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INVESTMENT MANAGEMENT

## Zscaler Scales Zero Trust and AI Agent Security

Price \$159.75

Growth Holding

February 21, 2026

- Zscaler's Zero Trust Exchange processes over 500 billion transactions daily, which creates a data advantage that vibe-coding cannot replicate.
- The AI Security segment reached \$400 million in Annual Recurring Revenue three quarters ahead of schedule.
- Z-Flex purchasing program accelerates the land-and-expand strategy, driving over \$175 million in bookings during the quarter ending October 2025.
- Recent acquisitions of Red Canary and SPLX expand the addressable market into AI governance and proactive security operations.

### Investment Thesis

Zscaler (ZS) is a cloud security platform that acts as a switchboard between users and the internet. Instead of routing traffic through an on-premises firewall or VPN for remote employees, Zscaler operates on the principle of zero trust, where even traffic that would otherwise be authorized is inspected anyway.

Already in 2026, Zscaler has seen a 29% drop in its stock price connected to the adoption of these AI tools, trading at a historically compressed multiple. Market sentiment has been harsh on the software bucket, with the bear case being that 'vibe coding' and the rapid adoption of AI-based programming tools will allow companies to build internal tools much more efficiently and at a lower cost than paying a vendor. While we are overall skeptical of this view, we are more skeptical on the view that security providers can be replaced by AI tooling.

Overall, we believe that the network effect of updating databases with new threats as they appear and its high gross retention coupled with emerging fields like providing security for AI agents conducting autonomous functions on enterprise networks, make Zscaler a compelling buy in a sector beaten down by sentiment.

### Estimated Fair Value

EFV (Estimated Fair Value) = EFY27 EPS (Earnings Per Share) times P/E (Price/EPS)

EFV = E27 EPS X P/E = \$4.49 X 41.8 = \$187.68



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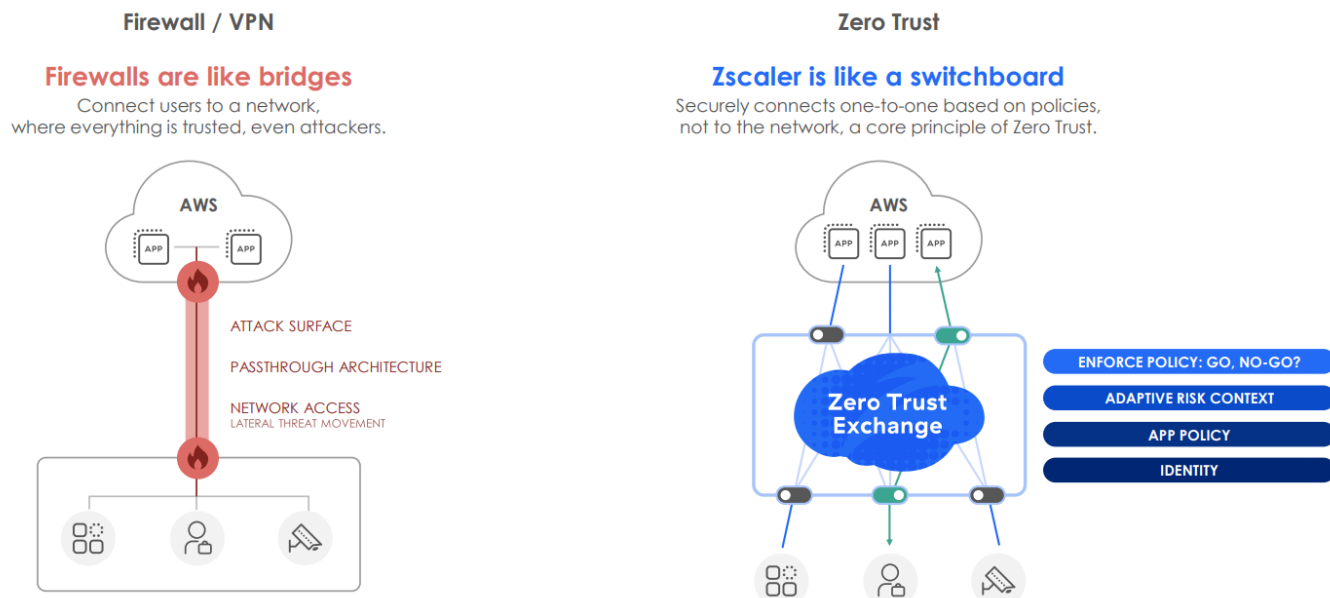
Zscaler is trading at a compressed multiple compared to its typical level, along with the rest of the software sector. While we do believe there are short-term margin headwinds at ZS, we do not believe that there is a broad threat to cybersecurity originating from AI software development tools.

	E2026	E2027	E2028
<b>Price-to-Sales</b>	7.7	6.5	5.4
<b>Price-to-Earnings</b>	41.8	35.6	29.1

SeekingAlpha Analyst Consensus

## Operations

In a traditional enterprise network, employees are filtered through a firewall and are typically connected to the network via a VPN. A common analogy in the industry is a 'castle and moat', where once you are past the moat, you are considered trusted. The weakness is, that if a user's credentials are compromised or attackers otherwise breach the moat they have full rein to attack a network.



Zscaler offers a 'zero trust' approach where every single request is treated as an outside request until inspected, and because Zscaler's software is cloud-based it does not add meaningful latency over a legacy system. According to investor materials, Zscaler processes more than 500 billion transactions daily across 50 million users. While



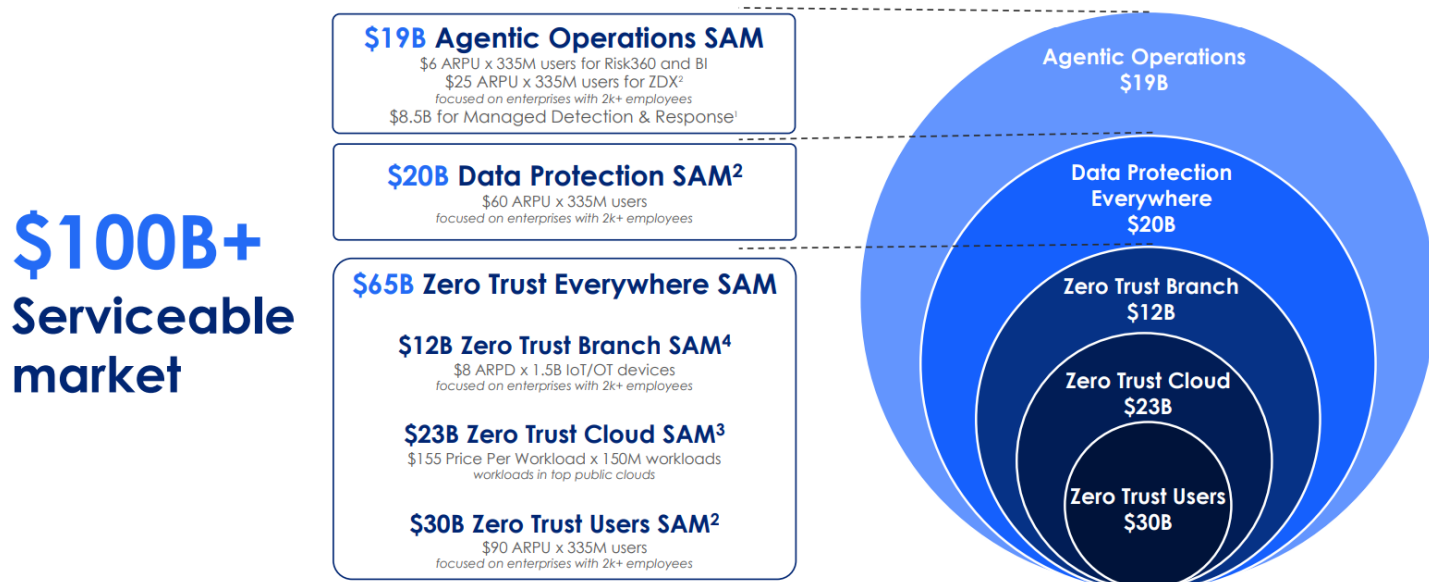
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impressive on its own, every time a novel threat is detected it instantly propagates across the network. This would be impossible to replicate internally, and with AI tools also being used to develop more advanced malware, traditional threats are becoming more frequent and more advanced.

## Growth and Expansion



Zscaler has heavily expanded into data security, which has \$450 million in annual run rate. Unlike a traditional firewall, these services prevent the transmission of unauthorized data out of the network. For example, it will scan the network to discover misconfigurations that may expose data to unauthorized individuals or scan for human-error, such as an unencrypted social security number sent over email. Of course, the data security platform also limits damage inside of a network should an attacker get through the zero-trust system, either through being an insider threat or a misconfigured database.

Outside of traditional threats, AI agents and AI tools are susceptible to attack themselves such as leaking of a system prompt, providing sensitive data to outside actors, or the AI ingesting information that causes it to generate harmful or incorrect content. Through the acquisition of [Red Canary in August 2025](#) and [November 2025 acquisition of SPLX](#), we believe Zscaler has become the dominant provider of AI-agent related security, which as of the quarter ending October 2025 already has exceeded the targeted run rate of \$400 million by 3 quarters, now estimated to exceed \$500 million in 2026. We believe that the \$500 million target is conservative, considering how prolific customer-facing AI-usage has become.



On the operations side, Zscaler has introduced Z-flex, which provides consultants and engineers to customers to allow them to deploy new Zscaler modules without re-entering the sales pipeline. We believe this will allow for a much more frictionless upselling process, as customers can add what they need as they need, such as AI-agent security without pre-deployment commitment. Quarter over quarter for the quarter ending October 2025, bookings originating from Z-flex grew 70% to \$175 million, including a Fortune 500 services firm doubling its ARR with Zscaler.

## Risk

We believe the largest risk to Zscaler is the bundling of security features in cloud-scalers like AWS or Microsoft Azure will be considered 'good enough' for most, and firms looking to cut costs may choose to avoid committing to a multi-year contract with Zscaler despite the superior service.

Management explicitly noted in the call for the quarter ending October 2025 that new products utilize public clouds and are optimized for faster go-to-market penetration rather than margins. Over the short-term, we believe that the acquisitions will be margin dilutive. While this will likely assist in upselling, it obviously will impact margins and earnings negatively.

Revenue concentration remains high, with the top 5 customers (and affiliates) making up around 30% of revenues. While the rip-out costs of Zscaler are high, it would not be out of the question for a large customer to scale back Zscaler tools. Pricing has become aggressive in the software space, with competitor PANW offering free services for the duration of a competitor's contract if a firm agrees to switch. We believe at least one of these customers is the US Federal government, as the disclosures state public-facing revenues are "significant". While it appears DOGE fizzled out without impacting Zscaler, increasing US expenditures will continue to put fiscal pressure on cutting costs.

## Financials

For the quarter ending October 2025, revenue grew 26% year over year, which was a reacceleration from FY25. Acceleration was largely driven by increases in AI and data security products from existing customers. While Zscaler does not break out revenue by vertical, 53.8% of the \$160.2 million increase in the quarter ending October 2025 was price increases and volume increases from existing customers. Total customer base grew 14% year over year, mostly because of new customers onboarded from Red Canary. As previously discussed, the direct Z-flex sales channel is growing rapidly with direct sales now representing 15% of revenue, up from 11% a year ago. Net retention for the quarter ending October 2025 was 115%, which was up 1% from last year, with performance obligations from contracts increasing 35% year over year to \$5.9 billion.



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GAAP gross margins contracted slightly to 76.6%, which was due to expansion of data center footprint and headcounts to manage new customers. Largely, we concur with management that gross margins will continue to expand over the long term toward the high 70s neighborhood as costs normalize and operating leverage continues to expand.

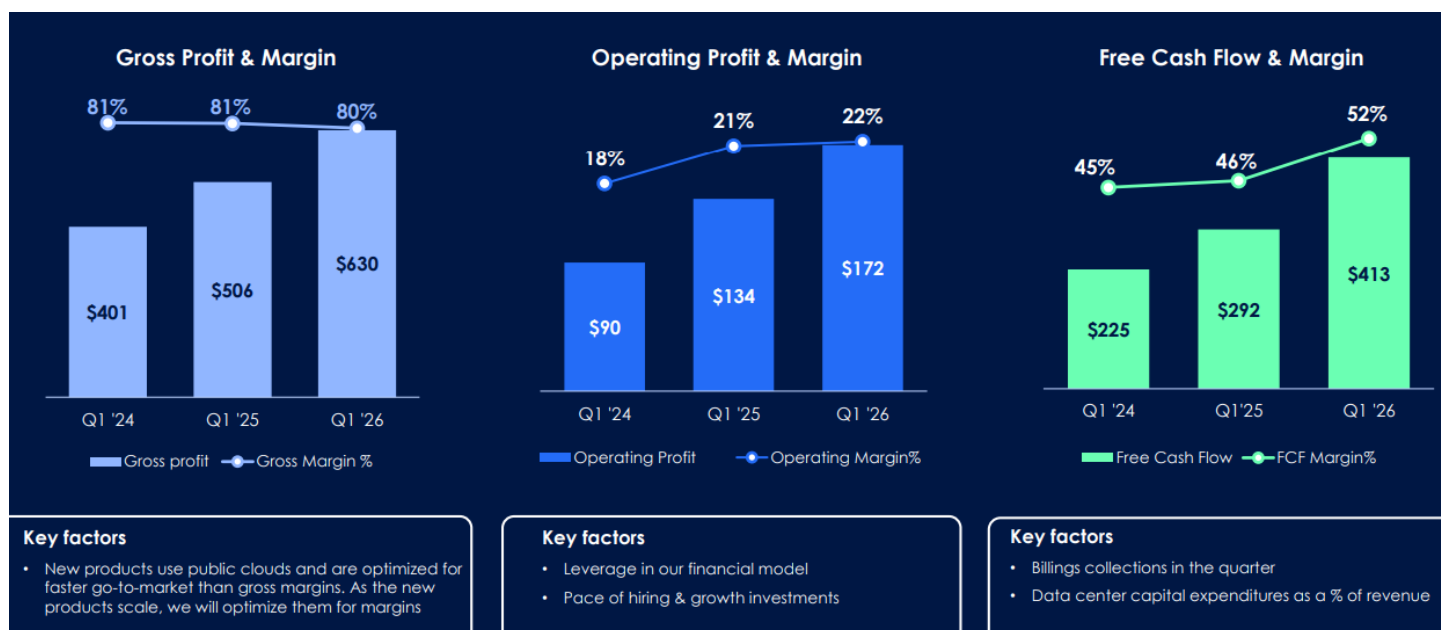
Operating margins are expanding, adding back stock based compensation and amortization of intangibles, operating margins expanded 0.40% to 21.8% year over year. Zooming out, since FY23, non-GAAP operating margins have expanded 6.80%, due to a reduction in sales and marketing expenses as well as administrative expenses leverage.



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For the full fiscal year ending July 2026, management is guiding toward 23.2% revenue growth at the midpoint. Management is guiding toward a flat non-GAAP operating margin, though we believe it is likely there will be some compression over the short-term as new products are being aggressively deployed onto higher cost public clouds for faster delivery rather than more cost-optimized instances. Free cash flow margin will be slightly down at around 26.3% from FY25's 27.2%, mostly due to timing and rising capex from new products.

The balance sheet is strong, with a 0.0% convertible in 2028 carrying \$1.7 billion. However, cash on hand is \$3.3 billion giving a net cash position. It is likely in our view that Zscaler will continue to target acquisitions in the AI space and will deploy cash aggressively to do so.

Our largest concern with financials is stock-based compensation, with FY25 deploying 25.6% of revenue to SBC which is high even in terms of the software sector. It is declining as a percentage of revenue as the company grows, but Zscaler does not conduct repurchases of its own shares and prioritizes acquisitions and infrastructure growth. While prioritizing growth is not a problem, we do expect the annual dilution of 3-4% to continue for the medium term, which in the quarter ending October 2025 was a \$1.16 per share drag on EPS quarterly.

## Conclusion

While there are short-term pressures on the stocks price due to what we believe is a market mispricing of AI risk and short-term margin pressure from acquisitions, we believe that Zscaler has an undeniable data moat and stickiness that makes it highly



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attractive. This data moat and best-in-class offering drives gross retention and new offerings in high growth areas should drive new customer growth and upselling potential to existing customers.

## Peer Comparisons

	Zscaler (ZS)	Fortinet (FTNT)	Cloudflare (NET)	Palo Alto Networks (PANW)	CrowdStrike (CRWD)
<b>Price-to-Earnings</b>	41.79	26.84	156.44	40.18	104.53
<b>Price-to-Sales (TTM)</b>	8.79	8.92	28.47	10.24	21.21
<b>EV-to-EBITDA (FWD)</b>	27.63	20.43	102.09	33.41	73.46
<b>EBITDA Margin</b>	-2.39%	32.74%	-0.52%	14.65%	-2.06%
<b>PEG (Non-GAAP)</b>	1.83	1.97	4.24	2.85	4.77



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This report was written by Julie Brown and reviewed and edited by Benjamin C. Halliburton.

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