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Q2 2020 Zscaler Inc Earnings Call

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PRESENTATION

Operator

Good day, and welcome to the Zscaler's Second Quarter 2020 Earnings Conference Call. Please note, today's conference is being recorded. At this time, I would like to turn the conference over to Bill Choi. Please go ahead, sir.

Bill Choi *Zscaler, Inc. - VP of IR*

Good afternoon, and welcome to the Zscaler Fiscal Second Quarter 2020 Earnings Conference Call. On the call with me today are Jay Chaudhry, Chairman and CEO; and Remo Canessa, CFO. By now, everyone should have access to our earnings announcement, which can be found on our website in the Investor Relations section. In addition, a supplemental financial schedule is available for download at ir.zscaler.com. Please note, unless otherwise noted, all numbers we talk about today, other than revenue, will be on an adjusted non-GAAP basis. You will find a reconciliation of GAAP to the non-GAAP financial measures in our earnings release. For historical periods, the GAAP to the non-GAAP reconciliations can be found in the supplemental financial information referenced a moment ago.

Let me remind you that we'll be making forward-looking statements during today's discussion, including, but not limited to, the company's anticipated future revenue, calculated billings, operating performance, gross margin, operating expenses, operating income, net income, free cash flow, dollar-based net retention rate, 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 risk and uncertainty, some of which are beyond our control. Our actual results may differ significantly from those projected or suggested in any forward-looking statements. These forward-looking statements apply as of today, and you should not rely on them as representing our views in the future. We undertake no obligation to update these statements after this call.

For a more complete discussion of the risks and uncertainties that could impact our future operating results and financial condition, please see our filings with the Securities and Exchange Commission as well as in today's earnings release.

I would like to inform you that we will be participating in several upcoming investor conferences. Management will be at the Morgan Stanley TMT Conference in San Francisco on March 4; the SunTrust Technology, Internet & Services Conference in New York City on March 11; and Crédit Suisse Investor Relations 1-on-1 Conference in New York City on March 12.

Now I'll turn the call over to Jay.



Jay Chaudhry Zscaler, Inc - Co-Founder, President, CEO & Chairman

Thank you, Bill, and thank you, everyone, for joining us. We delivered solid Q2 results, while making tremendous progress in important areas of our business, particularly with our go-to-market initiatives.

In Q2, our revenue grew 36%, and billings grew 18% year-over-year, which had a difficult comparison due to a non-recurring private cloud sale to a large public sector customer last year. Adjusting for this, revenue grew 41%, and billings grew 30%. During the quarter, we significantly expanded our sales leadership team, refined our territory coverage, revamped our channel program and retooled our sales management systems. It is remarkable how much progress we made on our go-to-market initiatives in a short period of time. Considering the significant undertakings, I am very pleased with our results. We are seeing good momentum in our business, and we are increasing our outlook for revenue and billings for the full fiscal year 2020.

On profitability, we delivered 11% non-GAAP operating margins, and our free cash flow was negative \$2 million. Excluding the \$15 million onetime cash payment to settle all Symantec lawsuits, free cash flow would have been positive \$13 million. While we delivered strong profitability in the quarter, we are focused on making strategic investments to position Zscaler well for the long term.

What excites me the most is seeing our customers leverage our cloud-native integrated security platform to accelerate their digital transformation journey. We are empowering them to transform their network and security to fully realize the benefits of cloud and mobility.

Let me highlight a few wins in Q2 that show the many use cases of our platform and what we believe are our sustainable competitive advantages.

I will start with a new logo win of a national public transportation provider in Europe that needed to modernize its infrastructure and better engage with its passengers. The scalability and elasticity of a cloud became a critical enabler of their transformation strategy, supporting large-scale data center consolidation, application migration and network changes. Zscaler is the only solution that could meet the requirements to scale from 2 gigabit per second Internet connectivity today to 100 gigabits per second in the future while delivering full SSL inspection and sandboxing for zero-day threats. We closely partnered with a global system integrator to implement our Transformation bundle for 45,000 users. This is a great example of the leverage we gained from working with a system integrator partner that was awarded the overall transformation project.

In our large ZIA deals, we continue to see increasing adoption of SaaS and Office 365 as primary drivers. In another new customer win, a Fortune 500 material sciences company purchased our Business bundle that includes advanced threat protection, SSL inspection and bandwidth control for 57,000 users. With a cloud-first strategy, their legacy on-premise security gateway became irrelevant. We provided protection across over 100 locations and, for mobile users, improving their security posture and delivering elasticity that's expected of a cloud service.

Now let me give an example of an upsell deal. A Fortune 100 healthcare company that started a large paid pilot of our Transformation bundle plus DLP for 10,000 users just 9 months ago, purchased additional seats, along with our newly released CASB to cover all 65,000 employees. With 120 SaaS and cloud apps already in use, their existing appliance-centric security approach was failing even with 40 large security appliances in their 2 primary data centers. With the upcoming Office 365 deployment which often doubles Internet bound traffic, this customer is implementing local breakout with SD-WAN, secured by Zscaler across 450 locations. Notably, this was our first CASB win as the customer wanted an integrated solution: CASB that is integrated with ZIA and that brings together both out-of-band and inline CASB capabilities. For the first phase of adopting a Zero Trust Network Access strategy across the company, they bought ZPA for 2,500 users to help integrate a recently acquired company and provide secure access to AWS for their developers.

I'm delighted to share our continued momentum with ZPA, which remains our fastest-growing product line. There is a growing customer interest in Zero Trust Network Approach to offer access to applications without granting access to the corporate network. As an early pioneer, ZPA is a mature, rich offering that is deployed in hundreds of enterprises. Let me highlight a few additional ZPA wins in the quarter.

2 years ago, a Global 10 multinational oil and gas customer bought our ZIA Transformation Bundle for 145,000 employees. After ZIA delivered excellent user experience while handling a 200% growth in their Internet traffic over 2 years, the customer purchased ZPA for over 100,000 users to replace its legacy VPN and to secure access to applications in the public cloud. ZPA represents the next step in this customer's IT transformation journey towards the cloud-first strategy. To improve security, ZPA will connect users to applications, not the network. This would not be possible with legacy VPN or firewall solutions. Since starting with Zscaler 4 years ago with Professional Bundle, this customer has increased the total annual spend with Zscaler by over 700%.

I'm thrilled that more customers are purchasing ZIA and ZPA together to leverage a single platform for secured cloud transformation.

A multinational industrial company purchased ZIA Business Bundle and Cloud Firewall for 60,000 users and ZPA for 40,000 users. The move to Zscaler was driven by: One, to pursue local breakout from 3 data centers to 750 locations globally as their Office 365 rollout overwhelmed their existing security infrastructure; two, to execute faster M&A and divestitures.

Zscaler is the only solution that could meet all the requirements and deliver an excellent user experience. Due to ZPA's Zero Trust Network access architecture, our ability to support M&A and divestitures is unique and was instrumental to winning this deal. The customer is leveraging Zscaler to provide secure, fast and reliable access for any user from any occasion on any device at a lower cost of ownership and with greater operational simplicity.

Lastly, I will share another combined ZIA and ZPA win. A Fortune 500 medical testing company with a strategic objective of expanding the business in cloud-based data analytics needed to transform their network and security for greater agility and IT simplification. This customer purchased the ZIA Business Bundle and Cloud Firewall for 25,000 users to secure local Internet breakouts with SD-WAN for 3,600 locations. While the incumbent firewall vendor offers an integrated SD-WAN solution, the customer chose a light branch architecture with Zscaler providing all security in the cloud as advocated by Gartner's SASE model. In the first phase of adopting a Zero Trust Network Access strategy across the company, the customer also purchased ZPA for 8,000 users to replace a legacy VPN remote access.

As these news show, a cloud-first world requires a cloud-native architecture. Unlike the traditional security appliances, our born-in-the-cloud security platform can scale. Remember, Zscaler stands for Zenith of Scalability. You've seen the legacy network security vendors trying to recast themselves as cloud security providers. The single-tenant architecture is not designed for the cloud. As I have said before, you can't create a Netflix service by stacking thousands of DVD players in the cloud; you can't offer an in-line, high-performance security cloud by spinning up a bunch of virtual machines in a public cloud.

As you may know, Gartner published 2 groundbreaking research reports to respond to customers' needs for better advice for security and network transformation.

First, "The Future of Network Security Is in the Cloud," which defines a new approach named Secure Access Service Edge, or SASE, that strongly validates Zscaler's platform and vision. Gartner predicts that most organizations will move their network security to a SASE model. Many vendors are claiming that they are SASE, but we believe Zscaler most comprehensively meets the core architectural principles of SASE, including cloud edge architectural, light branch design, proxy technology and cloud-native, multitenant architecture. We are SASE since 2008.

The second Gartner report defines Zero Trust Network Access, or ZTNA, architecture, which advocates that network security can no longer be done in a perimeter-less world. Hence, users should not be connected to the network, but only to specific applications. This architecture renders traditional network security products like firewalls irrelevant. We believe ZPA is the best implementation of ZTNA, and we are well positioned to capitalize on this rapidly growing market opportunity.

We have over a 10-year lead on operating our cloud platform at scale, processing over 85 billion transactions per day and providing an unprecedented network effect for better security for our customers.

Let me update you on the status of a new product that we believe will keep us well ahead of the competition. As we discussed previously, we have 4 new product offerings that will be generally available in early fiscal Q4.

Zscaler B2B and Zscaler Digital Experience, or ZDX, are 2 new product lines that are getting great initial feedback from our beta customers. We believe that these product lines will significantly expand our already large market opportunity.

We are engaged with several dozen customers for our CASB offering, and we have closed a few deals already. With the out-of-band CASB, combined with our existing in-line CASB capabilities, we now offer a complete CASB solution.

Our Browser Isolation offering is already being tested by a dozen customers.

It is important to point out that these new products are fully integrated with the Zscaler platform, which provides a common set of services, such as user authentication, central logging, single policy engine, making Zscaler a compelling and powerful platform for security transformation and vendor consolidation. We believe these new products will add to our growth in fiscal 2021 and beyond.

Let's now turn to our go-to-market. As I stated during the last earnings call, we are focused on improving our sales execution to take Zscaler beyond \$1 billion in annual revenue. I couldn't be happier having Dali onboard leading our go-to-market organization. I'm excited about the key initiatives that Dali and our sales leadership are putting in place to position us well for a long-term growth. The progress we are making in a short period of time is quite remarkable and, in many ways, ahead of my expectations. We accelerated the majority of our initiatives within the last quarter as we rolled out a refined, repeatable and scalable sales process.

Let me highlight the key initiatives.

We implemented our new sales enablement program. This program is having a great impact on the consistency and quality of execution across the entire sales organization. We expect this to enable our new hires to ramp faster with quality activity out of the gate.

We implemented new AI-based tools and systems to provide visibility into leading indicators such as sales activities and key go-to-market metrics.

We expanded and deepened our sales leadership structure, positioning us to scale our sales organization going forward. This included internal promotions to frontline leadership roles.

We rolled out a new sales leadership training program and trained all of our sales leaders in the past 90 days. Among other things, this training includes how to attract and hire the right talent.

We continue to aggressively hire in sales and plan to increase our sales rep headcount by 60% by the end of this fiscal year compared to prior year. I'm impressed with the quality of candidates we are attracting and hiring to drive top-down transformational sales.

We evaluated and defined territory coverage that we believe will lead to higher volume and quality of customer engagements.

To drive home these initiatives, we held 2 midyear sales kickoffs earlier this month, 1 in Europe and 1 in the U.S., to bring the global sales organization together for training and team building.

While it will take time to realize the full benefits of these changes, I'm excited to share that we are starting to see promising leading indicators: Customer engagements are up significantly, both in new business meetings and existing customer interaction, with more high-impact CXO meetings. And with the introduction of weekly pipeline generation day, the quality and volume of our pipeline is growing.

To complement our comprehensive platform, we have been integrating our solution with technology leaders and creating go-to-market leverage with deeper field engagements with their sales organizations. For example, after recently completing the integration of the

Zscaler platform with CrowdStrike, we are starting to see new opportunities with Global 2000 customers. Our field teams are partnering to sell to new customers and to our respective customer bases. Our Microsoft partnership is growing stronger and creating more tailwinds with the adoption of Office 365, Azure public cloud, Azure AD and Azure Sentinel. We are training Microsoft security professionals and architects on our integrated solution. Zscaler was also recently recognized as Microsoft Security 20/20 Partner Awards finalist, nominated in 2 categories, ISV Partner of the Year and Customer Impact. And we are working closely with both VMware and Silver Peak to secure their SD-WAN deployments.

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

Remo Canessa Zscaler, Inc. - CFO

Thank you, Jay. Revenue for the quarter was \$101.3 million, up 8% sequentially and 36% year-over-year. Recall that last year, Q2 '19 revenue was aided by \$2.3 million in nonrecurring revenue from a large public sector customer deploying our platform as a private cloud. Excluding this revenue from last year, revenue grew 41% year-over-year. From a geographic perspective, for the quarter, Americas represented 51% of revenue, EMEA was 40% and the APJ was 9%.

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 18% year-over-year to \$135.4 million against a typical comparison. Recall, we had a large upfront billing of \$11 million in Q2 of 2019 from the large public sector customer. Excluding this deal, our billings grew 30% year-over-year. As a reminder, our contract terms are typically 1 to 3 years, and we primarily invoice our customers 1 year in advance. Remaining performance obligations, or RPO, which represents our total committed noncancelable future revenue, was \$609 million on January 31, up 32% from 1 year ago. The current RPO is 56% of the total RPO.

Our strong customer retention and ability to up-sell have resulted in a consistently high dollar-based net retention rate, which is 116% for the quarter. This compares to 118% a year ago and 120% last quarter. As we've highlighted, this metric will vary quarter-to-quarter. Our increased success selling bigger deals, starting immediately with our Transformation Bundle and faster upsells within a year, while good for our business, can reduce our dollar-based net retention rate, which is calculated on a year-over-year ARR basis. Considering these factors, we feel that 116% is very strong.

Total gross margin was 82%, up 1 percentage point sequentially and up 2 percentage points year-over-year. We feel that 80% continues to be a good target range in the near term as it is important to continue to invest in our platform to drive top line revenue growth.

Turning to operating expenses. Total operating expenses decreased 1% sequentially and increased 44% year-over-year to \$71.9 million and increased as a percentage of revenue to 71% compared to 67% last year.

Sales and marketing increased 1% sequentially and 49% year-over-year to \$49.7 million. Please keep in mind that in Q1 2020, we had 2 Zenith Live user conferences and a global sales kickoff that represented \$6.5 million in expenses. The year-over-year increase is due to higher compensation expenses and investments in building our teams and go-to-market initiatives.

R&D was down 4% sequentially and up 33% year-over-year to \$14.2 million. The sequential decrease was primarily due to higher capitalization of software development costs as a number of our new products continue to progress towards general availability. On a year-over-year basis, we continue to invest to enhance our product functionality and to innovate new products.

G&A decreased 5% sequentially and increased 36% year-over-year to \$8.1 million. The sequential decrease was primarily due to lower professional fees, and the year-over-year increase is to support our company growth. G&A expenses exclude \$16.3 million in litigation-related expenses, including the \$15 million cash settlement for all Symantec lawsuits.

Our second quarter operating margin was 11%, which compares to 13% in the same quarter last year. Net income in the quarter was \$12 million or non-GAAP earnings per share of \$0.09.

We ended the quarter with \$385 million in cash, cash equivalents and short-term investments. Free cash flow was negative \$2 million in

the quarter. Excluding the \$15 million onetime cash payment to settle all Symantec lawsuits, free cash flow would have been positive \$13 million.

Now moving on to guidance. As a reminder, these numbers are all non-GAAP, which excludes stock-based compensation expenses, amortization of acquired intangible assets, certain litigation-related expenses, facility exit cost and any associated tax effects. For the third quarter, we expect revenue in the range of \$105 million to \$107 million, reflecting a year-over-year growth of 33% to 35%. Operating profit in the range of \$1 million to \$3 million. We plan to increase our sales investments in Q3. Also, please keep in mind that we spent approximately \$2 million on the 2 midyear sales kickoffs in February. Income taxes of \$950,000 and earnings per share of approximately \$0.01 to \$0.03, assuming 139 million common shares outstanding.

For the full year fiscal 2020, we expect revenue in the range of \$414 million to \$417 million or year-over-year growth of 37% to 38%; calculated billings in the range of \$512 million to \$517 million or year-over-year growth of 31% to 33%; operating profit in the range of \$16 million to \$18 million. In Q4, we expect to host our annual Zenith Live conferences in both EMEA and Americas. We expect the cost of these 2 events to be in the range of \$5 million to \$6 million; income taxes of \$3.5 million; and earnings per share in the range of \$0.14 to \$0.16, assuming approximately 139 million common shares outstanding.

Our guidance reflects our plans to invest aggressively in our business to pursue our significant market opportunity. We are very pleased with the progress Dali is making, and we are confident he is the right person to drive our sales and go-to-market execution. We are stepping up our sales and marketing investments in order to build the foundation for long-term growth. In addition, we will increase investments in our technology platform and cloud infrastructure.

As you model billings, I want to remind you that, historically, Q2 and Q4 have been our strongest billing quarters, with the sequential declines in Q1 and Q3 quarters, respectively. For the year, excluding \$11 million of upfront billings in Q2 of 2019, our updated billings guidance for the fiscal year implies 35% to 37% growth.

In terms of free cash flow, please note that we have additional spend for tenant improvements related to our headquarters move. Including the settlement of Symantec lawsuits, these extraordinary items are expected to total approximately \$22 million to \$25 million in cash payments for the full year. As a result of these payments, we expect our free cash flow margins in fiscal 2020 to be approximately 1 point lower compared to our operating profit margins. Longer term, we would expect free cash flow margins to be higher than our non-GAAP operating margins.

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

Jay Chaudhry Zscaler, Inc - Co-Founder, President, CEO & Chairman

Thank you, Remo. In closing, let me state 4 key points that make me excited. One, architecture matters for a cloud security platform that must fit in line to inspect all traffic for policy enforcement. We believe we have the best architecture, with over 10 years of operational experience to run a massive cloud, which is an enormous barrier to entry. Two, with multiple tailwinds, such as Office 365, SaaS adoption, SD-WAN and app migration to public clouds, we believe the market is coming to us. Three, we are in early innings of the cloud journey. We are disrupting a \$20 billion TAM with ZIA and ZPA. With recently announced Zscaler B2B and ZDX, we believe we will expand our addressable market significantly. Four, with expanded go-to-market leadership in place, we are building a sales machine that can deliver world-class execution and sustainable long-term growth.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) We'll take our first question from Brad Zelnick from Crédit Suisse.

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

So Jay, you spoke to this throughout your prepared remarks a bit, but I'd love if you can expound on it perhaps a bit more. In context of the business decelerating and the reacceleration required to achieve your full year guidance, what's driving your confidence at this point? And specifically, how should we think about the visibility you have into the back half of the year?

Jay Chaudhry *Zscaler, Inc - Co-Founder, President, CEO & Chairman*

Okay. Brad, thank you. As we have said before, we brought Dali on board, we knew we needed to do a number of things to further scale our business to a larger level. And some of the main things we have already addressed are enablement of sales teams. We had a small enablement team; we've grown it. We have proper training programs, refined the sales process to make it scalable. We put a number of systems in place that give visibility to not only headquarters, but also frontline leaders. And we significantly expanded the sales leadership in the field and created an extra layer that's needed for scaling. So a lot of those things are behind us and done. And we brought the entire sales organization together in 2 places for a midyear SKO, sales kickoff, Americas and EMEA, to really bring it all together.

So those are the things that are accomplished. Now the second question is about confidence. Obviously, we look for what some of the impacts are, what's giving us confidence to give you the projections we've done for the second half.

There are a couple of main things that fall in that area. Number one is, we are able to measure our sales engagement, engagement with our customers, engagement with new business. And the tools are put in place and the leadership we're driving, we are seeing a far better engagement than we used to have.

The second, even more important, is pipeline generation because that's a good indicator that the volume of pipeline, the quality of pipeline is all going up. So looking at the pipeline, looking at the engagements, that's what's reflected in our visibility and confidence for the second half of the business.

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

And Remo, if I can just follow up with a quick one for you. From a billings duration perspective, and I appreciate the adjustment on the year-ago comp for the large deal that you've called out, both then and now, but is there anything as we think about the average contract length, the mix of duration in this quarter, perhaps sequentially or even year-on-year, if we exclude that large deal, that we should take into account as we appraise your results that we're looking at tonight?

Remo Canessa *Zscaler, Inc. - CFO*

Yes. Thank you, Brad. Even with the deal that we had, the duration came down substantially year-over-year. When you take that large deal out, the duration did decrease slightly. I would say that the average duration is right around 12 months and hasn't really changed that much on a year-over-year or quarter-over-quarter basis.

Operator

We'll take our next question from Daniel Bartus with Bank of America.

Daniel Bartus *BofA Merrill Lynch, Research Division - Research Analyst*

First for Jay, I wanted to ask about the SD-WAN partners as I'm sure some see you guys as a bit of a competitive threat as well as a partner. So have there been any changes in the market where SD-WAN vendors have gotten more aggressive in pushing their own security offerings? And then for Remo as a quick follow-up. Pretty notable beat on operating margins. So can you discuss if you guys are behind on hiring? And to hit the lower second half operating margins, should we attribute this all to higher go-to-market spending pretty much?

Jay Chaudhry *Zscaler, Inc - Co-Founder, President, CEO & Chairman*

All right. Thank you. First of all, regarding the SD-WAN landscape, I'll share with you based on my field engagements. I'm out there meeting lots and lots of customers. There are largely 3 vendors we see in most of the enterprise deals. It's VMware VeloCloud, it's Cisco Viptela and Silver Peak. In all those deals, we are the preferred security choice. They don't try to build security in the branch box, so to

speak.

Yes, there are a couple of vendors who are trying to build security in the box. If you look at Gartner's SASE paper and if you talk to security experts in general, they don't believe security can be built in a branch box. Security needs to be done in the cloud. So perhaps there is some opportunity for some of these vendors in the mid-market where security is not viewed as very critical. But when you come to securities-heavy companies, which is generally larger enterprises, we don't really see a change in it. In fact, we have seen better engagement with some of the larger partners like VMware and Silver Peak.

Remo Canessa Zscaler, Inc. - CFO

And related to the questions you had for me, the beat on margin in the quarter was related to the beat on revenue, higher gross margin and also lower operating expenses and primarily related to headcount. On a go-forward basis, for the second half, we do expect to step up our go-to-market investments. One of the things we called out or a couple of things we called out was the 2 SKOs we had in February and also the 2 user conferences we're going to have in June. In addition, our expectation and one of the comments we made was that we'd be at a 60% RSM headcount growth year-over-year. We expect to be there. So our plan and expectation is to be at 60% growth -- RSM headcount growth year-over-year.

Operator

We'll take our next question from Alex Henderson with Needham & Company.

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

So I was hoping you could talk a little bit about the slope of the new sales hire and the timing which those people will get up and running as they go through the training process and the like. Obviously, you are accelerating your hires targeting 60% increase in staffing. Don't think that you're at that rate at this point. So is it going to accelerate into the back half? And if that's the case, should we not see an acceleration of the contribution with a lag of, what, 3 months, 6 months? Help us think it through.

Jay Chaudhry Zscaler, Inc - Co-Founder, President, CEO & Chairman

Thanks, Alex. I'll start, and Remo, you can add more color to it. As a part of our plan, one of the things we needed to do in this company was to expand our sales leadership at the front line. So that's the first priority we did to expand because we knew that it'd be right if we hired the right leaders in the field, they can actually hire a good number of sales reps.

So we accelerated sales leadership hiring and actually are ahead of what I thought it would be. Knowing that the priority, so yes, today, we are behind on the sales plan where we wanted to be, but knowing that the leaders are in place, knowing that they have been trained on actually hiring and training, we are pretty confident that we will get to our 60% hiring number. So that was one part of the question. And a lot of enablement we are doing in the systems we are putting in place is to make sure there's better visibility and more effective engagement with customers for a better ramp-up. So things are being done to provide faster ramp and have better productivity over time. Remo, you want to add to it?

Remo Canessa Zscaler, Inc. - CFO

Yes, Alex, it's a great question. When -- what Dali did in the first half, and as Jay mentioned, he significantly increased the leadership in the sales organization. And we put an additional level layer related with RVPs, regional vice presidents. When you look at the number of RVPs, area VPs and geo VPs in place, it's in the 80% range and that's, in my opinion, quite remarkable to be at that point.

Jay Chaudhry Zscaler, Inc - Co-Founder, President, CEO & Chairman

So 80% of our expanded target.

Remo Canessa Zscaler, Inc. - CFO

80% of our expanded target, exactly. So the highest probability that you have to hire the right RSMs is to have that leadership in place. So the concentration in the first half, and particularly in Q2, was to get that leadership level in place in the company. That's what gives me confidence also related to -- when I look at the quality of people that we're bringing on board, it is a very high-quality group of leaders as well as RSMs. When I look at also the Q2, we had the highest gross hires for RSMs in Q2 over the last 2 years. Now our



attrition was high also. We called that out on a prior call, saying that we expect attrition to be higher in Q2, which it was. We feel that's behind us. And on a go-forward basis, we feel attrition is going to decrease, and we expect to step up the RSM hires as we go forward. And as I mentioned before, we're very confident and it's our plan to increase at 60% year-over-year.

Jay Chaudhry Zscaler, Inc - Co-Founder, President, CEO & Chairman

I'll add one more point. As we are hiring these new reps, we're seeing that in their first quarter, they're having better sales engagements because we are measuring those engagements. And some of the enablement and some of the tools we put in place is helping us. So I feel very, very happy about it.

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

If I could do a follow-up question. So obviously, you're confident enough to accelerate your spending in the hiring. Have you seen any change in the competitive landscape that would impede the progress of this investment or offset or dilute the benefit as we look out? Any change in pricing conditions? Any change in competitor capabilities?

Jay Chaudhry Zscaler, Inc - Co-Founder, President, CEO & Chairman

Yes. Good question. Haven't really seen much impact on the competition side. In fact, our churn is down year-over-year. Our discount is pretty stable. Our average ARR of customers with greater than 3,000 users, which we track, is approaching \$400,000. And as you know, we help customers drive transformation. We drive agility, Zero Trust Access. And once they understand what we do, we rarely lose. So I don't worry about competition. I do want to stay focused on our sales execution. I think as we improve it, we're going to see better and better results.

Operator

We'll take our next question from Gray Powell with BTIG.

Gray Powell BTIG

Great. Maybe a question on your net retention rates. So how should we think about net retention going forward? And I mean, on the one side, you have a lot more customers landing with the Transformation Bundle. But on the other side, you're launching a lot of new products. So just how should we think about that?

Remo Canessa Zscaler, Inc. - CFO

It's a good question. We've talked about with more transformation part of our ZIA part of our business, customers buy for the entire user base, and so it's more transformation that puts pressure on the net retention rate. Even though it's good for the company, this does put pressure. In addition, if customers buy within the year, because the way we calculate net retention rate is the ARR for that set of customers a year ago versus what that customers have in ARR currently. So as customers buy within the year, that also puts pressure.

Also, basically, the mix between new and upsell. In the quarter, we saw kind of in the mid-range of what we've seen in prior quarters. It's 60% or 50% new, in the quarter, is basically in the mid-range of that. Prior quarter, our net retention rate was 120%, and we called out that, that was basically 50% new. So it's going to vary, and we've talked about that's a metric you should look at, but it's not one that we put a whole lot of importance to.

Operator

We'll take our next question from Patrick Colville with Arete Research.

Patrick Edwin Ronald Colville Arete Research Services LLP - Analyst

Can I just get a clarification on your point just then on the net retention rate? So were you saying that, this quarter, there was 50% revenue contribution from new customers? And last quarter, it was 40%? Was that right?

Remo Canessa Zscaler, Inc. - CFO

It was in the mid-range. So it was in the mid -- around 55% was new customers in the quarter. And last quarter, it was 50%.



Patrick Edwin Ronald Colville Arete Research Services LLP - Analyst

Got it. Okay. Okay. So slightly higher contribution this quarter from new customers?

Remo Canessa Zscaler, Inc. - CFO

That's correct.

Patrick Edwin Ronald Colville Arete Research Services LLP - Analyst

Got it. And then can I talk just competitively about the dynamics with Netskope? I mean is that someone that you see as competitive? And if not, where is Zscaler stronger?

Jay Chaudhry Zscaler, Inc - Co-Founder, President, CEO & Chairman

I mean we have seen some of the press releases they've done, but we hardly see them in the gateway area where they seem to be trying to go. I mean, they are in the CASB side of it, we're seeing them on the CASB side of it, but with our strong integrated platform where we are offering our full CASB that consolidates, that integrates inline and out-of-band, we are in a very strong position. So we don't really see them out there in the market, especially in the market area where we compete in.

Operator

We'll take our next question from Andrew Nowinski with D.A. Davidson.

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

Maybe just to start with a quick clarification. I know you said you had some attrition in the quarter which was in line with your expectations. So I'm just wondering why you decided to step on the gas on hiring now versus maybe the start of the fiscal year.

Remo Canessa Zscaler, Inc. - CFO

From -- it's really -- we've stepped on the gas hiring. So as I mentioned, we have the highest RSM hiring over the last 2 years last quarter. However, having said that, related to getting this management layer in place, the highest probability success that you have in hiring the right RSMs if you have the right leaders in place. So as we go forward with this leadership on board over a relatively short period, we expect to increase RSM hires as we go forward.

Jay Chaudhry Zscaler, Inc - Co-Founder, President, CEO & Chairman

Or, if I may add, yes, we have the largest hire for sales rep in Q2. We expect higher number of hiring in Q3 and Q4 because we have a strong field sales leadership in place.

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

Okay. Got it. And then maybe shifting gears, Broadcom, Symantec has made some announcements. They seem to be only focusing on their largest customers. I'm just wondering if you have seen any increase in displacements of Symantec Blue Coat.

Jay Chaudhry Zscaler, Inc - Co-Founder, President, CEO & Chairman

So we have seen a lot of additional interest on large enterprises. As you know, Blue Coat has been an enterprise market. They used to have a big presence. The presence is largely in the appliance space. So yes, a lot of interest, and it is helping us. It's a good opportunity for us, and we plan to take full advantage of it.

Operator

Our next question comes from Brian Essex with Goldman Sachs.

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

Jay, I was wondering maybe if you could talk a little bit about ZDX and ZB2B. How the progress is, I guess, going on the development front there. And it sounds like maybe the GA date pushed out a quarter. Anything to be concerned about there? Or maybe an update on the progress with the development of those 2 products?

Jay Chaudhry Zscaler, Inc - Co-Founder, President, CEO & Chairman

Yes. So, first of all, the GA date of those 2 products hasn't really pushed out. We have just told before that, we will be doing beta testing and we will be ready in the Q4 time frame. So we are actually pretty much on plan. What we have done, what we can report to you is the field engagement or the customer engagement of those 2 products. As you know, they're not just product features. They are product lines per se. So early beta engagement for B2B are very good. That's a new market actually. If you think about who leads this B2B market, nobody really does it. Whether it's ZPA-based architecture, Zero Trust, it's an ideal opportunity for us. So we're seeing tremendous interest from our customer base. That's where we're starting. But there will be some demand creation because people don't even know that this kind of thing exists out there.

When it comes to ZDX, Zscaler Digital Experience, there's tons of interest and demand from the customers. Because none of the tools that are designed for user experience in the old world work in the new world. We got some very good beta customers going on. And in Q4, we plan to start selling both of those products. So with a fairly good sales cycle in large enterprises, we don't expect a whole lot of contribution in Q4. But we expect it to help us in fiscal '21 and beyond.

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

Got it. Maybe just a follow-up on the launches of those products. Is there any analogy that you can point to, maybe learning -- maybe what you learned with the launch of ZPA? And then now that Dali's on board, how you're prepared to manage contribution from those product cycles as we head into 2021?

Jay Chaudhry Zscaler, Inc - Co-Founder, President, CEO & Chairman

I think if you look at ZPA was the first major product line introduction, right? In ZIA, we had many modules we launched. Module to me is a firewall. It's not a product line. Module to me is a cloud sandbox. So we have done quite well. We're pleased with how ZPA has come from nothing to a pretty significant contributing factor. For these products, we do have an incubation program. So rather than putting an overlay full sales team in place, we got an incubation team that's actually working with the early-stage customers who learn a sales process and buyers and all those things. So we could do proper training and the like for customers. So we have some good plans in place. We are comfortable. And also, we alluded to the fact that our sales process is meant for portfolio selling complex sales. So I think we'll be able to handle these product lines in our proper sales process.

Operator

We'll take our next question from Walter Pritchard with Citi.

Walter H Pritchard Citigroup Inc, Research Division - MD and U.S. Software Analyst

The first question, just around the 60% growth in RSMs as you exit the year, how should we think about productivity assumptions and so forth? I mean, given that volume of rep growth would seem like you're setting up for billings or revenue to accelerate as you get that capacity on board, but just want to make sure we're not missing anything in terms of other assumptions that may go into that.

Remo Canessa Zscaler, Inc. - CFO

No, I think you're right on. Basically, with the added RSMs coming on board, again, that adds to our capacity. So it takes about -- they're on full quota after 12 months. That doesn't mean all of our RSMs are at 100% capacity, but that's when they're full quota. So we do expect basically to be positive impact to that in fiscal '21. You're not going to see it that much in fiscal '20 or even very early fiscal '21. But as these RSMs kind of get on board, yes, we expect to see increased productivity. Because of the quality of the people we're bringing on board, because of the enablement that we're doing, because of the leadership, the increased products that we have, the market coming to us, we do expect to increase sales productivity as they get ramped.

Walter H Pritchard Citigroup Inc, Research Division - MD and U.S. Software Analyst

Great. And then just as it relates to the expense of those people and what happens before they get productive, what can you tell us about the margin impact? Is it fully -- do we fully see that as we exit this year? Or do you see that take on more of a burden as you go into next year? Just curious, sort of directionally, given that large increase in headcount.

Remo Canessa Zscaler, Inc. - CFO

Yes, I think you're going to see the bulk of the margin impact this year. Then you're going to see better margins as we go forward in fiscal '21.

Operator

We'll take our next question from Daniel Ives with Wedbush Securities.

Daniel Harlan Ives Wedbush Securities Inc., Research Division - MD of Equity Research

Can you just maybe talk on some of the larger deals in terms of what Dali bring -- in terms of the process, maybe today, cultivating some of those deals versus where we were maybe 6 to 9 months ago? And maybe you could give an example, Jay. Obviously, you're involved in a lot of those.

Jay Chaudhry Zscaler, Inc - Co-Founder, President, CEO & Chairman

Right. So just to clarify, the deals that we have been closing versus how we are closing? I just want to clarify.

Daniel Harlan Ives Wedbush Securities Inc., Research Division - MD of Equity Research

Yes. Just the larger deals and just the process that Dali brings to the organization versus where you were before he came.

Jay Chaudhry Zscaler, Inc - Co-Founder, President, CEO & Chairman

Right. I think the biggest thing we've done, if you look at the sales process, we figured out the sales process several years ago, that it can't be pushed through VARs, it has to be transformational C-level involvement and the like. So the reason we have seen this growth in the past several years is because we have been doing the right process. What we did not have is a proper discipline and structure and enablement to take it to a large-scale level. I had 2 people in my sales enablement team, and I was waiting for a new CRO to come and put that in place. Now we've got over 15 people in place in the sales development. So while we knew the process, the right thing, and we have further refined it, we have further kind of enhanced it to make it repeatable. But the biggest thing we've done is spend time to really make sure our people are enabled properly. That's one biggest thing, which also includes our proper inspection, proper qualifiers. We use something called 3 why's. So there's some better selling methodology behind it, proper questions, proper qualifications and the like. And along with that, the tools we have put in place which gives us visibility. We are measuring many things from engagement level, architectural workshop level. So they are giving us far better visibility in the quality of the pipeline, which helps us do better forecasting.

So those are the things that are needed to scale our business, and that's what we have been doing and very pleased with the progress. And that's what Dali has brought to the table.

Operator

Next question from Fatima Boolani with UBS.

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

Jay, a question for you. A number of times, you've mentioned that pipeline quality has seen significant improvement in terms of both volume and quality. And I'm wondering if you can elaborate on what you mean by quality. Is this the size of the customer? Is it the size of the engagement? Is it the size of the displacement? Would really appreciate more color on that. And I have a follow-up for Remo.

Jay Chaudhry Zscaler, Inc - Co-Founder, President, CEO & Chairman

Yes. The biggest part of quality we look at is, as we inspect, we are looking for certain attributes. For example, being able to understand all the stakeholders that are involved, being able to make sure engagements are happening. So there are several steps involved that help us give more confidence in the pipeline. For example, having a proper architectural workshops on the networking side and security side is an important piece of it. So being able to do all those things and inspect all those things and get visibility, it gives you better understanding of the quality. So you need both. We need the growth, we need the quality, and we are getting better visibility now. That's what I alluded to. Did I make sense?

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

That's helpful. And, Remo, for you, as I look at the geographical performance, Americas certainly outperformed. And I recall that EMEA had some leadership transitions within the region and also looking at APJ sequential downtick in that theater. But hoping to have you walk us through some of the dynamics, the ex U.S. this quarter. And that's it for me.

Remo Canessa *Zscaler, Inc. - CFO*

Great. Thank you, Fatima. EMEA grew 39% year-over-year. And the leadership changes that we made in EMEA, from my perspective, have been outstanding. The growth that we're seeing in EMEA, the traction, it's really, from my perspective, a great thing to see. APJ grew 56% year-over-year, so APJ has done well. I'll comment on Americas. Americas grew 32% year-over-year. But when you adjust it for nonrecurring onetime revenue last year, Americas grew 40% year-over-year.

Operator

We'll take our next question from Melissa Franchi with Morgan Stanley.

Melissa A. Franchi *Morgan Stanley, Research Division - VP and Research Analyst*

Great. I wanted to follow-up on the discussion on SD-WAN for you, Jay. So we've seen success with Fortinet selling kind of integrated SD-WAN security appliance in the branch locations. Can you guys both coexist in the branch and be successful? Are you becoming increasingly competitive?

Jay Chaudhry *Zscaler, Inc - Co-Founder, President, CEO & Chairman*

Good question. We have done a few deals where Fortinet SD-WAN devices are actually sending traffic to us. So typically, when there's a large enterprise that's security-savvy, that's what we engage with. We don't see a whole lot of SD-WAN guys doing security that's why the example I gave you. But there may be some low-end systems where the customer is okay with a good enough security that's built in the SD-WAN. But in our enterprise space, we are rarely seeing somebody that says, I am okay with the SD-WAN security. So we end up existing with SD-WAN. So I look at SD-WANs as our partners and friends. And as I commented earlier, in the enterprise space, 3 vendors are taking a big lion's share: Cisco, VMware and Silver Peak. And if you look at the Magic Quadrant leadership from Gartner, VMware and Silver Peak are in Gartner's Magic Quadrant. So I look at them as a complementary friendship. There's always some overlap from time to time, but we work closely with them.

Melissa A. Franchi *Morgan Stanley, Research Division - VP and Research Analyst*

Okay. That makes sense. And then I have a follow-up for Remo. Wondering if you can comment on whether you saw any changes in the sales cycles. On one hand, it sounds like you continue to sell more transformational deals, which I think would probably take a little bit longer to close. But on the other hand, you've made some changes to sales enablement and refining the sales process. And so how did that shake out in terms of sales cycle this quarter?

Remo Canessa *Zscaler, Inc. - CFO*

Yes. Good question. Over time, we expect to see a shortening of sales cycles. But currently, I'd say they're about the same. It's 3 to 6 months for smaller accounts; larger accounts, 6 to 12 months. So really not much change.

Operator

We'll take our last question from Yun Kim with Rosenblatt Securities.

Yun Suk Kim *Rosenblatt Securities Inc., Research Division - Senior Software Research Analyst*

So going back to Dan's earlier question on large deals. Any specific trends that you're seeing that point to improvement in large deal execution? For instance, for large deals, is sales cycle improving or closure rate improving? Just trying to better understand what metrics that you are seeing that kind of points to improvement in large deal execution. And real quick also, in terms of sales hiring, are you comfortable with the number of sales folks that you have and the talent that you have today around those large deal opportunities? Or is this an area that you also need to ramp?

Jay Chaudhry Zscaler, Inc - Co-Founder, President, CEO & Chairman

Right. So I'll take that question. So large deals. We dominate the large deals, we do very well. Actually, one of the things I noticed -- in fact, you may have noticed, as you saw, as you heard the script, there are a number of deals where ZPA and ZIA has been bought together in large deals, or like that. The story -- the part of evangelism we had to do early on is becoming less. Our leadership is becoming clearly stronger and stronger. And the more customers with CIOs and CSOs are moving from one company into the other company, and they're calling us. So I believe our execution in large deals is getting good. The other thing that's going to help our execution in large deals is large deals have complex sales cycle, there are lots of stakeholders, and our enablement process is actually helping us do a better job. So I feel more confident in our ability to handle larger deals now.

Your related question on reps for large versus small, I think we are hiring across the board. We have quite a few very good sales reps who are handling these large deals. We call them major account managers. But we are trying to add more because there's a big market opportunity, and we need to properly cover it.

Operator

Thank you. This concludes today's question-and-answer session. At this time, I would like to turn the call over to Jay Chaudhry for closing remarks.

Jay Chaudhry Zscaler, Inc - Co-Founder, President, CEO & Chairman

Thank you. Thank you for your continued interest in Zscaler. Hope to see you at the upcoming conferences. Goodbye.

Remo Canessa Zscaler, Inc. - CFO

Great. Thank you.

Operator

Thank you, ladies and gentlemen. This concludes today's teleconference. You may now disconnect.

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