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ZS.OQ - Q1 2024 Zscaler Inc Earnings Call

EVENT DATE/TIME: NOVEMBER 27, 2023 / 9:30PM GMT

OVERVIEW:

Company Summary

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PRESENTATION

Operator

Thank you for standing by, and welcome to Zscaler's First Quarter 2024 Earnings Conference Call. At this time, all participants are in listen only mode. (Operator Instructions) As a reminder, today's call is being recorded.

I will now turn the call over to your host, Mr. Bill Choi, Senior Vice President of Investor Relations and Strategic Finance. Please go ahead.

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

Good afternoon, everyone, and welcome to the Zscaler First 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.

The 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 UBS Global Technology Conference tomorrow.

Now I'll turn the call over to Jay.

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

Thank you, Bill. I'm pleased to share our First Quarter results, which exceeded our guidance across all metrics. We delivered 40% revenue growth and 34% billings growth. Our operating profit and free cash flow more than doubled year-over-year, and free cash flow margin reached a record 45%.

We exceeded the rule of 60 for the 13th consecutive quarter, at a significant scale of $2 billion plus in ARR. We are delivering a unique combination of high growth and high profitability that only a few SaaS companies have accomplished.

In Q1, we executed well in a challenging macro environment and what is typically a slower quarter for us. The elevated scrutiny of large deals remains mostly unchanged. The increased frequency of high-profile breaches, coupled with impending SEC disclosure requirements has propelled zero trust security more into focus at the management and the Board level. Against this backdrop, we achieved a Q1 record for number of new logo customers with over $1 million in ARR.

We also achieved a record for new pipeline generation in a quarter. More customers are adopting our broader platform to consolidate multiple point products, increasing our average deal size. As a result, we are actively working on more large, multiyear, multi-pillar opportunities than ever before.

To meet this demand and to further scale our business, we're adding 2 key go-to-market leaders, one in sales and one in marketing. I will provide details about these new executives after reviewing our Q1 performance.

Let me highlight 3 factors that drove our strong Q1 performance. First, large new logo wins were strong this quarter with a Q1 record of 14 new logos contributing over $1 million ARR. We ended with 468 such customers, up 34% year-over-year. These wins spanned across many verticals, proving that every vertical needs Zscaler.

Second, Customers are buying a prouder Zscaler platform with multiple product pillars. I have said before, over time, I believe every one of our customers will buy ZIA, ZPA and ZDX, for every user to deliver secure, fast and reliable access to any application anywhere.

This quarter, nearly half of our new logo customers purchased all 3 user pillars, ZIA, ZPA and ZDX. In addition, strong platform upsells drove our 120% dollar-based net retention rate.

Third, this was a record U.S. Federal quarter with new business up over 90% year-over-year, including 4 deals that are greater than $1 million in ACV. We are starting to see larger awards as multiple U.S. Federal agencies are standardizing on Zscaler to meet the President's executive order to adopt Zero Trust security.

We are extremely proud of having landed 12 of the 15 cabinet-level agencies as our customers, where we have plenty of opportunity to expand. For example, at a cabinet level agency, we expanded the ZIA and ZPA deployment from 25,000 users to 100,000 users, while cross-selling ZDX for all 100,000 users. We also won a top defense integrator who purchased ZIA, ZPA and ZDX for its employees. In parallel, they launched a go-to-market service to take Zscaler to their Federal customers. As our SI partners are selling and deploying Zscaler for their customers. They are also adopting Zscaler to make their own business secure, agile and competitive.

From my conversations with hundreds of IT executives, it's clear that cybersecurity is the #1 IT spending priority. Adopting Zero Trust architecture and protecting their enterprise from Gen AI risks are top priorities for CISOs in 2024.

We have enhanced our data and protection policies or AIML applications and tools to protect our customers' risk of data loss due to increasing use of Gen AI. Our AI-powered threat protection uses a diffusion model to detect complex exploits and to catch sophisticated phishing attacks that evade traditional security controls. These AI-driven features are included in our Advanced Plus bundles, which are often priced 20% higher than advanced bundles.

We now secured on average over 2 billion AI transactions every month for our customers. Next, let me discuss some of our Q1 deals, which demonstrate our differentiation and business value.

We are starting to see some wins where customers are coming to us after initially purchasing a firewall-based single-vendor SASE solutions that failed to deliver in the real world. For those who are not familiar, firewall-based single vendor SASE is the combination of SD-WAN and firewall and VPN deployed as VMs in the cloud.

A leading software company made an architectural shift to our Zero Trust Exchange platform after trying to deploy a leading firewall vendor SASE solutions across 50 office locations and multiple public cloud sites. It became clear to the customer that this solution expanded their attack surface to all locations and increased the risk of lateral threat movement. They decided to move to our Zero Trust security with the purchase of Zscaler for users, our complete bundle for ZIA, ZPA and ZDX, for all 25,000 employees.

Our Zero Trust Exchange connects users directly to apps, eliminating attack surface and lateral tech movement. Unmanaged devices, the customer is deploying our browser isolation with ZPA to enable third parties to access their applications. Deals like this reinforce our conviction that firewall-based SASE solutions are not the future of security that some analysts advocate. Customers are choosing Zscaler's purpose-built Zero Trust platform.

Let me highlight one new logo win where our superior security helped the customer after a breach. Despite extensive investments in firewalls and VPNs, a hospitality and gaming company experienced a crippling Ransomware breach. To restore their operations, they purchase the entire Zscaler for users bundle for 25,000 users. With Zscaler, the apps are now hidden from pet actors behind our Zero Trust Exchange and can't be discovered, exploited or DDoS.

This customer also purchased our new Risk360 solution to understand the organization-wide risk and to get actionable information to reduce it. We have shared with you that data protection is one of the fastest-growing solutions for us. For our customers, after implementing cyber protection, adopting data protection is the natural second phase of their Zero Trust journey. For example, a Fortune 500 travel and hospitality services provider more than doubled their annual spend with us with data protection being a critical component of the upsell.

The first purchase was ZIA for 22,000 users to inspect all traffic, including TLS encrypted traffic for cyber protection. As the next step, they are implementing real-time in-line DLP for sensitive data. Our solution also enables this customer to enforce policies for secure use of AI applications. These deals highlight the breadth and depth of our Zero Trust security platform. We also help our customers achieve high ROI by eliminating tech debt and consolidating multiple point products.

For example, a Fortune 200 financial services group turn to Zscaler to consolidate data centers and safely adopt cloud with the necessary security controls for regulatory compliance. They purchased Zscaler for users bundled for 10,000 employees and workload communication for 1,500 workloads. By leveraging our cloud platform, they will eliminate half of the data centers, reduce their MPLS spend and consolidate security and networking client products.

We are eliminating several point products, including secure web gateways, firewalls, IPS appliances, VPNs, CASB and DLP from 7 security vendors. This deal is expected to generate a remarkable 5x ROI for the customer.

I'm also excited to share that ZDX one of our emerging pillars continues to gain significant customer adoption. It is an important part of every deal conversation due to its unique ability to eliminate IT blind spots. ZDX significantly reduces helpless hours spent on ticket resolutions and manual correlation or metrics.

Let me highlight a new logo deal where ZDX played a pivotal role. A top-ranked U.S. hospital network purchased ZIA and ZDX advance plus for 87,000 users and ZPA for 40,000 users. What initially began as a ZIA and ZPA project quickly evolved into a significant ZDX opportunity. The ZDX component alone is 7 figures in ACV. Unlike their existing performance tools, ZDX provides comprehensive visibility and root cause analysis for users, devices and applications.

This deal is a great example of the leverage we gained from working with system integrators like Accenture, who was awarded this overall transformation project. We're also seeing strong customer interest in workload protection on other emerging product pillar. Our Zero Trust Exchange is designed for any to any secured communication. It may be users to apps, workload to workload or IoT OT devices.

Thousands of enterprises already leverage Zscaler platform for secure user-to-app communication. It is natural for them to extend our Zero Trust platform to secure their workload communication. To radically simplify multi-cloud connectivity and automated deployment of workload protection at scale, we recently released significant enhancements to our workload communications offering, including granular workload segmentation using AWS user-defined tags, the first zero trust security solution for workloads in the market, the only alternative is legacy virtual firewalls and real-time auto discovery of cloud resources.

More than a 1/3 of our customers have made initial purchases for workload protection. Workload communication often starts with small land deals. And we expect to rapidly expand to secure the growing number of workloads.

Zscaler pioneered Zero Trust and SASE, both delivered by our cloud-native platform. We have established ourselves as a premier provider for user protection and are now making progress expanding into workload protection and IoT OT protection. We continue to push the boundaries of what our platform can achieve, extending it for B2B and 5G use cases.

As we are like a switchboard for all communications, we collect full transaction logs and trillions of signals daily. We are utilizing those signals and logs to deliver AI-powered insights and automation for our customers. Let me discuss a few of the high-value products in our AI cloud family.

We recently launched Risk360, which is the industry's first holistic AI-powered risk quantification and mitigation solution. It delivers up-to-date risk posture and recommends corrective actions to mitigate risk in a timely fashion. We have already closed 10 plus Risk360 deals and are in active evaluations with over 100 enterprises.

For these deals, we are getting 6-figure ACV on average, and we expect to grow this value over time. Risk360 provides critical insights to CISOs when reporting on cybersecurity risk, strategy and governance, particularly in light of new SEC regulations.

Another exciting new product, breach predictor currently under development uses predictive and generative AI models to anticipate potential breach scenarios and eliminate those risks before they materialize. Early feedback from customers who have previewed breach predictor indicates the enormous potential value this solution can deliver. We are working with our technology partners to bring this world-class innovation to thousands of customers to proactively protect against potential breaches.

While we have achieved tremendous success for user protection solutions, our platform's potential in other categories is just beginning. Our relentless innovations have paved the way for an ever-growing stream of opportunities. As our platform continues to scale and expand, our go-to-market efforts are continuing to evolve and scale as well. To enable the next stage of go-to-market scaling, I'm excited to share the appointments of 2 exceptional leaders, Mike Rich, as CRO and President of Global Sales; and Joyce Kim as CMO. They bring a wealth of experience in driving revenue and pipeline growth. Mike joins from ServiceNow, viewed as the President for Americas. He established an efficient and scalable process to drive deeper engagements to large enterprises and to scale their business to over $8 billion in revenue and experience that's critical to the next phase of our growth journey.

Joyce's previous experience includes CMO roles at Twilio, Genesis and ARM with expertise in building high-performance marketing teams and driving impactful marketing strategies and campaigns. With Mike assuming leadership of our sales organization, Dali in his capacity as the COO can focus on scaling our business operations. Dali has been instrumental in establishing the go-to-market process. which has helped Zscaler achieve a milestone of $2 billion in ARR.

With our expanded portfolio of products and experienced CRO and CMO on board we will further scale our value-add sales process for larger platform deals, which will sustain our high growth. I'm thrilled to have strong go-to-market leaders who we believe will drive world-class execution to scale our business beyond $5 billion in ARR.

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

Remo Canessa - *Zscaler, Inc. - CFO*

Thank you, Jay. Our Q1 results exceeded our guidance on growth and profitability, even with ongoing customer scrutiny of large deals. Revenue was $497 million, up 40% year-over-year and up 9% sequentially. From a geographic perspective, Americas represented 53% of revenue, EMEA was 32% and APJ was 15%. As Jay highlighted, from a new business perspective, Federal had its best new ACV quarter ever, growing over 90% year-over-year. Our new ACV outside of the Fed also grew year-over-year.

Our total calculated billings in Q1 grew 34% year-over-year to $457 million. On a sequential basis, total billings declined 37% quarter-over-quarter with a difficult comparison to Q4, which had a $20 million upfront billing on a multiyear deal.

As a reminder, our contract terms are typically 1 to 3 years, we primarily invoice our customers 1 year in advance. Our calculated current billings grew 33% year-over-year, a seasonal decline of 32% quarter-over-quarter. Our remaining performance obligations, or RPO, grew 30% from a year ago to $3.49 billion, The current RPO is approximately 51% of the total RPO.

We ended Q1 with 468 customers with greater than $1 million in ARR, adding 19 such customers in the quarter. 14 of the 19 $1 million ARR customer adds were new logos, which was a record for Q1. The continued strength of this large customer metric speaks to the strategic role we play in our customers' digital transformation initiatives. We also entered the quarter with 2708 customers with greater than $100,000 in ARR.

Our 12-month trailing dollar-based net retention rate was 120%. Turning to the rest of our Q1 financial performance. Total gross margin of 80.7% compares to 80.7% in the prior quarter and 81.4% in the year ago quarter. Higher public cloud usage for emerging products drove the year-over-year change in the gross margin partially offset by approximately 60 basis points of benefit from a change in accounting attributed to the longer useful life of our cloud infrastructure.

As mentioned last quarter, as a result of advances in technology and efficiencies in how we operate our server and network equipment. Starting this quarter, we extended the depreciable useful life of these assets in our cloud infrastructure from 4 to 5 years.

Moving on, our total operating expenses increased a 11% sequentially and 26% year-over-year to $311 million. We continue to generate significant leverage in our financial model with operating margin reaching 18%, an increase of approximately 620 basis points year-over-year.

Our free cash flow margin was 45%, including data center CapEx of approximately 6% of revenue, Free cash flow benefited from strong collections for Q4 billings, including the $20 million upfront billings I mentioned.

We ended the quarter with over $2.3B 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. While the global macro environment remains challenging, and customers continue to scrutinize large deals from our perspective, customer sentiment seems to be stabilizing. Our customer engagements remain strong, and we have a large and growing pipeline. However, we want to be prudent in our assumptions given the sales leadership change.

In our outlook for fiscal '24, we're balancing our business optimism and continued sales execution with ongoing macroeconomic uncertainties. With that in mind, let me provide our guidance for Q2 and full year fiscal 2024. As a reminder, these numbers are all non-GAAP.

For the second quarter, we expect revenue in the range of $505 million to $507 million, reflecting a year-over-year growth of 30% to 31%, gross margins of 80%, including the change in accounting for useful life of server equipment. I would also like to remind investors that a number of our emerging products, including newer products like ZDX and Zscaler for workloads will initially have lower gross margins than our core products.

We are currently managing the emerging products for time to market and grow, not optimizing them for gross margins. Operating profit in the range of $84 million to $86 million. Net other income of $15 million, income taxes of $8 million, earnings per share in the range of $0.57 to $0.58, assuming a $160 million fully diluted shares.

For the full year fiscal 2024, we're updating our guidance as follows: increased revenue in the range of $2.09 billion to $2.1 billion or year-over-year growth of 29% to 30%; calculated billings in the range of $2.52 billion to $2.56 billion or year-over-year growth of 24% to 26%, we still expect our first half mix to be approximately 42% of our full year billings guide; increased operating profit in the range of $360 million to $365 million, which reflects up to 250 basis points of operating margin improvement compared to last year; income taxes of $35 million; increased earnings per share in the range of $2.45 to $2.48 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 a 3 to 4 percentage points of headwind to free cash flow margins. We expect the timing of CapEx spend to be more towards the second half of the year as we invest in upgrades to our cloud and AI infrastructure.

Our guidance reflects our plans to invest aggressively in our business to pursue our significant market opportunity. With our new CRO and CMO coming on board, we expect to step up our sales and marketing investments in the coming quarters. In addition, we'll increase investments in our technology platform and cloud infrastructure.

With a large market opportunity and customers increasingly adopting the broader platform, we plan to invest aggressively to position us for long-term growth while increasing profitability.

Operator, you may now open the call for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from the line of Brad Zelnick Deutsche Bank.

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

Great. And congrats on a strong start to the year and nice to see the leverage in these results. Jay, your distinction at SASE has always been clear and it's perhaps no more obvious than right now at a time when traditional network security providers are having a tough time selling more and more boxes. And it seems they're paying you a nice complement as they all double down their focus on the cloud and SASE.

So as this all plays out competitively and you're increasingly subject to the law of large numbers, how should we think about your ability to sustain high growth and specifically the rate at which you can scale your emerging product portfolio?

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

Very good question. It is flattering to see all kind of vendors becoming SASE vendors overnight. But the challenge for them would be, it's a different architecture. It's not an incremental change and feature you can add on to it. That's why we spent a dozen plus years building a true zero trust architecture, which is an advantage.

That's why we became the market leader. We pioneered this market. We evangelized to the fact that this is what's needed for better cybersecurity and then some protection and cost reduction. The way I look at -- to sustain high growth is the following. One, is there a market demand came out? The market is growing and expanding at much faster pace than I even thought. Two, do you have the right platform with the right architecture, the right functionality. You've seen us build this platform on a true zero trust architecture and expanded over the years, think of what we had at the time of IPO versus what we have today.

And the third area is go-to-market execution. We've done a great job starting with IPO, crossing $2 billion in ARR. And now we've got our sights set on crossing $5 billion. And we have been growing and adapting go-to-market also along with the platform. That's why I'm very excited about bringing 2 key leaders: Mike as CRO and Joyce as CMO, who can help us take us with next level. Great market execution, great platform. I think it is set. I'm very excited about the opportunity in front of us.

Operator

Our next question comes from the line of Saket Kalia, Barclays.

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

Jay, maybe for you, just building off of that last question on some of the slowness that we've seen with the traditional network security guys and the challenges with Appliances, there was (inaudible) maybe do you feel like customers are more willing now to replace their appliance firewalls at least at the branch with SASE architecture like what Zscaler provides so well?

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

You know what I said many times, firewalls won't go away, but they will become like mainframes. We have been replacing firewalls and the branches from the last several years. Now that trend is accelerating. And from one of the new things is done to help accelerate the demise of firewalls and branches is our branch connector technology, which now we package to make it available. So you can become a Starbucks-like office in a matter of minutes rather than trying to wait for a long, long time.

So we've seen in campus environment becoming just like that, the only place where firewalls have been playing a significant role for a while is the data center, the east-west traffic and the like. You know that half of it is going away from the data center and that demand has to go away. So a big thing for someone to do it right, had to really offer a Starbucks like branch and zero-trust architecture.

Market has made progress with traditional SD-WAN. We think traditional SD-WAN is a transfer technology. And once we have brought the market with Branch Connector actually is the next big phase to make it simple. Very excited with the opportunity to make the world free of firewalls.

Operator

Our next question comes from the line of Alex Henderson of Needham & Company.

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

I'm torn on what to ask, but I think I'll go with the question around the channels. So you guys have been doing a lot of work on expanding your VAR channels. expanding reach into Federal, expanding reach into MSPs, expanding into the cloud arena as much as possible. Can you give us some sense of how you think the mix of your sales leads will be driven by those different channel opportunities as we move through the current fiscal year, please?

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

Sure. Alex, you rightfully said, we don't have a simple straight VAR channel that traditionally firewall and network security vendors had. We have VARs who play a role. We have system integrators and we have service providers. And then there's a separate set of SIs for Federal business as well.

Let's look at each of these areas. VARs were slow to adopt Zscaler, but now as the market has moved more and more of them are embracing us and our leader called has launched a number of programs where we're seeing very good progress, but new source pipeline coming from our channel.

The area we see probably a very rapidly growing opportunity is global systems incubators. Actually, money coming from ServiceNow, where a lot of partnership with global SIs have played a big role. I expect that area to accelerate. And in this next level of fulfillment versus transformation. We like partners who work with us and work with partners -- sorry, our customers to do transformation. And we have been selective. You aren't going to find us the 5,000 or 10,000 channel partners. Our partners are hundreds. And we are doing targeted programs. We're working with some of the very large global SIs and very large deals to do transformation. I mentioned one of these deals in my prepared remarks, and I mentioned another SI who actually brought Zscaler internal along with actually launching the service to go out there.

Remo, do you want to add any more color?

Remo Canessa - *Zscaler, Inc. - CFO*

No, I think that's good, Jay.

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

No comment on internal sales? Which is obviously a piece of it? .

Remo Canessa - *Zscaler, Inc. - CFO*

So yes. So we've increased our capacity in the quarter for our sales reps. Our plan is to increase capacity through the year. The one comment I'd make on Q1 is that we were -- we did hit our expectations internally, but we expect to hit basically our sales targets for the year. .

The current sales capacity that we have supports our guidance. And as Jay mentioned, with the new leadership with Mike on board, we'll be looking to accelerate our hiring as we go through Fiscal '24.

Operator

Our next question comes from the line of Joel Fishbein of Truist.

Joel Fishbein - *Truist Securities, Inc., Research Division - Research Analyst*

Great execution here. Jay, one for you, and then I'll jump back in queue. On these new advances bundles, obviously very exciting. Just can you share with you they said AIs included some of the new AI or included in that. Can you talk about adoption rates and whether or not you're getting any pushback on pricing as it relates to some of those bundles?

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

Yes. So we have had advanced bundles that include a bunch of functionality of ZIA or ZPA type of stuff. Now we have added functionality where some of the data protection can be done with AI advanced techniques, some of the cyber threat protection can be done using that. So we clear these bundles, we call them advanced plus. So we're getting very good traction. And these advanced plus bundles are about 20% or so higher than the non-plus bundles. So this is a good area. In fact, this is a good way for us to reach our customers as they're looking at buying these bundles with additional functionality, it's helping them, it's helping us.

Now in addition, we are also creating some stand-alone SKUs. We talked about Risk360, a very popular recently introduced product. When I talked about having closed 10-plus deals in a pretty significant manner where the average ACV is sitting in 6 figures. And then you'll see some more SKUs coming down the road as you'll really be -- AI cloud is one of the big focus areas. And the reason we're making focus is because we have better logs, better data to train AIML models. The starting point of good AIML is the data that we have better than anybody else.

Operator

Our next question comes from the line of Rob Owens of Piper Sandler.

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

Maybe building a little bit on Joel's question. You mentioned in your prepared remarks with an example around data protection as kind of one of the faster-growing solutions and how it doubled spend at an existing customer. Just curious the potential for that and what you're seeing relative to typical uplift when you're able to attach that solution?

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

When these kind of customer started working with us several years ago, the #1 focus for them was cyber protection, so they don't get compromised. Data protection was slower in adoption, data protection also takes a little bit work, there's more contributions and customization needed. And in large enterprises where our large customers have been. They've used Symantec 1, 2, as one of the primary data protection products. Over the past 5, 6 years ago, we have expanded our data protection platform significantly, not just in line, but has been actually endpoint DLP cloud data protection, all those things, including EDM, IBM technology are there. So with all that technology, we are in a great position to replace some of those complicated data protection products out there.

And it's natural. If we are sitting in traffic path, if we are doing access and inspection, it's natural for the customers to use our cloud because the traffic is coming to a cloud from all kind of locations. That's really driving our growth. That's why we talked about this data protection DRR is approaching $0.25 billion and it grew 60% year-over-year for us, and we see a lot of growth for quite a long time in this area. Did I answer your question?

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

Yes. .

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

The one comment I'll make is we have more complete platform for data protection. And customers want one set of policies, whether they want to secure data address or data at motion. That's why it's picking up quite fast.

Operator

Our next question comes from the line of Joseph Gallo of Jefferies.

Joseph Gallo - *Jefferies LLC, Research Division - Equity Associate*

Remo, I appreciate the rationale on the full year billings guide. But just on methodology, is there any changes there? I mean you saw a strong 1Q driven by Fed stream why not pass along some of that beat. Is that solely due to the market? Or the go-to-market change conservatism? Or is there anything else you're seeing there with large customer calendar '24 budgets? And then maybe just to simplistically ask, is fiscal '24 billings more or less conservative now than it was 90 days ago?

Remo Canessa - *Zscaler, Inc. - CFO*

Great question. So I mean the guide that we gave is solely related to basically the go-to-market with our new sales leadership on board. We feel it's prudent to do that. When you take a look at close rates for Q2 this year versus last year, we're being a little more conservative with our close rates this Q2.

From a market -- overall market perspective, the macro still remains challenging, but we feel that things -- that there's more of an acceptance to Zero Trust, there's more of an understanding of our platform. So we feel good.

Regarding guidance, whether it's more conservative now or not, I'd like to say we like being prudent. And again, it's all related to go-to-market with our new CRO, and I don't want to comment any further than that.

Operator

Our next question comes from the line of Gabriela Borges of Goldman Sachs.

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

Remo, I wanted to ask you about some of the idiosyncratic drivers in your Federal business. And more specifically, if we think about all the momentum that you're seeing now. How should we think about the durability of growth in the Federal vertical? Meaning, is this like a 3- to 5-year product cycle where we'll see a ramp and then we should be cognizant of a slowdown? Is it an 18-month or 36-month product cycle? How do we think about some of the visibility you have in Federal and how it's going to impact your growth over the medium term?

Remo Canessa - *Zscaler, Inc. - CFO*

It's another great question, Gabriela. I'll start and then maybe Jay can come in also. We've invested significantly in Federal. This is not an overnight basically what's occurring. This is occurring over the last 5, 6 years of significant investments both from a platform technology as well as people within the Federal organization that works for us.

We're in 12 of the 15 agencies, cabinet agencies. As Jay talked about in the script, our growth rate in Federal in Q1 was 90% year-over-year. I feel that we are very well positioned in Federal, what we talked about, we've got incredibly strong Federal team. And I feel that going forward, Federal should be a good driver, potentially significant driver for Zscaler. And we're doing well in Federal. I'll turn it over to Jay.

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

Yes. So this is the how I think about it. First of all, number of users in the Federal government DoD, non-DoD. Yes, we do have 12 of the 15 cabinet level agencies, but they are in various stages. There's a big, big upsell opportunities there itself. Then DoD, just scratching the surface out there. So if you look at from a number of users' point of view, it's a massive market in front of us because we count number of users.

Then there are work loads for Federal. There's a whole range of IoT, OT devices in Federal business that needs to be taken care of. Massive stuff, but then on top of that, it's a platform. Our platform has expanded, it keeps on expanding. So I think this is a significant growth opportunity for a long, long time.

And then DoD takes us to next -- sorry, Federal takes to other Federal friendly countries out there. They all want to follow. The NATO friendly countries want to adopt what U.S. has done here. That's an opportunity for us. The state governments are getting very, very worried about adopting Zero Trust. That's another big opportunity for us. So very bullish. We've done some big investments, and that's why we have some of the best certifications for Zscaler platform than any other company out there.

Operator

Our next question comes from the line of Jonathan Ruykhaver of Cantor Fitzgerald.

Jonathan Ruykhaver - *Cantor Fitzgerald & Co., Research Division - Senior Research Analyst*

Yes. Thank you. So Jay, we are seeing this convergence between cloud workload protection platform, CSPM, CIEM a lot of other acronyms that are being thrown into this CNAPP kind of bucket. We're also seeing a number of next-gen vendors that seem to have more of a product-led drove sales motion aimed at the developer, which contrasts with your approach, which is more a high touch aimed at the C level. So as a product that fits between build and run time environment, and you could argue maybe that portfolio is shifting either even further left. How do you balance those dynamics when you look to go to market with your CNAPP offering?

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

It's a very good question. So all those 4 letter acronyms you gave us. And we tried to track them. And there have been 100-plus vendors in that space over the past 2 years. So about a year ago, I used to see a new vendor show up every other day. For the last year or so it has slowed down and actually they're shrinking. But there's adjacent next to it. That is cloud workload communication. Cloud workload communication is about workload talking with, internet workloads talking to each other. That's where our core strength comes in the Zero Trust architecture. We are the only vendor, I know out there.

We have workloads talk to each other through Zero Trust architecture without being on the network. That' s our starting point. Then we look at the CNAPP as an extension. To me, CNAPP is almost like CASB in many ways you make API call, leading logs, you're leading configurations to figure out the risk and whatnot. And that is towards shifting more of the left. We believe that a combination of cloud workload detection, along with CNAPP, puts us in a better position.

Regarding product net growth. I think there's an interesting opportunity for some of the companies. Obviously, we don't come from that side. I haven't seen very many security companies have grown to hundreds of millions of dollars doing product that growth. But we are watching and monitoring the space, but we will be going from where our strength is. Our large customers, loves Zscalers users, now they're embracing Zscaler for workloads, for communication, and that allows us to extend it to CNAPP space as well. That's how we look at it.

Operator

Our next question comes from the line of Patrick Colville of [Scotiabank].

Unidentified Analyst

I mean, really impressive set of results, guys. So congrats on the start in the new fiscal year. As you have with you guys have shown very impressive momentum. I guess I wanted to touch on the leadership change. These 2 new executive level hires. How has Dali role changed? Is he still at the firm? Or has he moved on? And if so, how can we expect his decisions to change going forward?

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

Dali has an active role as the COO of the company. He has played a phenomenal role in Zscalers growth you've seen over the past 4 years. He has built a great go-to-market machine that has helped us go past $2 billion in ARR. So Mike's goal is to take up from here to $5 billion and beyond. This frees up Dali to focus more in his capacity as a COO to really help scale our business operations capabilities.

Now what do you mean by that? As we are growing at a rapid pace. We have many things to improve on scaling side up in the operational side, streamlining our post-sale customer engagements. Ranging from support to TAM to deployment, to success. How do you bring them together to make it more productive and better stay in line for better value realization of the customers.

Second example, we do cash process systems, productivity improvement, streamlining. If we do a better job in these areas as a company will become a lot more productive and Dali's experience across the company will help us achieve some of those key things that are needed

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Operator

Our next question comes from the line of John Difucci of Guggenheim Securities.

John DiFucci - *Guggenheim Securities, LLC, Research Division - Research Analyst*

Jay and Remo both spoke about the challenging macro backdrop. And I think Remo, if I -- correct me if I'm wrong, but I think you said that you did not hit your internal targets for 1Q. I guess, what do you think the reasons for that were? I mean, you have new go-to-market people, and you explained that with the guide with Joe's question. And sometimes that means the previous people were an issue, but your COO is really good at it to say the least. I know Remo said customer sentiment is stabilizing, but I'm not quite sure how that sort of fits in. Has the macro gotten a little worse? Or is there something else that I'm not thinking about? .

Remo Canessa - *Zscaler, Inc. - CFO*

Yes. The macro has not gotten worse. And the comment, John, was related to quota-carrying reps. So we didn't hit our internal projections for internal reps. We do expect to catch up. We've talked about before on earlier calls, we're in a huge market opportunity. We're going to invest significantly in our company. You can see in the second half, we're going to increase our sales for marketing spend based on our guidance. That's related to just overall, we've gotten new CMO on board with Mike on Board. That was the shift of the comment. It's really basically purely to quota-carrying reps. We did increase capacity, but not to the levels we wanted. And from my perspective, John, it's really execution on our part. We need to execute better on that part.

Operator

Our next question comes from the line of Tal Liani of Bank of America.

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

I'm sorry, I pressed on the mute button. You can hear me now?

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

Yes.

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

Perfect. Okay. RPO growth was slower. Also, the billing guidance was a tad below, although you hit the quarter, you're above the quarter expectations. So I wanted to ask about the discount level contract duration. Was there any change in the pricing environment or contract duration this quarter that is driving the lower RPOs? And also, how do I think about -- I know you don't provide kind of quarterly, but how do I think about first half versus second half in terms of billings and RPOs?

Remo Canessa - *Zscaler, Inc. - CFO*

Yes. I mean a lot of questions in there, but I appreciate you bringing off. RPO decline, it's primarily related to Federal. Federal is a big piece of our business. And when you look at Federal, Federal contracts or even though they're multiyear contracts. We only take Federal in for 1 year in our CRPO. So that was a big driver for that.

When you take out basically Federal out of the contract duration, really contract durations are comparable year-over-year and also quarter-over-quarter. Discount levels, no, not really seeing anything on a discount level perspective. I'd say it's the same and has been the same for a while.

First half, second half, you can expect billings to be in the 42% range in the first half and the rest basically in the second half. But the RPO basically relates to primarily relates to Federal business, which is one year recognized.

Operator

Our next question comes from the line of Fatima Boolani of Citi.

Fatima Boolani - *Citigroup Inc., Research Division - Director & Co-Head of Software Research*

Jay, this one's for you. You were very explicit about the success in the Federal business coming from very strong wins and partnerships with Federal SIs. So I wanted to better understand what the moat and differentiation is. And if you can help explain to us why this wouldn't necessarily cannibalize your direct business, which you're executing just fantastically in?

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

So our direct business versus channel business, almost all of our business is supposed to be channel. A few customers insist that they must do a deal directly with us. So the channel is supposed to bring leverage. The more channel partners are working closely with us, the more heavy lifting to do, better productivity, better our sales acceleration happens. So it's important for us.

Now in a transformation sale like ours, the channel wasn't quite ready there to say, "Hey, tell me the latest box I'm ready to sell. " We had to work with them to show them transformation. Federal government is driving big transformation at all levels. President's Executive order is asking for Zero Trust architecture. And there are a large number of systems integrators in the Federal market who actually need technology like ours to make it happen.

And in Federal, it becomes more interesting as you must have certification up to certain levels, there are FedRAMP certification at the medium level at high level and whatnot and IFI. We've done most of them. So with certifications leveraging those system integrators we are able to drive transformation. And I think we are in a very good shape sitting there with a big market, working side by side with our partners.

So there's no cannibalization. Did I make it clear? Or did I miss something?

Operator

Our next question comes from the line of Hamza Fodderwala of Morgan Stanley.

Hamza Fodderwala - *Morgan Stanley, Research Division - Equity Analyst*

Remo, regarding your comment on the sales changes and the impact of the full year billings guide. Just curious. Are you anticipating the leadership change will drive a broader restructuring in the sales org? Like you saw a few years ago when Dali came on board? Or is it going to be more incremental?

Remo Canessa - *Zscaler, Inc. - CFO*

Yes. So the leadership we have in our sales organization is very strong with what Dali has created. I don't see significant changes. Maybe Jay can speak to it, but I don't see significant changes. And again, the structure that we've built under Dali's leadership was a very strong basically structure.

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

Yes. In many ways, our sales process at Zscaler is very similar to ServiceNow. it's consultative, it is top down selling, it's enterprise focus. Really, so we expect the same kind of stuff to carry on there needs to be -- there will be ongoing refinements, but don't expect any big changes. Some of the things, as I talked to Mike early on as he's understanding the organization. You'll see probably more focused on top account program. We have a big opportunity to take our large customers and double, triple or quadruple the ARR with us because our platform supports it.

You're going to see more focus on verticals. We already have some level of verticals, public sectors of vertical for us, health care, you'll see more focus area. You're also going to see more persona focus in our sales staff. And I mentioned early on too, you'll probably see more focus on global system integrators as they drive some of the large transformations, but no significant changes.

Operator

Our next question comes from the line of Matthew Hedberg of RBC.

Matthew Hedberg - *RBC Capital Markets, Research Division - Analyst*

Remo, a question for you on the macro. There's been a couple of questions on billings and RPO and obviously, the Federal strength. But I guess maybe I'm just a little confused because when I look back at your Q4 script, when you talked about the macros, you said you noted global uncertainty, but it seems to me like there was a change in tone from your comments here. I think you said -- you noted customer sentiment is starting to stabilize.

So I guess I'm just sort of curious, what drove that comment that things are starting to stabilize versus last quarter when you noted uncertainty? And is this something that happened during the quarter? Or anything that kind of prompt you to maybe change the script a bit from 4Q?

Remo Canessa - *Zscaler, Inc. - CFO*

Yes. I'll let Jay comment to...

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

I think what I commented last time, was, there's a slight reduction in scrutiny of the deal, so the tone I exactly used. I think what we're seeing though, we are saying there's no change in macro the way we haven't seen. So macro is not playing a role at this stage. To say the forecast seems to be assuming macros nor done any force than it has been.

Operator

Our next question comes from the line of Shrenik Kothari of Baird.

Shrenik Kothari - *Robert W. Baird & Co. Incorporated, Research Division - Senior Associate*

Jay and Remo, it's great to see your focus on large transformative deals in top accounts as we just highlighted, Jay, the ongoing traction with bundled offerings across our emerging new products contributing to the new business. So all of that speaks to create in-house kind of innovation model that you have talked about. Jay, how do you see the role of strategic M&A play in expansion plans as we are starting to see with some others especially around cloud and data security. And what are any potential areas to focus? And Remo, can you provide the new versus upsell split in the quarter and how it compares to the expected the 40-60 mix.

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

Yes. Very good question. So with tighter funding and lots of security companies out there, we're seeing lots of attractive opportunities coming our way. We are looking at a number of innovative technologies and strong development teams. It's an option. It's done. A number of small ones in the past some time Yes, there are some areas, interesting technologies, especially in the new world of data and AI kind of stuff. It's an option we're keeping.

I think you will not see us trying to buy revenue through an M&A they're going to see us buying innovative, disruptive technologies that can help us get to market sooner, faster is important. And that integrates with our platform. I hate to see acquisition being done where you have stand-alone products, they don't work together with each other. But we are actively exploring those areas. There's no reason we should not.

Remo Canessa - *Zscaler, Inc. - CFO*

Yes. And the new and upsell was 45% new 55% upsell. On our year-end call, we expect upsell to be above 60%. That's still our expectation for the year. But for the quarter, it was 55% or so.

Operator

Our next question comes from the line of Brian Essex of JPMorgan.

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

I guess, Remo, I wanted to dig into margins and specifically maybe gross margins, I mean, you guys are about 3x the size you were 2.5 years ago. But you've hovered kind of in this just below 81% gross margins, give or take, 50 basis points or so. And I appreciate the comments you had that emerging products will initially have lower gross margins. I think that's been the case for some time. But how do we think as you continue to grow at an accelerated pace and scale, how can we expect that to impact your margins? How are you managing your infrastructure?

And then maybe just an adjacent comment on sales and marketing, it seems as though that was quite a bit lower than billings. Did you hold back on sales and marketing spend ahead of the arrival of Mike and Joyce?

Remo Canessa - *Zscaler, Inc. - CFO*

Yes, a few questions. Did we hold back sales and marketing spend, not really. It's just the way things worked out. Maybe a little bit on the marketing side, but that's about it, but not really. From a gross margin perspective, our stated gross margin has been between 78% and 82% then you're right, Brian. We've been in the 80% range for a long time.

The beauty of Zscaler, quite frankly, is the platform technology that's been created. When I started here, we're doing 30 billion transactions per day. We are doing 360 billion transactions per day right now. And we still have 80% gross margin. The benefit that we have is we can make decisions really to maximize gross margin or to get applications or applications or increase the strength of our product by going through public cloud. So we balance that. I would expect gross margins to be in the 78%, 82% long term, short term, midterm, I'd expect the 80% gross margin range.

If we need to shift our focus with more increase in our margins, we will, but we do manage it. We do look at it and the emerging products do carry lower gross margins. And we'll keep on innovating.

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

We're not going to slow down building more products.

Operator

And that is all the time we have for questions today. I'd like to turn the call back over to Jay Chaudhry, CEO, for any closing remarks.

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

My sincere thanks to our employees, our customers and partners for delivering a strong quarter. Thank you for your interest in Zscaler. We look forward to seeing you at some of the investor conferences. Thank you.

Operator

Thank you. Ladies and gentlemen, this does conclude today's conference. Thank you all for participating. You may now disconnect. Have a great day.