Zoom Q2FY23 Earnings - Prepared Remarks

Slide 1 - Zoom Q2 FY23 Earnings

Tom McCallum, Head of IR

Thank you, Kelcey.

Hello everyone, and welcome to Zoom's earnings video webinar for the second quarter of FY23. I'm joined today by Zoom's Founder and CEO, Eric Yuan, and Zoom's CFO, Kelly Steckelberg. We are also pleased to have our new Zoom President, Greg Tomb join us for today's call.

Slide 2 - Use of non-GAAP financial measures

Our earnings press release was issued today after the market closed and may be downloaded from the Investor Relations page at investors.Zoom.com. Also, on this page you'll be able to find a copy of today's prepared remarks and a slide deck with financial highlights that, along with our earnings release, include a reconciliation of GAAP to non-GAAP financial results.

Slide 3 – Safe Harbor statement

During this call we will make forward-looking statements, including statements regarding our financial outlook for the third quarter and full fiscal year 2023; our expectations regarding financial and business trends; impacts from macroeconomic developments and the Russia-Ukraine war, our market position, opportunities, growth strategy and business aspirations; and product initiatives and the expected benefits of such initiatives.

These statements are only predictions that are based on what we believe today, and actual results may differ materially. These forward-looking statements are subject to risks and other factors that could affect our performance and financial results, which we discuss in detail in our filings with the SEC, including our Annual Report on Form 10-K and Quarterly Reports on Form 10-Q. Zoom assumes no obligation to update any forward-looking statements we may make on today's webinar.

And with that, let me turn the discussion over to Eric.

No slide - focus on Eric

Eric Yuan, Founder and CEO

Thank you, Tom! Thank you everyone for joining us today. I am on the road now and my internet access is limited. I will hand my remarks to Kelly and Greg and join you all for the Q&A portion.

No slide - focus on Kelly

Kelly Steckelberg, CFO

Thank you, Eric! Thank you everyone for joining us today.

Let me start with what's on everyone's mind - the macro environment. Zoom is not immune to the global downturn, but the situation is more complex than meets the eye.

Our Enterprise business continued to post strong growth, which we believe is because cloud migration and digital transformation continue to be a priority even when – and perhaps especially when – the economy slows. The headwinds we saw mainly relate to the strengthening dollar, new Online subscriptions, and to a lesser extent bookings linearity. We have implemented initiatives focused on driving new Online subscriptions, which have shown early promise but were not enough to overcome the macro dynamics in the quarter.

We believe Zoom remains well positioned in this environment as customers look to increase productivity and collaboration, while moving away from expensive legacy vendors. Our products are designed to drive efficiency and cost savings within organizations, and are loved by both their employees and their customers. In addition, we have strong margins and cash flows as well as a large cash balance. Even still, we are taking a prudent and cautious approach in this environment with focused investments and hiring to drive innovation and customer happiness.

Slide 4 - Zoom Phone's record quarter demonstrates strength of platform strategy

Our platform strategy is playing out very well and Zoom Rooms and Zoom Phone are critical components of that strategy. In fact, Zoom Phone was a real star in Q2, hitting several milestones. The number of customers with 10,000 or more paid seats increased 112% year over year. In addition, we broke our record for the largest Zoom Phone deal twice; first with a global retailer, and then with a global bank - both with more than 125,000 seats. Deals like these led Zoom Phone to post a record quarter, and surpass 4 million seats in August.

We are also seeing early traction for Zoom Contact Center and Zoom IQ for Sales. Zoom Contact Center is only six months old, but has already had deals reach seat sizes we did not expect until its second year. And customers value the user-friendly interface, efficiency gains, and savings they see in shifting to our modern, cloud-based, AI-driven contact center solution.

We are proud of the team that drove these results. And I'm thrilled to have Greg with us today. Greg joined last quarter as our new president leading our go-to-market teams and the office of the global CIO. He brings a wealth of leadership experience scaling bellwether Internet and enterprise companies. Greg, welcome to our call today!

Greg: Thanks Kelly, very happy to be here.

Kelly: We'd love to have you introduce some customer wins for the quarter.

Slide 5 - Customer wins highlight impressive Zoom Phone performance and early Zoom Contact Center adoption

Greg Tomb, President

Absolutely Kelly, hello everyone.

We had an exceptional sales quarter in the Enterprise market which Kelly will give more details on in a minute. This included a lot of great wins, among which was one of the largest US healthcare providers, which chose Zoom Meetings and Zoom Phone to provide telehealth services to caregivers and patients. They were impressed by Zoom's strong integration between video and voice to support their roughly 40,000 employees for a wide variety of telehealth use cases.

Let me also thank UCLA, which was recognized by U.S. News & World Report as the number one public university in the U.S., for expanding their relationship with Zoom by adding 15,000 Zoom Phone licenses. This large investment will accelerate their journey to the cloud and offer them the benefits of a unified communications platform.

And next, I want to thank Warner Brothers Discovery, a premier global media and entertainment company, for partnering with Zoom on its global communications needs. Our partnership began years ago with the legacy Discovery team and kicked into high gear recently when the two iconic brands merged. And the journey did not end there. They have chosen to expand their Meetings and Phone deployment and we are excited to deliver them a full, integrated suite of communications services.

I would also like to thank Ancestry, the global leader in family history, for expanding their relationship with Zoom. The strong customer relationship that we built during our original Zoom Meetings deployment and their already successful partnership with Solvvy - now a part of Zoom - enabled us to better understand their communications needs and work with them to expand towards a complete platform, including Zoom Phone and scalable Conversational AI-based chat and self-service capabilities from Solvvy.

Let me also thank Optiv, the cyber advisory and solutions leader, delivering strategic and technical expertise to nearly 6,000 companies across every major industry. Optiv started as a Zoom Meetings customer in 2016, and then expanded to Zoom Phone last year. They really appreciated the reliability and simplicity of our integrated solutions. In Q2, Optiv decided to replace their legacy contact center solution with Zoom Contact Center for more than 275 agents supporting roughly 90 workflows. They were impressed with our rapid product iteration and roadmap for integrations with other SaaS tools, as well as the ability to reduce costs.

Again, Thank you UCLA, Warner Brothers Discovery, Ancestry, and Optiv, and all of our customers worldwide.

And with that I’ll pass it back over to Kelly.

Slide 6 - Continued top-line expansion and strong Enterprise performance

Kelly Steckelberg, CFO

Thank you, Greg. Let me now turn to the quarter’s results and guidance.

In Q2, total revenue grew 8% year over year to $1.099 billion dollars, approximately $16 million dollars below the low end of our quarterly guidance. A stronger U.S. dollar, which had an impact of approximately $8 million dollars, weaker new Online sales, and to a lesser extent backend linearity in the quarter were the biggest factors contributing to the miss.

We recognize that the revenue results are disappointing and below our expectations as we navigate the current environment. It should be noted that while our Online business saw lower new subscriptions, renewals in Online continued to improve, and, as we just discussed, we have launched a number of initiatives to drive new Online subscriptions around local pricing, packaging, and free to paid conversion.

The growth in revenue was primarily driven by strength in our Enterprise business. Revenue from Enterprise customers grew 27% year over year and represented 54% of total revenue, up from 46% a year ago. We expect revenue from Enterprise customers to become an increasingly higher percentage of total revenue over time. From a product perspective, we had strong growth in Zoom Meetings and Zoom Phone coupled with contributions from Zoom Rooms and other products.

Slide 7 - Strong growth with new and existing Enterprise customers

The number of Enterprise customers grew 18% year over year to approximately 204,100. Our trailing twelve month Net Dollar Expansion rate for Enterprise customers in Q2 came in at a healthy 120%.

We saw 37% year-over-year growth in the up-market as we ended the quarter with 3,116 customers contributing more than $100,000 dollars in trailing twelve months revenue. These customers represented 26% of revenue, up from 20% in Q2 of FY22.

As the majority of our revenue has shifted back to the Enterprise and we have moved beyond the pandemic buying patterns, we are returning to more normalized Enterprise sales cycles with linearity weighted towards the backend of the quarter. This contributed to higher than expected deferred revenue in Q2 and as we believe this customer behavior will persist, we have factored it into our outlook.

Slide 8 – Double-Digit Americas & APAC growth but macro headwinds in EMEA

Our Americas and APAC revenue grew 12% and 10% year over year, respectively. EMEA continues to be impacted by the Russia-Ukraine war, the strengthening dollar, and Online performance, which led to an 8% year-over-year revenue decline.

Slide 9 – Q2FY23 expenses and margins

Now turning to profitability, I will focus on our non-GAAP results, which exclude stock-based compensation expense and associated payroll taxes, acquisition-related expenses, net litigation settlements, net gains or losses on strategic investments, undistributed earnings attributable to participating securities, and all tax effects resulting from non-GAAP adjustments.

Non-GAAP gross margin in Q2 was 78.9%, an improvement from 76.2% in Q2 of last year and 78.6% last quarter. The sequential improvement was mainly due to optimizing usage across the public cloud and our increasing number of co-located data centers. Given the improvements we are seeing so far this year, we expect gross margins to be approximately 78% for the remainder of the year which is higher than our previous view.

Research and development expense grew by 81% year over year to approximately $98 million dollars driven by our focus on innovation. As a percentage of total revenue, R&D expense increased to 8.9% from 5.3% in Q2 of last year. Our expanding product portfolio reflects our ongoing investments in building out Zoom’s platform and delivering on our customers’ evolving needs. We plan to further invest in R&D to reach our long term target of 10 to 12% of total revenue.

Sales and marketing expense grew by 35% year over year to $286 million dollars. This represented approximately 26.0% of total revenue, up from 20.7% in Q2 of last year. We are committed to investing in growth areas including sales capacity, channel partner enablement, and product marketing.

G&A expense grew by 2% to $90 million dollars or approximately 8.2% of total revenue.

Non-GAAP operating income expanded to $394 million dollars, exceeding the high end of our guidance of $365 million dollars as we continue to thoughtfully prioritize investments. This translates to a 35.8% non-GAAP operating margin for Q2, compared with 41.6% a year ago and 37.2% last quarter.

Non-GAAP diluted earnings per share in Q2 was $1.05, on approximately 307 million weighted average shares outstanding. This result was 13 cents above the high end of our guidance.

Slide 10 – Growing future revenue under contract

Turning to the balance sheet. Deferred revenue at the end of the period was $1.4 billion dollars, up 19% year over year from $1.2 billion dollars. This result was meaningfully higher than what we previously forecasted due to the strong Enterprise bookings which were back-end weighted in the quarter.

Looking at both our billed and unbilled contracts, our RPO totaled approximately $3.2 billion dollars, up 37% year over year from $2.3 billion dollars. We expect to recognize approximately 61% of the total RPO as revenue over the next 12 months, as compared to 69% in Q2 of last year, reflecting a shift towards longer term plans.

As a reminder, our seasonality of renewals is front-end loaded and moderates over the rest of the year, reflecting the sequentially smaller renewal base. As such, we expect Q3 deferred revenue to grow at approximately 13 to 14% year over year.

Slide 11 – Strong cash position in Q2

We ended the quarter with approximately $5.5 billion dollars in cash, cash equivalents and marketable securities, excluding restricted cash. We have purchased $426 million dollars of stock, representing 4.1 million shares over the past two quarters, as part of our billion dollar repurchase program.

We had operating cash flow in the quarter of $257 million dollars, as compared to $468 million dollars in Q2 of last year. Adjusted free cash flow was $222 million dollars, as compared to $455 million dollars in Q2 of last year. Our margins for operating cash flow and adjusted free cash flow were 23.4% and 20.2%, respectively.

As previously discussed, these metrics include a large cash outflow from an increase in cash taxes starting in Q2. As we update our full year outlook for the P&L and take into account the lower tax deductions for stock-based compensation caused by the lower stock price, we would expect adjusted free cash flow to be between 1 billion to 1.15 billion dollars.

Slide 12 – Q3 and Full Fiscal Year 2023 outlook

Now, turning to guidance.

This outlook is consistent with what we are observing in the market today. Specifically, it assumes that our Enterprise business will grow in the low to mid twenties while our Online business will decline 7 to 8 percent for the year, as compared to the previously provided flat outlook.

For the third quarter of FY23, we expect revenue to be in the range of 1.095 to 1.1 billion dollars. We expect non-GAAP operating income to be in the range of 325 to 330 million dollars. Our outlook for non-GAAP earnings per share is 82 to 83 cents based on approximately 306 million shares outstanding.

For the full year of FY23, we now expect revenue to be in the range of 4.385 to 4.395 billion dollars, which would represent approximately 7% year-over-year growth. At the midpoint, this represents a decrease of approximately $150 million dollars as compared to our previous full year guidance. Of this decrease approximately $35 million dollars is due to the stronger dollar and $115 million dollars is attributable to the broader macroeconomic environment.

We now expect our non-GAAP operating income to be in the range of approximately 1.44 to 1.45 billion dollars. We are still targeting a non-GAAP operating margin of approximately 33%, as we have adjusted spending in the second half to focus on high-ROI areas and have seen a modest benefit to expenses from FX. Our tax rate is expected to approximate the blended U.S. federal and state rate. Our outlook for non-GAAP earnings per share is $3.66 to $3.69, based on approximately 307 million shares outstanding.

Slide 13 - Zoomtopia & Investor Day

Before opening up for Q&A, we are excited to share our Zoomtopia event with you. It is our premier user conference and will be run on Zoom Events. We look forward to sharing our Platform strategy, new innovations and customer testimonials. Please join us at Zoomtopia and our Investor Day on November 8.

Zoom remains focused on building out our platform, leading in the hybrid work world, enhancing the customer experience and expanding into more and more business workflows. We will continue to make strategic moves to drive future growth as we navigate the current macro environment. Thank you to the Zoom team - which has grown to 8,000 strong - our customers, our community, and our investors!