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ZS.OQ - Q2 2024 Zscaler Inc Earnings Call

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## OVERVIEW:

Company Summary

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**Remo E. Canessa** Zscaler, Inc. - CFO

**Bill Choi** Zscaler, Inc. - Senior Vice President, Investor Relations and Strategic Finance

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**Andrew Nowinski** Wells Fargo Securities, LLC, Research Division - Senior Equity Analyst

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**Tal Liani** BofA Securities, Research Division - MD, Head of Technology Supersector & Senior Analyst

## PRESENTATION

### Operator

Good day, and welcome to the Zscaler Second Quarter 2024 Earnings Call. (Operator Instructions) Please be advised that today's conference is being recorded.

I would now like to hand the conference over to your speaker today, Bill Choi, Senior Vice President of Investor Relations and Strategic Finance. Please go ahead.

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**Bill Choi** - Zscaler, Inc. - Senior Vice President, Investor Relations and Strategic Finance

Good afternoon, everyone, and welcome to the Zscaler Second Quarter Fiscal Year 2024 Earnings Conference Call. On the call with me today are Jay Chaudhry, Chairman and CEO; and Remo Canessa, CFO.

Please note that we have posted our earnings release and a supplemental financial schedule to our Investor Relations website.

Unless otherwise noted, all numbers we talk about today will be on an adjusted non-GAAP basis. You will find the reconciliation of GAAP to the non-GAAP financial measures in our earnings release.

I'd like to remind you that today's discussion will contain forward-looking statements, including, but not limited to, the company's anticipated future revenue, calculated billings, operating performance, gross margin, operating expenses, operating income, net income, free cash flow,

dollar-based net retention rate, future hiring decisions, remaining performance obligations, income taxes, earnings per share, our objectives and outlook, our customer response to our products and our market share and market opportunity.

These statements and other comments are not guarantees of future performance, but rather are subject to risk and uncertainty, some of which are beyond our control. These forward-looking statements apply as of today, and you should not rely on them as representing our views in the future. We undertake no obligation to update these statements after this call.

For a more complete discussion of the risks and uncertainties, please see our filings with the SEC as well as in today's earnings release.

I also want to inform you that we'll be attending the following conferences in March. JMP Technology Conference in San Francisco on March 4, and Morgan Stanley TMT Conference in San Francisco on March 6.

Now I'll turn the call over to Jay.

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**Jay Chaudhry** - Zscaler, Inc. - Co-Founder, President, CEO & Chairman of the Board

Thank you, Bill. I am pleased to share our Q2 results, which once again exceeded our guidance for the top line and the bottom line even amidst an ongoing challenging macro environment. Revenue grew by 35% year-over-year and billings grew by 27%. Our customer base spending \$1 million or more continues to grow by over 30%. Our operating profit more than doubled year-over-year, and our free cash flow margin reached a record for Q2. During the quarter, we made solid progress on our strategy to scale our go-to-market engine to reach our goal of \$5 billion and beyond in ARR.

To augment our already strong sales team, we're adding more experienced leaders with a proven track record of running large operations. Considering these leadership changes, I am particularly proud of our field sales execution this quarter.

Before getting to the details of our fiscal Q2, let me share a few observations on the business environment. Based on my conversations with hundreds of CIOs and CISOs, I expect demand for zero trust security to remain robust in 2024 and expect customer budgets for zero trust to be up this year, particularly in light of the recent surge in the number of high-profile breaches.

Threat actors continue to exploit vulnerabilities of firewalls and VPNs, which allow them to spread ransomware, laterally inside an organization. In a recent example, a VPN vulnerability was so severe that CISA, the U.S. cybersecurity agency, took the extraordinary step of mandating that federal civilian agencies disconnect their Ivanti Policy Secure VPNs within 48 hours. This is yet another example of why customers are increasingly realizing that their security posture remains vulnerable and are motivated to transform their firewall-based security to our zero trust architecture.

Spinning up firewalls and VPNs in the cloud and calling it a SASE solution doesn't solve cybersecurity challenges while customers want to consolidate point products. They're looking for a fully integrated platform that delivers zero trust architecture. Cyber is so mission-critical that customers will invest in the industry-leading solutions rather than rely on cheaper or less effective products that are included as part of their ELAs. They want best-of-breed platforms with the best functionality that integrate with other platforms, thus eliminating dozens of point products.

Zscaler zero trust platform is an integrated and purpose-built solution that delivers comprehensive security and provides a compelling user experience while reducing cost. Strong customer interest in our platform drove a record first half total bookings with nearly half of net new bookings coming from new logo customers. We added a record number of new logos for our Q2. This demonstrates the momentum in our business, and we are increasing our outlook for revenue and billings for fiscal 2024.

We're operating in a strong demand environment for zero trust architecture. To capture this demand and scale our business to \$5 billion ARR and beyond, we appointed Mike Rich as our Chief Revenue Officer last quarter. Mike joined us from ServiceNow, where he established a scalable, go-to-market engine to drive deeper engagements with large enterprises. Going forward.

Mike and his team are focusing on 3 key areas. First, our existing opportunity-led sales engine has helped us deliver strong growth over the years, enabling us to surpass \$2 billion in ARR, to drive our next phase of growth, we are evolving from an opportunity centric to an account-centric sales motion, leveraging Mike's experience in building such plans.

As we grow our sales organization, we're adding more experienced leaders and strategic sellers with the right level of experience, working with CXOs and global system integrators. As we begin our planning for fiscal '25, we are developing account plans that are aligned with our customers' long-term strategic initiatives. And we are partnering with our customers to build transformation road maps to modernize their security and IT infrastructure. Second, we launched our top accounts pilot program a couple of quarters ago, which is successfully driving deeper platform engagements and adoption.

Building upon our initial success and leveraging Mike's experience, we are scaling this program across more top accounts. Third, we are increasing our focus on vertical selling. We introduced a vertical-specific sales motion a few years ago, starting with the public sector and expanded it to the health care vertical last year. Based upon the successful growth in these verticals, we plan to continue to expand the program into more verticals by adding domain experts who can drive vertical-specific strategies to better align with our customers' strategic initiatives.

We now have a double-digit number of customers spending more than \$10 million with us annually. With our expanded platform and these go-to-market initiatives, I believe we will see more and more of our large enterprise customers reach \$10 million ARR levels over time.

Now let me highlight 3 factors that drove our performance in Q2. First, we are seeing continued success in selling our broader platform, including ZPA, Data Protection, ZDX, Zero Trust for workloads, Zero Trust for branch and AI-powered solutions. Driven by upsells, our \$1 million ARR customer count grew by 31% year-over-year, ending the quarter with nearly 500 such customers.

Second, we had a strong federal quarter with particular strength in upsells to cabinet-level agencies. We have plenty of opportunity to expand further in the federal market. Third, we achieved a Q2 record for new logo additions, reflecting early success with our channel investments.

Our \$100,000 or more ARR customer base grew 21% year-over-year ending the quarter with over 2,800 such customers.

Let me highlight 2 new logo deals for the quarter. First, a Fortune 100 health care customer purchased ZIA, ZPA, ZDX and advanced Data Protection for 10,000 users in a 7-figure ACV deal. ZPA will greatly enhance their security and user experience while eliminating legacy security gateways by consolidating their VPN and VDI appliances.

Protecting patient health care records is of paramount importance to this customer, which made data protection, a crucial consideration for this deal. For the next phase, we are planning to expand to over 100,000 users, representing a significant upsell opportunity for us.

In another new logo deal, after suffering repeated ransomware attacks, a technology company purchased 20,000 seats of ZIA, ZPA, ZDX and advanced data protection, phasing out their legacy castle-and-moat firewall-based security, which failed to protect them against ransomware attacks. This customer excluded their incumbent firewall-based SASE vendor from consideration as they wanted a true zero trust architecture. This is a multiyear, 8-figure TCV deal, which is expected to generate over 100% ROI for the customer by eliminating the multiple firewalls, VPNs and VDI systems.

Now let me highlight 2 upsell deals that highlight broader adoption of our comprehensive platform. In a 7-figure ACV deal, an existing Fortune 500 financial services enterprise currently using ZIA, ZPA and data protection upgraded to our high-end ZPA transformation bundle and added endpoint DLP for 73,000 users. This also marks our largest endpoint DLP deal since the introduction of this module just 2 quarters ago in our Data Protection solution.

By moving to the high end of our ZPA and data protection packages, this customer increased their annual spend with us by over 60% to over \$10 million annually. In another 7-figure ACV deal, a major global mining company increased their ZIA and ZDX purchases to 48,000 users and purchased ZPA transformation for 30,000 users. With the ZPA purchase, the customer is eliminating their VPN appliances and providing Zero Trust access for the workforce spread across remote locations worldwide.

With this expanded purchase of our platform, the customer's annual spend with us nearly doubled to approximately \$5 million.

Next, let me discuss our opportunities in the federal market. As I mentioned earlier, we saw strong growth in net new ACV from the federal vertical in Q2. After our initial lands at 12 of the 15 cabinet-level agencies, we continue to win additional awards as agencies are increasingly adopting zero trust architecture to meet the President's executive order.

For example, in a 7-figure upsell deal, an agency customer expanded its seats with ZIA, ZPA and Data Protection purchases, nearly doubling the annual spend with us. With this upsell, the customer is already approaching \$5 million in annual spend, even though we are still less than 15% penetrated in terms of the number of users representing a significant upsell opportunity in this agency.

With the highest levels of FedRAMP certifications for both ZIA and ZPA, we are very well positioned to benefit from continued growth with our federal customers. Building upon our success in the U.S., we are investing in building public sector programs for half a dozen nations that have adopted FedRAMP-like certification programs. This is a significant opportunity for us. But like any government initiative, this will take time.

Moving on, our R&D engine continues to deliver innovations, rapidly, expanding our platform and providing larger upsell opportunities. Given our strategic position, we are interacting with more CXOs than ever before and having much deeper engagements. For example, we recently hosted a CXO Summit in India attended by over 200 senior IT leaders, including over 100 CXOs.

At the summit, one CXO said, and I quote, "The velocity of features that Zscaler releases every time we meet is extremely impressive." Our comprehensive platform protects not just users, but also workloads and IoT OT devices. While still early, we're seeing growing traction in our emerging platform solutions, including Zero Trust for workloads, Zero Trust for branch and Zero Trust for B2B as well as our AIML-powered solutions.

Zero Trust for workloads continues to gain wider adoption. For example, in an upsell win, a financial technology company purchased Zero Trust for workloads for 25,000 workloads, which contributed to nearly doubling their annual spend with us to over \$1 million. A large aerospace company more than tripled their Zero Trust for workloads purchase, contributing to a 60% increase in their annual spend with us to over \$1 million.

In January, we launched Zero Trust for branch, which enables one-to-one connectivity between branch devices and applications, thus securing branch IoT/OT devices and eliminating the risk of lateral threat moment. our Zscaler plug-and-play appliance would be the only solution customers will need at the branch as it eliminates the need for legacy SD-WAN appliances, routers and firewalls, thus dramatically simplifying branch networking and security.

Zero Trust for branch is a key component of our Zero Trust SASE solution, which is the industry's first single vendor SASE solution built on Zero Trust. Zero Trust SASE pairs Zscaler's leading SSE with our new Zero Trust SD-WAN. We have seen early adoption of our Zero Trust SASE from customers across a range of industries, including a U.S.-based energy and retail company, a Europe-based Fortune 500 manufacturing company, a U.S.-based financial services company and many more.

Moving to our AI cloud. Within this portfolio, our newest products, Risk360 and Business Insights are growing rapidly. Business Insights is helping CIOs and CFOs optimize cost of their SaaS applications, office locations and more. For example, an existing Global 2000 consumer products customer purchased Business Insights for 97,000 users to replace their homegrown solution that cost over \$0.5 million annually. Recently adopted SEC disclosure requirements and board level interest in understanding cyber risk are driving demand for Risk360. For example, a Global 2000 manufacturing customer purchased Risk360 for nearly 16,000 users to automate the process of risk quantification and take proactive measures to reduce cyber risk.

We have already delivered several innovations, including ML-based data classification, ML-based policy recommendations, Risk360, Business Insights and more. In addition, one of our AI products, I am particularly excited about, is breach predictor. Breach predictor is our vision to leverage the power of our platform to predict breaches before customers get breached. We are working relentlessly to bring this and more industry-leading AI innovations to our customers this year. With our innovation engine humming and delivering cutting-edge products and our go-to-market organization focus on scaling and growth, I am more excited than ever about the opportunities ahead of us and our ability to capitalize on those opportunities.

Now I'd like to turn over the call to Remo for our financial results.

**Remo E. Canessa** - Zscaler, Inc. - CFO

Thank you, Jay. Our Q2 results exceeded our guidance on growth and profitability, even with ongoing customer scrutiny of large deals. Revenue was \$525 million, up 35% year-over-year and up 6% sequentially. From a geographic perspective, Americas represented 54% of revenue, EMEA was 31% and APJ was 15%.

Our total calculated billings in Q2 grew 27% year-over-year to \$628 million. On a sequential basis, total billings increased 37% quarter-over-quarter. Our calculated current billings grew 26% year-over-year. Our remaining performance obligations, or RPO, grew 29% from a year ago to \$3.613 billion. The current RPO is approximately 51% of the total RPO. We ended Q2 with 497 customers with greater than \$1 million in ARR, adding 29 such customers in the quarter.

We also saw strength in \$100,000 ARR customers this quarter, which grew to 2,820, adding 112 customers sequentially. This continued strong growth of large customers speaks to the strategic role we play in our customers' digital transformation initiatives. Our 12-month trailing dollar-based net retention rate was 117%. While good for our business, our increased success in selling bigger bundles, selling multiple pillars from the start and faster upsells within a year, can reduce our dollar-based net retention rate in the future. There could be variability in this metric on a quarterly basis due to the factors I just mentioned.

Turning to the rest of our Q2 financial performance. Total gross margin of 80.8% compares to 80.7% in the prior quarter and 80.4% in the year ago quarter. On a year-over-year basis, gross margin benefited by approximately 60 basis points from a change in accounting attributed to the longer useful life of our cloud infrastructure. As mentioned on our previous earnings call, beginning fiscal 2024, we extended the depreciable useful life of our servers and network equipment in our cloud infrastructure from 4 to 5 years.

Moving on, our total operating expenses increased 3% sequentially and 22% year-over-year to \$321 million. We continue to generate significant leverage in our financial model with operating margin reaching 19.6%, an increase of approximately 700 basis points year-over-year.

Our free cash flow margin was 19%, including data center CapEx of approximately 6% of revenue. We ended the quarter with over \$2.4 billion in cash, cash equivalents and short-term investments.

Next, let me share some observations about the macro environment and our framework for guidance for the rest of the fiscal year. We believe we are still operating in a challenging macro environment and customers continue to scrutinize large deals. Customer interest in our platform remains strong, and we're adding experienced sales leaders to our already strong sales team to position us well for sustainable growth in the long term.

In our outlook for fiscal 2024, we're balancing our business optimism with ongoing macro economic uncertainties and sales leadership changes.

Moving on to guidance for Q3 and full year fiscal 2024. As a reminder, these numbers are all non-GAAP. For the third quarter, we expect revenue in the range of \$534 million to \$536 million reflecting a year-over-year growth of approximately 28%. Gross margins of 80%. I would like to remind investors that a number of our emerging products, including the newer products like ZDX and Zscaler for workloads will initially have lower gross margins than our core products. We're currently managing the emerging products for time to market and growth, not optimizing them for gross margins.

Operating profit in the range of \$98 million to \$100 million, net other income of \$15 million, income taxes of \$10 million, earnings per share in the range of \$0.64 to \$0.65, assuming 161 million fully diluted shares.

For the fiscal year 2024, we're increasing our guidance as follows: revenue in the range of \$2.118 billion to \$2.122 billion, reflecting year-over-year growth of approximately 31%. Calculated billings in the range of \$2.55 billion to \$2.57 billion or year-over-year growth of 25% to 26%. From a modeling perspective, Q3 is typically our seasonally weaker quarter.

Consistent with our historical seasonal patterns, we expect billings to decline sequentially by approximately 7% in Q3. Operating profit in the range of \$395 million to \$400 million, which reflects up to 400 basis points of operating margin improvement compared to last year. Income taxes of approximately \$35 million.

Earnings per share in the range of \$2.73 to \$2.77 assuming approximately 161 million fully diluted shares. We expect our free cash flow margin to be up year-over-year and in the low 20% range.

We continue to expect our data center CapEx to be high single-digit percentage of revenue for the full year, reflecting the 3 percentage points to 4 percentage points of headwind to free cash flow margins. We expect the timing of CapEx spend to be more towards the later part of the second half of the year as we invest in upgrades to our cloud and AI infrastructure.

With a large market opportunity and customers increasingly adopting the broader platform, we plan to continue to invest significantly to drive long-term growth while increasing profitability.

Before moving on to Q&A, I would like to note that Bill Choi, our Senior Vice President of Strategic Finance and Investor Relations, who will be leaving us in a couple of weeks. This is a bittersweet moment for me as Bill has been instrumental in building the finance practice here, but happy for him as he's moving to pursue his first CFO opportunity at an AI networking company. We wish him great success in his next endeavor.

With that, operator, you may now open the call for questions.

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## QUESTIONS AND ANSWERS

### Operator

(Operator Instructions) Our first question comes from Alex Henderson with Needham.

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### Alexander Henderson - *Needham & Company, LLC, Research Division - Senior Analyst*

Well, first off, I've got to say, Bill, it was great working with you, and congratulations on progression in your career. As for you guys on Zscaler, a nice quarter. The first question I have for you is really against the backdrop of already expected difficult decision-making environment. Has there been any change in deal size and deal process time, closure rates, win rates over the last quarter that might show some incremental improvement versus where we were in the prior quarter? Are there any green shoots evident in those key metrics?

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### Jay Chaudhry - *Zscaler, Inc. - Co-Founder, President, CEO & Chairman of the Board*

Alex, thank you for the question. The short answer is we haven't seen any meaningful change for a number of things you mentioned. Take for example, macro. It's pretty much a similar environment. Our deals keep on growing. We are doing large deals. So there's no big significant pressure on deals. We do see demand for cybersecurity products remaining strong. Customers do have budget for cyber, even though they may be tightening budget for IT overall. And this is because Zero Trust is a top priority.

But it boils down to 2 things when I talk to lots of CIOs. They do want to take care of cyber. But if you can fix cyber and reduce cost at the same time, it becomes a much better situation. Zscaler happens to be in a position where we do it extremely well. If you look at most on products out there, they don't save money. In fact, security generally is a cost. We replaced a number of point products, save money, give far better security, hence, we are sitting in a pretty good shape.

**Operator**

Our next question comes from Brad Zelnick with Deutsche Bank.

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**Brad Zelnick** - *Deutsche Bank AG, Research Division - MD of Software Equity Research & Senior US Software Research Analyst*

And congrats to you, Bill. It's been a fun ride since the IPO. Jay, just following the last question, I appreciate your comments on the environment. You obviously had one of your key competitors last week talking of customer fatigue. And you guys are, at least in the federal market, you're telling us a little bit of a different story. But can you specifically share thoughts about competitors giving away free product and the impact it can or is already having on Zscaler and maybe the extent to which you're factoring that into your outlook ahead?

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**Jay Chaudhry** - *Zscaler, Inc. - Co-Founder, President, CEO & Chairman of the Board*

Yes. Thank you, Brad. We really do not see any cyber spending fatigue among our customers. In fact, many of the CIOs had told me that cyber is a priority for spend, but they do have ELA fatigue because a lot of stuff has been becoming shelfware and it's being scrutinized. Regarding free stuff. Many vendors have been trying to give it away for a while, and we have been successfully winning against this strategy for a long time. I mean look at our retention rate, it used to be in 90s at IPO. Now it's high 90s. And fundamentally, cyber is so mission-critical that customers will invest in the industry's leading solution rather than rely on cheaper and less effective products that are included as a part of an ELA bundle.

Look, we are really dealing with a secular trend here. Just like the role of data center diminished and public cloud took off, similarly, the role of firewalls is diminishing and the demand for Zero Trust security is growing. And this is bound to impact sales of firewall vendors and this naturally puts the legacy vendors in a defensive position and they're trying to give away products as bundles, which end up becoming shelfware and this strategy starts to unravel over time. We'll stick to our strategy.

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**Brad Zelnick** - *Deutsche Bank AG, Research Division - MD of Software Equity Research & Senior US Software Research Analyst*

Jay, maybe just a quick follow-up, one for Remo. Remo, on the back half billing seasonality that you set up now for us, can you just maybe speak to any factors we may want to consider and what it is that drives your confidence? And now it looks like a pretty big sequential Q4 as you've set it up for us.

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**Remo E. Canessa** - *Zscaler, Inc. - CFO*

Yes. I mean we made a go-to-market change during the quarter. As you're aware, Mike Rich, Mike has hit the ground running and is doing an absolutely outstanding job, balancing the strength that we've got with our sales organization as well as bringing new leadership in. If you take a look at our guide for the year, it is slightly up. We're being prudent.

The key thing, I think, for our investors to recognize and what Jay said, this is a large market opportunity. It's a huge market opportunity. And when it's a huge market opportunity, when you look at companies giving away things for free, especially in security, that's one area that basically I wouldn't short change. So what we're seeing with the market opportunity, our engagement with our customers, with Mike Rich on board, we feel good about our guidance going forward.

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**Operator**

Our next question comes from Andrew Nowinski with Wells Fargo.

**Andrew Nowinski** - Wells Fargo Securities, LLC, Research Division - Senior Equity Analyst

Bill, certainly going to miss you. Can wait to see where you land next. And then overall, just a great quarter. Congrats on another strong execution. I wanted to ask you guys about the U.S. federal sector. It sounds like you had some strong upsells and the U.S. Fed may have contributed to some of your upside this quarter. Do you think some of these agencies that you mentioned that are really underpenetrated they might serve as a role model to other agencies in the U.S. government, which could help you continue your growth there? And how does your pipeline look in the U.S. Fed over the next few quarters?

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**Jay Chaudhry** - Zscaler, Inc. - Co-Founder, President, CEO & Chairman of the Board

As you know, we've been investing in the federal market for quite some time. We got the highest level of certification, and we're doing very well. In fact, we are heavily engaged with all federal agencies, including DoD, 12 of the 15 agencies are our customers. In my prepared remarks, I talked about the federal deal where we doubled the number of users and we doubled our ARR to approximately about \$5 million. And with this, we are less than 15% penetrated in the agency in terms of number of users, which means there's 85% wide space to go up there. We feel good. We keep on investing in it. And I think it's a strong area for us. Remo?

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**Remo E. Canessa** - Zscaler, Inc. - CFO

Well positioned. And as Jay mentioned, 12 to 15 basically agencies that we're in. These are big deals that in federal, it's hard to predict when these deals are going to close. From our perspective, we're well positioned very well positioned going forward. We've made significant investments with our certifications and also our team, which we feel is outstanding. So the answer to your question, Andy, is we feel good about federal. But again, bigger type deals, hard to forecast, but we feel good.

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**Operator**

Our next question comes from Tal Liani with Bank of America.

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**Tal Liani** - BofA Securities, Research Division - MD, Head of Technology Supersector & Senior Analyst

I have a small question and a big question. The small one is about billing. It's -- you guided down 7% sequentially and then guided up 53%, if I take the implied 4Q, which is the highest growth in billing. You had the same problem last year. What's the meaning of it? What's the meaning of billing being weak and then billing being so strong in the fourth quarter? What needs to happen for it to materialize? So that's a small one. The bigger one, Jay -- maybe you wanted me to take it one at a time or you wanted just to ask both?

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**Jay Chaudhry** - Zscaler, Inc. - Co-Founder, President, CEO & Chairman of the Board

No, go ahead. Go ahead.

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**Tal Liani** - BofA Securities, Research Division - MD, Head of Technology Supersector & Senior Analyst

Jay, the second one is a bigger question. SASE is -- used to be a secure, very safe market for you because there were only 2 players and maybe 2.5 players. And now we're seeing tons of competition coming in and competition is coming at very low pricing. And Fortinet is talking about 1/3 of your price and the newcomers are coming either through bundling, which enables them to reduce price or as an add-on to a firewall, which again, enables them to bundle and reduce price. And if I ask the question in a provocative way, I'll ask it what prevents this market from turning into what happened to FireEye and what happened to sandboxing that when competition started pricing collapsed in the market?

**Jay Chaudhry** - Zscaler, Inc. - Co-Founder, President, CEO & Chairman of the Board

Remo start, would you?

**Remo E. Canessa** - Zscaler, Inc. - CFO

So the things that we've got going on in the third quarter -- first of all, this is our normal range, sequential decline over the last 5 years from Q2 to Q3. I talked about on a prior question, the go-to-market changes that we've made. That certainly plays into things. Related to the back half in the fourth quarter with the implied increase basically in billings, it's related to pipeline, close rates. And the forecast that our teams come up with. Again, from our perspective, we feel it's prudent guidance. We feel good about it. And we feel that we are in a great position to go forward with the team that we have and will build in our sales organization.

**Jay Chaudhry** - Zscaler, Inc. - Co-Founder, President, CEO & Chairman of the Board

Yes. Regarding your bigger question, the SASE market and the competition. Let me put it this way, data point products and the platforms you absorb point products into platforms. And then there are products that are mission-critical, they're products that are not mission critical. FireEye sandbox was a feature from day 1, there's not a much barrier to entry. Everyone could build and add it into the main platform.

CASB was a point product all in all became that way. Cloud security posture management, a point product that's bundled with something. And then there's something called platform, for example, the core of a platform, Zero Trust architecture, proxy-based sitting online, inspecting traffic, and you add things to it. So it's almost like ERP. You see lots of product going out in many areas. Customers don't remove and put in an ERP for vendor A or vendor B because somebody feels like a need to enter the ERP space. I think SASE market is almost like that.

This is so mission-critical, all traffic goes through us. In fact, the CIO told me, "Jay Zscaler is more mission-critical than Microsoft Office 365 because you must work all the time." So with that in mind, our customers when I look at this thing, price is a secondary factor, reliability, availability and effectiveness of doing cyber protection is an important factor.

My customers also tell me that, they have so many firewalls, so many VPNs and the threats are growing, so the credibility of firewall vendors overall is less. Maybe I can use another analogy. You want to buy a pacemaker, you don't try to cut corner and buy one at sale. You want to buy something else. Yes, you may be able to do so.

Yes, competition is coming. We see that, but I can tell you some of the new firewall vendors that announced SASE entrance, I haven't come across them in the recent months as I've seen out there. I think as a platform keeps on going, we started with outbound traffic -- no, inbound traffic. The platform must have the most comprehensive data protection. Not only these firewall vendors can do a lot of data protection, data protection starts with a proper SASE architecture. Then we moved on to expand to workloads to IoT/OT and onto B2B and the pace of innovation is keep on going. I'm very comfortable that our platform story.

I need -- we need to keep on focusing on go-to market to keep on growing faster and faster. I hope that helps.

**Operator**

Our next question comes from Rob Owens with Piper Sandler.

**Robbie Owens** - Piper Sandler & Co., Research Division - MD and Senior Research Analyst

Could you touch a little bit more on your vertical selling motion and maybe some of those new markets that you will have special overlays for. And I would love a little more commentary around your success with your IoT/OT solution.

**Jay Chaudhry** - Zscaler, Inc. - Co-Founder, President, CEO & Chairman of the Board

Yes. So let's start with vertical market first. About 5 or 6 years ago, we started with the first vertical that was our public sector. And then within that vertical, we expanded into federal government and state government, education and the like. And those things have been very successful for us. About a year ago, we expanded to health care verticals. And then now we want to expand to a couple of more verticals. When a company gets to a certain level, you can actually afford to go vertical because vertical requires a decent amount of footprint. Vertical requires some of the expertise in those areas.

For example, we have hired some people who come from very good background who have spent time in those vertical markets. So we think it's a good natural area for us to expand. And it's not a new -- something totally new for us. We've been there, done it, we need to know. We need to learn how to expand it. For example, financial is a strong market for us. It's almost like a vertical today, though it's not a formal vertical. So we'll see. You'll see expanding in more verticals. That was a fast part. The second part of the question -- what was the second part? That's good. Rob, thank you.

**Operator**

Our next question comes from Matthew Hedberg with RBC.

**Matthew Swanson** - RBC Capital Markets, Research Division - Associate VP

Yes. This is actually Matt Swanson on for Matt Hedberg. I wanted to follow up on Andy's earlier question on the federal vertical. You've been at a place that's been a little bit mixed among your peers and with the strong results, just has anything changed from your perspective from a competitive standpoint? Or you mentioned the Zero Trust mandates. Are there things that are changing the federal government that are leaving Zscaler better positioned relative to some of your peers that maybe have seen a little weakness in that vertical?

**Jay Chaudhry** - Zscaler, Inc. - Co-Founder, President, CEO & Chairman of the Board

We have seen no weakness, no slowdown in the federal market. In fact, the adoption of Zero Trust keeps on going, especially under a president's mandate. So all agencies, whether federal government on the civilian side or defense side, we've got strong engagements, and we feel very good about it. But as Remo said, some of these deals can be big and lumpy. But we are in good shape. And the certification we got at the highest level for all products puts us in an especially very good position and our strong sales team in place.

**Operator**

Our next question comes from Fatima Boolani with Citi..

**Unidentified Analyst**

This is Mark on for Fatima. Can you maybe just speak up a little bit more on the leverage you guys recognized in this quarter? And then really the meaningful pivot on the margin expansion, even though there's a lot of pretty long roster of initiatives you guys are looking to implement such as verticalization. So any sorts of leverage performance this quarter? And how does sort of your investment stance or philosophy differs today versus maybe 3 months ago?

**Bill Choi** - Zscaler, Inc. - Senior Vice President, Investor Relations and Strategic Finance

Mark, it's actually very hard to hear you. So what I picked up was you were asking about a little more information about our vertical approach. Is that correct?

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**Unidentified Analyst**

Can you hear me now?

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**Jay Chaudhry** - Zscaler, Inc. - Co-Founder, President, CEO & Chairman of the Board

A little better.

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**Bill Choi** - Zscaler, Inc. - Senior Vice President, Investor Relations and Strategic Finance

A little better, yes.

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**Unidentified Analyst**

Okay. Great. Sorry about that. So we were just more so wondering, can you maybe speak a little bit more on the leverage you guys recognized this quarter and then maybe the meaningful pivot on the margin expansion. We know that there's a lot of initiatives you guys are looking to implement such as verticalization. So we just wanted to get a sense of the source of leverage performance this quarter? And how does your investment philosophy basically differs today versus 3 months ago and going forward?

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**Remo E. Canessa** - Zscaler, Inc. - CFO

So I'll take that. I believe, Mark, you're talking about operating leverage. So we exceeded in revenue, our gross margins were higher, and our operating expenses came lower. Having said that, we did hire significantly during the quarter and will continue to hire as we go forward. The key thing, I think, to really think about Zscaler is that, we are early in this market. We have a model, which we've talked about in the past that we can leverage related to operating profitability and free cash flow.

We've shown 700 basis points increase in operating profitability on a year-over-year basis. In one way, that's great. And another way is, we need to continue to invest. So our focus is still grow, we'll be mindful and manage our operating profitability and free cash flow. But this is a huge market opportunity. And quite frankly, with Mike Rich on board and our focus that we're going to have towards large accounts and penetrating large accounts, what we talked about is that we have a 6x opportunity in our existing installed base to upsell new products.

And also when you take a look at the penetration of the market, it's in the teens, probably that Zscaler has. So large market opportunity, the ability to leverage upwards, profitability and free cash flow. When you take a look at our contribution margin in years 2 and 3, it's over 60%, a lot of levers we can pull. And so we feel good about where we are. We're going to continue to invest, and we will manage our operating profitability. But again, I'm not concerned about hitting our operating profitability targets or free cash flow. Our model is well built, especially with 80% gross margins to do that. Jay, anything to contribute?

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**Jay Chaudhry** - Zscaler, Inc. - Co-Founder, President, CEO & Chairman of the Board

No, very clear.

**Operator**

Our next question comes from Roger Boyd with UBS.

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**Roger Boyd** - *UBS Investment Bank, Research Division - Associate Analyst*

Great. Bill, first off, congrats. I think Remo summarized it best when he called it a bittersweet moment. But Jay, I was wondering if you could expand on how you're approaching SD-WAN and single vendor SASE market, really how that approach differs from traditional vendors there and how you see this changing your competitive standpoint in the market for security edge in general?

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**Jay Chaudhry** - *Zscaler, Inc. - Co-Founder, President, CEO & Chairman of the Board*

Yes. We have always wanted to make sure we deliver Zero Trust solutions. SD-WAN was a good technology because it was cheaper. But SD-WAN did nothing for security. SD-WAN enables the same lateral movement that the previous networks did. So -- but our customers do want to simply file branches. So they've been talking to us, we launched our Zero Trust for branch solution a few months ago, and then actually there was a January, the second release of that. So with that, we actually are making available plug-and-play points that you simply ship, you drop in the branch, you plug on the Internet and its auto discovers and in 15 minutes, it's up and running, no route tables to manage, no zero trust architecture, makes it wonderful.

So our customers are very excited about it. So really -- so that is our Zero Trust SD-WAN. It's not traditional SD-WAN. So combined, with our SSE and Zero Trust, so we are actually offering a full SASE solution for the first time in the market zero Trust SASE solution. I can tell you the number of customers who are eager and ready to roll it out is very large. We are already working with a number of customers, but over the coming quarters, I'm very bullish with the success of this new offering. And it has the full potential to disrupt traditional SD-WAN and traditional SASEs as well.

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**Operator**

Our next question comes from Brian Essex with JPMorgan.

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**Brian Essex** - *JPMorgan Chase & Co, Research Division - Research Analyst*

First of all, Bill, congratulations from me as well. It's great to see your success. Maybe Jay -- sure. Maybe, Jay, for you, we've seen a little bit of executive turnover here as we watch the story from the side lines and would love to get your sense of -- and obviously, some of these make a lot of sense, right? People come as a team, people leave as a team, there are relationships there. And you did a great job previously calling it out as being a factor of conservatism in your outlook. So maybe a 2-parter for me. One, has turnover been what you expected it to be, particularly given what you've kind of like folded into your guidance? And then two, maybe frame out what kind of -- or how deep and meaningful some organizational changes that Mike Rich might be driving within the organization?

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**Jay Chaudhry** - *Zscaler, Inc. - Co-Founder, President, CEO & Chairman of the Board*

Okay. Good. So starting with our sales attrition is down in the quarter. And second, when leaders leave, it's natural for some people to follow. But as you know, Zscaler has become a very big brand. We have become a top destination for top talent, and we are no short in attracting some of the best and the brightest sales leader and account manager in the market. Mike has built and he continues to build a strong team that includes many, many good leaders.

Now when it comes to these organization changes as we mentioned last time, we are evolving our sales model. There's no wholesale meaning significant change. We -- years ago, we had to move to top-down, concerted selling at the C-level because that's what drives transformation. Remember, I said when I used to go and sell to box huggers, they would kind of say, please go away. So our process has been top down. It has been

strategic. It's aligned with the background Mike brought from. So we have been doing a lot of that stuff, the business value assessment top accounts type of stuff. So these are evolutionary changes, and they're not really -- they're not large scale change across. So we are pretty comfortable in evolving from where we are to get to where we need to go.

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**Operator**

Our next question comes from Peter Levine with Evercore ISI.

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**Peter Levine** - *Evercore ISI Institutional Equities, Research Division - Analyst*

And Bill, congrats on the opportunity. Two parts. One, can you maybe help us understand where NRR maybe troughs out where you see that trending throughout '24, perhaps, into fiscal '25. And then Jay, you had comments and maybe the back of the last question on opportunity-centric through more of an account-centric sales motion. Maybe explain to us really what that means and who kind of somewhat initiated that change?

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**Remo E. Canessa** - *Zscaler, Inc. - CFO*

Yes. I'll answer the NRR question and Jay can answer the opportunity question. So we don't guide to NRR. And quite frankly, we only look at NRR at the end of each quarter. So we're not providing any guidance on NRR. It can be impacted as we called out on the script related to large deals or more being bought upfront, customers buying within the quarter. So it is a metric that it's going to move around. But again, we do not provide any guidance on NRR. .

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**Jay Chaudhry** - *Zscaler, Inc. - Co-Founder, President, CEO & Chairman of the Board*

Okay. The second part, opportunity-centric versus account-centric. In an opportunity-centric model that normally engages on a tactical basis with customers like all being where is my opportunity, where's the deal. Let me close the deal. In the account-centric sale, we create account plans. We focus on growing the accounts.

Now when you are a young company, you don't have that many customers, you naturally are opportunity-centric, and it serves you well. At our stage, a large number of customers, it is important for us to move it towards being account-centric. We have a large platform to sell. So once we land, working that account, creating a joint plan to expand becomes far more effective. And as we scale to \$5 billion ARR and beyond, so evolving to really will become a long-term strategic partner with the customer. We have been doing it at a small scale in some pockets of the business. Now we want to take it across at a larger scale.

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**Operator**

Our next question comes from Gregg Moskowitz with Mizuho.

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**Gregg Moskowitz** - *Mizuho Securities USA LLC, Research Division - MD of Americas Research*

Bill, congrats to you. It's been a pleasure. I have a question for either Jay or Remo. Some investors are harping just a bit on short-term billings slowing down a little this quarter. But conversely, based on my numbers, both RPO bookings and CRPO bookings actually accelerated this quarter, which is impressive. So just to level set for all of us because we know that these metrics can sometimes be a little noisy. Is there any incremental slowdown that you have observed in any facet in the Q2 or any change in the level of execution?

**Remo E. Canessa** - Zscaler, Inc. - CFO

First of all, RPO, CRPO is based on contracted value. And again, those did very well. Billings is actually what's being built. So there's always going to be differences between CRPO and RPO versus short-term billings. The -- and in billings. As the company gets bigger, it's just -- the numbers are growing, but the numbers are -- it's -- you're not going to get the type of growth rates 4 or 5 years ago. But again, from my perspective, the short-term billings growth rate of 26%. That's very good. That's outstanding.

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**Operator**

Our next question comes from Keith Bachman with BMO.

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**Keith Bachman** - BMO Capital Markets Equity Research - Research Analyst

Remo, I wanted to start with you, if I could. I wanted to turn the federal comments around a little bit. Your federal business has been very strong for a number of different quarters. And in the past, you've actually provided some context of growth on the federal stand-alone. And I just wanted to see if you could revisit that. And the lens that I'm putting on the question is there's been some investor concern that your federal business has been outstanding and yet that would suggest that there's been a more -- a greater slowdown, if you will, on the corporate business. So I just wanted to see if you could provide any context for that?

And then Jay, perhaps for you is you actually, in your prepared remarks, talked about I think you said 1/2 of your net new bookings were from new logos, if I heard you correctly, which is a very strong metric. And I just wondered if you could characterize how you see that unfolding, new logos in particular, as you look out over the next number of quarters? And congrats to Bill.

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**Remo E. Canessa** - Zscaler, Inc. - CFO

Keith, I'll start. The federal business has been good for us as I mentioned, we're well positioned. We'll provide color on the contribution of federal on an annual basis. Having said that, I'll go out and put my neck out which (inaudible) -- Maybe I should but...

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**Keith Bachman** - BMO Capital Markets Equity Research - Research Analyst

Bill's leaving so it's safe.

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**Remo E. Canessa** - Zscaler, Inc. - CFO

Bill's leaving. That's right. He keeps kicking me under the table. We're well positioned in federal. It really comes down to execution. Let the numbers play the way they play. We'll see how it plays through. But we feel good about our federal business. It's been strong. I would not say it's been carrying us. That's the key comment. But it is basically a vertical that I see that we have a lot of potential, we just need to execute.

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**Jay Chaudhry** - Zscaler, Inc. - Co-Founder, President, CEO & Chairman of the Board

Yes. And nonfederal is pretty good, too. So I mean, we are bullish about both sides of the business. Moving to the second part, yes, business, strong business coming from net new logos, it's good. In terms of future, and our customer base is getting bigger and bigger, and we have lots of platform to sell. From a rational point of view, I think we have been planning upsell being in the, whatever, 60%, 65% range, somewhere out there, Remo, and new logo, the rest. So I think that's really how we see us moving forward. .

Now part of the thing that I'm excited about is, we are seeing more and more \$1 million customers being on board. The number is about almost 500 customers that are \$1 million then they are trying to get to \$5 million and \$10 million. So we are getting towards getting more and more customers, \$1 million to \$5 million to \$10 million that's probably the bigger target than trying to get lots of new logos by count of logos.

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**Operator**

Our next question comes from Josh Tilton with Wolfe Research.

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**Joshua Tilton** - *Wolfe Research, LLC - Research Analyst*

Congrats, Bill, and I apologize for the amazing cafe music in the background. But the one question I have, that's been on my mind is just, none of what you guys are talking about, it kind of happens overnight. So I guess were these sales changes factored into the initial guidance that you gave back in Q4? Or are you actually embedding incremental conservatism related to these changes in the outlook going forward?

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**Remo E. Canessa** - *Zscaler, Inc. - CFO*

I'll speak to basically both Q2 and Q3. In Q2, we said we we're expecting close rates to be slightly worse. Things came in pretty much as we thought they would. For Q3, in our assumption also there's a level of conservatism, slight again for Q3 related to close rates.

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**Operator**

We'll have our last question from the line of Peter Reed with AB Bernstein.

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**Petiri Reed**

And I guess following up maybe a couple of questions that we've had here. I mean I will agree -- impressive to see the continued acceleration in new customer contribution. I think that had been a worry maybe a year ago, whether or not that was going to continue. And obviously, you've talked a little bit about expansion coming down with landing larger deals upfront, leaving a little bit less upsell, cross-sell opportunity.

Maybe help break down a couple of things. One is with a lot more new customers landing in the short term, would this be a good signal for kind of a year from now and in the short term, getting some lift just because newer customers expand more. And secondly, how would you think about the opportunity around expansion? Like what are the things that you think you can do to grow the upsell opportunity, even though customers are landing larger today, what are you going to be doing to kind of create some lift there with expansion in the future?

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**Jay Chaudhry** - *Zscaler, Inc. - Co-Founder, President, CEO & Chairman of the Board*

Yes. So if you think about what we've done over the past several years since our IPO, we essentially due to start with, in fact, ZIA, mostly business, they would ask what about transformation, and what about next and ZPA came in, great expansion; ZDX came in; a number of new products have been coming in. So we are actually able to expand quite a bit. In fact, even today, as we said, in our current customer base, we could literally take our ARR by 6x, if we sold all Zscaler user products to our customers. So even I would even say we have no lack of product to sell.

And customers are embracing broader and broader platform. If you look at all the deals I talked about, reading the script and say, ZIA, ZPA, ZDX and Data Protection. And so it is becoming pretty significant. So we have a big, big upsell opportunities, things like Data Protection. They aren't going to go with someone else to do Data Protection if the traffic is going through our platforms. So that's one piece.

And the second piece is everyone is talking about only users when they talk about Zero Trust, SASE or they talk about whatever SASE. That's only one piece. When you talk about how much workloads that's the bigger opportunity, IoT/OT is significant opportunity; B2B, where your customer suppliers and partners need to access information through our Zero Trust platform. So I think this is big opportunity on the product side.

On the sales side, we keep on learning and refining some of the stuff. We do have some of the overlay specialists. We do have some of the overlay specialist, we don't do overlay sales per se, but there are specialists in certain areas because you need to be able to go deeper. So we are definitely taking advantage of that. We are pleased with the results, but we'll keep on tweaking and refining to get better and better results.

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**Petiri Reed**

And the new customer success that you've been having, do you anticipate that provide some additional lift kind of looking out a year or so, just as the mix of new customers has increased.

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**Jay Chaudhry** - Zscaler, Inc. - Co-Founder, President, CEO & Chairman of the Board

We don't wait for a year or 2 years for the contract. We are in the process of resell, we go, literally, it's an ongoing engagement with the customers. So you're not going to see lumpy things from us. My people said, "Hey, after COVID, what's going to happen after 3 years?" When 3 years came in, most of our customers had done an upsell or 2 with us.

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**Operator**

That concludes the question-and-answer session. At this time, I would like to turn it back to Jay Chaudhry for closing remarks.

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**Jay Chaudhry** - Zscaler, Inc. - Co-Founder, President, CEO & Chairman of the Board

Well, thank you for your interest in Zscaler. We look forward to seeing you at one of our investor conferences. Thanks.

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**Remo E. Canessa** - Zscaler, Inc. - CFO

Thank you.

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**Bill Choi** - Zscaler, Inc. - Senior Vice President, Investor Relations and Strategic Finance

Thank you.

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**Operator**

Thank you for your participation in today's conference. This does conclude the program. You may now disconnect.

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