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ZS.OQ - Q2 2023 Zscaler Inc Earnings Call

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OVERVIEW:

Co. reported 2Q23 revenue of $388m. Expects FY23 revenue to be $1.558-1.563b and non-GAAP EPS to be $1.52-1.53. Expects 3Q23 revenue to be $396-398m and non-GAAP EPS to be approx. $0.39.

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PRESENTATION

Operator

Hello, and welcome to the Zscaler Second Quarter Fiscal Year 2023 Earnings Conference Call.

(Operator Instructions) I would now like to hand the conference over to Bill Choi, Senior Vice President, Investor Relations and Strategic Finance. Sir, you may begin.

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

Good afternoon, everyone, and welcome to the Zscaler Second Quarter Fiscal Year 2023 Earnings Conference Call. On the call with me today are Jay Chaudhry, Chairman and CEO; and Remo Canessa, CFO.

Please note that we have posted our earnings release and a supplemental financial schedule to our Investor Relations website. Unless otherwise noted, all numbers we talk about today will be on an adjusted non-GAAP basis. You will find the reconciliation of GAAP to the non-GAAP financial measures in our earnings release.

I'd like to remind you that today's discussion will contain forward-looking statements, including, but not limited to, the company's anticipated future revenue, calculated billings, operating performance, gross margin, operating expenses, operating income, net income, free cash flow, dollar-based net retention rate, future hiring decisions, remaining performance obligations, income taxes, earnings per share, our objectives and outlook, our customer response to our products and our market opportunity.

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. These forward-looking statements apply as of today, and you should not rely on them as representing our views in the future.

We undertake no obligation to update these statements after this call. For a more complete discussion of the risks and uncertainties, please see our filings with the SEC as well as in today's earnings release. I would also like to inform you that we'll be attending the following upcoming events in March, Morgan Stanley TMT Conference in San Francisco on March 6, JMP Technology Conference in San Francisco on March 7. Now I'll turn the call over to Jay.

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

Thank you, Bill. We delivered a solid Q2 despite economic challenges that have impacted the broader tech industry. For the quarter, our revenue grew 52% year-over-year and billings grew 34%. Billings were impacted by new customers being more deliberate about their large purchasing decisions at the start of the calendar year. These deals have not gone away, and we have closed a few already in February.

On the other hand, we had strong growth in our expansion business with existing customers, increasing their deployments and adopting our broader platform. Once again, our dollar-based net retention rate was over 125%. We continue to delight our customers by accelerating their path to better security, business agility and cost elimination, helping them solve some of their highest priorities.

This drove our Net Promoter Score, or NPS, to a new high. Our NPS now exceeds 80, which is more than 2x the average for SaaS companies. And today, more enterprises than ever before, recognize Zscaler as the best choice to secure their digital transformation, strengthening my confidence in our $72 billion serviceable market opportunity.

Our disciplined approach to growth is reflected in our strong operating profit and free cash flow, both of which doubled on a year-over-year basis. Our operating margin expanded by approximately 4 percentage points, while our revenue also continued to grow at a very high rate.

As the world's largest security cloud, we have outstanding unit economics with a stable, high 90% gross retention rate and 80% gross margins. These best-in-class metrics are the result of our differentiated services, market leadership and highly scalable multi-tenant cloud platform.

Let me share with you some of my observations about the environment and how we plan to manage our business for the remainder of 2023. With macro concerns weighing on business leaders, more organizations are being cautious and measured about their spending. In January, we saw a higher scrutiny on budgets compared to December, resulting in additional delays in large deals.

These deals haven't gone away. And customers are taking longer to make decisions and requiring additional approvals. In select instances, where timing of budgets was a hurdle for new customers, we enabled them to ramp into larger subscription commitments. These strategic deals lowered our first year billings but will grow into a higher annual run rate level in the second year.

We typically have some ramp deals each quarter. But in Q2, the impact of ramp deals on our billings was higher. These ramp deals position us to expand the customer relationship over time to create long-term value. As we enter the second half of fiscal '23, we are expecting customer cautiousness to continue.

We have accounted for further lengthening of sales cycles and the uncertain timing of large deals in our outlook. Even though our current pipeline has grown and has more mature deals, we are assuming a slight deterioration in close rates.

While not immune to economic slowdowns, cybersecurity is relatively more resilient. In my conversation with hundreds of IT executives, cybersecurity remains their organization's #1 IT priority. 2 weeks ago, we hosted a CISO Summit with 80 CISOs from Global 2000 companies.

They talked about the business need to innovate, become agile and gain competitive advantage with security as the enabling foundation. They talked about their plans to shift to zero trust security, to reduce attack surface, and to adopt the direct-to-cloud architecture that Zscaler pioneered.

Customers are excited by the new innovations being added to our platform and their engagement with us remains very strong. Given the large opportunity we see in front of us, we will keep on building and innovating while also increasing profitability. After significantly growing our teams in recent years, we took a fresh look at our organization and found opportunities to streamline operations and to align people, roles and projects to our strategic priorities.

As a result of the review, we initiated our targeted cost optimization plan to drive additional operational efficiency that best positions us to deliver profitable growth. Remo will cover this in more detail. As I mentioned before, I believe that periods of uncertainty can accelerate the adoption of disruptive technologies like ours.

C-level leaders are telling me that technical depth of legacy network and security point products impedes progress and slows down business operations. By consolidating point products and embracing zero trust architecture with Zscaler, our customers are modernizing their security while reducing costs, giving them the competitive edge they need to succeed in today's rapidly evolving business environment.

We have expanded our business value team to collaborate with customers to create CFO-ready business cases with clear ROI and payback periods that facilitate necessary deal approvals. In today's environment, customers can't afford to risk their mission-critical projects with immature offerings from unproven vendors.

We are starting to see deal wins from customers who initially purchased a single-tenant SASE solution from their incumbent firewall vendor that failed to deliver in the real world. These customers were misguided by the flawed message, keep on buying my boxes and use my so-called cloud service when your users are on the road or in a branch office.

A 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 secured digital transformation. Every customer we have won has lots of firewalls in the data centers. But when it comes to zero trust security and digital transformation, they're choosing Zscaler because of our multi-tenant cloud architecture that scales and delivers business agility.

Our Zero Trust Exchange is the largest in-line security cloud in the world, processing over 280 billion transactions and preventing 9 billion security and policy violations per day. This massive amount of traffic provides us with more than 300 trillion signals per day to feed our machine learning and AI engines for better detection of user and application traffic anomalies resulting in superior threat protection.

Our AI/ML capabilities are driving customer success at scale in the real world today. Let me share an example with you. In December, we helped a Global 500 conglomerate, experiencing a targeted cyber attack on one of its divisions. Our ThreatLabZ team worked closely with the customer to identify the root cause of the attack and acted quickly to prevent any potential damage.

Subsequently, this customer upgraded to our ZIA Transformation Bundle to prevent 0-day attacks and secure the entire ecosystem. This win highlights the value of our high-end product bundles and the benefits that our ThreatLabZ research brings to our customers.

I'm delighted to share that an increasing number of customers are purchasing our comprehensive platform capabilities, which not only accelerates their business value realization but also establishes us as a critical partner for their success. As I mentioned before, customers are increasingly buying Zscaler for Users, our complete platform for user protection, which includes ZIA, ZPA and ZDX bundled together.

In addition, we are gaining traction with workload protection powered by the same core ZIA and ZPA technology. Thanks to new and existing customers purchasing these expanded bundles, we drove a 51% year-over-year growth in the number of customers with greater than $1 million in ARR, ending with nearly 380 of these customers.

And over 30 of these customers have ARR greater than $5 million. Let me highlight 3 deals this quarter. where the customers purchased all 4 product pillars. In a new logo win, a top 10 global IT software and services company purchased Zscaler for Users bundle for 400,000 users, including our advanced data protection suite and our Zero Trust for Workloads for 3,000 workloads.

This customer pursued a zero trust strategy due to their business growth, resulting in a complex application and network environment and heightened risk from data sprawl. They selected Zscaler as the only scalable zero trust platform that reduces their attack surface and protects their sensitive data while bringing agility to their business.

With our integrated platform, they will simplify their security operations by consolidating dozens of point products, including firewalls, VPN, VDIs, DLP and CASB. By purchasing all 4 product pillars, the customer is making a platform bet on Zscaler to secure their users, workloads and devices regardless of their location.

Next, in an exciting upsell win, a major auto manufacturer upgraded to Zscaler for Users bundle for 35,000 users and purchased Zero Trust for Workloads for 8,000 workloads. This platform purchase was driven by the customer strategy to digitally transform their business operations, including management of the vast supply chain. In fact, we are helping them accelerate time to market for new EVs.

Before purchasing ZPA, this customer experienced significant delays in commissioning new vehicles as third parties did not have fast and secure remote access for collaboration. By using ZPA and ZDX, they can provision secure access to new third parties within a few days compared to over a month, it used to take with legacy remote access technology.

In addition, Zscaler for Users significantly reduces the risk of ransomware that the firewalls and VPNs allow. Finally, a Global 500 pharmaceutical company upgraded from ZIA for 45,000 users to Zscaler for Users bundle for 85,000 users and purchased Zero Trust for Workloads for 2,000 workloads.

They purchased all 4 product pillars to pursue a cloud-first strategy with zero trust security for all users and workloads. With this upsell, the annual spend of this existing $1 million customer increased by 6x with additional opportunity for workload protection as the public cloud usage grows.

Earlier, I mentioned that in some instances, we enable new customers to ramp to larger commitments. In one such new logo win, we are excited to partner with an innovative retail leader that's using facial recognition technology and cashless checkouts to redefine their future store experience. This is a significant win for us as retail was a smaller vertical for us historically, where we are now enabling new digital transformation possibilities.

This retail company committed to an 8-figure total contract value for a multiphase ramp to secure over 90,000 ZIA users, 20,000 ZPA users, and 400 petabytes per month of data from the 20,000 retail store operations. This customer had bought a firewall-based SASE solution, which failed to scale as well as expanded their tax surface.

Leveraging our highly scalable and reliable Zero Trust Exchange platform, they will use ZIA to create direct Internet access for employee tablets and terminals while using ZPA to secure private access for store managers. Additionally, Zero Trust for Workloads will secure all traffic from cameras and terminals in the retail stores to the cloud.

Workload protection accounts for approximately 40% of the total deal value. As these deals show, customers are embracing our expanded platform, including our 2 emerging product pillars, ZDX for digital user experience management and Zscaler For Workloads, for securing servers and workloads. These emerging products are on track to meet or exceed our full year target of contributing high-teen percentage of our new business.

Our Zero Trust for Workloads solution is roughly doubling year-over-year. In addition, our new CNAPP solution is generating significant customer interest. You may recall at Zenith Live in June, we launched our CNAPP solution called Zscaler Posture Control, which is an integrated solution that correlates vulnerabilities and risks across CSPM, CIEM and Infrastructure as Code scanning.

This quarter, we had a Posture Control upsell win with a Global 1000 engineering company or $0.5 million ACV to secure 5,000 workloads. Posture Control provided visibility across multi-cloud assets, remediated compliance violations and revealed previously undetected high-risk vulnerabilities.

We are proud that our Posture Control solution were recently recognized by research firm G2 in the leader quadrant based on independent peer reviews. We are bringing more innovations to our customers than ever before. In our latest major cloud software release, we brought over 150 new features to market, including product innovations such as AI-powered phishing detection and dynamic, risk-based access policy.

We continue to drive both internal innovation and highly targeted acquisitions to expand our leadership in the SASE and zero trust security markets. As announced a few weeks ago, we acquired Canonic Security, an innovative start-up in SaaS supply chain security, which protects customer data in SaaS applications.

For example, Google Suite could be sharing data with 30 other third-party connected SaaS apps that are posing significant risk of data breaches and data loss. Together with our in-line DLP, browser isolation, out-of-band CASB and SSPM for SaaS posture management, Zscaler now provides unprecedented visibility and most comprehensive data protection for SaaS applications and customer data.

As we look ahead to the next few years, we are committed to driving broader adoption of our zero trust platform for users, workloads and IoT and OT to maximize the value of our customers' secured digital transformation efforts. CIOs are telling me that they're using this challenging environment to drive change.

ROI and cost optimization are becoming bigger priorities as they're being asked to do more with less. With our superior architecture and proven experience, we deliver measurable outcomes at the CXO level that are aligned with our customers' top priorities.

Our business value proposition is resonating, and more customers are consolidating multiple point products with our broader platform, which increases our wallet share with them. We believe that we are still in the early stages of a significant market opportunity to enable secured digital transformation and we are on track to achieve our $5 billion ARR goal. Now I'd like to turn over the call to Remo for our financial results.

Remo Canessa - *Zscaler, Inc. - CFO*

Thank you, Jay. Our Q2 results exceeded our guidance on growth and profitability even as we managed through continued deal scrutiny and longer reviews. Revenue was $388 million, up 52% year-over-year and up 9% sequentially.

ZPA product revenue was approximately 20% of total revenue, growing 74% year-over-year. From a geographic perspective, Americas represented 53% of revenue, EMEA was 32% and APJ was 15%. From a new business perspective, EMEA grew strongly on a year-over-year basis despite continued macro challenges in the region.

Our total calculated billings in Q2 grew 34% year-over-year to $494 million. Until we get more certainty around the macro environment, we believe looking at total billings on a sequential basis can be a relevant measure of our billings performance in the near term.

On a sequential basis, billings grew 45% quarter-over-quarter. Our current billings grew 32% year-over-year, which includes the impact of strategic deals with phased subscription ramps that Jay talked about earlier. Our remaining performance obligations, or RPO, grew 44% from a year ago to $2.809 billion. The current RPO is 51% of the total RPO.

Our dollar-based net retention rate was once again above 125%. We have a strong base of large enterprise customers, which provides us with significant opportunity to upsell our broader platform. At the end of Q2, we had 378 customers with greater than $1 million in ARR, up 51% from 251 in the prior year.

The continued strength of this metric speaks to the strategic role we play in our customers' digital transformation initiatives. We added 120 customers in the quarter with greater than $100,000 in ARR in the quarter at 2,337 such customers. Turning to the rest of our Q2 financial performance.

Total gross margin of 80.4% is unchanged from the prior year. Our total operating expenses increased 6% sequentially and 44% year-over-year to $263 million, primarily due to higher compensation expenses. As we indicated last quarter, after exceeding our hiring plans in Q1, we moderated our pace of hiring in Q2.

This contributed to a strong operating margin performance in the quarter with operating margin increasing 380 basis points year-over-year to 12.6%, which exceeded our guidance. We're seeing the leverage in our financial model that is driven by our strong underlying unit economics. Our free cash flow margin was 16%.

We continue to expect data center CapEx to be around the high single-digit percentage of revenue for the full year. We ended the quarter with over $1.9 billion in cash, cash equivalents and short-term investments. Next, let me provide more details about the targeted cost optimization plan that Jay mentioned.

In the past 18 months, we doubled the size of our team to approximately 5,900 employees as we invested aggressively based on a strong market momentum. As we watched the macroeconomic uncertainty at the start of fiscal 2023 in the fall, we commented that if the business environment becomes more challenging, our business model allows us to adapt quickly and to deliver expanded operating profitability while we grow.

With the announcement today, we are adapting to the changes we saw in Q2. This is a targeted optimization initiative to address inefficiencies in certain job functions and projects. As a result, we're reducing our workforce by approximately 3%. Most of the impact from these changes will be seen in Q3 and will take a charge of $8 million to $10 million, including noncash expenses.

We'll continue to hire the best candidates in high priority areas. Now moving on to guidance and modeling points. As a reminder, these numbers are all non-GAAP. For the third quarter of fiscal 2023, we expect revenue in the range of $396 million to $398 million, reflecting year-over-year growth of 38% to 39%; gross margins of approximately 80%; operating profit in the range of $55 million to $56 million; net other income of $10 million; income taxes of $4.5 million; earnings per share of approximately $0.39, assuming 156 million fully diluted shares.

Please note that starting in fiscal 2023, we adopted the new accounting standard, which requires the use of the if-converted method for calculating EPS. To account for our convertible notes, we will need to add back $360,000 in quarterly interest expense.

For the full year fiscal 2023, we expect revenue in the range of $1.558 billion to $1.563 billion or year-over-year growth of approximately 43%, calculated billings in the range of $1.935 billion to $1.945 billion or year-over-year growth of approximately 31%. For Q3, we're assuming billings to decline by approximately 9% sequentially compared to the mid-single-digit percentage declines we've seen over the last few years.

This guidance incorporates the macro-related uncertainties that Jay mentioned in his comments. Operating profit in the range of $213 million to $215 million. Our guidance reflects approximately 350 basis points of operating margin improvement compared to last year, which is an increase from our prior guidance, while growing revenue at above 40%.

Income taxes of $18 million. Earnings per share in the range of $1.52 to $1.53, assuming approximately 156 million fully diluted shares. As noted earlier, to account for a convertible note and EPS, you will need to add back $1.4 million in annual interest expense.

Let me conclude with comments on our investment framework. We remain confident in our ability to deliver on our growth opportunity while increasing profitability. We will balance growth and profitability based on how our business was growing. The recurring nature of our business model gives us good visibility on top line revenue and allows us to adapt quickly to changes in market conditions to deliver on our operating profit and margin goals.

If the environment becomes more challenging, we will continue to prioritize profitability, leveraging our strong unit economics and driving efficiencies in our cost structure. In fiscal '23 as a result of our focus on operational efficiency, we're increasing our profitability in the second half to achieve a full year operating margin of 13.7%, reflecting a 350 basis points expansion, while revenue is still growing over 40%.

If the environment improves, we'll prioritize growth. Our long-term investment framework still applies. If we are growing revenue faster than 30%, you can expect less than 300 basis points of margin expansion in the year. We remain confident of reaching 20% to 22% operating margins in the long term.

With a large market opportunity and customers increasingly adopting the broader platform, we'll continue our disciplined approach to managing our business to maximize value for our shareholders. Operator, you may now open the call for questions.

QUESTIONS AND ANSWERS

Operator

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

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

Jay, I appreciate the backdrop is tough. We hear it from every company. But can you frame for us your outlook in terms of things within your control and things that aren't? And maybe also if you could comment on the integrity of the data that you look at that underpins your confidence in Zscaler's competitive position in the market?

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

Brad, thank you. But if you look at the quarter, we found that our upsell was quite strong. Customers loyal to us, they like our solution, upselling becomes easier for us.

In terms of challenging, new logos with large deals are more challenging as there was additional scrutiny and additional approvals needed. The other thing that worked well was the customers like the fact that we are able to do consolidation of lots of point products that clean architecture and give them strong ROI.

That thing has worked well for us. In terms of competitive positioning, we haven't really seen any change. In fact, I would say that on the high end of the market, we actually feel like we are stronger than even before because we have established that. We actually have the right architecture, right solution with thousands of customers well deployed and very happy customers.

In part other than we are beginning to see that some of the solutions that are sold by firewall vendors as SASE solutions, and when customers can deploy them, they are coming falling apart. I have been asked many times in the past 2 years, hey, are you replacing some of the firewall-based solution?

Answer I used to give is I haven't seen very many out there, now we're beginning to see some of them. The large retailer I mentioned on my call with 20,000 stores tried for about 18 months to deploy a firewall-based SASE solution, so to speak, and eventually give up and we are really taking care of it.

The other thing I would mention is Remo has often said we can adjust our business model as needed. As environment is getting tighter, we are adjusting the model by slowing down hiring. Our unit economic cost is very high. So you're seeing expansion of gross margins and operating margins -- sorry, operating margins, which our investors do like to see.

Lastly, my confidence is coming from tons and tons of customer calls I made, we had 80 CISOs with us for 2 days doing an exchange. All of these guys I have deployed have done a great job. They understand the architecture, the more the word spreads out there, a better understanding of the architecture, the more they're able to fend off the fluff being spread by competitors. So I'm very confident and comfortable in our ability to stay far ahead of the competition.

Operator

Our next question comes from the line of Sterling Auty with MoffettNathanson.

Sterling Auty

I'm just kind of curious, Jay, when you look at the business, can you give us a high-level sense of how much of the business in the quarter is replacement of legacy security solutions where cost savings is a driving factor?

And how much of the business is actually brand-new implementations to enable some sort of project where maybe it's a little bit riskier in these tighter budgetary times?

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

As you know, every company has strong kind of legacy solution for Internet gateway or even VPN apps. Those are the 2 starting points for us. ZIA starts with replacing some kind of Secure Web Gateway and ZPA starts with replacing some kind of VPN, then expand from there. So almost all business we do start by replacing something, except -- well, upsell too.

Actually, if you look at our upsell, that means we may have ZIA, some pieces deployed. We may be upselling to replace DLP of some vendor or we may be replacing VPN of some vendor or some of other stuff.

So almost all business is replacement for us. You can call some of the stuff expansion, for example, when customers want to have direct access to applications sitting in Azure and AWS without going through the data center, we're still replacing some of the stuff sitting in the data center and some of the direct connects they may have bought.

So it's replacement of a bunch of point products into a fewer interior offerings. That's really where the savings come from, that's where simplicity and operational ease comes from.

Operator

Our next question comes from the line of Andrew Nowinski with Wells Fargo.

Andrew Nowinski - *Wells Fargo Securities, LLC, Research Division - Senior Equity Analyst*

So I just wanted to ask about those ramp deals that you talked about. Just wondering if you could quantify how much those deals would have added to billings in Q2 if they were normal deals versus ramping over time. And also, are customers contracted to spend a certain amount that was deferred? Or can they still back out of that ramp piece of it?

Remo Canessa - *Zscaler, Inc. - CFO*

Yes. So they're contractually obligated to the ramps and the ramps are strategic that Jay talked about, with large deployments, we are seeing more ramps. The impact on billings, probably a couple of percentage points is what you can think.

But again, with large customers, large deployments buying more of our pillars, ramps were more in Q2. If I may add, I mean, we look at this as a strategic investment on our part to help customers get started and actually manage your cash for investments in year 1 by deferring some of that stuff to future years.

Operator

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

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

Great. So I was actually interested in asking about the ramps as well. But I also wanted to put it in context to the duration in the calculated billings numbers. Can you give us some sense of the magnitude of each of those?

I guess a couple of percent on the ramps. But if I look at the ramps, once you get all of that back in a couple of quarters, once they get past the initial start day, so isn't that actually just a timing issue?

Unidentified Company Representative

Yes. I mean, you're absolutely right, Alex. I mean the ramps are a timing issue, lower billings upfront and higher billings later based on the ramp. Related to the billing duration, there was a -- it was slightly favorable in Q2. If you look at our billings, calculated billings, they're at 34%, short-term billings were at 32%. That's generally what you can think about the favorableness related to the billing duration.

Operator

Our next question comes from the line of Roger Boyd with UBS.

Roger Boyd - *UBS Investment Bank, Research Division - Associate Analyst*

I wonder if I could poke up the efficiency versus capacity debate. I know you reiterated the $5 billion long-term goal. And Jay, your confidence in the market opportunity. But if you do see conditions improve, how do you think about sales capacity heading into fiscal '24 and your ability to accelerate growth at an agile base?

Unidentified Company Representative

Yes. And that's a great question. We are a growth company. We feel that the market opportunity is huge. $5 billion still what we are shooting for. We saw this as -- based on the comments that I made, we've increased our headcount almost 100% over an 18-month period.

And we saw basically inefficiencies in the organization. That's why we're doing this cost optimization. Having said that, our selling capacity remains very strong. And we continue -- we are going to continue to invest in our selling capacity as we go forward into the second half.

So we are going to moderate hiring throughout the company, but our focus is still selling capacity and R&D development. Yes. So we are still selectively going to hire quota-carrying sales reps as well as core engineering leaders -- sorry, core engineering key members. And we expect our year-end headcount to be higher than the headcount today.

Operator

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

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

Remo, just on the billings guidance, if you could, just give us a characterization of how you would give a -- say, is it conservative? Is it based on what you're seeing today? It getting worse, the environment thing? We're getting a lot of questions on that. Hopeful to get any color you have on that.

Remo Canessa - *Zscaler, Inc. - CFO*

Yes. I mean, thanks for asking the question, Joel. So there was an elongation of the sales cycle. So we're basically baking into that to our second half, slightly worse, not a lot but slightly worse than what we saw in Q2.

So a little more conservatism related to our billings guidance than the past.

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

Yes. And we are assuming that current levels of these scrutinies will continue.

Operator

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

Patrick Colville - *Scotiabank Global Banking and Markets, Research Division - Analyst*

So I guess I'd like to ask about the sales changes that we discussed last quarter on the call. Is the slowdown we're seeing have any bearing on the sales changes that were made earlier in the fiscal year? Or has that process been kind of wrapped up and that's in the background now?

Unidentified Company Representative

Patrick, as we discussed, we made changes to our enterprise segment, the lower end of market segment at the start of the year and where it now reports to Geo leaders. Those changes are behind us, they've done Q1, and no bearing on Q2 numbers. Okay? So the main thing we're seeing at the highest level is some of the macro conditions that are impacting some of the higher and larger deals are low end of the market segments, enterprise and commercial. They actually had done quite well. But they're still impacted.

Operator

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

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

Okay. Great. Remo, maybe for you, can we just dig into the ramp deals just a little bit more? And maybe specifically, are these deals that take multiple years to ramp up to their sort of normal run rate on average?

Or are these things that maybe come back in the next couple of quarters? And relatedly, are you assuming a similar mix of ramp deals in the second half as you think about the conservatism in that guide?

Remo Canessa - *Zscaler, Inc. - CFO*

So -- no, it's not multiple years, it's shorter than that. Also related to what are we thinking of ramps in Q3 and the second half, similar to what we saw in Q2. Again, as we talked about, dealers are getting bigger, buying more of our platform.

It is a very -- it's a strategic buy for large companies. Regarding the architectures that are out there today, I mean companies understand. They understand that they've got a problem. And for that, these ramps do help us. I would expect it to continue about the same pace in Q3 and Q4.

Operator

Our next question comes from the line of Matt Hedberg with RBC.

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

I just wanted to ask about linearity. It sounded like in your prepared remarks that January was worse than December. I'm curious, did those trends continue into February, i.e., was February worse than January? And is there any way to quantify sort of the impact of the deals that pushed out of the quarter?

Remo Canessa - *Zscaler, Inc. - CFO*

Yes. I mean, some deals certainly pushed into February. And February -- but again, some of the deals that we thought we'd do in January came through in February.

Regarding linearity, overall linearity was actually better in Q2 versus Q1. But that's also a function of the elongation of the deals. So that's why linearity is better. Going forward, I would expect back-end loaded linearity as we've seen the last few quarters. I really don't see that changing.

Operator

Our next question comes from the line of Mike Walkley with Canaccord.

Thomas Walkley - *Canaccord Genuity Corp., Research Division - MD & Senior Equity Analyst*

Remo, I guess, with new customer pipeline taking longer to close, it seems like upsell is going to be maybe even greater mix over the intermediate term. Can you share with us maybe how that mix changes over the implied guidance for the remainder of the fiscal year?

Remo Canessa - *Zscaler, Inc. - CFO*

Yes, that's a great question. If you recall in Q1, it was about 50-50.

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

That's right.

Remo Canessa - *Zscaler, Inc. - CFO*

And we said we felt on -- for the year, it's going to go more in the 60-40 upsell versus new. In Q2, it was about 35% new and 65% upsell. From my perspective, I think for this year, I think 60-40 is still the right metric to think about, 60% upsell and 40% new.

Operator

Our next question comes from the line of Keith Bachman with BMO.

Keith Bachman - *BMO Capital Markets Equity Research - MD & Senior Software & IT Services Analyst*

I wanted to ask about if you look at the phase deals and/or just the general economic backdrop, is there a change in pricing? In other words, are more customers asking for a release in terms of pricing?

And related to that, Remo, I know you talked about the billings and you're assuming some more conservative, or things can get worse. But if I look at the billings guide, if in fact, billings are down 9% sequentially in the April quarter, in order to make the annual guide, the sequential growth in July quarter is 50% or higher, and that's roughly equal to or above the sequential growth for the last 3 years.

So I'm just struggling a little bit to understand why the billings guide, we should think there's basically some room, if you will, when I look at the Q4. It just seems like you're asking a lot for Q4.

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

Yes. I will start on the pricing pressure or discount you talked about, and Remo can get into the billing part of it. So due to a tighter macro environment, there is increasing scrutiny and pressure on CIOs this year.

Our customers are negotiating order over payment and deal terms. But customers do view us as one of the most mission-critical service, and they want to make sure they buy the service that works, the service they can depend upon. But they're not looking for the cheapest solution. So from that point of view, I would say we aren't seeing tremendous pressure on discounting.

We're seeing some focus on it. And to help that, that's where some of the ramp deals come in to help lower the first year cost for the customer to manage their spend. But being strategic, being dealing at the right level and actually delivering a lot of ROI value reduces pressure on us from a pricing point of view. Remo?

Remo Canessa - *Zscaler, Inc. - CFO*

Yes. So if you look at the average that we've had in the second half sequentially from Q3 to Q4, it's been in the 48%, 49% range. But we've gotten our guidance as 46% at the midpoint.

Operator

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

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

So Jay, I'm wondering if you can talk in more detail on the adoption trends you're seeing around cloud workload protection. And what those initial lands look like from a deal size perspective relative to ZIA and ZPA? And also, just touch on the go-to-market, are all reps equipped to sell that solution today? Is there an initial overlay strategy?

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

Overall adoption of cloud workloads product is pretty good as planned. And as customers are launching more and more workloads, they have 2 options. Either they extend their corporate network just like a branch network to every cloud region and put virtual firewalls there or they do zero trust architecture with Zscaler.

So these products are primarily sold to our customers. Our customers understand the value of it, and that's why they're embracing it. Now that initial deals are smaller, customers are growing, and there are some large deals, but majority of the deals start small, and customers start buying into it.

They largely end up doing the same thing, just like ZIA for users, ZPA for users, and this is ZIA for workloads, ZPA for workloads. That's where we believe the opportunity for us is significant. In terms of go-to-market, all reps are equipped to sell it, but we also understand that there are a bunch of nuanced discussions in this area.

So we do have product specialists. This is not overlay sales team. These product specialists are experts in this area, and they do help in the sales process. And Remo, overall, we are expecting the emerging products, too.

Remo Canessa - *Zscaler, Inc. - CFO*

Yes. Emerging products still tracking to high teens, both total new and upsell.

Operator

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

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

I wanted to ask you on the market opportunity for best of breed. With Zscaler now having a versity of the Global 2000, how do you think about the risk that the enterprises that can merged to that best of breed are essentially or already Zscaler customers?

In other words, where do you think the ceiling is to that G2000 penetration rate? And are you getting feedback from, let's say, the next sort of take-offs, but perhaps I don't care as much about best-of-breed technology? How do you think about that?

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

Next bake-offs? I'm sorry, can you expand the last part again?

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

Yes. Essentially, the deal size you're competing for today, are you getting any signs of feedback from customers saying, we know you're best of breed, but we're not going to prioritize you?

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

Yes. Our customers are not looking for best-of-breed point products. They're looking for best-of-breed platform with the right architecture. We can tell you if -- when you talk about low end of the market, they can kind of limp it with some of the solutions that are kind of halfway.

But when you talk about Global 2000, these customers are generally pretty savvy. The requirements are complicated. And we believe the best architecture will win in the long term. I gave you an example this time. We're a large retailer kind of have gone a different way, thinking that a firewall-based architecture will work, tried, failed and came back. I expect to see a lot more customers do the same thing. I think we have ample opportunity in the Global 2000 to take our current penetration to a much, much higher level.

Operator

Our next question comes from the line of Peter Levine with Evercore.

Peter Levine - *Evercore ISI Institutional Equities, Research Division - Analyst*

Maybe just to piggyback off an earlier question on upsell versus net new. So it seems like you're able to kind of somewhat toggle your sales force to maybe focus more on those back-to-base opportunities. So one, are you changing incentives, comp plans at all to, I guess, better incentivize your sales force to focus more on those back-to-base opportunities?

And then second, the ones that you are seeing a better upsell, like what product is having the highest hit rate?

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

So we aren't really making any special changes to upsell versus new logo. This has been asked to us many times over the years. Do we have a special incentive on new logos? Not really. Our platform is very broad and big. So we really -- we want new logos, and we want expansion. And expansion, we know that expansion means upsell is a little bit easier than new logos.

That's why you've seen some of the upsell numbers going up this quarter as compared to new logos down. We keep on making refinements to our go-to-market structure and model from time to time, but there's nothing significant we've done now to make any changes.

I think one of the best things is we have a very good sales organization. Our architecture is very good. Our deployments are very good. That's why customers come back and they rave us. I mean, talking to so many customers, they believe we have the best service, best architecture and best security. That's why we win. And I think we'll keep on driving it. But in today's market, we expect upsell numbers to stay high because it's a bit easier as compared to a new a logo.

Peter Levine - *Evercore ISI Institutional Equities, Research Division - Analyst*

And then which products are getting the biggest hit rate?

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

Oh, sorry. Big product. Yes. So if you look at almost every Zscaler customer as ZIA, okay, ZPA can be a starting point, but that's not common. But more and more, if customers are starting with ZIA, ZPA, ZDX but there's still a sizable installed base that has ZIA. Now ZIA, ZPA together in the higher end, they will be close to 60%, right?

That means so many customers have ZIA, ZPA both. There's upsell opportunities on ZPA. There's upsell opportunity within bundles. Lot of these customers have bought business, they moved to transformation. From transformation, there's a big opportunity for us to sell data protection.

Data protection, especially advanced data protection is very much in the mind of large corporations. And there's a lot of old stuff sitting from Symantec Vontu and some of the McAfee stuff. And when you deploy Zscaler, you can't be really sitting with the old school DLP technology. Data protection is a big opportunity for us.

If there's one other product I would highlight, it is ZDX. Digital experience is one of the favorite services of CIOs and Head of Networking because when someone is coming from some home, some coffee shop, some hotel, when things are slow, customers struggle to figure out. ZDX has become very sophisticated to help them pinpoint issues and take care of them.

User experience is becoming more and more important. And this highly, highly differentiated service that we offer. Did I answer your question?

Peter Levine - *Evercore ISI Institutional Equities, Research Division - Analyst*

Perfect. Yes.

Operator

Our next question comes from the line of John DiFucci with Guggenheim.

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

You said that EMEA grew strongly year-over-year. But was it the kind of growth you thought it would be? Because the reason I ask is that our checks in the regions were -- they were pretty mixed. And your revenue growth decelerated in the region. And given the recurring model of revenue is usually a lagging indicator, I get that. But I guess you answered that question. And how do you expect the region to progress going forward? Is there any reason that region might be more competitive?

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

I'll start, and Remo can add things to it. This quarter, EMEA had less dependency on large deals, okay? And as you know, large deals are getting more scrutiny. And U.S. was relatively speaking, weaker because they had higher dependency on large deals. Remo, do you want to add any more?

Remo Canessa - *Zscaler, Inc. - CFO*

Yes. I mean you're right, John. I mean, revenue is a lagging indicator. And for our new and upsell business, it was one of our strongest, if not our strongest, if you will. So EMEA did do well.

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

And if there's another color I could give you on the market vertical kind of stuff, there are certain verticals that is better than others. As you would expect, the tech vertical was weak in today's market. And some of the retail and all was a little bit slower.

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

But that would be more for the U.S., right, Jay, the tech vertical?

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

For the U.S., that's correct. That's correct.

Operator

Our next question comes from the line of Shaul Eyal with Cowen.

Shaul Eyal - *Cowen and Company, LLC, Research Division - MD & Senior Analyst*

Jay or Remo, one of the topics to jure? in recent quarters is cloud-related costs or in other words, some enterprise customers are indicating that some of the cost benefits they have subscribed to under the big cloud promise in recent years, at times, that is not leading up to their expectations. So interested to learn whether your customers have been bringing up that point in recent discussions.

Unidentified Company Representative

Kind of hard time hearing you, Shaul. So you might -- I think we've caught something about maybe hyperscaler and perhaps if you could repeat that.

Shaul Eyal - *Cowen and Company, LLC, Research Division - MD & Senior Analyst*

Yes. No. So I was asking whether some customers have been bringing up maybe some disappointment with the overall promise as it relates to cloud-related costs. Is that a topic that has been brought up in recent discussions with your customers?

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

Yes. So let me share with you lots of conversations I have. Customers are embracing cloud, okay? There's no -- somebody is not saying, "I want to come back or not embrace the cloud." That's point number one.

Point number two, the speed at which these guys are moving forward is slowing down. You can expect because some of these large software development projects are slowing down for cost reasons.

Number three, that's actually creating an interesting phenomenon, whereby customers aren't able to use all the spend that's committed. That's actually giving us an opportunity where we are actually partnering more closely with some of these hyperscalers, where our deal can be part of that customer commit because we are as an approved partner for some of the cloud spend.

So those are some of the things we are seeing. But overall, we do see -- it's rare to find a CIO that says, I don't like cloud anymore. Are there complaints about cost in the cloud? Yes. Do they see an alternate to go back to the data center? No.

Operator

Ladies and gentlemen, due to the interest of time, that concludes our Q&A session. I would now like to turn the call back over to Jay for closing remarks.

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

Thank you for your continued interest in Zscaler. We look forward to seeing you at some of the upcoming conferences. Thank you again.

Remo Canessa - *Zscaler, Inc. - CFO*

Thank you.

Operator

Ladies and gentlemen, this concludes today's conference call. Thank you for your participation. You may now disconnect.