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PRESENTATION

Operator

Good day, and welcome to the Zscaler First Quarter 2019 Earnings Call. Today's conference is being recorded. At this time, I would like to turn the conference over to Mr. Bill Choi, VP of Investor Relations. Please go ahead, sir.

William Choi ***Zscaler, Inc. - VP of Investor Relations***

Good afternoon, and thank you for joining us to discuss Zscaler's financial results for the fiscal first quarter 2019. With me on the call are Jay Chaudhry, Chairman and CEO; and Remo Canessa, CFO. By now, everyone should have access to our earnings announcement. This announcement may also be found on our website in the Investor Relations section. In addition, a supplemental financial schedule was posted to our website earlier today.

Let me remind you that we'll be making forward-looking statements during today's discussion, including, but not limited, the company's anticipated future revenue, calculated billings, operating performance, gross margin, operating expenses, net loss, pro forma net loss per share, free cash flow, and dollar-based net retention rate. 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.

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

I would also like to inform you that we will be participating in the Barclays Global TMT Conference in San Francisco tomorrow and the Needham Growth Conference in New York on Tuesday, January 15.

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

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

Thank you, Bill, and thank you, everyone, for your interest in Zscaler. I'm pleased to share with you our solid first quarter results. We posted strong revenue and calculated billings as we continue to experience robust growth in our business. Our revenue grew 59% year-over-year to $63.3 million and total billings grew 56% year-over-year to $64.6 million.

In addition to our top line growth, we achieved positive operating profit and free cash flow for the quarter. Our operating margins improved approximately 20 percentage points year-over-year to 2%. We are very pleased with reaching profitability this quarter. This demonstrates the leverage in our business model. Having said that, we will continue to aggressively invest in our business to pursue our significant market opportunity.

We believe the primary driver for our market success is the change in data center and network architecture to support the adoption of cloud. Cloud and mobility are breaking the traditional perimeter where organizations built a hub-and-spoke network to backhaul branch office traffic over private networks to the data center. Then they built a moat of security appliances to secure the network -- that is why we call it network security.

In the cloud world, applications can be anywhere and devices and users can be anywhere; the notion of "inside the network" or "outside the network" is disappearing. We believe the corporate network is changing to a direct to Internet architecture. This is commonly known as "local Internet breakout," which significantly improves user experience and lowers networking costs.

But when you go direct to the Internet, what is the corporate network and where would you build the moat? How do you do network security in this world? Well, you can't. Network security is becoming irrelevant. Designed for the world, which has no walls, Zscaler Security Cloud acts as a business policy enforcement engine, deployed across 100 plus data centers to securely connect the right user to the right application: ZIA for Internet and SaaS applications and ZPA for internal applications in your data center or the public cloud.

As organizations embrace the cloud, more and more of our deals start with our high-end Transformation Bundle, which includes cloud firewall, IPS and sandboxing. I would like to highlight three new customer wins in the quarter that we believe illustrate the value we deliver for secure network transformation.

A Fortune 100 conglomerate purchased Transformation Bundle for all of its 100,000 employees. While we are replacing traditional network security appliances, such as secure web gateway, branch firewall, DNS in a dozen data centers, it is mostly a greenfield opportunity -- we are creating about 400 new secure local Internet breakouts. Zscaler will be the only security check-post for traffic headed to the Internet from all of the branches and all the data centers, thus, enabling a cloud-first approach to applications, such as Office 365. They also purchased ZPA for third-party contractors who needed access to internal applications, replacing legacy VPN that provides them access to the entire corporate network increasing their security risk.

In another deal, a Fortune 500 global food and beverage company purchased Transformation Bundle for 52,000 users to secure local Internet breakouts for over 400 sites, including about 350 international locations. This customer had already realized the need for local breakouts, but went about it the old way -- they installed over 300 branch firewalls, which was complex and required substantial resources to manage. Our system integrator partner saw an opportunity for the customer to do it the new way -- using Zscaler's cloud platform. Our approach enhances security with coverage of all users, including mobile, with full SSL inspection. It also improves user experience. All this at a lower cost of ownership and greater operational simplicity, while eliminating on-prem security appliances. This customer also purchased DLP for all users. When customers do local Internet breakout, data leakage becomes a major risk and they need a cloud-based DLP solution to secure sensitive information at any location.

Another new customer, a global pharma company, had a strategy to pursue a full transformation to the cloud -- for the network and for their applications. To realize this strategy, they bought our Transformation Bundle for ZIA and ZPA for over 15,000 users. They're deploying SD-WAN across 80 sites with Zscaler securing all traffic from these locations. With this new architecture, the customer is estimating a 50% reduction in their $35 million per year MPLS spend plus lower CapEx and management cost for the network and security infrastructure. While ZIA provides secure and fast access to Internet and SaaS, ZPA will do the same for the internal applications, some of which are in the data center, while others are moving to Azure and AWS. The Zscaler platform enables the realization of their strategy - a perimeter-less enterprise with direct access to any service or application from anywhere, on any device without backhauling traffic through the data center.

I also want to highlight 2 up-sell deals with existing customers that are leveraging our platform for the next phase of their cloud journey.

A customer in the food processing industry started with Zscaler one year ago with a security-led use case of protecting 50,000 mobile users with our Business Bundle. Last quarter, they purchased the Transformation Bundle and DLP for all 100,000 employees. The value realized from the initial security use case helped us win over the networking team as they began to rearchitect their network for the cloud. This customer had recently deployed the leading next-gen firewalls across 200 sales and manufacturing offices, but they realized that deploying security appliances and spinning virtual machines in the public cloud fails to deliver cloud security. The customer expects Zscaler to save them over $10 million per year on purchasing and managing firewall appliances.

Finally, let me highlight a customer headquartered in Europe that has been using Business bundle and DLP for 32,000 users. Last quarter, they purchased additional 9,000 seats and added cloud sandbox for all users. Drivers of this deal were two-fold. One, M&A used case -- the customer acquired a competitor in the U.S. and wanted to implement a consistent policy and protection across the entire organization. Number two, this initiative is part of a larger managed network services RFP, where all five telecom service providers bid Zscaler for the security.

With over 40% of our sales in EMEA, we have been very successful in the European market because our cloud service is architect to meet stringent EU data privacy requirements. The only customer data that we store are customer logs, and customers can choose to store these logs in our EU data centers, or they can choose to store them in their own data center.

We believe these deals demonstrate the tremendous value we are delivering. Our strategic advantage for us is the partnerships with large system integrators and global service providers who implement cloud transformation projects. SI and SPs represent over 50% of our revenue, and they are the fastest growing channel for us. We will continue to invest in our partners to enable them to create leverage and accelerate our sales.

We are investing in a go-to-market capabilities, which enables us to sell top-down at the C-level. During the quarter, we hired a new CMO, Micheline Nijmeh, with deep experience in enterprise marketing and proven ability to grow revenue and pipeline. In addition, we hired Kavitha Mariappan, as an SVP for a newly created role to drive customer experience and transformation. With these two roles filled, our priority remains to find the right leader for our global sales organization. With strong sales leaders in place for Americas and International markets, I'm confident that our sales momentum will continue. We also continue to expand our global salesforce.

Overall, we are executing well on our vision. We believe we have a significant competitive advantage on the technology and architecture for cloud security. We have 10 years of operational experience running our security cloud at scale. We process about 60 billion Internet request per day, which you can see on our website real-time. Each day, we detect and block about 100 million threats and perform more than 120,000 unique security updates. This network effect delivers superior security as compared to traditional appliances or a hybrid security cloud.

Last week's report by Gartner named Zscaler a leader in its Secure Web Gateways Magic Quadrant for the eighth year in a row.

In October, we brought our Zenith Live Cloud Summit to London, with hundreds of customers and partners attending from 19 countries. Zenith Live is where CIOs, CTOs, CISOs, security and networking practitioners meet to discuss cloud transformation with insights from leaders who have gone through this journey. We had an outstanding lineup of keynote speakers, including Microsoft, Siemens, Orange Business Services, Carlsberg Group and others.

In summary, we are very pleased with our strong Q1 results and continued momentum in our business. We believe we are in the early innings of a significant market opportunity to disrupt traditional network security.

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

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

Thank you, Jay. As Jay mentioned, we had a very strong start to our fiscal year. Revenue for the quarter was $63.3 million, up 13% sequentially and 59% year-over-year. From a geographic perspective, for the quarter, Americas represented 49% of revenue, EMEA was 43% and APJ was 8%.

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 56% year-over-year to $64.6 million. As a reminder, historically, Q2 and Q4 have been our strongest billings quarters with sequential declines in Q1 and Q3 quarters, respectively. The sequential decline in Q1 is higher than prior years due to a difficult comparison from a large upfront deal we had in Q4. Excluding the $16.5 million upfront deal from Q4, billings would have declined sequentially to 18%, which is an improvement over the 25% declines seen in the prior 2 years. Also, as a reminder, we primarily invoice our customers one year in advance, and our contract terms are typically one to three years. The upfront greater-than-one-year billings year-over-year were fairly small in both periods.

Total backlog, which represents remaining performance obligations, was $411 million on October 31, up 77% from $232 million one year ago.

Our strong customer retention and ability to up-sell have resulted in a consistently high dollar-based net retention rate, which was 118% for the period ended October 31. This compares to 116% a year ago and 117% last quarter. Our increased success selling bigger deals upfront, which start with the Transformation Bundle and faster up-sells within a year, while good for our business, can reduce our net dollar retention rate, which is calculated on a year-over-year ARR basis. Considering these factors, we feel 118% is outstanding, and it will vary quarter-to-quarter.

Total gross margin was 82%, up 2 points sequentially and 2 points year-over-year. The year-over-year increase was driven primarily by an increased mix of higher-priced bundles and more functionality as well as operational efficiencies. While we were pleased with our gross margins, our focus is not to maximize our gross margins at this stage. We feel 80% continues to be a good target range in the near-to-medium term, and it is important to continue to invest in our platform and to drive customer satisfaction to drive top line revenue growth.

Turning to our operating expenses. Our total operating expenses grew 7% sequentially and 29% year-over-year to $50.5 million, but decreased as a percentage of sales to 80%. As we continue to invest to grow our business, we increased our headcount by over 80 employees in Q1 and approximately half were in sales and marketing.

Sales and marketing increased 10% sequentially and 29% year-over-year to $33.7 million. We have been building our sales and marketing teams and investing in marketing programs to drive growth and awareness, including the Zenith Live Conference held in Europe during the quarter.

R&D was flat sequentially and up 22% year-over-year to $10.3 million as we continue to invest to enhance product functionality and to offer new products.

G&A increased 1% sequentially and 42% year-over-year to $6.5 million. The year-over-year growth in G&A includes investments in building our teams, consulting and other expenses that we have made as we became a public company. These expenses exclude $2.2 million in litigation-related expenses.

Our first quarter operating margin was a positive 2%, which compares to a negative 19% in the same quarter last year. Net income in the quarter was $2 million. Our non-GAAP earnings per share $0.01. Given the positive earnings in the quarter, our EPS was calculated on a fully diluted basis of approximately 134 million shares.

We ended the quarter with $314 million in cash, cash equivalents and short-term investments. Free cash flow was positive $5.2 million in the quarter compared to negative $8.9 million for the same quarter a year ago. Our ESPP program contributed approximately $3 million to our free cash flow in the quarter. The first stock issuance under the ESPP program will be in December, which will reduce our free cash flow by approximately $8 million in Q2 but will have no impact on overall cash balance.

Now moving on to guidance. As a reminder, these numbers are all non-GAAP, which excludes stock-based compensation expenses, amortization of intangible assets, certain litigation-related expenses and any associated tax effects. For the second quarter, we expect revenue in the range of $65 million to $67 million; operating loss in the range of $1 million to $3 million; income taxes of $600,000; and net loss per share in the range of $0.00 to $0.02, assuming approximately 122 million to 123 million common shares.

While we're pleased with our profitability ahead of schedule, we will continue to aggressively invest for growth. We believe we have a unique opportunity to disrupt and to capture a large market opportunity. As I mentioned in the past, we plan to achieve sustained profitability and positive free cash flow sometime in fiscal 2020.

For the full year 2019, we expect revenue in the range of $268 million to $272 million or year-over-year growth of 41% to 43%. Operating loss in the range of $4 million to $6 million; income taxes of $2.4 million; and net loss per share in the range of $0.01 to $0.03, assuming approximately 124 million common shares outstanding.

As you model billings for fiscal 2019, I want to remind you that the Q4 2018, we had a large upfront billing of $16.5 million from one customer. This will produce a difficult year-over-year comparison in Q4 2019. If we exclude this large upfront billing of $16.5 million from fiscal 2018 results, we believe total billings growth in fiscal 2019 would be comparable to our guided revenue growth, which would imply a billings range of $340 million to $345 million for the year.

We're very proud of what we have achieved and look forward to building on our opportunity. Now I will hand the call back over to Jay.

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

Thank you, Remo. We believe we are the best choice for securing the cloud and the mobile-first world. The right architecture matters. On-prem, single tenant architecture, whether deployed as appliances or as virtual machines spun up in a public cloud, will not allow enterprises to fully realize the benefits of cloud. They can't scale, leave gap in security, are expensive, and deliver a poor user experience.

With multiple tailwinds, such as SaaS adoption, SD-WAN, and app migration to public clouds, we believe the market is coming to us. We are making solid progress in the Global 2000 accounts as these large enterprises embrace cloud transformation. We are executing on our vision: we are scaling our cloud to meet the growth in customer base, driving greater adoption of our high-end Transformation Bundle and ZPA. We are delivering high ROI for customers that leverage our platform for transformation.

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

QUESTIONS AND ANSWERS

Operator

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

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

Congratulations on another phenomenal quarter, guys. I've got two questions. My first is for Jay. Jay, your primary competitor has experienced disruption of late with leadership turnover and various company-specific distractions. Is this perceptible to you in the field? And can you maybe give us an update more generally on the competitive environment?

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

Brad, thank you. We are having tremendous success in the field. I think our #1 reason for the success is our innovative multi-tenant architecture, which scales and works well. And whether the success is due to competitors' issues or not, I'm not sure. I can't tell, but we are winning the same market and growing rapidly. I don't see a significant shift in the competitive landscape.

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

Appreciate the commentary. And Remo, just for you. Thanks for calling out, reminding us the $16.5 million upfront billing in Q4, which if you remove that, you've actually done better than the seasonality we've seen in Q1 in the past couple of years. And also appreciate the guidance that you've given us on billings for the full year. But as we think about the seasonality from here, anything we should take into account as we model the quarterly billings, just given the strong start that you've had here in Q1?

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

Brad, just what we've said before, basically as you mentioned, as we've called out, both Q2 and Q4 are strong quarters. Q4 year-end and Q2 straddles 12/31 and also our prior year-end as a company was 12/31, so we have a lot of renewals to come through. I'd expect the same type of seasonality. It was a great quarter for us, and so I'd expect the same type of seasonality going forward.

Operator

(Operator Instructions) We'll take our next question from Daniel Ives with Wedbush.

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

So Jay, I mean, you alluded to it a little bit but maybe you could elaborate, how are conversations changing in regards to more enterprises looking to really expand with Zscaler? I mean, maybe customers at 6, 12 months now had small deployments, now the pipeline is expanding significantly. And what do you think the drivers are there when you compare your conversations?

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

The biggest change in the past 1 to 2 years versus now is that almost every CIO wants to do cloud transformation with security in mind. That was, well, 2 years ago. That's directly impacting us is in a couple of ways. One was with transformation, that all are looking at local Internet breakout as one of the key drivers, which really drives our Transformation Bundle, which includes cloud firewall, cloud sandbox and the like. That's number one. Two, we used to have a lot more deals starting with Business Bundle, which really get more security breakout but did not have all protocols, all ports functionality. So moving to bigger bundle is having bigger pipeline and more momentum. And that's why we are posting strong growth in sales.

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

Great. Could you just quick comment about tuck-in M&A and how you're thinking about that just as we go through 2019?

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

We are always open to M&A opportunities. We aren't looking to buy companies for revenues. If we look at something, it will be largely driven by a strategic fit to expand our platform in a meaningful way. We did a small acquisition last quarter. It was in the machine learning and AI area. It's already delivering results. As opportunities present themselves in the strategic area, we will be open to those.

Operator

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

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

I would also extend that congrats, that's a spectacular quarter. The question I wanted to address -- actually, there's 2 pieces of it. One is, can you talk a little bit about, in terms of new orders, what the mix looks like between ZIA and ZPA? And are you seeing an accelerated uptake or any metrics around the rate of uptake on ZPA, which obviously is a small part of revenues currently, but is a key piece. And then second, can you give us any metrics around the move up the stack from professional business to Transformation bundles? Where are we on that? Have we seen a meaningful change in the rate of uptake of Transformation bundles versus the other two?

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

From a new business perspective, which is new or up-sell, what we said is that we'll talk about it when there's meaningful changes in our business. What we called out last quarter is for full-year 2018 new and up-sell business for ZPA represented approximately 10%. What I can say about ZPA on a year-over-year basis is it's close to doubled. So good traction with ZPA. Similarly for Transformation, what we called out last quarter is that Transformation has increased to 35% of our total ARR for ZIA. What I can say is that it is going up, so it's increasing. And we'll make updates when we feel it's meaningful.

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

Is there any change in the sales cycle associated with the time it takes for either of those upsell purchase orders? Or is the sales cycle still fairly similar despite the fact that you're selling a lot more product?

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

We are selling more higher bundles, and the sales cycle hasn't changed. But I would say that a year ago, if the sales cycle was x month to sell Business Bundle, we are able to sell the Transformation Bundle in the same kind of sales cycle. Similar sales cycle, but being able to sell bigger bundles. And that's partly because market is moving faster in our direction.

Operator

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

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

Over the last few weeks, we've heard a lot of questions around the macro environment and the sustainability of the improved IT spending, which we have seen in 2018 extending into 2019. So how do you feel about things going into calendar 2019, and then how do you think Zscaler is positioned if the overall macro next year is not as strong as it was in 2018? Thanks.

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

Good question. I'll answer it in two parts. Number one, Zscaler not only helps you drive cloud transformation, it actually drives tremendous ROI. So in many ways, when spendings are tight, we become actually a more attractive solution. That's one. Number two, we are still such a small piece of the overall IT environmental budget that I don't think we will see much of a change because of some of the environment tightening. I'll tell you an interesting dialogue I had with the CIO of probably Global 2000 companies. I went to see him. I said, thank you for making time for me. I know I'm a very tiny fraction of your overall IT budget. He interrupted me and said, "Stop. You may be small piece of my IT budget, but I don't have a cloud strategy without you. So I want you to come and see me every 6 months." So with that kind of strategic positioning for transformation, with such a small piece of budget, I don't think we'll see a negative impact.

Operator

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

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

Jay, you noted how adoption of the Transformation bundle is being driven by the need to enable secure local Internet breakout. Can you maybe elaborate what functionality exclusively within the Transformation Bundle enables those local breakouts? And since the cloud firewall solution is part of the Transformation Bundle in that incremental relative to the prior bundle. Does it mean that you are increasingly displacing firewall even at the branch or in the data center?

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

So good question. So first of all, to give you the difference, Business Bundle has lots of good functionality and local breakout for the web traffic. But the 2 big modules in Transformation Bundle that's outside of the Business Bundle, one is cloud firewall, second is cloud sandboxing. People are buying Transformation Bundle not because they are displacing branch firewalls. People are buying it because they are creating new local Internet breakouts. And when they see the option with a cloud firewall where they can handle all ports and protocols, rather than just web traffic at a relatively smaller cost, it becomes attractive for them to buy Transformation Bundle. So the driver for Transformation Bundle is cloud firewall to handle all kinds of traffic. And especially Office 365 traffic, Skype and all, which works beautifully to our cloud firewall and which won't work very well to a traditional web proxy. And sandboxing, everyone has bought sandbox in the data center. They all buy into it because of security threats. When they find that with Zscaler, now this functionality is available everywhere on every branch office, even for a road warrior, it becomes very easy for new add-on of cloud sandboxing. Those are the 2 drivers. One key module that's not in the Transformation Bundle is DLP, data loss prevention, and that's still bought à la carte.

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

Remo, in terms of operating margin improvement and particularly related to sales and marketing leverage, I'm wondering if you can elaborate what's enabling that magnitude of sales and marketing leverage? And particularly, I'm wondering if you can comment on hiring plans and how that came in relative to your expectations in the quarter? And if you see any change in the sales attrition?

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

We had a very good sales and marketing leverage. The productivity on a quarter-over-quarter basis from Q1 of last year versus this year was up. From a hiring perspective, what we called out is that we hired over 80 net employees. And about half of those were in sales and marketing and most of those were in sales. So what we plan to do as we go forward, we're very proud of achieving profitability, but we see this as such a large market opportunity that we are going to continue to invest. So from our perspective, there's no change to what we said before in that we expect to be sustained profitability and free cash flow positive sometime in fiscal '20. What we've demonstrated over the last 3 quarters, being positive free cash flow and reaching operating profitability, we've got the model in order to really show significant expansion in profitability. But because of the large market opportunity, we are going to do investment, and we are going to try to capture this market opportunity as best we can.

Operator

We'll take our next question from Gabriela Borges with Goldman Sachs.

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

Jay, I would love to understand a little bit better, for your new CMO and your new SVP for customer engagement and customer success, what are the priorities for those two roles? And what are some of the key initiatives that the ladies will be working on over the next 12 months or so?

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

CMO, Micheline Nijmeh, her #1 priority is overall to help us do more demand generation. As our goals are getting bigger and bigger, targets are getting bigger and bigger. So is the need for higher demand gen. And along with that, we are going to focus on building our brand and awareness overall. IPO has helped us in this area quite a bit. A lot of visibility, but we think a lot more can be done in that area. So those are 2 big objectives in addition to many others. Regarding our SVP of Customer Experience and Transformation, we are a very customer-focused company. It starts from me. And this customer experience is really starting with a product experience, to sales experience, to once the sale is made, deployment and ongoing interaction. So Kavitha is able to really pull together all these things in a holistic fashion across multiple functions to make sure our customers have the best experience. And that second part in the transformation is actually, not only just a customer side of it, but it's our own transformation as a company. We have been going through changes and transformation in the way we deal with customers and the way we go to market. You have seen some of the innovations we've done in go-to-market at Zscaler, which is not traditional sale through VARs. We figured out that go-to-market top down CXO, CTO level. We figured out all the new transformation sales need to be done with solution architects and the like. So this is more to focus on making sure Zscaler as a company is transforming, changing itself as the world is moving fast. We are very happy to have these 2 very capable executives join my team.

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

That's helpful. And the follow-up is on the status of some of the telecom service provider partnerships that you have. I think you mentioned in the prepared remarks that there was one deal where 5 separate telecom providers bid to offer the Zscaler services. Are there large telecom providers that you can still bring online? Do you feel like you have good penetration in the partnerships that you already have? And then is there more willingness to embrace the Zscaler platform as a counter to what may otherwise be headwind in MPLS?

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

Yes, we all know that the world is moving from hub-and-spoke network to local breakouts. It is true that of 2, 3 or 4 years ago, many telcos were kind of wondering between how fast to move in this direction and how much they can do to slow it down. But everyone understands and realized that the market is moving in that direction. So all large telcos, in fact, if I would say, the top 10 largest telcos in the world, they all do business with us. Some of them a lot more than others, so our goal is to make sure we work more closely with them. And they see it as a joint opportunity. They want to see the customer moving to a new network that's still managed by them. As they are managing the network, they are managing Zscaler security service for the customer. It's a good win-win proposition, and we are seeing more leverage, more traction coming from SPs, partly because of 2 reasons. One, the market is taking them there. That's number one. Number two, they are seeing increased revenue opportunity with Zscaler, along with able to keep account control.

Operator

We'll take our next question from Saket Kalia with Barclays Capital.

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

Jay, just to pick up on an earlier line of questioning on the Transformation Bundle and the traction there, do you track any stats on which of those modules are being used particularly heavily? So you mentioned cloud firewall and cloud sandboxing are the biggest additions versus the Business Bundle. Are you seeing one module used perhaps more heavily than the other?

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

It's a good question. If we were in the appliance world, then you would say, "Well, this module got turned on, this did not." Because when you buy a cloud sandbox in a traditional world, there are a bunch of steps to figure out to integrate how to take traffic, how to authenticate users, how to set up SSL sandboxing. All of those things are essentially in place when the traffic comes to Zscaler. So turning on firewall or turning on sandboxing is very simple. Once the customer has bought Zscaler modules, they are essentially turned on almost all the time. It's very rare when those modules are not used. Now it is possible that the customer may have only 20 local Internet breakouts early on and it may take them 9 months to go from 20 to 200. They still turn on sandboxing and firewall on those 20 local breakouts, and as an additional 180 gets added, they still remain turned on and now getting more benefit. It's rare to have customers buying a module from Zscaler and not using it because turning it on is simple. It's simply a single click in our configuration. In fact, in our sales process, we show the customer what we call a single-click deployment of cloud firewall and cloud sandbox from our console.

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

You mentioned DLP is sold à la carte outside of the bundling strategy. Can you just talk about why à la carte pricing for DLP is the best avenue? And could we ever see DLP as part of a bundle in the future?

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

Yes, bundling is an interesting exercise. There are no simple answers. If you bundle too much, you can increase the price too much. If you don't bundle enough, you're not selling additional modules. So it's one of those art and science - we try to learn and figure out. And I think when a module becomes widely accepted and more and more customers start buying it à la carte, it tells us it's really time to bundle it. If you asked me 2 years ago, I wasn't ready to bundle cloud firewall or cloud sandbox. Transmission Bundle is relatively new. It's a 15-month-old bundle. We didn't have this bundle before. We sold cloud firewall and cloud sandbox separately. DLP is an interesting area. We have been selling decent amount of DLP before. There's one critical module we needed to add to make it the richest DLP functionality in the world - that's called Exact Data Match, where we can match exact field from a customer's record about Social Security number or data of what they like, and that module became available. As customers are opening hundreds of local breakouts, and they may have DLP deployed in 3 or 5 data centers, DLP is no good because these locations don't really go through the DLP systems, so to speak. So we are seeing an increased demand of DLP. We're selling more of it as we highlighted a few customers during our call earlier. We do see potentially DLP becoming a part of a bundle in the future. I'm not exactly sure what timing is, but it's a natural course for us to move to.

Operator

We'll take our next question from Fatima Boolani with UBS.

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

Jay, maybe to start with you. In your prepared remarks around the customer examples, you gave a lot of instances where customers went in with both the ZIA and ZPA. So just broadly speaking in terms of the pipeline, are you starting to see a greater incidence of landing with both your product portfolios? And just as an extension, what sort of impact is this having on your land and expand?

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

Approximately half the deal of ZPA are coming as new customers who have never bought from Zscaler before. And the other are up-sell. It is true that a number of deals are picking up ZPA along with ZIA upfront. But I would say that in majority of those cases, ZPA is bought for a subset of users, not for all users. As we have said before, when ZIA is bought, it is bought to protect all users from all locations, essentially every employee in the company. When ZPA is bought, it's largely driven by business application needs. And typically in an enterprise, the number of ZPA users may be somewhere from 40% to 80% of the total users. So if I were to simplify it, wherever ZPA is bought, majority of the cases it's a subset of users. People are also moving applications to Azure and AWS. They're still in early phases. And as that market matures more and more, the number of ZPA users will go up significantly.

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

That makes a ton of sense. And Remo, just a follow-up for you on the profitability strength in the quarter. As I think about some of the commentary you gave us during the IPO around unit economics being fairly weak in the first year of the customer acquisition process, but then see a significant improvement in year 2. As I think about you doing larger deals upfront, doing more Transform bundle deals at the outset, you've got better awareness as a public company, and just generally better awareness overall. Can you give us a sense of how those unit economics have changed from a customer acquisition perspective?

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

So you're talking about contribution margin?

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

Yes.

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

So our contribution margin, as we talked about at the public offering, is with years 2 and 3 was in the high 60% range. What I'd like for you to keep in mind is that we see this as a very large market opportunity, and our plan is to grow the company as quickly as we can. As we talked about on the roadshow, and it hasn't changed, relates to our long-term model of 20% to 22% operating profitability once we reach $800 million to $1 billion in revenue. That's still our plan. So we have not deviated at all related to our long-term goals. Our expectations of hitting breakeven and positive free cash flow profitability on a sustained basis in fiscal '20. When you think about contribution margin, if we stopped everything and just went renewals, then it goes incredibly high. With this large market opportunity, we are going to keep on investing the business to maximize what we feel is the biggest shareholder value.

Operator

We'll take our next question from Jonathan Ruykhaver with Robert W. Baird.

Jonathan Ruykhaver ***Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst***

You've commented in the past that high-volume transaction business into the midmarket through channel was tracking at about 40% of total business. I'm just wondering, that was something that I heard several quarters ago, is that still consistent with what you are seeing today?

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

What we talked about in the past is the business coming through the VAR channel in the 40% range. It's not really the midmarket business. It's the total business coming to the VAR channel. That's still sitting in broadly the same range. And I mean, if you look at the two broad channel buckets, SP/SI is one bucket and VAR is the second bucket. Yes, we are seeing some VARs are successfully able to pivot to the cloud, and they are driving more business for us. But overall, growth from a channel is coming faster from the SP/SI side of it.

Jonathan Ruykhaver ***Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst***

Okay. So it's safe to assume that when you look at the channel investments you're making, the greater allocation is going to SP/SI side?

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

Yes, but we are also investing in VAR channel as well, proportionately, to make sure we're working all channels. We are picking up a new kind of channel called born in the cloud VARs. These guys were built for the new world who are not really married to pushing boxes, and they are a pretty good channel for us. Small, but growing.

Jonathan Ruykhaver ***Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst***

That's good to hear. And Remo, I just wanted to get some clarification. The large deal activity you saw in 3Q and 4Q in fiscal '18, you've suggested that the impact of those large initial upfront deals is very positive on retention rates when they occur. But as they anniversary, should we expect to see somewhat of a dampening effect as we anniversary those 2 quarters?

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

It depends. Related to those deals, if we get these large upfront deals for multiyear, customers are making the investment and also having Zscaler as their security and networking company that they use. So these upfront deals, what we look at is more on a contract basis. On a contract basis, over the last 4 or 5 quarters for new business, it's been over 70% for 3-year type deals. Related to dollars, if customers would like to give us -- pay more to Zscaler because of budgetary reasons, then we will accept that. So does that answer your question?

Jonathan Ruykhaver ***Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst***

Yes, that provides a little bit more insight. But I'm just wondering, in specific situations like that, the opportunity I would imagine to drive greater subscribers and the higher bundled offerings are somewhat limited. So does it become increasingly incumbent upon additional large deals like that to kind of keep that retention rate where it was? Or is that not the case?

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

Got it. Good questions. So yes. So we called out before that more customers are going Transformation. So as more customers go Transformation, that's ZIA. They typically purchase that for all employees. So as that happens, that will put a downward impact potentially on our net retention rate. Related to that also is that, what we are seeing, is we are seeing more customers upgrading sooner. When we calculate net retention rate, we look at the customers we had a year ago, and for the same customers, what is their ARR? So we look at ARR a year ago versus ARR currently. What you're seeing is that if customers are upgrading within that period, we're not picking that up potentially in that retention rate. As we go forward, though, ZPA could have a positive impact, DLP could have positive impact. And as we add more services under our platform, those can have positive impacts. Our net retention rate at 118%, we feel is outstanding when you think about how we sell. And again, ZIA, we're selling more Transformation upfront to customers.

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

Yes, if I may add, Remo, we have many metrics. We are less focused on net retention rate. We're focused more on growth and customer retention, or reducing a churn, but this net retention rate may fluctuate up and down.

Operator

At this time, there are no further questions in the queue. I would like to turn the call back over to CEO, Jay Chaudhry, for closing remarks.

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

Thank you for your time to join us. We look forward to talking to you during the next quarter's earnings call. Thank you again.

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

Thank you.

Operator

Thank you. Ladies and gentlemen, this concludes today's teleconference. You may now disconnect.