STRATEGIC PRODUCT MANAGEMENT ANALYSIS OF ZSCALER, INC.: NAVIGATING GROWTH AND PROFITABILITY IN THE CLOUD SECURITY MARKET

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Abstract

This paper analyzes Zscaler, Inc., a cloud security SaaS company that went public in March 2018. Zscaler offers cloud-first security products, specifically a secure web gateway (SWG) tailored for enterprises migrating applications and data to the cloud. Despite rapid revenue growth exceeding 50% annually, Zscaler has yet to achieve profitability, prioritizing aggressive investment in sales and marketing to expand its market share and customer base. The company faces competition from established players like Symantec and Cisco, who dominate the on-premise and hybrid SWG markets, and ongoing patent litigation challenges. However, Zscaler's early market entry, cloud-native platform, and proprietary technologies provide a strategic edge. Opportunities lie in expanding to government sectors and international markets, particularly in Asia-Pacific. The analysis suggests Zscaler could achieve profitability by 2020 if it scales efficiently, maintains high customer retention, and gradually reduces sales and marketing expenses. The paper concludes that Zscaler's cloud-first focus positions it for long-term leadership in the SWG market, with significant growth potential as the industry matures.

Keywords: Cloud Security, SaaS (Software as a Service), Product Strategy,Market Expansion, Revenue Growth, SWG (Secure Web Gateway), Customer Acquisition, Profitability, Patent Litigation, Strategic Product Management

I. INTRODUCTION

Zscaler is a SaaS (Software/Security as a Service) company, founded in 2008 in San Jose, California on a vision to provide cloud-based SWG (Secured Web Gateway) to the enterprises whose application and the data are stored and accessed through the cloud. Zscaler went IPO by getting listed in NASDAQ on 16 March 2018, [1]and within the six months of the IPO, the stock prices increased by 130% valuing the company over $5bn.

The company has set up the organization for long-term growth at the expense of posting profits. Their business strategy involves it spending heavily on sales and marketing to support revenue growth of ~50% YoY. The company has more than 3200 customers globally and provides subscription-based service with an annual contract value of $55,000 [2], customer acquisition cost of $160k, higher lifetime customer value, and a YoY (Year on Year) growth rate of more than 51%.

The company is competing with the legacy platform vendors such as Symantec, Cisco, Check Point, Palo Alto networks who are the leaders in the On-premise and hybrid SWG market and has a risk factor from the legal proceeding with Symantec on infringing its patents. The company has spent more than $8mn on the litigation in 2018, and $5.8mn in 2017.

The company continues to focus on its core competency, i.e., cloud-first security products. Their strategy is to tap the cloud-based security market growing at a tremendous rate of 32% annually, as more and more internally managed applications are moving to the public cloud which will eventually make the on-premise data center market obsolete.

Being a highly liquid company, and a promising IPO, the future financial projections looks phenomenal, the future growth will continue to focus on three key areas, i.e., Landing new customers, expanding in existing accounts, and developing new market segments (e.g., US federal, Asia-pacific region). Gradually, the company will reduce the Sales and Marketing expenses and will start generating the profits, and there is no doubt that Zscaler will become the pioneer in the SWG market and will have the stock price soar in the coming future.

II. MARKET ANALYSIS

2.1 Financial Analysis

Zscaler is an excellent example of an enterprise SaaS company that has found excellent traction with its market and customers. For the most recent fiscal year ended July 31st, Zscaler reported excellent YoY revenue growth of ~51% and an average of ~52% over three years. This revenue growth has primarily been fueled by heavy investment in sales and marketing. Gross profit margin has also been steady at ~80%. Sales and marketing expenses have been consistently over ~60% of gross revenue for the past three years, 71% in 2016, 63% in 2017 and 61% in 2018. From analyzing the previous three years of financial results, it shows the successful execution of their strategy which invests predominantly in sales and marketing. Net losses (Non-GAAP) for Zscaler have been decreasing over the past three years, from ~30% of revenue in 2016 to ~8% in 2018. If this trend continues and expenditures in other areas remain consistent or decrease, Zscaler could be profitable by 2020.

2.2 Internal Strategic Analysis
2.2.1 Strengths

Zscaler success in leading cloud-based security market relies on its unique platform technology and distributed data centers in the early stage of the cloud market. Zscaler has a strong sales and marketing team to help to grow the revenue of the company rapidly and to keep the dollar-based retention rate high.

2.2.2 Environment

Zscaler was established in 2008 based in San Jose, Silicon Valley when AWS and Google App Engine also started. Therefore, it was a quite early stage for Zscaler to get into cloud security market by providing security service for organizations who are trying to switch from company-owned hardware and software assets to per-use service-based models.

2.2.3 Technology

To compete with the existing security companies, Zscaler provides two cloud services by selling subscription business model: Zscaler Internet Access and Zscaler Private Access. The service can provide comprehensive user reports in real-time with Zscaler Nanolog servers without using any on-premises and on-device hardware or software. Zscaler has held more than 100 issued and pending patents all over the world, and such technology innovations are hard for a new startup to compete with Zscaler's existing customer market.

2.2.4 Economic

Besides Zscaler's unique SaaS platform technology, it has a pretty competitive Sales and Marketing team. Zscaler has spent a significant amount on S&M in the past three years but has kept YoY revenue growth and gross profits over 50%. The net dollar-based retention rate has kept ~120% high, which indicates Zscaler has an impressive growth in acquiring a new customer and upselling to the existing customers. Such data is very competitive in the SaaS security industry compared to its competitors. The Sales team in Zscaler also established strong channel partnership from both US and outsides US. The account receivable from different channel partnership has won more than 10% [3] of the revenue every year, and the channel partnership helps Zscaler expand its market outside the US quickly.

2.2.5 Political

Zscaler expands its customer base to government agencies who need Zscaler service transform to the cloud in the global. Cloud-based security growth got support from the governments.

2.2.6. Social

Zscaler has offices all over the world with an employee strength of 950 of diverse culture. According to Glassdoor, Zscaler is listed as #43 of best places to work. The positive employee satisfaction rate is attracting more technology experts to join the company and help Zscaler grow faster.

2.3 Weaknesses

Although Zscaler joined the cloud-based security market in a quite early stage, the company faces a threat with the competitors who provide both on-premises and cloud-based security products in acquiring new customers. Also, Zscaler has never been profitable in any of the fiscal years since inception which possesses a big concern to the investors.

Technology: Zscaler core competency is providing services to cloud-based enterprise customers. Zscaler competitors such as Symantec, Cisco, Palo Alto Networks, FireEye, etc. have on-premise

and hybrid network security products. Once their customers start adopting cloud network, they will retain to their original vendors who will eventually slow down Zscaler's market expansion.

Environment: Zscaler has spent more than 60% of the gross revenue on Sales and Marketing Operating expense to tap the cloud-based market quickly by sacrificing the profits.

Economic: In the past ten years, Zscaler has incurred an average of 25% YoY net losses which will not give enough confidence to its investors to provide more fundings and keep the stocks higher.

III. EXTERNAL STRATEGIC ANALYSIS

3.1 Opportunities

Environment: The cloud-based SWG market has grown at an annual rate of 32% versus only 5% for on-premise appliances in the last five years [4]which suggests that there is a significant potential to attract new customers. Besides US enterprise customers, Zscaler can continue to expand its market in government agencies and find opportunities to penetrate in the developing markets such as Japan, and Asia Pacific region who are entirely new to the cloud market.

Technology: Zscaler can leverage its customer base by investing in established long-term relationships with global telecommunication services providers and system integrator partners such asBT Telecommunications plc, Deutsche Telekom AG, Orange S.A., and Verizon Communications Inc. It will attract potential customers who have quite amount of more mobile, remote users.

Zscaler expanded its business by acquiring a new AI startup TrustPath[5]. The company can incorporate AI and Machine Learning technology to quickly deliver new sophisticated security defensive capabilities and protections to keep existing customers and attract more potential new customers.

Economy: Zscaler's customer retention rate is high as it provides unique, non-substitutable platform in cloud-based security. The existing customers will not spend extra money to switch to a new product unless the cost of the similar services is significantly low. If Zscaler keeps gaining new customers, it is very predictable that Zscaler can maintain upselling rate high and keep revenue growing.

3.2 Threats

Zscaler faces a number of threats in the cloud security market as it overgrows.

Technology: With the increase in customers and the use of the Zscaler's cloud platform, the cost of operating expense will increase due to higher bandwidth and data center expenses. Zscaler will soon need to spend extra money on R&D to find a better solution to host increasing traffic volumes.

Legal: Zscaler faces a risk of dealing with lawsuits filed by Symantec and Finjan, Inc for Legal Proceedings. According to the 10-k Annual report, Zscaler spent $5.8 million in 2017 and $8 million in 2018 to fight for the defense and the likelihood of success is unpredictable. The unclear result and the expensive costs are significant obstacles for Zscaler to grow.

Environment: Zscaler's faces pricing pressure from its competitors as they are selling the similarservices at zero or negative margin

Political: During the international expansion segments, it might require Zscaler to spend extra cost on developing product service to fit for foreign privacy, data protection, and information security laws and regulations.

Economic: The unstable international exchange currency rate might be a potential threat for Zscaler. According to Brexit in 2019, Zscaler has almost ~45% revenue from Europe and ~8% revenue from Japan and the Asia Pacific segment. It might become a challenge if the global developing countries market is not stable.

IV.   BUSINESS STRATEGY ASSESSMENT
4.1 Product Strategy and Target Market
Zscaler's cloud-based security is based on the modern architecture of direct-to-cloud, acts as middleware to route all the transactional data through its SWG adhering to the corporate and the security policies.

With the current shift in the technology, enterprise applications which were installed on premises are now moving to the public or private cloud and with the growing use of cloud-based applications, security risk has also increased. Zscaler envisioned the increased rate of applications moving and access through public and private clouds, and with the mobile-first world where organizations depend on the internet, a network they do not control and cannot secure, a strong footprint of the secured cloud platform would be essential to secure access for users on applications, services, and devices regardless of location.[3]

The cloud-based SWG market is small as compared to on-premises (holds 71% of the market share and is growing at a rate of 5%) but is growing at a tremendous rate of 32% annually. Zscaler continues to focus on their core competency, i.e. cloud-first security products and has no plans to invest in a hybrid or on-premise deployments. Their strategy is to tap the growing market as more and more internally managed applications are moving to the public cloud which will eventually make the on-premise data center market obsolete. Their strategy also includes reducing network infrastructure costs for their customers, as ZScaler removes the need for a significant amount of enterprise network hardware.

4.2 Customer Acquisition
Zscaler is a cash-rich company with $135 million in cash and cash equivalent and $438 million in the capital surplus[6] from their IPO with remarkable YoY growth rate (more than 50%). The company has set up the organization for long-term growth at the expense of posting profits. It

has the leverage of focusing on landing the customer first and then expanding, without thinking about the Net profits with a goal to first make the presence in the SWG market and get the majority of share. The company has spent a significant amount of capital in Sales and Marketing to acquire new customers and make a space in the SWG market. Sales strategy has driven strong relationships with their customers, as evidenced by the strong dollar retention rate (122%) for the previous three years [3].

4.3 Business Expansion
Zscaler has expanded its presence in the market by acquiring TrustPath, an innovative AI and ML company[5]and partnered with Barracuda to resell its cloud SWG as a rebranded replacement for Barracuda Web Security Service. [4]
Their strategy is to expand into adjacent markets also for network security such as new Wi-Fi Guest Security Platform that protects the guest Wi-Fi users and the company by securing the network[7].

4.4 Competition
The company is currently in a growing phase and trying to make a footprint in the cloud-based SWG market. The company is directly competing with the big players in the market such as Symantec, Palo Alto Networks, Cisco, Juniper, FireEye and F5 Networks, which directly correlates their strategy to spend a significant amount of money to create, hold, and tap the new customers in the market. None of the competitors have the core competency of cloud security like Zscaler as the competitors are focusing on targeting the current market on-premises and hybrid. Zscaler's cloud first strategy in network security and spending all their R&D cost in enhancing cloud-based security product has helped them build a strong market leadership position. Zscaler holds 100 pending and issued patents which can create an entry barrier for the competitors in the cloud-based security market.

4.5 Future Growth
Zscaler's future growth will continue to focus on three key areas: landing new customers, expanding in existing accounts, and developing new market segments (e.g., US federal, Asia pacific region). The opening of their cloud platform to third-party developers is planned, enabling a new customer acquisition channel and revenue source. Based on the past trends in the revenue growth rate, dollar net retention rate, gross profits, and their expansion plans, it is safer to assume that the company will continue to grow at a healthy rate of more than 50% in revenue. The company has landed more than 3200 customers and holds a good share in the cloud-based security market which will make them spend relatively less money on Sales and Marketing. The projections for the coming years based on the assumptions that the company Zscaler will spend 50% of the gross revenue on Sales and Marketing next year and 35% the year after, the future trend line shows an increase in Net Income from -$33 million to $70 million profits in 2019 and $200 million profits in the year 2020.

Figure 1 Projections derived from Income statement based on the assumptions

The company's expeditious growth could make it an attractive acquisition target. The other big players in the market such as Symantec, Cisco, and likewise, are well-established and moreexperienced in the SWG market (predominantly in on-premises and hybrid). More importantly, they have a strong purchasing power to acquire the company with its patents and its know-how technology instead of establishing themselves in the cloud-based security market by spending extra money on R&D, S&M, and acquiring customers.

V. CONCLUSION

Zscaler is a pioneer in the cloud network security market, and its fundamentals of finances are very promising. With the growing shift in technology from on-premises to cloud-based, the market is getting created automatically for Zscaler. They will have an advantage of sticking to their core competency of cloud-based secured web gateway and focusing on the improvement of web security rather than adding a portfolio of products which would get obsolete in coming years.

Most importantly, their pull market strategy to acquire customers by spending a huge percentage of gross revenue on Sales and Marketing is so far working for them as they have attracted more than 3200 customers since inception and generated revenue with a YoY growth rate of more than 50% consistently for the past three years.

The stress test will come when they reduce spending on sales and marketing. The projected revenue growth in-line with their historical financial performance suggests the company will continue generating healthy revenues in the future. The net income heavily depends on the Sales and Marketing expenses and the prediction based on our analysis is that the Sales &Marketing expense per gross revenue will decline and the company will start generating profits form next year.

Zscaler is currently trading at $37, and as per our analysis, it is a safe bet to invest in the company now as in coming quarters the stock price will soar.

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