Forward-Looking Statements

Unless otherwise noted, all numbers presented will be on an adjusted, non-GAAP basis. Reconciliation of GAAP to the non-GAAP financial measures is included in our earnings release.

This document contains forward-looking statements that involve risks and uncertainties, including, but not limited to, statements regarding our future financial and operating performance, including our financial outlook for the third quarter of fiscal 2023 and full year fiscal 2023. There are a significant number of factors that could cause actual results to differ materially from statements made in this document, including but not limited to: macroeconomic influences and instability, including the ongoing effects of inflation, geopolitical events and the COVID-19 pandemic on our business, operations and financial results and the economy in general; our limited operating history; our ability to identify and effectively implement the necessary changes to address execution challenges; risks associated with managing our rapid growth, including fluctuations from period to period; our limited experience with new product and subscription and support introductions and the risks associated with new products and subscription and support offerings, including the discovery of software bugs; our ability to attract and retain new customers; the failure to timely develop and achieve market acceptance of new products and subscriptions as well as existing products and subscription and support; rapidly evolving technological developments in the market for network security products and subscription and support offerings and our ability to remain competitive; length of sales cycles; and general market, political, economic and business conditions.

Additional risks and uncertainties that could affect our financial results are included under the captions “Risk Factors” and “Management’s Discussion and Analysis of Financial Condition and Results of Operations” set forth from time to time in our filings and reports with the Securities and Exchange Commission (SEC), including our Quarterly Report on Form 10-Q for the fiscal quarter ended October 31, 2022 filed on December 7, 2022 and our Annual Report on Form 10-K for the fiscal year ended July 31, 2022 filed on September 15, 2022, as well as future filings and reports by us, copies of which are available on our website at ir.zscaler.com and on the SEC’s website at www.sec.gov. You should not rely on these forward-looking statements, as actual outcomes and results may differ materially from those contemplated by these forward-looking statements as a result of such risks and uncertainties. Additional information will also be set forth in other filings that we make with the SEC from time to time. All forward-looking statements in this document are based on information available to us as of the date hereof, and we do not assume any obligation to update the forward-looking statements provided to reflect events that occur or circumstances that exist after the date on which they were made.
CEO Commentary

We delivered a solid Q2 despite economic challenges that have impacted the broader tech industry. For the quarter, our revenue grew 52% year-over-year and billings grew 34%. Billings were impacted by new customers being more deliberate about their large purchasing decisions at the start of the calendar year. These deals have not gone away, and we have closed a few already in February. On the other hand, we had strong growth in our expansion business with existing customers increasing their deployments and adopting our broader platform. Once again, our dollar-based net retention rate was over 125%. We continue to delight our customers by accelerating their path to better security, business agility and cost elimination, helping them solve some of their highest priorities. This drove our Net Promoter Score, or NPS, to a new high. Our NPS now exceeds 80, which is more than 2 times the average for SaaS companies. And, today, more enterprises than ever before recognize Zscaler as the best choice to secure their digital transformation, strengthening my confidence in our $72 billion serviceable market opportunity.

Our disciplined approach to growth is reflected in our strong operating profit and free cash flow, both of which doubled on a year-over-year basis. Our operating margin expanded by approximately 4 percentage points, while our revenue also continued to grow at a very high rate. As the world’s largest security cloud, we have outstanding unit economics, with a stable high-90% gross retention rate and 80% gross margins. These best-in-class metrics are the result of our differentiated services, market leadership, and highly scalable multi-tenant cloud platform.

Let me share with you some of my observations about the environment and how we plan to manage our business for the remainder of 2023.

With macro concerns weighing on business leaders, more organizations are being cautious and measured about their spending. In January, we saw a higher scrutiny on budgets compared to December, resulting in additional delays in large deals. These deals haven't gone away, and customers are taking longer to make decisions and requiring additional approvals. In select instances where timing of budgets was a hurdle for new customers, we enabled them to ramp into larger subscription commitments. These strategic deals lowered our first-year billings, but will grow into a higher annual run-rate level in the second year. We typically have some ramped deals each quarter, but in Q2, the impact of ramped deals on our billings was higher. These ramped deals position us to expand the customer relationship over time to create long-term value.

As we enter the second half of fiscal 23, we are expecting customer cautiousness to continue. We have accounted for further lengthening of sale cycles and the uncertain timing of large deals in our outlook. Even though our current pipeline has grown and has more mature deals, we are assuming a slight deterioration in close rates.

While not immune to economic slowdowns, cybersecurity is relatively more resilient. In my conversations with hundreds of IT executives, cybersecurity remains their organization’s #1 IT priority. Two weeks ago, we hosted a CISO summit with 80 CISOs from Global 2000 companies. They talked about the business need to innovate, become agile and gain competitive advantage – with security as the enabling foundation. They talked about their plans to shift to Zero Trust security, to reduce attack surface and to adopt the direct-to-cloud architecture that Zscaler pioneered. Customers are excited by the new innovations being added to our platform, and their engagement with us remains very strong.

Given the large opportunity we see in front of us, we will keep on building and innovating while also increasing profitability. After significantly growing our teams in recent years, we took a fresh look at our organization and
found opportunities to streamline operations and to align people, roles and projects to our strategic priorities. As a result of that review, we initiated a targeted cost optimization plan to drive additional operational efficiency that best positions us to deliver profitable growth. Remo will cover this in more detail.

As I mentioned before, I believe that periods of uncertainty can accelerate the adoption of disruptive technologies like ours. C-level leaders are telling me that technical debt of legacy network and security point products impedes progress and slows down business operations. By consolidating point products and embracing Zero Trust architecture with Zscaler, our customers are modernizing their security while reducing costs, giving them the competitive edge they need to succeed in today’s rapidly evolving business environment. We have expanded our business value team to collaborate with customers to create CFO-ready business cases with clear ROI and payback periods that facilitate necessary deal approvals.

In today’s environment, customers can’t afford to risk their mission-critical projects with immature offerings from unproven vendors. We’re starting to see deal wins from customers who initially purchased a single-tenant SASE solution from their incumbent firewall vendor that failed to deliver in the real world. These customers were misguided by their flawed message: Keep on buying my boxes and use my so-called cloud service when your users are on the road or in a branch office. A single-tenant architecture, whether deployed as appliances or as virtual machines spun up in a public cloud, will not allow enterprises to fully realize the benefits of secure digital transformation. Every customer we’ve won has lots of firewalls in their data centers; but when it comes to Zero Trust security and digital transformation, they are choosing Zscaler because of our multi-tenant cloud architecture that scales and delivers business agility. Our Zero Trust Exchange is the largest in-line security cloud in the world, processing over 280 billion transactions and preventing 9 billion security and policy violations per day. This massive amount of traffic provides us with more than 300 trillion signals per day to feed our machine learning and AI engines for better detection of user and application traffic anomalies, resulting in superior threat protection. Our AI/ML capabilities are driving customer success at scale in the real world today. Let me share an example with you.

- In December, we helped a Global 500 conglomerate experiencing a targeted cyberattack on one of its divisions. Our ThreatLabZ team worked closely with the customer to identify the root cause of the attack and act quickly to prevent any potential damage. Subsequently, this customer upgraded to our ZIA transformation bundle to prevent zero-day attacks and secure the entire ecosystem. This win highlights the value of our high-end product bundles and the benefits that our ThreatLabZ research brings to our customers.

I’m delighted to share that an increasing number of customers are purchasing our comprehensive platform capabilities, which not only accelerates their business value realization but also establishes us as a critical partner for their success. As I mentioned before, customers are increasingly buying Zscaler for Users – our complete platform for user protection which includes ZIA, ZPA and ZDX – bundled together. In addition, we are gaining traction with workload protection, powered by the same core ZIA and ZPA technology. Thanks to new and existing customers purchasing these expanded bundles, we drove a 51% year-over-year growth in the number of customers with greater than $1 million in ARR, ending with nearly 380 of these customers. And, over 30 of these customers have ARR greater than $5 million.

Let me highlight three deals this quarter where the customers purchased all four product pillars:

- In a new logo win, a Top 10 global IT software and services company purchased Zscaler for Users bundle for 400,000 users including our advanced data protection suite, and our Zero Trust for Workloads for 3,000 workloads. This customer pursued a Zero Trust strategy due to their business
growth resulting in a complex application and network environment and heightened risk from data sprawl. They selected Zscaler as the only scalable Zero Trust platform that reduces their attack surface and protects their sensitive data while bringing agility to their business. With our integrated platform, they will simplify their security operations by consolidating dozens of point-products, including firewalls, VPNs, VDIs, DLP and CASB. By purchasing all four product pillars, the customer is making a platform bet on Zscaler to secure their users, workloads, and devices regardless of their location.

- Next, in an exciting upsell win, a major auto manufacturer upgraded to Zscaler for Users bundle for 35,000 users and purchased Zero Trust for Workloads for 8,000 workloads. This platform purchase was driven by the customer's strategy to digitally transform their business operations including management of their vast supply chain. In fact, we are helping them accelerate time-to-market for new EVs. Before purchasing ZPA, this customer experienced significant delays in commissioning new vehicles as third parties did not have fast and secure remote access for collaboration. By using ZPA and ZDX, they can now provision secure access to new third parties within a few days, compared to over a month it used to take with legacy remote access technology. In addition, Zscaler for Users significantly reduces the risk of ransomware that their firewalls and VPNs allow.

- Finally, a Global 500 pharmaceutical company upgraded from ZIA for 45,000 users to Zscaler for Users bundle for 85,000 users and purchased Zero Trust for Workloads for 2,000 workloads. They purchased all four product pillars to pursue a Cloud-First strategy with Zero Trust security for all users and workloads. With this upsell, the annual spend of this existing million-dollar customer increased by 6x with additional opportunity for workload protection as their public cloud usage grows.

Earlier, I mentioned that in some instances, we enable new customers to ramp to larger commitments.

- In one such new logo win, we're excited to partner with an innovative retail leader that is using facial recognition technology and cashless checkouts to redefine their future store experience. This is a significant win for us as retail was a smaller vertical for us historically, where we are now enabling new digital transformation possibilities. This retail company committed to an 8-figure total contract value for a multi-phase ramp to secure over 90,000 ZIA users, 20,000 ZPA users and 400 petabytes per month of data from their 20,000 retail store operations. This customer had bought a firewall-based SASE solution which failed to scale as well as expanded their attack surface. Leveraging our highly scalable and reliable Zero Trust Exchange platform, they will use ZIA to create direct internet access for employee tablets and terminals, while using ZPA to secure private access for store managers. Additionally, Zero Trust for Workloads will secure all traffic from cameras and terminals in the retail stores to the cloud. Workload protection accounts for approximately 40% of the total deal value.

As these deals show, customers are embracing our expanded platform including our two emerging product pillars: ZDX for digital user experience management and Zscaler for Workloads for securing servers and workloads. These emerging products are on track to meet or exceed our full-year target of contributing high-teens percentage of new business. Our Zero Trust for Workloads solution is roughly doubling year-over-year. In addition, our new CNAPP solution is generating significant customer interest. You may recall at Zenith Live in June, we launched our CNAPP solution called Zscaler Posture Control, which is an integrated solution that correlates vulnerabilities and risks across CSPM, CIEM, and Infrastructure-as-Code scanning.

- This quarter, we had a Posture Control upsell win with a Global 1000 Engineering company for half-a-million-dollar ACV to secure 5,000 workloads. Posture Control provided visibility across multi-cloud assets, remediated compliance violations, and revealed previously undetected high-risk vulnerabilities.
We are proud that our Posture Control solution was recently recognized by research firm G2 in the “Leader” quadrant based on independent peer reviews.

We are bringing more innovations to our customers than ever before. In our latest major cloud software release, we brought over 150 new features to market, including product innovations such as AI-powered phishing detection and dynamic, risk-based access policy. We continue to drive both internal innovation and highly targeted acquisitions to expand our leadership in the SASE and Zero Trust security markets. As announced a few weeks ago, we acquired Canonic Security, an innovative startup in SaaS supply chain security, which protects customer data in SaaS applications. For example, Google suite could be sharing data with 30 other third-party connected SaaS apps that are posing significant risk of data breaches and data loss. Together with our inline DLP, browser isolation, out-of-band CASB and SSPM for SaaS posture management, Zscaler now provides unprecedented visibility and most comprehensive data protection for SaaS applications and customer data.

As we look ahead to the next few years, we are committed to driving broader adoption of our Zero Trust platform for users, workloads and IoT/OT to maximize the value of our customers’ secure digital transformation efforts. CIOs are telling me that they are using this challenging environment to drive change. ROI and cost optimization are becoming bigger priorities, as they are being asked to do more with less. With our superior architecture and proven experience, we deliver measurable outcomes at the CXO level that are aligned with our customers’ top priorities. Our business value proposition is resonating, and more customers are consolidating multiple point products with our broader platform, which increases our wallet share with them. We believe that we’re still in the early stages of a significant market opportunity to enable secure digital transformation, and we’re on track to achieve our $5 billion ARR goal.
CFO Commentary

Our Q2 results exceeded our guidance on growth and profitability, even as we managed through continued deal scrutiny and longer reviews. Revenue was $388 million, up 52% year-over-year and up 9% sequentially. ZPA product revenue was approximately 20% of total revenue, growing 74% year-over-year. From a geographic perspective, Americas represented 53% of revenue, EMEA was 32% and APJ was 15%. From a new business perspective, EMEA grew strongly on a year-over-year basis despite continued macro challenges in the region.

Our total calculated billings in Q2 grew 34% year-over-year to $494 million. Until we get more certainty around the macro environment, we believe looking at total billings on a sequential basis can be a relevant measure of our billings performance in the near-term. On a sequential basis, billings grew 45% quarter over quarter. Our current billings grew 32% year-over-year, which includes the impact of strategic deals with phased subscription ramps that Jay talked about earlier.

Our remaining performance obligations, or RPO, grew 44% from a year ago to $2.809 billion. The current RPO is 51% of the total RPO. Our dollar-based net retention rate was once again above 125%. We have a strong base of large enterprise customers, which provides us with a significant opportunity to upsell our broader platform.

At the end of Q2, we had 378 customers with greater than $1 million in ARR, up 51% from 251 in the prior year. The continued strength of this metric speaks to the strategic role we play in our customers' digital transformation initiatives. We added 120 customers in the quarter with greater than $100,000 in ARR, ending the quarter at 2,337 such customers.

Turning to the rest of our Q2 financial performance. Total gross margin of 80.4% is unchanged from the prior year. Our total operating expenses increased 6% sequentially and 44% year-over-year to $263 million, primarily due to higher compensation expenses. As we indicated last quarter, after exceeding our hiring plans in Q1, we moderated our pace of hiring in Q2. This contributed to a strong operating margin performance in the quarter with operating margin increasing 380 basis points year-over-year to 12.6%, which exceeded our guidance. We are seeing the leverage in our financial model that is driven by our strong underlying unit economics. Our free cash flow margin was 16%. We continue to expect data center capex to be around the high single-digit percentage of revenue for the full year. We ended the quarter with over $1.9 billion in cash, cash equivalents and short-term investments.

Next, let me provide more details about the targeted cost optimization plan that Jay mentioned. In the past 18 months, we doubled the size of our team to approximately 5,900 employees, as we invested aggressively based on strong market momentum. As we watched the macroeconomic uncertainty at the start of fiscal 2023 in the fall, we commented that if the business environment becomes more challenging, our business model allows us to adapt quickly and to deliver expanded operating profitability while we grow. With the announcement today, we are adapting to the changes we saw in Q2. This is a targeted optimization initiative to address inefficiencies in certain job functions and projects. As a result, we are reducing our workforce by approximately 3%. Most of the impact from these changes will be seen in Q3, and we will take a charge of $8 to 10 million, including non-cash expenses. We will continue to hire the best candidates in high-priority areas.
Now moving on to guidance and modeling points. As a reminder, these numbers are all non-GAAP.

For the third quarter of fiscal 2023:

- We expect revenue in the range of $396 million to $398 million, reflecting a year-over-year growth of 38% to 39%.
- Gross margins of approximately 80%.
- Operating profit in the range of $55 million to $56 million
- Net other income of $10 million; income taxes of $4.5 million
- Earnings per share of approximately $0.39, assuming 156 million fully diluted shares. Please note that starting in fiscal 2023, we adopted the new accounting standard which requires the use of the iif-converted method for calculating EPS. To account for our convertible notes, you will need to add back $360,000 in quarterly interest expense.

For the full year fiscal 2023:

- We expect revenue in the range of $1.558 billion to $1.563 billion or a year-over-year growth of approximately 43%.
- Calculated billings in the range of $1.935 billion to $1.945 billion or year-over-year growth of approximately 31%. For Q3, we are assuming Billings to decline by approximately 9% sequentially, compared to the mid-single digit percentage declines we have seen in the last few years. This guidance incorporates the macro related uncertainties that Jay mentioned in his comments.
- Operating profit in the range of $213 million to $215 million. Our guidance reflects approximately 350 basis points of operating margin improvement compared to last year, which is an increase from our prior guidance, while growing revenue at above 40%.
- Income taxes of $18 million.
- Earnings per share in the range of $1.52 to $1.53, assuming approximately 156 million fully diluted shares. As noted earlier, to account for our convertible notes in EPS, you will need to add back $1.4 million in annual interest expense.

Let me conclude with comments on our investment framework. We remain confident in our ability to deliver on our growth opportunity while increasing profitability. We will balance growth and profitability based on how our business is growing. The recurring nature of our business model gives us good visibility on top line revenue and allows us to adapt quickly to changes in market conditions to deliver on our operating profit and margin goals. If the environment becomes more challenging, we will continue to prioritize profitability, leveraging our strong unit economics and driving efficiencies in our cost structure. In Fiscal 23, as a result of our focus on operational efficiency, we are increasing our profitability in the second half to achieve a full-year operating margin of 13.7%, reflecting a 350 basis points expansion while revenue is still growing over 40%. If the environment improves, we will prioritize growth. Our long-term investment framework still applies. If we are growing revenue faster than 30%, you can expect less than 300 basis points of margin expansion in the year.

We remain confident of reaching 20% to 22% operating margins in the long term. With a large market opportunity and customers increasingly adopting the broader platform, we'll continue our disciplined approach to managing our business to maximize value for our shareholders.