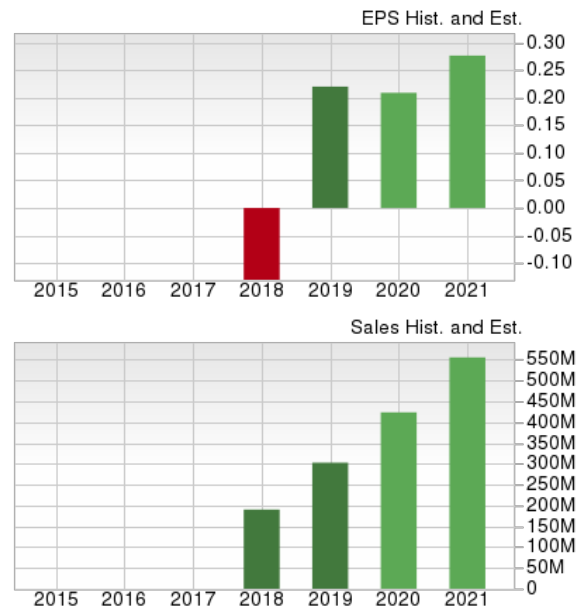
Zscaler offers two tools — Zscaler Internet Access and Zscaler Private Access. With the Zscaler Internet Access tool, users securely connect to externally managed applications, such as Salesforce and Microsoft Office 365. The Zscaler Private Access provides access to internally managed applications, either hosted internally in data centers or in public or private clouds.

Zscaler operates in an industry which is characterized by the existence of a large number of patents. Here, more than 80 issued and 50 pending patents for the company's cloud platform provide a competitive advantage.

The company has adopted a joint-sales approach, per which Zscaler's sales team develops relationships directly between channel sales partners and customers. The approach helps facilitate client acquisition process, improving account coordination, and developing sales and overall market.

The company distributes its cloud-based solutions to more than 150 data centers across five continents. It processes approximately 70 billion requests per day from users across more than 185 countries. At fiscal 2019-end, the company had more than 3,900 customers globally, which includes more than 400 of the Forbes Global 2000.

In fiscal 2019, Zscaler's revenues increased 59% year over year to approximately \$303 million, of which 51% was contributed from customers outside the United States.



Reasons To Buy:

- ▲ Zscaler is benefiting from the rising demand for security and networking products amid the COVID-19 crisis. In an effort to contain the spread of the virus, a huge global workforce is working remotely. But more people logging into employers' networks means a greater need for security. This trend is positively impacting demand for Zscaler's products. Moreover, the company's Edge cloud for policy enforcement, multi-tenancy, proxy for SSL or TLS inspection and zero trust network access are well poised to gain adoption amid the thriving remote work culture.
- ▲ Growing adoption of Software-Defined Wide Area Network (SD-WAN) solutions could be a key growth driver for Zscaler over the long run. Research firm MarketsandMarkets, predicts that the market size for SD-WAN solutions could grow to \$4.1 billion by 2023 from \$1 billion in 2018, indicating a CAGR of 32.7%. As there are only few vendors that offer security and SD-WAN solutions, Zscaler is well positioned to capitalize on the increasing opportunities in the market. Additionally, the company's collaboration with both VMware and Silver Peak is helping it secure SD WAN deployments.
- ▲ Zscaler sells subscription-based services, which has helped fueled its customer growth significantly. This business model generates recurring revenues that leads to stable revenues. Also, it is more futuristic as companies increasingly move to the cloud, where the as-a-service model is common. Subscription-based services also generate higher margins for the company (approximately 80%) than the hardware-centric model. We believe continued focus on subscription-based products and services and product upgrades will boost its top line.
- ▲ Rising demand for cyber security owing to the slew of data breaches is a positive for Zscaler. Enterprises face continued sophisticated cyber threats making cyber security a mission critical, high-profile requirement. Zscaler's rich experience in the security space and continued delivery of mission-critical solutions will help it maintain and grow its market share. Per Gartner's latest report, worldwide information security spending is expected to grow 2.4% year over year to reach \$123.8 billion in 2020. Going by MarketsandMarkets, the global cyber-security market size was valued at \$152.71 billion in 2018 and is projected to reach \$248.6 billion by 2023, witnessing a CAGR of 10.2% during the period. These predictions bode well for Zscaler, which has a diversified product portfolio for large- and mid-sized organizations to protect their sensitive data.
- ▲ Zscaler has adopted a joint sales approach, per which the company's sales team develops relationships directly between channel sales partners and customers. The approach helps it facilitate client acquisition process, improve account coordination, and develop sales and overall market. The company emphasizes on customer services which helps it further develop relationships with customers and generate incremental revenues. Additionally, Zscaler's market strategy is focused on platform and brand awareness, and done through both, digital and non-digital channel activities. The company is continuously increasing marketing headcounts and investing in programs to enhance brand awareness, which is driving its top-line performance.
- ▲ Zscaler has made strategic acquisitions to boost growth. This May, the company acquired Edgewise, which focuses on securing communications among applications running in cloud and datacenter networks. Prior to this, the company bought a Cloud Security Posture Management (CSPM) company Cloudneeti. Cloudneeti prevents and remediates application misconfigurations and compliance violations in SaaS, IaaS and PaaS. We believe these acquisitions have not only strengthened the data-protection capabilities of Zscaler but have expanded its customer base as well.
- ▲ Zscaler has a strong balance sheet with ample liquidity position and less debt obligations. Cash and cash equivalents were \$391 million, while total debt (including current maturities) was \$41 million as of Apr 30, 2020. Moreover, in fiscal 2019, the company generated \$66 million of operating cash flows compared with \$58 million in fiscal 2018. It is to be noted that the company has been able to regularly increase its cash and marketable securities, as well as cash from operations in the last two fiscal years. The increasing liquidity and cash flow trend reflect that the company is making investments in the right direction. Moreover, since it carries a low long-term debt, the excess cash is available for pursuing strategic acquisitions, investment in growth initiatives and distribution to shareholders.

Zscaler is benefiting from rising demand for cyber-security solutions owing to increased data breaches. Also, its sustained focus on launching new products, acquisitions and partnerships will continue to drive top-line.

Risks

- To survive in the highly competitive cyber-security market, each player must continuously invest in broadening its capabilities. Over the past few years, Zscaler has invested heavily to enhance its sales and marketing capabilities, particularly by increasing the sales force. Additionally, investment in R&D is a top priority for Zscaler. Over the last couple of years, the company has almost doubled its R&D expenses to improve the design, architecture, operation and quality of its cloud platform. Though the company foresees these investments to garner benefits over the long run, we note that there is uncertainty about the payback period. Also, higher sales and marketing, and R&D expenses might weigh on the company's bottom-line results.
 - Zscaler faces competition from numerous big and small companies in the security application market. As Internet threats and attacks increase, stiff competition will follow suit. Competing firms must deliver prompt and advanced technologies to suit customer requirements and expedite product introduction in order to survive. Moreover, we believe Zscaler's dominance could be challenged by new entrants. This could lead the company to resort to competitive pricing to maintain and capture market share.
 - A substantial portion of the company's sales is derived from outside the United States. During fiscal 2019, 2018 and 2017 approximately 51%, 55% and 54%, respectively, of total revenues was garnered in currencies other than the U.S. dollar. This exposes the company to exchange-rate fluctuations and counterparty default risk. Thus, an economic condition, which impacts foreign currency-exchange rates, does result in transaction exposure, which leads to profit fluctuation.
 - Zscaler currently has a trailing 12 month Price/Book Value (P/B) ratio of 45.4. This level compares unfavorably with what the industry saw over the last year. Hence, valuation looks slightly stretched from a P/B perspective.
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Last Earnings Report

Zscaler Q3 Earnings and Revenues Surpass Estimates

Zscaler reported third-quarter fiscal 2020 adjusted earnings of 7 cents per share that beat the Zacks Consensus Estimate by 250%. Quarterly earnings also jumped 40% from the year-ago quarter's earnings of 5 cents per share.

Revenues of \$110.5 million surged 40% year over year on rise in adoption of the company's cloud platform security solutions by global enterprises. The figure surpassed the consensus mark by 3.9%.

Americas accounted for 51% of revenues, while EMEA contributed 40%. The rest came from the Asia Pacific and Japan.

Calculated billings increased 55% year over year to \$131.3 million in the reported quarter.

Customer Details

Zscaler continued to win customers and its net dollar retention rate was strong at 119% compared with the 116% recorded in the previous quarter and 118% in the year-ago quarter.

Remaining Performance Obligations (RPO), which represents Zscaler's committed non-cancelable future revenues, were \$654 million as of Apr 30, up 31% year over year.

Operating Details

In the reported quarter, gross margin contracted 200 basis points (bps) year over year to 80%. The company stated that the decline was mainly due to increased ZPA traffic which grows 10 times in the fiscal third quarter. The company had to use AWS and Azure data centers to support the sudden spike in demand, which run at higher cost than Zscaler's data centers.

Research & development (R&D), sales & marketing (S&M) and general & administrative (G&A) expenses flared up 39%, 35% and 26% to \$17.1 million, \$52.6 million and \$9.9 million, respectively.

Non-GAAP operating income was \$8.3 million in the fiscal third quarter compared with the year-ago quarter's \$6.1 million.

Balance Sheet & Cash Flow

As of Apr 30, Zscaler had \$391.3 million in cash, cash equivalents and short-term investments compared with the previous quarter's \$384.9 million.

In the reported quarter, cash provided by operations was \$20.8 million. Free cash flow was \$9 million. In the first nine months of fiscal 2020, the company generated operating and free cash flows of \$47.7 million and \$16.6 million, respectively.

Deferred revenues surged 42% year over year to \$300.8 million.

Guidance

For fourth-quarter fiscal 2020, Zscaler expects revenues between \$117 million and \$119 million.

Non-GAAP income from operations is expected between \$2 million and \$4 million. Non-GAAP earnings are projected between 2 cent and 3 cents per share.

Buoyed by the better-than-expected fiscal third-quarter results, the company raised its outlook for fiscal 2020. For fiscal 2020, Zscaler now expects revenues between \$422 million and \$424 million, revised upward from prior guidance of \$414-\$417 million.

Non-GAAP income from operations is expected to be \$24-\$26 million, up from the previous expectations of \$16-\$18 million. Non-GAAP earnings are now anticipated between 20 cents and 21 cents per share, up from the prior estimate of 14-16 cents.

The company's fiscal 2020 calculated billings are now projected between \$529 million and \$531 million, up from the previous projection of \$512-\$517 million

Quarter Ending **04/2020**

Report Date	May 28, 2020
Sales Surprise	3.85%
EPS Surprise	250.00%
Quarterly EPS	0.07
Annual EPS (TTM)	0.26

Recent News

On Jun 23, Zscaler announced the pricing of \$1 billion aggregate principal amount of 0.125% convertible senior notes due 2025.

On Jun 22, Zscaler announces proposed offerings of \$1 billion of convertible senior notes due 2025.

On May 29, Zscaler revealed that Defense Innovation Unit, a U.S. Department of Defense organization, has selected the company for secure cloud management project.

On May 28, Zscaler announced that it has acquired Edgewise, which focuses on securing communications among applications running in cloud and data-center networks.

On May 13, Zscaler revealed that its Zscaler Private Access has received Federal Risk and Authorization Management Program (FedRAMP) authorization. The certification enables Zscaler Private Access to meet the requirements of civilian, DOD and Intelligence organizations.

On Apr 28, Zscaler announced that the San Francisco Business Times and the Silicon Valley Business Journal have recognized the company as one of the 2020 Bay Area Best Places To Work.

On Apr 9, Zscaler announces that it has agreed to acquire Cloudneeti, a Cloud Security Posture Management (CSPM) company.

On Jan 14, Zscaler announced the dismissal of all patent lawsuits filed by Symantec against the company. The dismissal resulted from a complete settlement agreement with Broadcom following the latter's acquisition of Symantec's enterprise security business.

Valuation

Zscaler's shares have increased 152.7% in the year-to-date (YTD) period and 38.1% over the trailing 12 months. Stocks in the Zacks sub-industry and the Zacks Computer & Technology sector have rallied 16% and 19.9%, respectively, YTD. Over the past year, while the Zacks sub-industry has increased 25.1%, the sector increased 33.9%.

The S&P 500 Index has increased 4.2% YTD and 14.9% in the past year.

The stock is currently trading at 27.11X forward 12-month sales, which compares to 6.69X for the Zacks sub-industry, 3.99X for the Zacks sector and 3.67X for the S&P 500 index.

Over the past two years, the stock has traded as high as 40.9X and as low as 10.38X, with a 2-year median of 18.21X. Our Outperform recommendation indicates that the stock will perform better than the market. Our \$135 price target reflects 31.18X forward 12-month sales.

The table below shows summary valuation data for ZS

Valuation Multiples - ZS					
		Stock	Sub-Industry	Sector	S&P 500
P/S F12M	Current	27.11	6.69	3.99	3.67
	2-Year High	40.90	8.77	4.01	3.67
	2-Year Low	10.38	5.13	2.62	2.76
	2-Year Median	18.21	6.13	3.22	3.19
P/B TTM	Current	45.40	5.92	6.14	4.68
	2-Year High	51.98	6.23	6.34	4.68
	2-Year Low	15.61	3.99	3.59	3.03
	2-Year Median	23.61	5.11	4.67	4.02
EV/Sales TTM	Current	37.90	6.97	4.59	3.23
	2-Year High	43.52	7.34	4.59	3.46
	2-Year Low	13.19	4.46	3.05	2.24
	2-Year Median	23.66	5.82	3.81	3.01

As of 08/11/2020

Industry Analysis Zacks Industry Rank: Top 47% (118 out of 253)



Top Peers

Company (Ticker)	Rec	Rank
Dropbox, Inc. (DBX)	Outperform	1
Eventbrite, Inc. (EB)	Neutral	3
HealthStream, Inc. (HSTM)	Neutral	3
LivePerson, Inc. (LPSN)	Neutral	3
Sify Technologies Limited (SIFY)	Neutral	2
SVMK Inc. (SVMK)	Neutral	3
Upwork Inc. (UPWK)	Neutral	4
YY Inc. (YY)	Neutral	2

Industry Comparison Industry: Internet - Services				Industry Peers		
	ZS	X Industry	S&P 500	LPSN	SVMK	UPWK
Zacks Recommendation (Long Term)	Outperform	-	-	Neutral	Neutral	Neutral
Zacks Rank (Short Term)	2	-	-	3	3	4
VGM Score	C	-	-	D	C	F
Market Cap	15.20 B	763.34 M	23.61 B	3.81 B	3.04 B	1.68 B
# of Analysts	8	3	14	4	3	2
Dividend Yield	0.00%	0.00%	1.69%	0.00%	0.00%	0.00%
Value Score	F	-	-	F	F	F
Cash/Price	0.02	0.17	0.07	0.05	0.05	0.08
EV/EBITDA	7,255.11	2.36	13.32	-58.16	-183.66	-264.11
PEG Ratio	NA	2.20	2.95	NA	NA	NA
Price/Book (P/B)	45.40	3.41	3.22	26.59	9.32	5.95
Price/Cash Flow (P/CF)	1,080.06	18.77	12.79	NA	NA	NA
P/E (F1)	424.64	33.09	22.02	NA	NA	NA
Price/Sales (P/S)	38.83	2.85	2.57	11.76	8.87	5.09
Earnings Yield	0.24%	0.69%	4.29%	-0.64%	-0.18%	-2.58%
Debt/Equity	0.08	0.09	0.77	1.36	0.91	0.03
Cash Flow (\$/share)	0.11	0.09	6.94	-0.81	-0.21	-0.06
Growth Score	A	-	-	B	B	C
Hist. EPS Growth (3-5 yrs)	NA%	18.24%	10.41%	NA	NA	NA
Proj. EPS Growth (F1/F0)	32.34%	-7.61%	-6.51%	49.32%	20.00%	-136.67%
Curr. Cash Flow Growth	632.15%	-3.00%	5.22%	-1,955.49%	-73.07%	-51.89%
Hist. Cash Flow Growth (3-5 yrs)	NA%	19.91%	8.55%	NA	NA	NA
Current Ratio	1.60	1.64	1.34	1.53	1.01	1.74
Debt/Capital	7.69%	12.41%	44.59%	57.65%	47.53%	2.50%
Net Margin	-18.10%	-8.91%	10.13%	-33.59%	-24.73%	-8.91%
Return on Equity	-14.93%	-5.73%	14.59%	-57.08%	-27.64%	-11.18%
Sales/Assets	0.59	0.61	0.51	0.64	0.42	0.71
Proj. Sales Growth (F1/F0)	31.15%	0.00%	-1.45%	23.20%	20.26%	16.90%
Momentum Score	C	-	-	F	A	D
Daily Price Chg	-3.99%	0.00%	-0.17%	-0.40%	-0.32%	-3.66%
1 Week Price Chg	-3.08%	0.70%	2.30%	33.81%	-4.21%	-1.07%
4 Week Price Chg	-4.02%	0.28%	6.41%	48.13%	-5.70%	0.58%
12 Week Price Chg	56.18%	17.01%	15.42%	61.44%	11.47%	10.71%
52 Week Price Chg	38.18%	8.25%	2.88%	52.99%	20.59%	-9.83%
20 Day Average Volume	2,121,532	212,475	2,007,486	1,369,310	1,161,224	2,794,410
(F1) EPS Est 1 week change	0.00%	0.00%	0.00%	-0.58%	1.59%	-5.97%
(F1) EPS Est 4 week change	0.00%	0.00%	1.84%	1.13%	1.59%	-9.23%
(F1) EPS Est 12 week change	-6.35%	2.36%	2.40%	1.32%	1.59%	-9.23%
(Q1) EPS Est Mthly Chg	0.00%	0.00%	0.72%	-3.90%	11.77%	-14.29%

Zacks Stock Rating System

We offer two rating systems that take into account investors' holding horizons: Zacks Rank and Zacks Recommendation. Each provides valuable insights into the future profitability of the stock and can be used separately or in combination with each other depending on your investment style.

Zacks Recommendation

The Zacks Recommendation aims to predict performance over the next 6 to 12 months. The foundation for the quantitatively determined Zacks Recommendation is trends in the company's estimate revisions and earnings outlook. The Zacks Recommendation is broken down into 3 Levels; Outperform, Neutral and Underperform. Unlike many Wall Street firms, we have an excellent balance between the number of Outperform and Neutral recommendations. Our team of 70 analysts are fully versed in the benefits of earnings estimate revisions and how that is harnessed through the Zacks quantitative rating system. But we have given our analysts the ability to override the Zacks Recommendation for the 1200 stocks that they follow. The reason for the analyst over-rides is that there are often factors such as valuation, industry conditions and management effectiveness that a trained investment professional can spot better than a quantitative model.

Zacks Rank

The Zacks Rank is our short-term rating system that is most effective over the one- to three-month holding horizon. The underlying driver for the quantitatively-determined Zacks Rank is the same as the Zacks Recommendation, and reflects trends in earnings estimate revisions.

Zacks Style Scores

The Zacks Style Score is as a complementary indicator to the Zacks rating system, giving investors a way to focus on the highest rated stocks that best fit their own stock picking preferences.

Academic research has proven that stocks with the best Value, Growth and Momentum characteristics outperform the market. The Zacks Style Scores rate stocks on each of these individual styles and assigns a rating of A, B, C, D and F. We also produce the VGM Score (V for Value, G for Growth and M for Momentum), which combines the weighted average of the individual Style Scores into one score. This is perfectly suited for those who want their stocks to have the best scores across the board.

Value Score	F
Growth Score	A
Momentum Score	C
VGM Score	C

As an investor, you want to buy stocks with the highest probability of success. That means buying stocks with a Zacks Recommendation of Outperform, which also has a Style Score of an A or a B.

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