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# EDITED TRANSCRIPT

Q4 2018 Zscaler Inc Earnings Call

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## CORPORATE PARTICIPANTS

**Bill Choi** *Zscaler, Inc. - VP of Investor Relations*  
**Jay Chaudhry** *Zscaler, Inc. - Chairman & CEO*  
**Remo Canessa** *Zscaler, Inc. - CFO*

## CONFERENCE CALL PARTICIPANTS

**Alex Henderson** *Needham & Company, LLC, Research Division - Senior Analyst*  
**Brad Zelnick** *Credit Suisse AG, Research Division - MD*  
**Fatima Boolani** *UBS Investment Bank, Research Division - Associate Director and Equity Research Associate Technology-Software*  
**Gabriela Borges** *Goldman Sachs Group Inc., Research Division - Equity Analyst*  
**Gray Powell** *Deutsche Bank AG, Research Division - Research Analyst*  
**Keith Weiss** *Morgan Stanley, Research Division - Equity Analyst*  
**Saket Kalia** *Barclays Bank PLC, Research Division - Senior Analyst*  
**Shebly Seyrafi** *FBN Securities, Inc., Research Division - MD*  
**Srini Nandury** *Summit Insights Group, L.L.C - MD & Senior Analyst*  
**Tal Liani** *BofA Merrill Lynch, Research Division - MD and Head of Technology Supersector*

## PRESENTATION

### Operator

Good day, ladies and gentlemen. Thank you for standing by. Welcome to the Zscaler Fourth Quarter 2018 Earnings Conference Call. Today's conference is being recorded. (Operator Instructions) At this time, I'd like to turn the conference over to Bill Choi. Please go ahead.

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### Bill Choi *Zscaler, Inc. - VP of Investor Relations*

Good afternoon, and thank you for joining us to discuss Zscaler's financial results for the fiscal fourth quarter and full year 2018. With me on the call are Jay Chaudhry, Chairman and CEO; and Remo Canessa, CFO.

By now, everyone should have access to our earnings announcement. This announcement may also be found on our website in the Investor Relations section. In addition, a supplemental financial schedule was posted to our website earlier today.

Let me remind you that we'll be making forward-looking statements during today's discussion, including but not limited to, the Company's anticipated future revenue, operating performance, gross margin, operating expenses, net loss, pro forma net loss per share, free cash flow, dollar-based net retention rate. These statements and other comments are not guarantees of future performance but rather are subject to risks and uncertainties, some of which are beyond our control. Our actual results may differ significantly from those projected or suggested in any forward-looking statements. 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 that could impact our future operating results and financial condition, please see our filings with the Securities and Exchange Commission as well as in today's earnings release.

Unless otherwise noted, all numbers we talk about today will be on an adjusted non-GAAP basis. Please refer to our earnings release on the Investor Relations portion of our website for a reconciliation of GAAP to the non-GAAP. For historical periods, the GAAP to the non-GAAP reconciliations can be found in the supplemental financial information referenced a few moments ago.

I would also like to inform you that we will be participating in the Citigroup's TMT Conference in New York City on Friday, September 7; and the Deutsche Bank's Technology Conference in Las Vegas on Thursday, September 13.

Now I'd like to turn the call over to Jay.

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### Jay Chaudhry *Zscaler, Inc. - Chairman & CEO*

Thank you, Bill, and thank you, everyone, for your interest in Zscaler. I'm pleased to share with you our strong fourth quarter and full year fiscal 2018 results. We posted record revenue and record billings in the quarter as we continued to experience rapid growth. In Q4, our revenue grew 54% year-over-year to \$56 million, and billings grew 72% year-over-year to \$95 million. It was an exceptionally strong end



to the fiscal year as we closed a number of seven-figure deals.

For the full year, our revenue grew 51% to \$190 million, and billings grew 65% to \$258 million. In addition to our top line growth, we had healthy operating performance in the quarter as our operating margins improved 16 percentage points year-over-year and we generated positive free cash flow.

We ended fiscal 2018 with over 3,250 customers. Total Global 2000 customers increased to 300 as of July 31, up from over 200 a year ago, which reflects strong traction among large enterprises.

We believe these results demonstrate Zscaler's increased adoption and the pivotal role our cloud platform plays to enable secure cloud transformation. It also shows strong sales and marketing execution. An increasing share of our sales are coming from our Transformation bundle, which includes cloud firewall, IPS and sandboxing.

Cloud and mobility are breaking the traditional perimeter where organizations build a "hub-and-spoke network" to backhaul branch office traffic over wide area networks to the data center. Then they built a moat of security appliances that established a perimeter around the corporate network to secure the network. Well, that's why they call it network security.

We believe that network security is irrelevant for the cloud. Applications can be anywhere. Users can be anywhere. The notion of inside the network or outside the network is disappearing. In the cloud world, where Internet is becoming the corporate network, where would you build the moat? Spinning up firewall of web proxy virtual machines on AWS doesn't make it cloud security; it is still network security.

Designed for the world of cloud, which has no walls, Zscaler acts as a policy engine deployed across 100-plus data centers to securely connect the right user to the right applications -- ZIA for Internet and SaaS, and ZPA for internal applications in your data center or the cloud. We believe we have the right architecture and are the best choice for securing the cloud and mobile-first world.

We are going after a \$17.7 billion TAM that, our analysis of IDC's data indicates, are spent annually on network security products.

Our strong business momentum is reflected in our financial results. I would like to highlight several noteworthy new customer wins during the quarter.

Let me start with the largest deal in our company's history, which contributed \$16.5 million to billings in Q4. With rapidly growing Internet traffic to 60 gigabits per second throughput and need to inspect SSL traffic for security, this customer required a highly scalable Internet gateway. To give you a reference point, majority of Fortune 100 enterprises need a few gigabits per second of sustained throughput. True to its name, Zscaler scales well; we were the only solution that could meet the requirements and deliver good user experience. Zscaler cloud architecture allowed us to extend our cloud to the data center and deliver a hybrid solution.

A Fortune 100 communication services company with headquarters in Asia and presence in over 50 countries purchased both ZIA and ZPA for 50,000 users to securely enable the business for the cloud, a very good example of customers embracing the entire Zscaler platform upfront. This customer acquired and restructured its entities and needed to standardize secure application access across four business units with different network and security infrastructure. ZPA is designed to do exactly this without having to integrate networks of acquired companies. This will also result in elimination of VPN infrastructure from multiple vendors, leading to better user experience, cost savings and simplification of infrastructure.

A leading European IT services company purchased our Business bundle for over 100,000 users. They have traditional network and security infrastructure, hub-and-spoke network with a handful of Internet gateways. This customer had a CEO-driven mandate to make business more agile and reduce costs. To achieve this, the IT team identified two initiatives: one, network and security transformation; and two, increased use of cloud, including a move to Office 365. The strategy they arrived at: local Internet breakout at every office. And their solution: Zscaler, to secure over 200 local breakouts around the globe, plus security for the mobile workers to enable cloud transformation. Our service provider partner will deliver Zscaler as a managed service to this customer. In parallel, this customer's systems integration business unit will be commercially offering Zscaler services for resale and consulting engagements.



We also had a number of notable upsell wins in Q4. A top 10 bank in U.S., who purchased our Transformation bundle and DLP for 10,000 users 6 months ago, purchased additional user licenses to cover all 55,000 employees. As the bank is embracing the cloud, including Office 365, they developed local Internet breakout strategy for 2,800 branches and 200 back offices to replace their traditional perimeter security and hub-and-spoke network that had only 2 Internet gateways. In addition, they wanted to enhance security -- security for mobile users, secured guest Wi-Fi, and inspection of SSL traffic for malware and data leakage. The natural solution? Zscaler Transformation bundle along with SD-WAN devices. Zscaler will be the only security checkpost for traffic headed to the Internet from all branches and the data centers. While we are replacing traditional network security appliances, such as Secure Web Gateway, outbound firewall, DNS, sandboxing and DLP in current 2 data centers, it is mostly a greenfield opportunity; we are creating about 3,000 new secure local Internet breakouts. Driven by M&A requirements and user unhappiness with the traditional VPN, they also bought ZPA for a subset of users.

A financial services customer that bought Transformation Bundle for 15,000 employees about 2 years ago purchased ZPA for all 15,000 users. While ZIA provided them secure and fast access to Internet and SaaS, ZPA will do the same for their internal applications, some of which are in the data center, while many are in Azure and AWS. This deal enables realization of their strategy, perimeterless enterprise with direct access to any service or application from anywhere on any device without backhauling traffic through the data center. The result? Fast user experience and lower cost. They will no longer need either a site-to-site VPN to Azure or AWS, or a remote access VPN. This eliminates all network security appliances, including traditional VPN, except the inbound firewalls to the data center.

A Fortune 100 multinational oil and gas company in Europe that bought a small paid pilot of our Transformation Bundle 1 year ago expanded their purchase to all 65,000 users. This customer is launching an initiative for global IT transformation. It is comprised of: one, local Internet breakouts in 450 locations across 65 countries; two, cloud-first approach to applications, such as Office 365; and three, minimal on-premise infrastructure. Another driver was to enhance security with SSL inspection and to secure hundreds of guest Wi-Fi locations. Like many other deals, while we are replacing network security appliances in the current Internet gateways, it is mostly a greenfield opportunity to create about 450 secure local Internet breakouts.

Let me make a few comments about ZPA, a complementary set of services for internal application access. We are very excited about its rapid growth. ZPA was introduced nearly 2 years ago and was made available to all sales reps 1 year ago. In fiscal 2018, ZPA contributed approximately 10% to new and upsell business, with almost half coming from new customers to Zscaler.

We believe these new and upsell examples demonstrate the continued adoption of the Zscaler platform as customers increasingly rely on us to enable their transformation journey. Our born-in-the cloud, for-the-cloud platform is delivering value to our customers. Zscaler provides four compelling benefits to customers: one, deliver a better user experience with local Internet breakouts; two, enhance security with cloud effect and full in-line inspection, including SSL scanning at scale; three, minimize cost of security appliances and MPLS network; and four, simplify infrastructure by reducing the need for hub-and-spoke networks and related hardware infrastructure.

We feel that our go-to-market team is getting stronger and is executing well on our vision. We are investing in our unique go-to-market capabilities, which enable us to sell top down at the C-level. A strategic advantage for us is our channel partnerships with large system integrators and global service providers.

During the fourth quarter, we upgraded our cloud with scores of features that strengthen our security, improve reporting and enhance usability. Notably, we took our data loss prevention, or DLP, functionality to a new level -- we introduced the Exact Data Match, or EDM. We believe this is the industry's first multi-tenant DLP for the cloud that scales to billions of fields. Rather than looking for generic match for any credit card or Social Security number, which is prone to false positives found in other DLP solutions, our DLP EDM can make sure that personally identifiable information by credit card numbers or millions of users at a bank or an insurance company don't leak out.

We significantly enhanced our cloud IPS capabilities for threat detection. The overall efficacy of a cloud IPS is far superior to traditional IPS because we natively inspect all traffic, including SSL. Zscaler was designed as a proxy architecture that is required to inspect SSL traffic. Most vendors attach IPS to firewalls, which are stateful architecture and are designed to look at a subset of the data flow at a time. That does not work well for SSL inspection.

We delivered significant enhancements to real-time interactive analytics. Rather than showing just security counters, like number of threats, Zscaler provides normalized risk score, at the user level, location or department level and the company level. CISOs can see the risk posture trends as well as how they are doing against their peer groups.

Two weeks ago, we announced the acquisition of market-leading artificial intelligence and machine learning technology and the development team of stealth-mode security start-up, TrustPath. TrustPath developed AI algorithms to identify new threats and provide deep visibility, resulting in enhanced security efficacy. These innovations will be incorporated into our extensible cloud platform and derive intelligence from 50 billion transactions we process daily to identify enormous traffic, build user behavior profiles, and detect sophisticated targeted attacks as they emerge.

We are excited about our future because of what we enable for our customers on their cloud journey. In June, we had our first inaugural cloud summit, ZenithLive, in Las Vegas, with hundreds of customers and partners attending. We had an inspiring lineup of keynote speakers who talked about the cloud transformation, including Scott Guthrie, the Head of Microsoft's Cloud and Enterprise Group; and executives from GE, Siemens, AT&T and others. We will be bringing Zenith Live to London next month on October 21 to 23.

We are also excited about a major milestone, ZPA-Gov. ZPA-Gov, our ZPA version for the federal government, has achieved FedRAMP certification for the moderate security level and was granted Authority to Operate by the Federal Communications Commission, FCC. ZPA-Gov is the first Zero Trust remote access platform that has received FedRAMP approval. This authorization enables us to expand into the federal market.

In summary, we are very pleased with our record Q4 and fiscal '18 results. We believe we are in the early innings of a significant market opportunity to disrupt traditional network security.

I would now like to turn the call over to Remo to walk through our financial results.

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

Thank you, Jay. As Jay mentioned, we had very strong fourth quarter and fiscal 2018. We are pleased with the results we achieved. Revenue for the quarter was \$56.2 million, up 14% sequentially and 54% year-over-year. From a geographic perspective for the quarter, Americas represent 48% of revenue; EMEA was 45%; and APJ was 7%. From inception, we've invested across all geographies and have built a strong international sales and operations team with an extensive global cloud infrastructure. We feel these investments have created a strategic advantage, allowing Zscaler to provide our services to customers around the world. For the full year, revenue was \$190.2 million, up 51%.

ZPA remains the fastest-growing new product in our history. ZPA contributed 10% of our new and upsell business in fiscal 2018, up from 4% in the prior year.

Turning to billings and backlog. We define billings as the change in deferred revenue for the quarter plus total revenue recognized in that quarter. Billings grew 72% year-over-year to \$95.4 million for the quarter and grew 65% to \$257.6 million for the full year. This quarter, we benefited from a higher mix of upfront greater than 1 year billings, including \$16.5 million from one customer Jay previously mentioned. As a reminder, our contract terms are typically 1 to 3 years and we primarily invoice our customers 1 year in advance. Excluding upfront greater than 1 year billings in both periods, billings would have grown slightly below 60%. Total backlog, which represents remaining performance obligations, was \$398 million on July 31, up 81% from \$220 million 1 year ago and 30% from \$305 million last quarter.

Based on our ending July 31 annual recurring revenue for ZIA, approximately 35% is from our high-end Transformation bundle, which includes our next-generation firewall and sandbox, up from approximately 20% that we referenced during our IPO. In addition, ZPA, which was released last fiscal year, is additive as a cross-sell to our existing customers.

Our strong customer retention and ability to upsell have resulted in a consistently high dollar based net retention rate, which was 117%

for the period ended July 31. This compares to 115% a year ago and 120% last quarter. Our increased success selling bigger deals upfront, which start with the Transformation bundle and faster upsells within the year, while good for our business, can reduce our net dollar retention rate, which is calculated on a year-over-year ARR basis. Considering these factors, we feel 117% is outstanding and it will vary quarter-to-quarter.

Total gross margin was 80%, up 2% compared to Q4 last year and down 1% sequentially. The year-over-year increase was driven by an increased mix of higher-priced bundles with more functionality as well as operational efficiencies. We feel 80% is a very strong gross margin, and our focus is not to maximize our gross margins at this stage. We feel it's important to continue to invest in our platform and to drive customer satisfaction to drive top line revenue growth.

Turning to operating expenses. Our total operating expenses grew 11% sequentially and 32% year-over-year to \$47.4 million but decreased as a percentage of sales.

Sales and marketing increased 8% sequentially and 34% year-over-year to \$30.7 million. We've been building our sales and marketing teams investing in marketing programs to drive growth and awareness. We incur significant sales and marketing costs initially to sell our products, but after first year, our sales and marketing costs decline significantly as our commissions and marketing efforts are concentrated on initial sale.

R&D increased 15% sequentially and 24% year-over-year to \$10.3 million as we continue to invest to enhance product functionality and to offer new products. The growth in R&D primarily includes investments in building our teams and, in addition, expenses to complete the FedRAMP certification for ZPA.

G&A increased 17% sequentially and 37% year-over-year to \$6.4 million. These expenses exclude \$1.4 million in litigation-related expenses. The growth in G&A includes investments in building our teams, consulting and other expenses we have made as we became a public company.

Our fourth quarter operating margin was a negative 4%, which compares to negative 20% in the same quarter last year. Net loss from the quarter was \$1.4 million or pro forma net loss per share of \$0.01.

We ended the year with \$299 million in cash, cash equivalents and short-term investments. Free cash flow was positive \$11.9 million in the quarter compared to negative \$5.4 million for the same quarter a year ago and was positive \$2.1 million for the full year compared to negative \$14.2 million last year. We started our ESPP program in March, which contributed approximately \$3 million to our free cash flow in the quarter. The first stock issuance under the ESPP program will be in December, which will reduce our free cash flow by approximately \$7 million to \$8 million in Q2 and will have no impact on overall cash balance.

Now moving on to guidance. As a reminder, these numbers are all non-GAAP, which excludes stock-based compensation expenses and certain litigation-related expenses. For the first quarter, we expect revenue in the range of \$58 million to \$59 million, operating loss in the range of \$6 million to \$7 million, taxes of \$600,000, and net loss per share in the range of \$0.05 to \$0.06, assuming approximately 121 million common shares outstanding.

For the full year 2019, we expect revenue in the range of \$250 million to \$260 million, operating loss in the range of \$16 million to \$18 million, taxes of \$2.4 million, and net loss per share in the range of \$0.12 to \$0.13, assuming approximately 124 million common shares outstanding.

Our plan is not to give billing guidance on a go-forward basis. However, due to the large upfront billing from one customer in Q4 of 2018, we want to provide some modeling points for billing. Historically, Q2 and Q4 have been our strongest billing quarters with sequential declines in Q1 and Q3, respectively.

For Q1 2019, the large upfront billing in Q4 will provide a difficult sequential comparison. Excluding the effects of the \$16.5 million from our Q4 billings, we expect a sequential percentage decline in Q1 '19 to be consistent to our previous Q4 to Q1 sequential declines. In the



last 2 fiscal years, billings declined approximately 25% from Q4 to Q1.

For fiscal 2019, we expect the billings year-over-year growth rate to be lower than the revenue growth rate with a difficult comparison in Q4 2019. If we exclude this large upfront billing of \$16.5 million, total billings growth in fiscal 2019 would be comparable to the revenue growth, implying billings of \$320 million to \$330 million for the year. We will not be updating this billings commentary in the future.

We're very proud of what we have achieved and look forward to building on our opportunity.

Now I will hand the call back over to Jay.

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**Jay Chaudhry Zscaler, Inc. - Chairman & CEO**

Thank you, Remo. I would like to leave you with these key takeaways from our results.

One, with multiple tailwinds, such as SaaS adoption, SD-WAN and app migration to public clouds, the market is coming to us. We are winning bigger deals, including the biggest deal in our company's history.

Two, while we replace security appliances in current Internet gateways, majority of ZIA sales are coming from creating and securing new, local Internet breakouts. It is a greenfield opportunity.

Three, our platform strategy is working well. Customers are purchasing our higher-end Transformation bundles and ZPA services as they increasingly rely on us to enable cloud transformation. The Zscaler security cloud is delivering not just better and more pervasive security but also a dramatic return on investment for our customers, decreasing network infrastructure and bandwidth costs while providing better user experience.

Four, we have purpose-built our cloud platform to be extensible with the ability to quickly introduce new functionality, such as DLP EDM and user behavior and analytics in our latest cloud update.

We thank you for your interest in Zscaler and look forward to reporting on our progress in the future. Operator, you may now open the call for questions.

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**QUESTIONS AND ANSWERS**

**Operator**

(Operator Instructions) We'll go to Brad Zelnick with Credit Suisse.

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**Brad Zelnick Credit Suisse AG, Research Division - MD**

Jay, Remo, congratulations on a strong finish to a spectacular year. I've got one for Jay and one for Remo. Jay, we get asked by investors all the time. Why can't the traditional network security players do what you're doing? And I think you've done a great job in your prepared remarks addressing this with examples of customer success, and your performance this quarter would also suggest you're doing something very different. But there's a lot of noise out there and I think we've seen this. It's an industry where the best tech doesn't always win. So from a go-to-market perspective, how do you cut through the noise when most likely, the customer you're calling on already owns a box and has a relationship with a legacy network security provider that says they do something that sounds like what you do?

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**Jay Chaudhry Zscaler, Inc. - Chairman & CEO**

It's a good question, Brad. Thank you. In the high-tech world, there are always incremental changes going on. Every 10 to 15 years, some disruptive technologies come because the market changes. We are seeing that kind of disruption. I talked about network security becoming irrelevant, and I think that's what customers are understanding. We have always seen the same phenomena happen.

Salesforce had to fight Siebel. Workday had to fight PeopleSoft to really get the word out. We have seen web proxy vendors talking about a hybrid cloud offering like Zscaler for the last 6 years. Now we are seeing firewall and other companies trying to do the same. I think we

have a growing sales team. We have a very strategic channel. We have some very, very referenceable customers who are helping us to spread the word out. So the momentum is there. So I feel very comfortable that we will see the same movie run in our case that we saw with other SaaS vendors.

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**Brad Zelnick Credit Suisse AG, Research Division - MD**

That's helpful context, Jay. Thank you. And Remo, as I think about and look at the cash flow and margin upside -- at least relative to our model, it makes me wonder about the investments that you're making this year, particularly in sales productivity in the context of the growth that you're putting up. So how do we -- how do you think about sales productivity and measure it? And how is it trending? And what are you baking into your forecast for this year? Specifically if you can comment on sales and marketing hiring targets that you're solving for in fiscal '19.

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

Thank you, Brad. A lot of questions. I'll try to answer most of them. With our performance that we've had for the first 2 quarters as a public company, I think you've seen the strength of our model. One of the things that Jay and I are acutely aware of is the large market opportunity that we have. We're going to continue to invest in sales and marketing. Our long-term model that we've talked about is that we will get to breakeven operating profitability and free cash flow positive on a sustained basis sometime in fiscal '20. So we're going to continue to drive to that. So we'll be hiring aggressively through fiscal '19 and also into fiscal '20. Related to sales productivity, sales productivity in the year for fiscal '18 was up versus fiscal '17. Our internal plans have sales productivity being slightly up to flattish in fiscal '19. The reason for that is we're going to aggressively hire in the sales and marketing organizations. The basis that I use for sales productivity, and the company uses, is based on new ACV. So we look at new ACV per sales rep, and that's how we base sales productivity. And now I'll turn it over to Jay.

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**Jay Chaudhry Zscaler, Inc. - Chairman & CEO**

I think it's good. The number of people we are hiring in sales and marketing is increasing. We are being selective. It's a tough market, but we have no problem attracting good talent.

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**Operator**

Our next question comes from Alex Henderson with Needham.

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

Let me start off with just a very simple one. Do you have the ending fully diluted share count for the period? Assuming solid profitability, what would be the share count?

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

In the 134 million range.

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

And more to the fundamentals and sort of more of a real question. Looking at ZPA, obviously, very nice acceleration, 4% to 10% is outstanding. But when I met with your customers at your trade show, virtually every customer I talked to said he was aggressively moving to it. Could you talk a little bit about what the backlog of business, pipeline of business looks for -- looks like for ZPA? And second, what is the time line from the beginning of the discussion to actually closing that -- those type of transactions as you push on that opportunity?

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**Jay Chaudhry Zscaler, Inc. - Chairman & CEO**

Yes, Alex. ZPA has done well and we're seeing constant momentum. So we expect ZPA to gain -- to grow at a faster rate than ZIA, but ZIA is growing very fast, too. It will be very hard for ZPA to catch up with ZIA even though the market TAM of both platforms are essentially the same. In terms of sales cycle, it depends. We have 2 types of use cases in ZPA. One is what I call transactional, the customers saying, "I hate my VPN. Could you replace it?" That's quick. That's faster. That will be probably more so in the 3 to 6, 7 month time frame. The second is more transformational. "I want to eliminate the old way of going to cloud. My applications are going to Azure,



AWS, Google. I want to go direct through Zscaler ZPA." Those things take a little bit longer because we have to educate the customer of our architectural transformation. But we are bullish on numbers, and we expect ZPA market share to grow as a part of the overall product mix.

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

And related to backlog inside...

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

Yes, so that channel...

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**Jay Chaudhry Zscaler, Inc. - Chairman & CEO**

Sorry, what's it?

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

I'm sorry. I didn't mean to interrupt you, Remo. I didn't know you were coming on.

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

That's all right.

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

I was wondering if you had any statistics around the pipeline. What percentage of the pipeline is -- has ZPA in it or is combined ZIA, ZPA?

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

Yes, that's what I was going to answer. We're not going to comment on our pipeline and break it out between ZPA and ZIA or our backlog. What's important to understand is ZPA has momentum and it's doing well and we're expecting to grow as we go forward.

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

All right. One last kind of add then. Could you talk about what percentage of your deals are directly related to digital transformation, local breakout initiatives?

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**Jay Chaudhry Zscaler, Inc. - Chairman & CEO**

Thanks. So yes, I can probably -- if you're to look at one indicator of transformation-related deals, that would be the sale of Transformation bundles even though there are some deals we start with cloud transformation and then they may still choose to buy a Business bundle to start with for pricing and budget reasons. Remo, you had commented on the Transformation bundle sales.

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

Yes. So I mean, the Transformation bundle sales was like -- they're 35% of our business now, and that's up from 20% at the time of our public offering and that's based on ARR. The -- we're seeing an uptick on transformation both with new customers and existing customers. So if you look at the split, I'd say it's fairly even between new and existing customers.

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**Jay Chaudhry Zscaler, Inc. - Chairman & CEO**

And if I were to say the number of deals that are started with cloud transformation use case by Zscaler, that's actually a good majority of them. But some of them will go into Transformation bundles, other will go to Business bundle, and then we upsell from there. Honestly, my preference is actually to sell Business bundle and take the deal sooner than try to sell the bigger deal, but we take whatever works.

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**Operator**

We'll continue on to Gabriela Borges with Goldman Sachs.

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**Gabriela Borges Goldman Sachs Group Inc., Research Division - Equity Analyst**

Maybe one for Remo to start. On the guidance fiscal year '19, I was hoping you could outline for us a little more on the puts and takes that you're assuming for that mid-30% type growth rate coming off of such a strong year. You touched on the productivity a little bit, but any other factors that will be driving a deceleration would be really helpful.

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

So the guidance that we gave was \$250 million to \$260 million for the year, which is a 32% to 37% increase over our base -- over fiscal '18 of \$190 million. That, from our perspective, is outstanding. We are giving guidance that we feel is prudent, and we're comfortable with the guidance that we're giving. The way we look at it is that we have an outstanding opportunity in front of us and we want to make sure we are looking forward in building our company for success. That's been our focus related to how we ran the business as a private company and how it will be as a public company going forward.

**Gabriela Borges Goldman Sachs Group Inc., Research Division - Equity Analyst**

That makes sense. And the follow-up is for Jay, which is related to transformation but more on the SD-WAN side. Could you maybe talk about how often SD-WAN is coming up as a catalyst or as one of the areas of ROI post the Zscaler deployment? I know comms infrastructure transformation can sometimes be slow, but given the ROI attached to it, this does seem like it might be progressing nicely. So any color on that would be helpful.

**Jay Chaudhry Zscaler, Inc. - Chairman & CEO**

Yes. If you think about fundamental value propositions Zscaler brings to the table, it's enabled by secure local Internet breakouts. Now we don't require SD-WAN to do local Internet breakouts because lots of our customers already in place have been using Zscaler without SD-WAN. But SD-WAN actually makes it easier for a customer to roll out and deploy hundreds of branches because these are cloud-managed boxes. We are seeing more and more adoption of SD-WAN. And when that thing happens, it actually helps accelerate our business. So we see it very, very complementary, and we are working with most of the SD-WAN vendors with, one, joint selling; two, actually integrating with them. So the deployment of Zscaler and SD-WAN can be done quickly because the products are integrated. Momentum is growing and building, and we like it.

**Operator**

We'll continue on and hear from Keith Weiss with Morgan Stanley.

**Keith Weiss Morgan Stanley, Research Division - Equity Analyst**

I was going to dig down a little bit more to the competitive environment. Can you just -- from your side of the equation, we see a broader sale happening. You guys have given us the data on it that you're doing these broader sales. You're getting into areas of upside, kind of that core value proposition we were talking about 3 or 4 years ago, and talking about stuff like SD-WAN and access. And we're also hearing other companies outside of the traditional contender sets start to talk about assets and SD-WAN and the like. So it just seems like the competitive environment is broadening out a lot. Is that still like -- is it just marketing? Or are you actually seeing that in reality? I actually see a broadening of the competitive environment that we are trying to sell against.

**Jay Chaudhry Zscaler, Inc. - Chairman & CEO**

So I look at SD-WAN as a very complementary market. I think there will be a few SD-WAN vendors who try to say I will not only do SD-WAN; I'll put the full security stack in every branch office, hundreds of them. We don't think that really works. But that's why if you really look at real customers who had done SD-WAN deployments, most of the time, Zscaler shows up as the default cloud-based business policy engine, so to speak. So that part is very natural for us. Did -- was there a second part of the question? I didn't catch it.

**Keith Weiss Morgan Stanley, Research Division - Equity Analyst**

It was just that -- are you seeing that broader competitive environment in the field? Has it changed the way you have to sort of go to market and sell or change your sales cycle now that is extending beyond just traditional sort of Internet gateway that you're competing against?



**Jay Chaudhry Zscaler, Inc. - Chairman & CEO**

So if you look at the evolution 4, 5, 6 years ago, it used to be we competed against the traditional Secure Web Gateway vendors. Then as we got success, those vendor changed. It became hybrid Secure Web Gateway vendors. And in the past year or so, we have been hearing about the firewall guys trying to say, "People are buying my firewalls. But if you're on the road, if you got a branch, I'll spin up these VMs and use me." And I'm sure it will be some of the same message coming from SD-WAN vendors down the road, some of them. So I think it's a natural part of it. We actually like the fact that there are more vendors who are trying to make noise about the need for doing local Internet breakouts but being able to solve for a proper solution where your users can be -- go to any place, policy that moves around, logs. And all that come together with full SSL inspection. It's a very hard business problem to solve. So we like the more noise because our big challenge has been awareness, and we welcome it.

**Keith Weiss Morgan Stanley, Research Division - Equity Analyst**

Got it. That's helpful. And then one [probably] for Remo. Backlog number, I suppose the \$400 million, I think, as of this quarter, can you give us any kind of sense, kind of the duration on that? How much of that is expected to be billed or invoiced over the next -- probably next 12 months?

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

Yes. So that will be in our 10-K and under ASC 606. What that represents, it's a billed or unbilled revenue backlog. And of that \$398 million, we expect 53% to be revenue this next fiscal year.

**Operator**

Our next question comes from Shebly Seyrafi with FBN Securities.

**Shebly Seyrafi FBN Securities, Inc., Research Division - MD**

So my question is, it looks like, with your guidance, that the operating margin, which was negative 4% last quarter, is going to decline about maybe 7 points sequentially to like negative 11%. And it looks like in the prior fiscal Q1, if you were down like 1 to 4 points sequentially, just talk about your increased -- I think it's your increased investment in OpEx. What are your plans there? Why are you being more aggressive right now? And why is this guidance on operating margin a little bit more lower than normal?

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

Good question. The key thing is that we see a huge market opportunity with our platform. We don't want to short change ourselves. So we are going to invest in our company. What we said before -- and we're staying with it, is that in fiscal '20, at some point in fiscal '20, we're going to be, on a sustained basis, positive free cash flow and operating profitability. So that's what we're going to do. And along the way, we're going to keep on investing as much as we possibly can. Now having said that, Jay and myself have been around. Jay has founded 4 companies. I've been CFO of 6 public companies. And so we are, like, I think, probably 2 of the most frugal people. I know Jay is and I think I put myself in the same category, incredibly frugal people. We're going to try to maximize the value of the company and the shareholders by driving top line growth, and the way to do that is to continue to invest. And we'll make prudent judgments along the way. We'll make those investments. In Q1, we also had our sales kickoff. So there was a significant expense which is coming through Q1, the sales kickoff. We had about 450, 500 of our employees at a kickoff. So that is going to increase expenses during the quarter a little bit.

**Shebly Seyrafi FBN Securities, Inc., Research Division - MD**

Okay. Can you quantify that for us, estimated sales?

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

The estimated for the sales kickoff was around \$2 million during the quarter in Q1.

**Shebly Seyrafi FBN Securities, Inc., Research Division - MD**

\$2 million, okay. And then the next one from me is on ZPA. I think you said it was around 10% of your business. When you say business, you mean billings, you mean net new ACV? What do you mean by that?



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

New ACV, whether it's new or upsell.

**Shebly Seyrafi FBN Securities, Inc., Research Division - MD**

Okay. And you're not going to give us any kind of revenue estimate on ZPA?

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

No. ZPA business is based on a ratable basis. It's still less than 5%.

**Shebly Seyrafi FBN Securities, Inc., Research Division - MD**

Okay. And last one is the fed gov certification for ZPA. How important is that in your opinion?

**Jay Chaudhry Zscaler, Inc. - Chairman & CEO**

Well, it's very important because without it, we couldn't play in the federal market. So it opens up a market we couldn't play in. And in fact, we are pursuing the same thing with ZIA as well, which should be happening in the coming months, so brand new opportunity in federal market with ZPA and ZIA, both.

**Operator**

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

**Tal Liani BofA Merrill Lynch, Research Division - MD and Head of Technology Supersector**

I have 2 questions that are related to questions that were asked before. The first one is, how long does it take to translate the government certification or approval into revenues? Do you have to now start from scratch presenting the products and going through testing, et cetera, so that means a long sales cycle? Or have you already done it and you were just waiting for approval so it could be a quick sales cycle? So that's the first question. The second question, I want to go back to the first question you were asked. And the question was, how much of a threat you see from firewall companies? And I want to reverse it. How much of a threat do you represent to the firewall companies? And I know you were asked this question multiple times in the past, but I still get this question from investors and I'm wondering if you can address it. Can you expand the addressable market to traditional firewalls with ZPA and ZIA? Or is it not the case for technical reasons?

**Jay Chaudhry Zscaler, Inc. - Chairman & CEO**

Okay. Good. The first question, the FedRAMP certification, going through FedRAMP certification for the cloud has been very painful because being the first one to get it done when no one really knows how to interpret some of the certification was quite a lot of work. But we spent months and months and lots of money to become the first vendor to get this thing done for ZPA. So that's point number one. Point number two, have we been talking to a number of federal agencies to understand the need and whatnot? The answer is yes, and there's a lot of receptivity to the solution. That leads to the third part of your question. Well, can sales happen real quickly? You know the federal market. Can you count on fast sales in federal market? I don't think so. We think it's a big market for us. A lot of these federal sales are driven by year-end, and that is end of September. So we -- while our federal market share today literally is, you can say, 0 or 1% of the total revenue, it's nothing. We expect to start growing some revenues, but it's hard to speculate. I think we will get some revenue in fiscal '19, but we are not counting a big part in our plan, being conservative, not committing to the board. Could it have upside? Probably, but that's where we're at with federal, bullish and optimistic. The second question, threat to firewall companies -- or firewall companies being a threat to us. I think what we had talked about before is we are not directly going after replacement of firewalls, as you saw me cover a number of use cases, a number of customer wins. It's mostly a greenfield opportunity because enterprises are creating new Internet local breakouts, and that's where we go in and that's -- also, our focus is user traffic, traffic that's headed to Internet or the cloud. So they won't see a whole lot of impact with that. Now we have always said that. And as I said during my comments, we are not focused on inbound traffic coming to your data centers. So we are not replacing any of the inbound firewalls in your data centers. And that DMZ is so complex that people rather not mess with it. Now as more and more applications move to the cloud, internal applications go to Azure, AWS, our ZPA approach eliminates the need to do traditional VPNs and firewalls and the like. So I think in the long run, we will be probably reducing the need for that kind of traffic, but there's no need for us to have a head-on competition and we are not trying to go after it directly.



**Operator**

Our next question comes from Gray Powell with Deutsche Bank.

**Gray Powell Deutsche Bank AG, Research Division - Research Analyst**

I've been juggling calls. So hopefully, this hasn't been asked and answered already, but I'm just going to give it a shot. So from a competitive standpoint, have you seen any changes in the level of discounting at your appliance-based peers the last 6 to 12 months? And does that even have an impact on your customer conversations?

**Jay Chaudhry Zscaler, Inc. - Chairman & CEO**

So as we do more and more deals with cloud transformation, we really don't get into any bake-offs or real competition because it's very different positioning. So are we seeing a big impact? We don't know. We do know that some of the appliance vendors have standing orders for the field and say, "If you see Zscaler out there, drop your prices and you can do whatever you want to do." But we haven't really lost any business because of that, and this is because of our positioning and this is because how we go to market.

**Operator**

We'll continue on to Saket Kalia with Barclays.

**Saket Kalia Barclays Bank PLC, Research Division - Senior Analyst**

Maybe starting with you, Remo. First of all, thanks very much for the billings guidance for fiscal '19. If I think about some of the other drivers of cash flow next year, one item that's a little less predictable is litigation expense. We saw that, that was slightly lower this quarter than last quarter. I know that, in fact, can ebb and flow with activity, but I was just wondering if you had any thoughts on how that line item could trend throughout fiscal '19.

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

Yes, I'm glad you asked that question. In Q4, we had \$1.4 million in litigation expenses. We're expecting \$3 million to \$4 million in Q1. And for the full fiscal year, we're expecting \$15 million to \$20 million. Again, that can ebb and flow, but that's we have in our internal plans.

**Operator**

And we'll go to Fatima Boolani with UBS.

**Fatima Boolani UBS Investment Bank, Research Division - Associate Director and Equity Research Associate Technology-Software**

Jay, you gave a lot of examples in your prepared remarks around strategic deals and specifically that \$16.5 million deal and then just various examples, sort of wall-to-wall deployment for ZIA and ZPA. So I'm curious if you can speak to the enterprise ARR trends that you're seeing and sort of frame for us how that's changed over the last year or so.

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

I'll take that question. By customer, our ARR has been going up every quarter. It increased in Q4 over Q3. It's in the low \$300,000 range, and this is for customers with greater than 3,000 users or more. So it's been consistently going up every quarter.

**Operator**

We'll now hear from Srinu Nandury with Summit Insights Group.

**Srinu Nandury Summit Insights Group, L.L.C - MD & Senior Analyst**

Jay, can you talk about your TrustPath acquisition? What does it provide for Zscaler? And when will the AI be paired with your services?

**Jay Chaudhry Zscaler, Inc. - Chairman & CEO**

Yes. As we have been collecting billions and billions of logs, it has been natural for us to do some of the data mining, machine learning type of activities. And TrustPath is actually helping accelerate and get bigger and better benefits. So the platform is extensible. We have looked at the technology. We like it. So we will be integrating more and more with it, but you are not going to see a separately priced product that's coming out of it in the near term. You'll see the kind of analytics we provide, the kind of security detection we do get much



better. So the results, I think they will not be an incremental thing one day and say TrustPath is part of it. I think our customers will see the benefit of better detection as well as better reporting with better analytics and more actionable information they can use to make better decisions.

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**Operator**

At this time, I'd like to turn the floor back over to CEO, Jay Chaudhry, for any additional or closing remarks.

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**Jay Chaudhry Zscaler, Inc. - Chairman & CEO**

Well, thank you again for your interest in Zscaler. We'll see some of you at the upcoming conferences, otherwise, talk to you during the next earnings call. Thank you again.

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

Thank you.

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**Operator**

Thank you. Ladies and gentlemen, again, that does conclude today's conference. Thank you all again for your participation. You may now disconnect.

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