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Q4 2023 ZeroFox Holdings Inc Earnings Call

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PRESENTATION

Operator

Thank you for standing by, and welcome to the ZeroFox Fiscal Fourth Quarter 2023 Results Conference Call. (Operator Instructions) And as a reminder, today's call is being recorded. I would now like to turn the conference over to Marc Griffin, Senior Vice President of Investor Relations for ICR. Marc?

Marc P. Griffin ***ICR, LLC - SVP***

Thank you, operator. Good morning, and thank you for joining us today to review ZeroFox's fiscal fourth quarter 2023 financial results. With me on the call today are James C. Foster, or as many of you know him, Foster. Foster is the Founder, Chief Executive Officer and Chairman of ZeroFox. Also with me on the call is ZeroFox's CFO, Tim Bender. After prepared remarks, we will open up the call for questions.

During this call, we may make statements related to our business that are forward-looking statements under federal securities laws, including statements related to our anticipated financial results, growth opportunities in external cybersecurity, our progress in achieving profitability and expected benefits from our acquisition of IDX.

These statements are not guarantees of future performance, but rather are subject to a variety of risks and uncertainties. Our actual results could differ materially from expectations reflected in any forward-looking statements. Forward-looking statements made today speak only to our expectations as of today, and we undertake no obligation to publicly update or revise them.

For a discussion of the material risks and other important factors that could affect our actual results, please refer to the Risk Factors section in our SEC filings and on the SEC's EDGAR system and our website as well as the risks and important factors discussed in today's earnings press release.

Additionally, non-GAAP financial measures will be discussed on this conference call. Please refer to the tables in our earnings release and on the Investor Relations portion of our website for a reconciliation of these measures to the most directly comparable GAAP financial measure.

With that, I'd like to turn the call over to ZeroFox's Chief Executive Officer. Foster, please go ahead.

James C. Foster ***ZeroFox Holdings, Inc. - Chairman & CEO***

Thanks, Marc. Good morning, everybody. I'm really excited to speak with you today about our strong close to the fiscal year, the continued significant growth opportunity we see in external cybersecurity and our focus for the upcoming year on taking a balanced approach between capitalizing on growth and progressing on our path to profitability.

Let's start with a high-level look at our Q4 performance. As the only cybersecurity company to go public in 2022, I'm proud of what our team was able to accomplish. We closed out the year on a high note, beating the high end of our guidance for the second consecutive quarter.

We ended the year with ARR of $157 million and year-over-year platform ARR grew 27%. We also had another strong quarter of new customer wins ending the quarter with over 1,200 subscription customers, up 20% year-over-year. We saw continued success winning larger deals as well, ending the year with 147 subscription customers with ARR greater than $100,000, an increase 25% year-over-year.

Overall, we were pleased with the performance, particularly given a continued volatile and uncertain macro environment. The demand environment we experienced in Q4 was consistent with what we saw in Q3 and thus far is remaining more stable than the macro environment. That said, like other cybersecurity and technology companies, we've continued to see increased scrutiny on larger deals and longer sales cycles in certain cases and geographies, but it has not affected our overall demand.

We attribute this experience to the resiliency of cybersecurity and our go-to-market execution. We also recognize our smaller size and emerging nature of the market are positive factors. Taking a closer look at Q4, we continue to see healthy demand from both new and existing customers across our external cybersecurity platform and service offerings.

During the quarter, we had several key platform and service wins, including a multi six-figure deal with a Fortune 100 U.S. grocery chain. This deal was a competitive displacement opportunity that we won over key public company competitors. The customer is using ZeroFox to protect multiple brands, domains, executives and mobile apps to detect and disrupt coordinated campaigns across the dark web through our threat intelligence products.

ZeroFox won this deal due to the strength and comprehensiveness of our platform, differentiated dark web and dark ops capabilities and our ability to take action against the threats we discovered, including removing leak data and personal information with our new PII disruption service.

We signed a six-figure deal with a Fortune 100 retail company that is using ZeroFox to protect and disrupt threats to their corporate and executive social media accounts and domains. We also won a six-figure multiyear deal with a large European critical infrastructure company. This was a competitive displacement with the customers selecting ZeroFox for our comprehensive platform across three of our four pillars, including digital risk protection, threat intelligence and disruption.

ZeroFox Response, our fourth and newest pillar focused on incident and breach response capabilities, also performed well in the quarter. We had several key wins, including a large deal with a U.S. restaurant chain where we were brought in to leverage our Response platform and operations center. This was a competitive deal where the customer selected ZeroFox because of our proven track record of delivering market-leading breach response services at scale.

Importantly, in Q4, we started to see early signs of synergies following our Q3 acquisition of IDX. For example, our recently launched PII removal disruption service, a joint IDX and ZeroFox innovation, was a key required capability for several in-quarter ZeroFox platform deals.

One of our long-standing ZeroFox customers, a Fortune 50 media and technology company, also engaged with ZeroFox Response for the first time over their legacy incumbent provider. We also were able to drive some improvement in Response win rates by launching marketing campaigns to drive education and the value of the 2 combined businesses. This is an example of how we're leveraging ZeroFox's larger and more established go-to-market capabilities to drive synergies.

While we are pleased with this early progress, we know there is still a lot more work ahead of us. Consistent with what we said last quarter, we continue to expect these synergies to become more meaningful in the latter half of this year. Because this is only our second earnings call since going public and some investors are newer to the story, I'd like to spend just a few minutes to provide an overview of external cybersecurity.

The external cybersecurity category of products helps customers expose, disrupt and respond to threats beyond the device and outside the perimeter. Traditionally, the focus of cybersecurity has been on endpoints and firewalls with the goal of protecting owned assets with internal security controls. However, digital transformation is propelling a proliferation of digital assets and data on external platforms that are outside the control of organizations and not protected by traditional security controls.

Examples of these platforms include the surface web, deep and dark web, social media sites, collaboration platforms, code sharing sites and mobile app stores.

As business shifts online, the external attack surface for every organization continues to grow, increasing potential financial and reputational risk. And the risk is real. The adversaries are increasingly targeting this external attack surface with phishing attacks, impersonations of companies, brands and executives, account takeovers, frauds and even attacking those exposed external platforms.

At the same time, the volume of threats continues to increase, making it more critical to use actionable threat intelligence for continuous visibility and continuous protection from threats beyond the perimeter.

The size and scale of the external attack surface is driving a growing need for external cybersecurity solutions. And today, we provide continuous visibility into that entire external attack surface, robust threat intelligence, protection with the ability to disrupt active threats and comprehensive response capabilities to assist with investigations, incidents and breaches.

So why do we believe that ZeroFox is well positioned to capitalize on this opportunity? Three main reasons. The first is our platform. We believe that solving the external cybersecurity problem requires a platform-based approach. This is exactly what we have and what we will continue to build upon. Our platform combines patented AI-powered analysis, full spectrum threat intelligence, adversary disruption and response capabilities into a single comprehensive solution. Customers want a single pane of glass.

The second reason is scale. We believe that the scale at which we operate and disrupt threats on a daily basis for our customers represents a competitive advantage. We also believe that our growing size and customer base will increase this scale advantage over time. We believe this will be especially true in less predictable macro environments like we're operating in today.

And the third reason is our experience and focus. Solving the external cybersecurity problem has been our focus since we founded the company just over 10 years ago. We continue to innovate and deepen our platform to ensure that we have identified and disrupt every external attack.

Fiscal year '23 was transformational for ZeroFox. We were the only cybersecurity company to go public last year, and we have the capital required to cross over free cash flow breakeven late next year. We raised new growth capital, and with the acquisition of IDX, we strategically expanded our platform to include ZeroFox Response.

As we look to this upcoming fiscal year, we believe that ZeroFox has the resources, scale and platform depth to ensure another successful growth year. At the same time, we believe it's important to pursue this growth in a disciplined way that allows us to make progress towards becoming profitable.

Looking forward, I would like to outline our top three priorities, and you'll be able to remember these by the simple acronym, F-O-X. First is for focus. We will continue to focus on executing our strategic plan to lead and grow our external cybersecurity platform, capabilities and customer base. Success here will be reflected in quarterly performance metrics with a focus on core growth.

Second, O is for optimization. We know that the path to profitability is an important area for focus for investors, and it's a key area of focus for ZeroFox. This year, we will continue to optimize our infrastructure to support our near-term growth while laying the foundation to drive operational efficiencies and leverage. Our goal is to achieve cash flow breakeven late next year.

Lastly, X represents X factor. This year, our X-factor will be executing on driving more meaningful synergies and improving our overall cross-selling efforts from our recent acquisitions.

In summary, a strong fourth quarter capped off a transformational year for ZeroFox. And with the continued energy, passion and commitment of our Foxes around the world, I believe that ZeroFox is well positioned to execute on our initiatives and further leverage our platform.

With that, I would like to turn the call over to our CFO, Tim Bender, who will provide more color on our financial performance and our guidance for Q1 and this fiscal year. Tim, the floor is yours.

Timothy S. Bender ***ZeroFox Holdings, Inc. - CFO***

Thanks, Foster. As Foster mentioned, ZeroFox ended its fiscal year '23 on a positive note. Before we take a closer look at our Q4 results, I wanted to remind everyone that due to the accounting requirements of the transaction, prior period financials presented reflect only the results of ZeroFox on a stand-alone basis, and do not include the results of IDX. For comparable purposes, we have provided investors with supplemental financial information that includes historical stand-alone financial statements for both ZeroFox and IDX. This information can be found on our Investor Relations website.

Now let's take a closer look at our Q4 results. With the exception of revenue, unless otherwise stated, all financial results we will discuss today are non-GAAP financial measures. Reconciliations between our GAAP and non-GAAP results can be found in our earnings release.

For Q4, ZeroFox reported revenue of $45.4 million. This exceeded the high end of our inferred Q4 guidance range. Subscription revenue was $16.5 million. Subscription revenue consists of revenue from ZeroFox platform sales. Services revenue was $28.9 million. Services revenue consists of revenue from Response services as well as revenue from recurring and nonrecurring intelligence services.

As of January 31, our annual recurring revenue was $157 million. ARR primarily consists of platform subscriptions as well as a small amount of recurring intelligence services and $83 million from our large government contract. We ended the quarter with 1,203 subscription customers.

We continue to see a significant opportunity to both land new customers and expand platform capabilities and services within our existing customer base. As Foster mentioned, in fiscal year '23, we saw continued success winning larger deals. We ended the year with 147 subscription customers with ARR greater than $100,000, representing a year-over-year increase of 25%.

Turning to gross margin. For the fourth quarter, subscription gross margin was 73%, an increase from last quarter's subscription gross margin of 72%. While there were some positive impacts from increased efficiencies, subscription gross margin also benefited from the timing of investments. From a seasonality perspective, our investments tend to be more heavily weighted to the first half of our fiscal year.

Given this, we would expect subscription gross margin to slightly decline in Q1 '24 and then increase moderately over the remainder of the year. While there is a potential for quarter-to-quarter volatility, our goal is to deliver consistent, moderate subscription gross margin improvement on an annual basis as we have done so for several years.

Total gross margin was 41% compared to 40% last quarter. The improvement in total gross margin was driven primarily by the higher subscription gross margin referenced above. We continue to see opportunities to improve our overall gross margin as we scale our business, drive greater cost efficiencies and our higher margin subscription revenue becomes a greater portion of our overall revenue mix.

Turning to operating expenses. Total operating expenses were $26 million in the quarter. When comparing expense levels to last quarter, keep in mind that Q3 was a partial quarter that reflected three fewer days of expenses. Setting this aside, the increase in expenses was primarily driven by increased sales commissions, which is typical in Q4 for us, as well as continued investment in R&D and transaction expenses in G&A related to becoming public.

As we look to Q1 '24, we would expect operating expenses to increase slightly in absolute dollars driven by the timing of professional fees for our annual audit, residual transaction-related filing costs and planned investments that should provide operating leverage in the second half of the year. Our loss from operations was $7.2 million.

Looking at the balance sheet. We ended the quarter with $48 million in cash, $30 million in accounts receivable and $54 million in total deferred revenue. Our total outstanding debt was $174 million, including $157 million in convertible debt. The convertible note has a cash interest rate of 7% and a PIK rate of 8.75%.

Consistent with last quarter, we elected the PIK option for our second interest payment due on March 15. We believe the PIK option continues to provide us the opportunity and flexibility to prudently invest in the growth of our business.

Turning to cash flow. Cash flow used in operations was $5.3 million.

Now to our outlook. As we indicated last quarter, we are providing revenue and non-GAAP loss from operations guidance for Q1 and fiscal year '24. Our outlook reflects our solid Q4 '23 results, assumes no material changes in the macro environment, consistent demand for our external cybersecurity solutions and does anticipate volatility within our service business. Our outlook also incorporates my prior commentary regarding the trajectory of subscription gross margin and operating expenses for Q1.

For Q1 '24, we currently expect revenue to be in the range of $44.0 million to $44.6 million, and non-GAAP loss from operations to be in the range of $9.8 million to $9.3 million. For fiscal year '24, we currently expect revenue to be in the range of $183 million to $187 million, and non-GAAP loss from operations to be in the range of $29 million to $26 million.

As Foster mentioned earlier, we are focused on the path to profitability, and we continue to expect that we will achieve free cash flow breakeven in the latter part of fiscal year '25.

With that, we'd like to take your questions. Operator?

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

The first question comes from Joseph Gallo with Jefferies.

Joseph Anthony Gallo ***Jefferies LLC, Research Division - Equity Associate***

Obviously, there's a lot of factors that impact the revenue guide between macro and the different components of the business following the transaction. How should we think about ARR growth trending versus revenue growth, which is probably a truer reflection of the health of the business?

Timothy S. Bender ***ZeroFox Holdings, Inc. - CFO***

Joe, this is Tim. Yes, I mean, if you think about our overall growth, the subscription side of the business does grow a little bit faster. So you would expect that the ARR would grow a little bit ahead of our overall total revenue growth.

Joseph Anthony Gallo ***Jefferies LLC, Research Division - Equity Associate***

Okay. That's helpful. And then maybe just, Tim, while I have you, just talk to the puts and takes of the guidance. Your revenue guidance, I would believe, appears prudent. I mean you just did 17% growth. And I think your full year guide implies you're exiting the year at mid-single digits. So one, how should we think about your guidance methodology? And two, maybe as we move beyond these macro headwinds, how should we think about the sustainable growth rate of the business?

Timothy S. Bender ***ZeroFox Holdings, Inc. - CFO***

Yes. So I guess if we get into methodology and philosophy, the first thing, we have the OPM contract that certainly weighs as an anchor on the overall growth rates, obviously, a very consistent cash flow generating contract, but does weigh on overall growth. Again, subscription growth, that line of the business is the strongest performer. And I think you'll see that continue through Q1 and the fiscal year.

And then we're just really mindful right now of our -- the services business. Obviously, the acquisition is fairly new for us, and there's a bit more volatility in that line of business relative to subscription revenue.

Joseph Anthony Gallo ***Jefferies LLC, Research Division - Equity Associate***

Awesome. And then maybe if I can just sneak in one more. Foster, what surprised you in your first quarter as a public company? And then maybe focusing on the F in Fox, what are the inputs to the growth algorithm that you're factoring in? And what are the biggest opportunities for growth in fiscal '24?

James C. Foster ***ZeroFox Holdings, Inc. - Chairman & CEO***

Yes. Thanks, Joe. Well, I mean, outside of the fact that we had a near tech banking melt down 72 hours ago, throwing a wrench days before our first public earnings call. I think we had a strong Q4 performance. As Tim iterated, we beat the high end of our guidance range. I'm pleased with what the team is doing, but we have meaningfully more in synergies available to us. But we're being mindful of the growth that we project this year given this uncertainty.

And certainly, the last 72 hours, adding a new element of uncertainty in the macro environment that we have. If you look back at the growth numbers that we did put up for Q4, Tim mentioned that our subscription businesses far outpacing the rest of our businesses in terms of growth rate. And I'd like to draw another proof point towards here is the growth in large customers.

I mean our growth in large customers over $100,000 in ARR is also outpacing our overall growth. That's a positive factor that I'd like to make sure that everybody's cognizant of is when in general cybersecurity customers pay more for a solution set, we believe that shows that there is a demonstratable problem that's out there and that we have enough trust from our customers to solve it on their behalf. And so that's a very important metric that we keep a close eye on.

Operator

(Operator Instructions) Our next question comes from Brad Reback with Stifel.

Brad Robert Reback ***Stifel, Nicolaus & Company, Incorporated, Research Division - MD & Senior Equity Research Analyst***

Great. Foster, you indicated some early synergies on cross-selling with IDX. Can you maybe give us a sense of where the sales force is in training? And is everyone fully up to speed or is there still opportunity there?

James C. Foster ***ZeroFox Holdings, Inc. - Chairman & CEO***

Yes. I appreciate the question, Brad. We have sales kickoff in 48 hours. And so we're using that as the foundation as we do every year to re-enable, re-establish the positioning, re-anchor any of our pricing changes that we have. We're using that as a meaningful catalyst to accelerate the revenue synergies for the acquisition of IDX this year.

We did, however, see some nice, what I'd call, early synergies in Q4 that we mentioned. The release of the new PII disruption service capability in our platform was a meaningful win for multiple customer opportunities in Q4. I think we were positively surprised at how fast those deals moved through the pipeline and the traction and the demand that we saw from those customers.

And those were just small single-digit percentages of the total net new customers we acquired in Q4. And so I think our saturation of opportunity is really just looking at a couple of points of our total customer base. There's a lot of opportunity, upside and white space that we anticipate tackling this year with the team from IDX and the technologies that are in our platform now.

Brad Robert Reback ***Stifel, Nicolaus & Company, Incorporated, Research Division - MD & Senior Equity Research Analyst***

That's great. And then, Tim, you had mentioned some seasonality on expenses. How about helping us with seasonality on cash flow?

Timothy S. Bender ***ZeroFox Holdings, Inc. - CFO***

Sure. I mean I think typical for ZeroFox in our history, I know it's a short history for you guys, but Q1 has always been our most challenged quarter from a cash flow standpoint and we wouldn't expect that this year would be different, but just like the expense flow, cash flow tends to perform better throughout the year and getting better each quarter, and we would expect that to happen again this year.

Operator

(Operator Instructions) The next question comes from Yi Fu Lee with Cantor.

Yi Fu Lee ***Cantor Fitzgerald & Co., Research Division - Research Analyst***

Congrats on the strong finish, Foster and Tim, of course as a public company. A couple of questions for Foster or Tim. Starting with the IDX, I was wondering if you guys could give us some updates on revenue synergy generations from the platform, upsell, cross-sell?

I know, Foster, you mentioned about a deal -- a joint deal between ZeroFox and IDX, the media company. Wonder if you could double-click on that one for us on cross-sell revenue synergies?

James C. Foster ***ZeroFox Holdings, Inc. - Chairman & CEO***

Good morning, Yi. For better or worse, in terms of revenue synergies, I think it was minimal in Q4. We are excited to see, what I call, feature demand within the platform that accelerated sales cycles, but for me to say that just because of that feature alone, we won those net deals would probably be doing our platform a disservice as a whole. Where I see revenue synergies really manifesting itself here this fiscal year will be on overall pipeline and demand generation improvement. We are seeing consistent trends from Q4, although we're being mindful of what this year could bring in terms of the macro.

And then outside of that, we mentioned as we were getting ready to go public, the very small overlap in customers that we had as an organization. Let me put on record, it was about 5% or less total customers that overlap between the two organizations, which by definition leaves us a lot of upside for cross-sell and upsell this year. And that's something that we think about when we talk about our X factor is top of mind for performance.

And a quick math would lead you to believe that if you look at our subscription ARR, any meaningful improvement in cross-sell, upsell would see an incremental accelerated growth rate there for ARR.

Yi Fu Lee ***Cantor Fitzgerald & Co., Research Division - Research Analyst***

That makes sense, Foster. And then on the multi six-figure deal, we understand ZeroFox is coming from a platform play. I was wondering, you mentioned about (inaudible), what type of solutions did you (inaudible)? How long is the deal cycle? Was the customer concerned with the cost? They want to lower their TCO, total cost of ownership, that's why they went to ZeroFox. Can you give us more color on that multi-six-figure win (inaudible) deal?

James C. Foster ***ZeroFox Holdings, Inc. - Chairman & CEO***

Yes. Yi, thanks for that question. A couple of thoughts come to mind. We're in a competitive market. And I think that is -- that's a good thing for cybersecurity as a whole to have multiple solutions and multiple options that allows customers to get educated on the problem set from multiple points of view. But as an organization, we've been working on this problem longer than our competitors. We've been focused on this problem longer than our competitors. And I think the market is really starting to take note of the differentiated capability set and our multi-pillar strategy within our platform.

And it's something that's been asked for by our customers. When I think about innovation, we're a customer-first organization and our path to innovation really is built on top of customer feedback and customer demand. The competitors that we see, especially in the enterprise, just about every enterprise deal we do is competitive in nature. Come to this from maybe one of our pillars, maybe they're a DRP pillar or threat intelligence pillar but what we see is some folks don't feel like they're getting the true value.

We have threat intelligence companies that we displace on a regular basis, where the constant feedback we hear is they're too expensive, and we're tired of searching for data or intelligence. We want to understand what's actionable, and we want somebody to help us take action immediately. We don't want more work where we need to constantly search for answers.

And I think our customers appreciate the proactive nature and protective nature of our platform as opposed to a search and find platform.

Yi Fu Lee ***Cantor Fitzgerald & Co., Research Division - Research Analyst***

That makes sense. And then I'm going to end off, Tim, on like two more financial questions, if I may, is like the breakout between your existing deals, we understand the macro conditions, right? Any percentage breakdown between new logos versus existing? And the last one is about the investments, you mentioned it's going to be first half heavy -- first half of fiscal '24 heavy. You have about 800 Foxes at the moment. What's your hiring plans, investment plans, et cetera? And that's it for me.

James C. Foster ***ZeroFox Holdings, Inc. - Chairman & CEO***

Yi, would you mind clarifying the first part of that question again? We have...

Yi Fu Lee ***Cantor Fitzgerald & Co., Research Division - Research Analyst***

On the new and existing deals, like how much of the revenue generation is coming from new logo versus your existing customer base? And then the second part is your investment plans. You have about 800 Foxes right now, I was wondering your investment plans for the first half -- throughout the year, actually?

Timothy S. Bender ***ZeroFox Holdings, Inc. - CFO***

So yes. So if we think about like the revenue mix, again, I think it's in line with our ARR growth that we talked about from new customers and existing customers. Most of our revenue does come from existing customers. We have a nice base. And we're adding roughly maybe 100 new customers a quarter, but if you think about that number. So it's still mostly aligned to our existing base because we have a strong customer base in that regard.

And then I would say maybe on the hiring plan, I mean I think our hiring without giving the exact numbers, it's, again, going to be balanced where we need to see the growth in the company and support the growth. So as we grow our revenue, we'll grow our services delivery commensurate with our margin to keep that in line. Again, talking about adding moderate growth over the course of the year.

And then I think G&A will kind of moderate as we become more mature. Sales and marketing is as we add customers and as we continue to grow, we'll have to add capacity in our sales and marketing functions to handle new customers, handle our growth in customers and to drive growth for the upcoming and future years.

And then R&D is just -- we want to be balanced in our investment. Again, we have a strong and robust platform, but as Foster mentioned, there's competition out there. So we want to continue to innovate as well as keep our platform, strengthening, keep our strong platform as it's a driver of our revenue.

So I think we're balanced there. I don't think we're over investing in growth. I think it's the right balance to handle our revenue growth.

Operator

I show no further questions at this time. I would now like to turn the conference back to Foster for closing remarks.

James C. Foster ***ZeroFox Holdings, Inc. - Chairman & CEO***

Thank you, operator. As you can tell, we are very excited about the opportunity in front of us. I want to emphasize that we are focused on taking a mindful approach that allows us to capitalize on the growth opportunity we see this year, while also making progress on our path to profitability. Again, I want to thank everybody for joining us today and a special thanks for those that asked questions. Have a great day. Cheers.

Operator

This concludes today's conference call. Thank you for participating. You may now disconnect.

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