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ZS.OQ - Q2 2021 Zscaler Inc Earnings Call

EVENT DATE/TIME: FEBRUARY 25, 2021 / 9:30PM GMT

OVERVIEW:

Co. reported 2Q21 revenue of \$157m, non-GAAP net income of \$14m and non-GAAP EPS of \$0.10. Expects FY21 revenue to be \$634-638m and non-GAAP EPS to be \$0.39-0.40. Expects 3Q21 revenue to be \$162-164m and non-GAAP EPS to be approx. \$0.07.

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PRESENTATION

Operator

Good day, ladies and gentlemen, and thank you for standing by. Welcome to the Zscaler's Second Quarter 2021 Earnings Call. (Operator Instructions) As a reminder, this conference call is being recorded. (Operator Instructions) At this time, I would like to turn the call over to Mr. Bill Choi, Senior Vice President, Investor Relations and Strategic Finance.

Bill Choi;Senior Vice President, Investor Relations

Good afternoon, everyone, and welcome to the Zscaler Fiscal Second Quarter 2021 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, and earnings per share. These statements and other comments are not guarantees of future performance, but rather are subject to risks and uncertainty, some of which are beyond our

control, including, but not limited to, the duration and impact of COVID-19 on our business, the global economy and the respective businesses of our customers, vendors and partners, market adoption of our offerings and our expectations regarding the development of the markets in which we compete.

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. We will upload a copy of today's prepared remarks to our Investor Relations website when we move to the Q&A segment of the call.

I would also like to inform you that management will be presenting at the following upcoming virtual events: JMP Securities Technology Conference on March 1; Morgan Stanley TMT Conference on March 2; Truist Securities Tech Conference on March 9. These presentations will be webcast, and the links will be available on our Investor Relations website.

Now I'll turn the call over to Jay.

Jay Chaudhry; Co-Founder, President, CEO & Chairman of the Board

Thank you, Bill. We are very pleased with our strong performance in Q2, which showed accelerating growth at scale and rapid innovation of our Zero Trust platform. We drove 55% growth in revenue and 71% growth in billings, while also generating growth in operating profits and free cash flow. Our optimized go-to-market engine is driving significant velocity, including a strong pace of new customer additions. During the quarter, we achieved a milestone of over 5,000 customers, including over 500 of the Global 2000. Our strategic decision last year to increase our investments across all areas, particularly the expansion of our go-to-market and R&D teams is yielding strong results. We drove increased wins in our enterprise segment, as we begin to pursue smaller enterprises with 2,000 to 6,000 employees. We are helping our customers to securely accelerate the digital transformation journey which remains the top priority. With our Zero Trust Exchange, Zscaler provides secure any-to-any connectivity for users, applications, workloads, and IoT and OT systems regardless of your location. The recent SolarWinds security incident has further elevated the need for a true Zero Trust platform like Zscaler. During such sophisticated attacks, our proxy-based architecture would prevent loss of sensitive data and our application level segmentation eliminates lateral threat movement. We provide users access to applications, not the network, which is fundamentally different from firewalls and legacy network security architecture. The CIO level awareness, engagement and inbound requests for our purpose-built Zero Trust platform have significantly increased and we are viewed as a foundational application, network and security transformation.

I'm proud of our speed of innovation, which is accelerating, and further expanding our substantial technology lead. There are 4 pillars of our Zero Trust Exchange. ZIA, ZPA and ZDX for user protection and experience, and ZCP for workload protection. Last quarter, we launched our fourth pillar called Zscaler Cloud Protection or ZCP, which extends on Zero Trust exchange from users to workloads, and has an expanding portfolio of products, including CSPM to ensure proper configuration and compliance, Workload Communication to secure app-to-app and cloud-to-cloud secure communications, and Workload Segmentation to achieve app segmentation without legacy network segmentation.

In our latest major cloud upgrade, we added over 100 new product enhancements. Over the past 12 months, we have significantly increased the number of solutions delivered through our platform, including Zscaler Browser Isolation, out-of-band CASB, Zscaler B2B, and Zscaler Digital Experience, or ZDX. All this innovation is making our cloud platform wider and deeper. For enterprises who want network and security modernization, we believe we are the only Zero Trust multi-tenant platform that meets the needs. Many vendors have tried and failed to build a high-performance, highly reliable proxy required for proper cybersecurity protection and data loss prevention. As a true SASE framework, we are deployed across 150 data centers, enforcing policy at the edge instead of a limited number of public cloud locations. Every day, we are processing more than 150 billion transactions, while preventing up to 7 billion security incidents and policy violations. We are operating at a massive scale and doing so with environmental sustainability in mind.

Our platform uses over 75% renewable energy today, with a goal to use over 90%.

I would like to thank our engineering team for an exceptional job in expanding our platform and keeping Zscaler at the forefront of innovation.

Now on to the customer wins. There is an accelerated market shift towards work from anywhere, which is the world Zscaler was built for. In an upsell win, a Fortune 500 chemical company that was using ZIA for a subset of its workforce accelerated the Zero Trust initiative by purchasing ZIA Transformation, ZPA and ZDX for all 45,000 employees. In addition, they bought 2 of our recently announced ZCP solutions. They purchased Workload Communications to secure server traffic out to the Internet from 200 plants, and Workload Segmentation for 7,000 servers to secure east/west traffic in the public cloud and data center.

I'm excited to see wins like this where the customer is buying all 4 pillars of the Zscaler platform.

In a new logo win, a new Global 2000 customer in the high-tech industry purchased all 3 pillars of our user protection service. They purchased ZIA Transformation, ZPA and ZDX for all 10,000 employees to move away from network security to Zero Trust architecture. This customer had standardized on next-gen firewalls and VPNs, which left gaps in security, leading to a ransomware attack. In spite of an ELA license from the firewall vendor, they couldn't do SSL inspection at scale. Since Zscaler is a purpose-built proxy architecture, the customer can now inspect encrypted traffic without impacting user experience, leading to better security, and reduced business risk.

In another new logo win, a customer in the transportation services industry purchased 3 of our 4 pillars ZIA, ZPA and ZDX for their 7,500 employees. With a cloud and mobile-first strategy, they purchased on best-in-class DLP and CASB to protect sensitive information from leaking, no matter where the user is. ZDX was purchased to pinpoint and resolve performance issues in real-time by monitoring the digital experience score of every user and application regardless of their location.

We have seen a strong customer interest for our new pillars, ZDX and ZCP. Over 200 customers to date have purchased ZDX. ZCP is also off to a great start, with a few dozen deals closed in Q2 and great excitement for our ZCP workload communication.

Moving on to ZPA. Our customers view ZPA as the foundation for their architectural shift to Zero Trust access for private applications. ZPA is a clear market leader with proven maturity and scalability, supporting millions of daily active users and nearly 40% of our Global 2000 customers. Today, ZPA is delivering over 10 million unique application segments without operational overhead of traditional network segmentation.

Let me highlight several ZPA deals in the quarter. A Global 500 consumer products company with headquarters in EMEA that has been a ZIA customer, purchased ZPA for all 100,000 employees and 10,000 third-party B2B partners. This customer wanted to eliminate the security risk of VPN, which provides unfettered access to network resources. ZPA represents the next step in Zero Trust adoption for the IT transformation journey.

In an upsell deal, a Global 2000 bank with headquarters in EMEA, started with ZIA and ZPA for 10,000 employees in July to expand their work-from-home capacity as a result of the pandemic. Within 6 months of the initial purchase, the customer bought ZIA and ZPA for the remaining 30,000 employees and CASB for all 40,000 employees. In addition, the purchased ZPA to enable 3,000 third-party B2B partners.

Let me highlight a ZIA and ZPA new logo win in the federal space. A recent organization mandated with advising federal agencies on cybersecurity, purchased our ZIA transformation bundle and ZPA for all 10,000 employees after evaluating various Zero Trust architectures. This customer concluded that if a user connects to the network with a VPN, that is not Zero Trust. Based on this criteria, the legacy firewall and VPN providers were disqualified. An important consideration for our selection was ZPA's position as the first and only cloud security service with FedRAMP certification for Zero Trust Remote Access. With the highest levels of FedRAMP certifications for both ZIA and ZPA, we are very well-positioned to serve the Federal government.

Lastly, I would like to share another new customer win that highlights our continued ZIA success with large enterprises that are embracing direct-to-cloud architecture and migrating away from the complex legacy on-premise appliances. A Fortune 100 professional services customer purchased our ZIA transformation bundle plus CASB, advanced DLP and CSPM for Office 365 to protect 125,000 employees across 150 countries as they embraced work from anywhere. Zscaler eliminated the need for 30 different gateways and consolidated 6 different legacy point products, while meeting the customers' environmental goals for their ESG program. With sensitive customer data at risk, security was a major requirement, and the customer only considered solutions with a proxy architecture.

Let me conclude with some thoughts on our vision and strategy. At our Analyst Day in January, we laid out our audacious goal of serving 200 million users and 100 million workloads on our Zero Trust Exchange. To achieve that, our entire organization is focused on attracting and developing talent, and creating a culture of excellence. Our commitment to culture starts at the top with our executive team and creates an environment where a global and diverse workforce that can deliver excellence to help our customers succeed. We are scaling our world-class engineering organization, which continues to rapidly deliver new products and features to our customers.

On the go-to-market front, as we had demonstrated over the last 12 months, we have built a sophisticated sales machine to sell value and deliver measurable outcomes at the CXO level. We will continue to scale our sales organization as we are a destination for top talent. Our marketing organization is augmenting talent in all critical areas, while specializing campaigns by persona and segment to better address our significant opportunity. We are focused on driving broader adoption of our 4 pillars. We will continue to expand our ecosystem of technology partners and value-based channel partners, who are contributing to sales velocity and expanding our reach.

I believe we are on the right track to capture a material share of the \$72 billion serviceable market that we outlined on our Analyst Day. We are also seeing opportunities in bringing Zero Trust to IoT and OT systems and are excited about 5G which pushes computing further to the edge and opens up additional opportunities for Zscaler. We are excited about our future.

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

Remo E. Canessa - Zscaler, Inc. - CFO

Thank you, Jay. As Jay mentioned, we are pleased with the results for the second quarter of 2021. Revenue for the quarter was \$157 million, up 10% sequentially and 55% year-over-year. ZPA product revenue was 14% of total revenue.

From a geographic perspective, we had broad strength across our 3 major regions. Americas represented 51% of revenue, EMEA was 38%, and APJ was 11%.

Turning to calculated billings, which we define as the change in deferred revenue for the quarter plus total revenue recognized in that quarter. Billings grew 71% year-over-year to \$232 million, with billing duration around the midpoint of our 10 to 14-month range. As a reminder, our contract terms are typically 1 to 3 years, we primarily invoice our customers 1 year in advance. Remaining performance obligations, or RPO, which represents our total committed noncancelable future revenue, exceeded \$1 billion during the quarter and ended at \$1.025 billion as of January 31. RPO grew 68% from 1 year ago. The current RPO is 53% of the total RPO.

Our strong customer retention and ability to upsell have resulted in a consistently high dollar-based net retention rate, which is 127% compared to 122% last quarter and 160% a year ago. As we have highlighted, this metric will vary quarter-to-quarter. While good for our business, our increased success selling bigger Transformation Bundles, selling both ZIA and ZPA from the start and faster upsells within a year can produce our dollar-based net retention rate in the future. Considering these factors, we feel 127% is outstanding.

Total gross margin of 81% was flat quarter-over-quarter and declined 1 percentage point year-over-year, but exceeded our expectations. The year-over-year decline was primarily driven by a higher mix of newly introduced products.

I would like to remind investors that a number of our emerging products, which include ZDX, Workload Segmentation and CSPM will initially have lower gross margins than our core products. As a result, we expect gross margins to be approximately 80% for the full year in fiscal 2021.

Turning to operating expenses. Our total operating expenses increased 18% sequentially and 60% year-over-year to \$112.9 million. Operating expenses as a percentage of revenue increased by 2 percentage points from 70% a year ago to 72% in the quarter.

Sales and marketing expense increased 19% sequentially and 57% year-over-year to \$76.5 million. The year-over-year increase was due to higher compensation expenses and investments in building our teams and go-to-market initiatives, offset by lower T&E with our employees working from home.

We've been very successful in hiring and onboarding remotely. And we are accelerating our sales and marketing hiring throughout the second half of the fiscal year.

R&D expenses increased 15% sequentially and 71% year-over-year to \$24 million. The increase is primarily due to continued investments in our engineering teams.

G&A expenses increased 14% sequentially and 57% year-over-year to \$12.5 million. The growth in G&A includes investments in building our teams, compensation-related expenses and professional fees.

Our second quarter operating margin was 9% compared to 12% in the same quarter last year. Net income in the quarter was \$14 million or non-GAAP earnings per share of \$0.10. We ended the quarter with over \$1.4 billion in cash, cash equivalents and short-term investments. Free cash flow was positive \$18 million in the quarter, which compares to negative \$2 million during the same quarter last year. The strength in free cash flow was driven by strong receivable collections.

Now moving on to guidance. As a reminder, these numbers are all non-GAAP, which excludes stock-based compensation expenses, related payroll taxes, amortization of debt discount, amortization of intangible assets, facility exit costs, and any associated tax effects.

For the third quarter of fiscal 2021, we expect revenue in the range of \$162 million to \$164 million reflecting a year-over-year growth of 47% to 48%. Operating profit of \$11 million to \$12 million, other income of \$300,000, net of interest payments on our senior convertible notes. Income taxes of \$1.5 million and earnings per share of approximately \$0.07, assuming approximately 146 million common shares outstanding.

Due to better-than-expected first half performance and our strong pipeline, we're increasing our full year fiscal 2021 guidance for revenue, calculated billings and operating profit. For fiscal 2021, we now expect revenue in the range of \$634 million to \$638 million or year-over-year growth of 47% to 48%. Calculated billings in the range of \$820 million to \$825 million or year-over-year growth of 49% to 50%. Operating profit in the range of \$59 million to \$61 million; other income of \$2.4 million, income taxes of \$5.3 million, and earnings per share in the range of \$0.39 to \$0.40, assuming approximately 145 million to 146 million common shares outstanding.

For your modeling, we would like to remind investors that Q2 and Q4 have been historically our strongest billing quarters, with declines in Q1 and Q3 quarters, respectively. The average sequential decline in billings during fiscal third quarters over the last 5 years was approximately 20%. We continue to see the market coming to us and remain committed to investing aggressively in our company behind the growth in our business.

We have a highly efficient business model and are making investments across the organization today in order to capitalize on the large opportunity ahead of us. While we will balance growth and profitability, growth will continue to take priority considering our strong business momentum.

Operator, you may now open the call for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question or comment comes from the line of Brad Zelnick from Crédit Suisse.

Brad Alan Zelnick - *Crédit Suisse AG, Research Division - MD*

Congratulations, guys, on all the success, really phenomenal results. Jay, I wanted to ask you a high-level question around the impact that the SUNBURST breach is having on the industry. At your Analyst Day in January, you'd mentioned that the impact is likely to be larger than the Target breach was in 2013. And if you can, maybe parse out for us how the event has impacted your pipeline across your strategic accounts, maybe all the way down to smaller commercial accounts. And how, if at all, you've changed the way you approach initial conversations with new prospects?

Jay Chaudhry;Co-Founder, President, CEO & Chairman of the Board

Thank you, Brad. As we discussed during our Analyst Day, we are having increased conversations with our customers as well as prospects. We had SUNBURST-related webinar recently and had over 800 customers attend it. This week, I was asked to talk to a Board of Directors of a pharma company, and the primary topic was protecting against sophisticated threats like SUNBURST. So all this is making cyber a bigger priority than it has been. It's a bigger priority for CIOs as well as the Board. So what is that causing? It is increasing engagement. I'm not sure I can quantify the impact on the pipeline, but we're seeing that the customers, who are already educated on Zero Trust quite a bit, are making implementation of Zero Trust a bigger priority. The #1 question ends up being, if people get compromised, how do we make sure that the lateral movement doesn't happen? The answer is simple. Don't connect people to your network, don't build a moat with firewalls and VPNs. Do Zero Trust implementation where you connect users to applications, not to the network.

Operator

Our next question or comment comes from the line of Mike Walkley from Canaccord Genuity.

Daniel J.W. Park - Canaccord Genuity Corp., Research Division - Associate

This is Daniel on for Mike. So I know over the past quarter or so, you've been working on really improving your sales motion in the SMB and small enterprise area. Can you just, I guess, provide some color on some of the investments you're making, and I guess, where do you expect to be moving forward?

Jay Chaudhry;Co-Founder, President, CEO & Chairman of the Board

I will start, and Remo can add on. Yes, we talked about our expansion towards the enterprise segment that we defined as between 2,000 and 6,000 employees in a company. As you know, we have done extremely well in the higher end and in large enterprises for the last several years. So in this segment, the progress we made is ahead of our expectations. Our growth was faster in this segment. Well, it did come from a smaller base. Having said that, our large enterprise segment is driving the overall strength of our business. We are doing 3 specific things to grow our business in this enterprise segment: one, adding more sales reps, more sales teams, and we have done a lot of good progress in the past 2 quarters, and we'll do more in the coming quarters. Secondly, we are adding and expanding channel partners who cover the segment. And third, we are directing our marketing programs to support this segment as well.

So in summary, it's a good opportunity to expand the segment, and we're doing well. We're pleased with our performance.

Remo E. Canessa - Zscaler, Inc. - CFO

Yes. Just as a quick follow-on. We put together a -- or initiated a Summit program a few quarters ago, and that is doing well. And so as a percentage of our revenue, VARs did pick up slightly in the quarter. VARs as a percentage of our revenues in the quarter was about just above 50%, where as the quarter before, it was in the high 40s. So as Jay talked about, I mean, the segments that we sell into commercial is the less than 2,000 employees enterprise to the 6,000 in large enterprise, 6,000 to 40,000 and majors at the 40,000. So the channel program, we're expecting to have positive results for us in the lower floor part of the market.

Operator

Our next question or comment comes from the line of Alex Henderson from Needham.

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

I [was sure] talk to a -- one of the architectural issues that I think is a fairly interesting differentiator, which is the argument that you guys have built a network based off of per user policy implementation versus architectures from some of your want-to-be competitors that are unable to differentiate the traffic flows on a per user basis or the policy implementations on a per user basis. Can you talk about that delta between what you're doing and how that shows up in alternative competitors or networks?

Jay Chaudhry; **Co-Founder, President, CEO & Chairman of the Board**

Yes. The fundamental difference is being a pass-through on network security architecture when traffic is flowing over the network. And a traditional device like a firewall is trying to scan what kind of application it is, guess it and trying to stop it or not. With our proxy architecture where we [prominate] every connection inspect and decide to connect to a particular user. So we have policies that are per user by design. There's no -- in fact, a user coming from company A or company B or company C each looks like an untrusted user. While in the traditional way, they are kind of batch-based policies. The end result is our architecture gives us 2 big benefits: one, with proxy we can do far better inspection at a high scale, high performance, including SSL. Two, it allows us to do Zero Trust where you don't connect people to a network, you connect to a specific application. And Zero Trust is probably the biggest thing to help you minimize the damage of lateral movement if something gets infected.

Operator

Our next question or comment comes from the line of Andrew Nowinski from D.A. Davidson.

Andrew James Nowinski - *D.A. Davidson & Co., Research Division - MD & Senior Research Analyst*

Congrats on a great quarter. I just wanted to follow up on Brad's earlier question regarding SolarWinds. It sounds like that's creating more pipeline, but not necessarily contributing to revenue yet. But your billings growth is the strongest that we've seen in over 2 years. So I'm wondering if you could just comment on what the key drivers are that are contributing to that inflection in your billings growth now since SolarWinds. It doesn't look like it's really had much of an impact yet?

Jay Chaudhry; **Co-Founder, President, CEO & Chairman of the Board**

Generally, in all these sessions, analysts like to pinpoint to a particular event that may cause something. So COVID was viewed as maybe a catalyst. This is being viewed as a catalyst. As we have said before, the overall catalyst is that everyone is driving towards digital transformation, COVID may be helping it, SolarWinds may be helping it. But customers have realized, they believe that they need to accelerate their transformation, and we are the one, who enabled that transformation. If you do your transformation without something like Zscaler, your risk goes up significantly. So where is our growth coming from? ZIA, which has been our workhorse. Yes, now we got over 25% of Global 2000 companies, but we have 75% more to go. It is generating pretty good sales. ZPA, which was a relatively young product 2 or 3 years ago, now is actually contributing significantly, about 40% of our Global 2000 customers already have our ZPA. So these 2 are the biggest contributors of our billings growth. And then the new pillars ZDX is picking up quite well and also is the new pillar of cloud protection. I think we're very pleased that our customers are buying more and more bigger bundles together. I talked about ZIA, ZPA and ZDX being brought together by our customers during our -- in my prepared remarks.

So across the board, we're seeing strength from product side of it, across geos, we are seeing strength. Remo, you want to add to my comment?

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

No. I think Jay is absolutely right. If you take a look at the breadth of our platform. Before we're user centric, now, basically, we're also cloud protection, so -- workload protection. So the breadth of the platform is resonating with our customers. In addition, when we talked at the Analyst Day that for companies of 5,000 employees on the user side, we'd expect -- we're seeing ARPUs in that \$145 range. I can say that in the quarter, we've had deals

with customers at the 5,000 employee range in that range at \$145. So what's happening basically is that there's a huge need in the market. Legacy architecture is not the answer. And so with Zscaler, with the breadth of platform, the increasing platform that we've created and will continue to create, is really perfectly set to go forward into this market.

Operator

Our next question comment comes from the line of Erik Suppiger from JMP Securities.

Erik Loren Suppiger - *JMP Securities LLC, Research Division - MD & Equity Research Analyst*

Jay, given what you were saying earlier about proxy versus firewall, can you comment on how if you -- how difficult it is to augment firewall architectures with proxy capabilities? Because I think one of your competitors is talking about introducing that kind of capability to their solution.

Jay Chaudhry;Co-Founder, President, CEO & Chairman of the Board

Well, what should I say? Imitation is the best form of flattery. Having said that, I would say that there's something called native architecture or purpose-built architecture, there is something called bolt-on. Building proxy is hard, because you terminate, you inspect and you reconnect. Compare that to a pass-through firewall, you don't stop anything, you let it go. If you catch something, it's great. If you don't, you don't. Many vendors have tried and failed to build a high-performance proxy, because it's hard. The only 2 vendors in the past 20 years have successfully penetrated enterprises for zero -- for user security, Blue Coat for on-prem, and they've done it for the cloud. So I think am I surprised that people try to get by without a proxy and finally, the customer said, no, no further changes. I think delivering the same will be tricky. We've seen many companies do it. There have been vendors who have been saying that they had a proxy for 6, 7 years. I would rather not name them, but I still haven't seen them in the market.

So we keep on -- we are not sitting still. We keep on advancing. The most functionality you add, browser isolation, to CASB, to content inspection, to DLP and all, your proxy has to do more and more work and still deliver throughput and still do threat inspection. So we welcome the competition, but we are very pleased with our performance, the kind of lead we have over traditional legacy vendors.

Operator

Our next question comment comes from the line of Sterling Auty from JPMorgan.

Sterling Auty - *JPMorgan Chase & Co, Research Division - Senior Analyst*

So how off the networks on the earnings call pointed out the success that they've had with Prisma Access? And given the commentary about the success that you're seeing in the enterprise, I'm curious, are you running into each other in an increasing fashion in that segment? And it's just that the space is so big that you're both able to grow at these rates? Or do you think you're serving different segments of the overall opportunity in the market?

Jay Chaudhry;Co-Founder, President, CEO & Chairman of the Board

So firewall vendors started making noise a couple of years ago, a lot of noise, then it died down about 6 months after that. In the field, we haven't really change -- seen a whole lot of change to it. When it comes to large enterprises where we dominate, we haven't seen any change in competitive landscape. And I can understand why. Large enterprises are security savvy. They understand the difference between proxy and non-proxy. They understand Zero Trust and VPN. And that's why we don't expect to see firewall-based architecture in those enterprises. And all of you guys are so close to banks. Find a large bank who believes in not having proxy, but using firewall architecture for security. I have not found one. I think when

it comes to lower end of the spectrum, probably in the 5,000 users or below, we do see firewall vendors from time to time. And from time to time, these guys aren't that sophisticated. They can be probably tricked into buying something that may not be that sophisticated. So I think you'll see less sophisticated solutions being bought on the lower end. But on the higher end, we haven't seen any change in competition.

Operator

Our next question comment comes from the line of Patrick Colville from Deutsche Bank.

Patrick Edwin Ronald Colville - *Deutsche Bank AG, Research Division - Research Analyst*

Congrats on a very impressive quarter. Just asking about headcount hiring. I mean that was a major theme of fiscal '20. And it looks potentially in the numbers that, that's probably helping to contribute to growth this quarter. I mean can you just help us understand how you guys think about hiring now? And if you can share any numbers around net headcount adds year-on-year sequentially? That would be great.

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

Yes, I'll take that. So the net headcount adds we had in the quarter was about 240 and it was about 260 in Q1. Generally speaking, it's around 60% sales and marketing heads. And that's what it was also -- and historically, it's been pretty much every quarter, and that was the case in Q2. The comment about accelerating hiring, yes, we are. We're accelerating hiring. We see a huge market opportunity. We see that we are doing well. We see that we've got the right product for this market. So we're going to continue to invest across the board in the company. In particular, with field quota sales reps, we had a record quarter hiring in Q4. We had a comparable quarter in Q1, and we had a very good quarter in Q2. And we plan to continue to hire aggressively throughout the back half of the year. Again, from our perspective, we've talked about putting growth ahead of profitability. We'll be mindful of profitability. Since our public offering, we've been positive profitability and free cash flow. Jay and I are very mindful of that and we'll continue to be mindful of that.

But this is such a big opportunity, that we feel that we want to take advantage of it, and we're going to invest in it, and we're going to try to capture it.

Jay Chaudhry;Co-Founder, President, CEO & Chairman of the Board

If I may add, over the past 4 quarters, we have pretty openly shared with you a game plan of scaling our sales organization, building our sales engine from enablement to training and all those things. And I think you're seeing the results being delivered quarter after quarter. So we are bullish about it, and we'll keep on increasing our headcount in sales, in engineering, in customer support and all other related areas.

Operator

Our next question comment comes from the line of Fatima Boolani from UBS.

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

Remo, a question for you. Jay, in his prepared remarks, alluded to a number of very large sort of wall-to-wall transactions that were also multi-product. So I'm wondering if you could comment on the large deal activity that you saw in the quarter? And if it was maybe outsized in any particular regions? That would be really helpful if you can give us some of that quantification of that.

Remo E. Canessa - Zscaler, Inc. - CFO

Yes. Good question. So large deal activity was strong in the quarter. It was comparable to Q1. It was significantly higher than last year. From a geographic perspective, all regions did well. I mean we are investing in all regions pretty much the same level. APJ, probably a little bit faster than the other regions, but all regions have done well, and we continue to invest.

Related to the other comment I made before, when companies see -- with the breadth of the platform that we have, and companies see the value of Zscaler, and the ease of implementation, the increased security, and also the ROI, the value proposition is resonating with our customers. And so we're seeing that. And so by adding ZDX and ZCP and broadening the platform, it actually increases the value of what we're -- of Zscaler.

Jay Chaudhry;Co-Founder, President, CEO & Chairman of the Board

If I may add a couple of points to it. We have truly expanded the platform. We haven't gone on a buying spree and thrown them in there and call it a platform because those -- these unintegrated products don't add a lot of value. Our customers see the value. For example, to turn on ZDX, it's literally a few minutes. It hardly takes anything because the traffic is already flowing through, everything is happening. The second point I'd like to make is, yes, we did have what you call wall-to-wall deals, I guess that meant all pillar deals. But there are no mega deals in the quarter, okay? And there's no onetime kind of special deals that artificially increased our billings numbers. It was properly distributed various pillars and across all geos.

Remo E. Canessa - Zscaler, Inc. - CFO

Yes. As a follow-on for Jay, also. It was a near record quarter also for new customers. So it was broad. It was strong. And as Jay mentioned, there's no mega deals that we've had in the quarter.

Operator

Next question or comment comes from the line of Matt Hedberg from RBC Capital Markets.

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

This is Matt Swanson on for Matt. Jay, kind of going back on some of those large deals, it seemed like you had a lot of success upselling, ZIA and ZPA. I know at the Analyst Day, we talked about maybe a 6x upsell opportunity within your base. When it comes to kind of realizing that opportunity, is it more just a matter of time and as customers see the value they're coming back? Or are there steps you can take to kind of more aggressively pursue that expansion?

Jay Chaudhry;Co-Founder, President, CEO & Chairman of the Board

So I think our customers are happy and trusting us. So that's a starting point. If that's not the case, you won't sell. Two, you need proper sales execution, engagement. Our engagements start from the C level, the sales machine we have built is helping us. So we are getting pretty good share of upsell deals. In fact, we don't have differentiation between incentive, sales incentive or sales versus new upsell. So we are pleased with the upsell performance, the new performance. We have an internal debate between how much do we need new versus upsell. Remo and I decide let the total ACV rule where we have both opportunities. But we are seeing good growth, good upsell numbers every quarter.

Remo E. Canessa - Zscaler, Inc. - CFO

Yes. As a quick follow-on for Jay. Just some numbers. Upsell was very strong. New business was very strong also. If the split between new and upsell in the first half was approximately 50-50. Upsell in Q2 was slightly below 50%. We feel...

Jay Chaudhry;Co-Founder, President, CEO & Chairman of the Board

Sorry, sorry. New was slight -- slightly below.

Remo E. Canessa - Zscaler, Inc. - CFO

Excuse me. New was slightly below 50%. And going forward, we think a good mix for Zscaler is 50-50. And the reason for this is the point that you brought up. I mean, the 6x ability to upsell into existing customers just for ZIA and ZPA. And so it is significant.

Operator

Our next question comment comes from the line of Brian Essex from Goldman Sachs.

Brian Lee Essex - Goldman Sachs Group, Inc., Research Division - Equity Analyst

Great to see that billings acceleration. And on that, I was wondering if we can get a little bit of color around your hiring rate, I think it was brought up on a previous question. But wondering, have you reached some kind of a terminal velocity in terms of the rate of hiring and the rate of training and the rate of maturation within your sales force? And maybe a little bit of color, too, around how you're attracting talent in the market? Is it primarily in a localized area? Or is it from multiple geographies that you're able to attract better talent on your platform?

Jay Chaudhry;Co-Founder, President, CEO & Chairman of the Board

I will start, then, Remo, you can add on. So first of all, we have become the top destination for the top talent. When the market is competitive, we actually don't have problem attracting good talent, whether that's in sales organization or engineering. So pleased obviously, with that, you need to make sure things are in place, a proper team for hiring, but that's happening. Related to geos of where the concentration is, from sales point of view, we are where the customer is. We are a very global organization with big presence all over U.S., all over Europe, APJ, Japan, India, Singapore. All these places. So we are attracting talent from everywhere.

And generally, on the sales side, we're looking for talent coming from companies who know how to sell solutions, who need to sell software, who know how to sell transformation sales. That's the first part. The second part was ability to train. Over the past 4 quarters, we shared with you how we built the sales enablement team, how we built the team with sales leaders, the proper -- even proper process for interview for these people with the whole documented process. I think we are very optimized. I would say as optimized as I ever see out there. So that's why we are able to add significantly large number and make them pretty productive in a shorter amount of time than we would do otherwise.

We shared a little bit of that during our Analyst Day, the kind of impact that's being made with better training and better enablement. Remo?

Remo E. Canessa - Zscaler, Inc. - CFO

Yes. Just a quick follow-on, from my perspective around sales organizations, my career -- really good sales organizations. Nothing matches what we have here at Zscaler. Nothing. The organization top to bottom, from the way it's structured and the ability to scale. as Jay talked about, the training with the sales enablement group, never seen anything like it in my career. It gives us the ability -- as Jay said, we're not looking for people who sell traditional, we're looking for people who can sell transformation. And to do that, you need to be trained. And we are a destination. So do we have the ability to increase our hiring pace? We do. Do we have the ability to onboard quickly? We do. Do we see salespeople getting to productivity faster? We are. So I mean, it's a good place to be.

Operator

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

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

My question is about the comps for 2021. Do you feel or do you have any data to think that some of the growth this year was related to COVID, an increase in license take rate because of COVID? And if that's the case, we might have an issue second half '21 with the comps? I know that this is on investors' mind, and I'm wondering if you have any data to support the view one way or another.

Jay Chaudhry;Co-Founder, President, CEO & Chairman of the Board

Yes. Let me start with a general comments and Remo, you can be more specific. I give you the hard part, the numbers. Look, we do believe that work from anywhere is here to stay. As COVID became a catalyst to shake off inertia, it actually changed the mindset. And it really not just gave momentum, but also brought to right the limitations of legacy network and security. So we are seeing a customer saying, "We are implementing Zero Trust," which means they need ZIA, ZPA type of deployments even after everything gets back to normal. If that were not the case, they would be doing short-term ZPA deal and saying, I'm going back to the office, I no longer need to do renewals of ZPA. We aren't seeing that. So we think the world is changing. So going back to the office should not be impacting our momentum of the business. That's how I look at it overall. Remo?

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

Pipeline is strong, and interest is high in Zscaler, and engagement is significant.

Operator

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

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

Jay, my first question for you. You talked about really strong traction with ZDX. I think it was over 200 customers on that product. When you initially launched the solution, it seemed like it would be something that would be perhaps more complementary with the monitoring vendors. I'm wondering, given the strong traction that you've had, what is your sort of ambition with this product?

Jay Chaudhry;Co-Founder, President, CEO & Chairman of the Board

So it is complementary with application monitoring vendors. So -- but it's not complementary with network monitoring vendors. Because network monitoring vendors are monitoring traffic between your branch office and the data center over your private network. Private networks are going away. People are sitting anywhere. When you're sitting at home and going to Office 365 or your data center, what network monitoring tools can you use? Hardly any. So we are sitting on the endpoint. We are connecting the user application. We're sitting in the middle, we see the application side. We see the endpoint side. We're the best players to give you end-to-end monitoring and complement application monitoring vendors.

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

Got it. And then just maybe a follow-up question for Remo. Obviously, a massive expansion of the sales force and the channel over the past couple of years. But I'm curious, what percentage of these reps are fully productive, right, given that your traditional ramp period that they have?

Remo E. Canessa - Zscaler, Inc. - CFO

Yes. Let me just answer it saying that 2/3 of our sales reps are still ramping. So they're not fully ramped. When I say ramping, they have been here -- they've been here for less than 1 year.

Operator

(Operator Instructions) Our next question on the comment comes from the line of Gray Powell from BTIG.

Gray Wilson Powell - BTIG, LLC, Research Division - Director & Security and Analytics Software Analyst

So just looking back last year, a lot of companies they went out and they purchased additional VPN capacity from legacy vendors, really as part of continuity initiatives. Are you seeing some of those deals come up for renewal? And do you think that gives you an incremental opportunity to gain share as those companies look to modernize their solutions?

Jay Chaudhry;Co-Founder, President, CEO & Chairman of the Board

No. I would say as I have discussion with our large enterprises, and I personally do quite a few. I have yet to find a customer who has -- I talked to who said, I want to keep VPN for the long run. They're all in various stages of the journey. The growth you see of ZPA from our customer base is the result of more and more Zscaler customers embracing Zero Trust and ZPA. I do believe that although there'll be some exception, but most of these current ZIA customers will embrace ZPA. And I see them more and more embracing ZDX as well. Our strategy of offering, a well designed, integrated platform with 4 pillars is working well. 2 years ago, the question used to be can ZPA take off, right? That question has been answered over and over. Another question is can ZDX and ZCP take off? Early indications are very good. But back to your question of, is VPN replacement vendors an opportunity for us? Absolutely, yes. Our starting point of ZIA is replacing the user protection, which typically is a proxy, and then we start expanding into the full bundle. Our ZPA entry point is generally a VPN vendor, and then you expand to Zero Trust App segmentation.

Operator

We have time for one last question. Our final question will be from the line of Yun Kim from Loop Capital Market.

Yun Suk Kim - Loop Capital Markets LLC, Research Division - MD

So Jay, on the new cloud workload protection product, it seems like you're already getting some early traction there. Are you seeing an opportunity to partner with a hyperscaler -- scalars such as AWS and Azure, since a lot those -- a lot of the cloud workloads will reside on those hyperscaler platforms? And I know you already have partnership with ZIA, ZPA with AWS? And then also, in addition, do you see the need to begin to target like DevOps team for your cloud workload product?

Jay Chaudhry;Co-Founder, President, CEO & Chairman of the Board

Yes. It's a good question. Fair you said, we have already been engaged with leading cloud providers with ZIA and ZPA. Okay. On the cloud protection area, we got some early initiative going. There's a good complementary fit we see with them. And I think it's a little bit early. I mean, it's only a quarter or so, but the momentum is strong, the pipeline we're building is strong. The way you should look at Zscaler Cloud Protection is not the way you look at traditional vendors, who say, "I'm going to take my firewall and put the virtual firewall in the cloud." We think that trying to replicate your data center in the cloud would never work for even moving apps. How is it going to work for security? We look at workloads like mirror image of users and should be protected like users. So with Zero Trust Exchange, we are able to connect a workload in region A to workload in region B over the Internet coming through our Zero Trust Exchange. That's really what makes us very different architecturally.

Now the next part of your question was left shift stuff. As we are engaging with our customers, they are having dialogue with us. As they are figuring out their left shift strategy, it's a new area and we are closely monitoring it. As the market evolves, you can rest assured, we will be there to serve our customers.

Operator

That concludes our question-and-answer session for today. I'd like to turn the conference back over to Mr. Jay Chaudhry, Chief Executive Officer, for any closing remarks.

Jay Chaudhry;Co-Founder, President, CEO & Chairman of the Board

Thank you for joining us. I hope the session was worthwhile. We hope to see you at our next earnings call or before that, in one of the investor events, will be joining. Thank you.

Remo E. Canessa - Zscaler, Inc. - CFO

Thank you.

Operator

Ladies and gentlemen, thank you for participating in today's conference. This concludes the program. You may now disconnect. Everyone, have a wonderful day.

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