MOI GLOBAL

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WIDEMOAT Investing Summit

Wide Moat Investing Top Pick: Zscaler

How secular tailwinds and strong economics create value for a potential multi-bagger

About Zscaler

- Zscaler (NASDAQ: ZS) is a cybersecurity company that protects inbound and outbound gateways for enterprises (Fortune 2000 and beyond).
- Bulk of revenue is derived from the Zscaler platform which provides Zscaler Internet Access (ZIA) and Zscaler Private Access (ZPA).
- ZIA protects users connecting to apps (i.e. think a remote user logging on to Salesforce). It monitors and secures users connecting to these apps through the open internet and ensures nothing bad comes in and nothing good leaves the organization. Malware detection and application security fall under ZIA.
- ZIA sits in between the users and the internet allowing it to inspect all traffic going to these internal applications. Policies are enabled which can follow the user around and provide specific access.
- ZPA is a whole new way to provide access cloud or data center applications without a VPN infrastructure (i.e. no network access and therefore no exposure to the Internet).

Product Advantages of Zscaler

- Full cloud deployment unlike legacy competitors which utilize appliances into their data center
- Full scalability allows enterprises to add customers easily and instantly with no technical cost to the organization
- Purpose built cloud security protecting organizations with full security stack: URL filtering to DNS security to Data loss protection and cloud applications
- Ease of deployment
- Significant cost savings in security as organizations move more traffic to the cloud
- Focused on “access security” for the enterprise cloud and eventually replacing VPN via ZPA

Current Landscape

- More and more enterprises are less reluctant to move applications and data to the cloud.
  - US Gov't opening up to cloud deployments (i.e. NSA)
  - Emergence of applications running on Azure and AWS will rise exponentially over the next decade.
- Secular shift beyond cloud: infrastructure as a services, IoT deployments, mobile connections are all bringing on mission-critical workflows.
- Internal applications will continue to play a major part of enterprise capabilities.

Risks and Competition

- Faces legacy competition from fragmented legacy security vendors who are centered around appliances within the data center (i.e. Cisco, Palo Alto)
- Legacy appliance based competitors may only have strength in one area (i.e. endpoint protection)
- Competition has significant resources (Palo, Checkpoint, Cisco) and will eventually enter the market
- Lots of enterprises are facing sunk costs: spent billions in developing data centers or in their IT infrastructures only to use a major security vendor like Palo Alto
- Question of large scale cloud vendors to enter access-based, multi-tenant security still a question (i.e. Microsoft)

Investment Thesis

- Significant secular growth story: cloud computing isn't new but transforming the enterprise to cloud-based architecture for mission critical workflows is still in very early innings
- Despite resources, legacy competitors face opportunity costs entering into this market as they currently lack focus, expertise and patents in these deployments.
- ZPN has not been material and can completely displace corporate networks; if enterprises are shifting to cloud-based architectures this may create an opportunity for ZPA to control the network (i.e. internet security for remote access users without need for VPN fully integrated into Azure or AWS)
- Security partnerships with Microsoft and Partner Network with AWS reduce "vendor" risks
- Fully recurring revenue; sticky infrastructure; high FCF/Sales (and growing); strong revenue growth and gross margins (third quarter saw revenue increase 61% with GM at 82%)
- Potential acquisition target
- Network effects, high returns on capital, defensive nature of technology

Valuation

- At 33.8x sales, we believe ZS is on the expensive side given growth and ROIC prospects (est. 10-year CAGR at 30% revenue growth)
- However, given current cycle and execution we do not see signs of excess just yet
- FCF grew from $2 million to over $31 million in one year. We expect $55 million by year end.
- Book value per share TTM is at $2.23 from $2 at 2018 year-end. We expect close to $4 by year end.
- Gross Margin should touch close to 84% by year end.
- We expect price to book to be maintained within the 32-34x range