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PRESENTATION

Operator

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

Bill Choi ***Zscaler, Inc. - VP of Investor Relation***

Good afternoon, and thank you for joining us to discuss Zscaler's financial results for the third quarter of fiscal 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 the Investor Relations section of our website earlier today.

Let me remind you that we'll be making forward-looking statements during today's discussion including, but not limited to, the company's anticipated future revenue, calculated billings, operating performance, gross margin, operating expenses, operating income, net income, free cash flow, dollar-based net retention rate, income taxes and earnings per share. These statements and other comments are not guarantees of future performance but rather are subject to risks and uncertainties, 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 financial measures. 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 Bank of America Merrill Lynch's Global Technology Conference in San Francisco on June 5. Now I will turn the call over to Jay.

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

Thank you, Bill, and thank you, everyone, for joining us on our call today. I am pleased to share with you our strong third quarter results. Our revenue grew 61% and calculated billings grew 55% year-over-year. In addition to our top line growth, our operating margins improved 14 percentage points year-over-year to 8%. Our Q3 results demonstrate the leverage in our business model and our ability to drive growth and profitability. While we are pleased with our third consecutive quarter of profitability, we will continue to aggressively invest in our business for a significant market opportunity that is ahead of us. Based on our analysis of IDC's data, we believe we are going after a $20.3 billion TAM in calendar 2019.

Just as enterprises have adopted multi-tenant SaaS applications like Salesforce and Workday due to replace legacy on-premise applications, enterprises are saying goodbye to security appliances and choosing Zscaler's born-in-the-cloud multi-tenant security platform to securely embrace the cloud.

Unlike traditional network security which builds a moat around a castle, our cloud security platform acts as a business policy engine to securely connect the right user to right applications regardless of location: ZIA for access to SaaS or the Internet and ZPA for access to internal apps in a data center or a public cloud.

Our customers are leveraging increased functionality of our comprehensive cloud security platform as they progress through various stages of their cloud journey. We see this progression in product bundles purchased by our customers. A significant majority of our revenue used to come from customers purchasing Professional and Business Bundle. As expected, we're seeing continued strong adoption of our premium ZIA Transformation Bundle, which is growing as a mix of our ARR. In addition, while we replace security appliances in existing Internet gateways, the majority of ZIA sales are coming from creating and securing new Internet breakouts. These are greenfield opportunities.

We are continuing to see significant interest in ZPA, which we introduced only a couple of years ago. It remains the fastest-growing product in our history. ZPA delivers what Gartner calls "zero-trust network access" to provide application access to users without granting network access. This significantly reduces business risk. While ZPA has been and continues to be purchased as an up-sell by existing ZIA customers, we are seeing more upfront sales of both ZIA and ZPA. ZIA and ZPA together provide our customers a single platform for secure cloud transformation, which we believe no other vendor can match.

Let me highlight several new customer deals in the quarter. I will start with a deal that shows how large enterprises are buying the ZIA and ZPA platform. One of the world's largest pharmaceutical companies with its headquarters in Europe purchased our Transformation Bundle for 100,000 users and ZPA for over 17,000 users. Moving from a decentralized IT and business units to a centralized IT model, this customer had a strategy to transform to the cloud, for their network and for their applications. To achieve this, the IT team identified 2 initiatives: One, increased use of cloud, including a move to Office 365, Zoom and AWS, and number two, network and security transformation. They adopted a strategy to create secure local Internet breakouts for 200 offices around the globe. Our cloud security platform allowed them to realize the vision of perimeter-less enterprise with direct access to any service or application from anywhere on any device without backhauling traffic through regional hubs. The result: reduced business risk, faster user experience and significant cost savings. They will no longer need either a site-to-site VPN to AWS or remote access VPN. ZPA also enables the customer to rapidly integrate mergers and manage divestitures while increasing the level of security with the zero trust network access approach.

Another deal involving both ZIA and ZPA upfront was a Fortune 500 financial services company that purchased our Transformation Bundle for 85,000 users and ZPA for 20,000 users. This customer was preparing to deploy Office 365. The anticipated scaling issues with their on-premise web proxy appliances, which would not keep up with the significant growth in Internet-bound traffic from 750 worldwide offices. The initial discussion of proxy replacement expanded significantly once the security team realized that Zscaler was much more than a traditional web proxy; we offer the full security stack, including next-gen firewall, sandbox and SSL inspection. This customer decided to pursue a local Internet breakout strategy and use Zscaler to secure their SD-WAN initiative. They purchased ZIA for all employees, which will also cover mobile users and improve the user experience. In addition, they purchased ZPA for two use cases: One, to integrate acquisitions of new businesses, and two, to replace remote access VPN for business units that were having poor user experience.

I often see personal notes from CIOs, CTOs and CISOs of Global 2000 enterprises indicating how much they appreciate the quality of service of the Zscaler team and our commitment to their success. A number of them have brought Zscaler into their new organizations after making a career move. I'm excited to share with you 2 recent examples. A travel and leisure company purchased our Transformation Bundle for 17,000 users and ZPA for 6,500 users. The new CTO came from a large healthcare company where he had deployed Zscaler 1 year ago. In another case, a financial services company purchased our Transformation Bundle for 10,000 users. Their new CIO moved from another financial services company, which had rolled out Zscaler 3 years ago. These wins demonstrate the strong loyalty of our customers and the value of our platform.

We also had a number of notable up-sell wins in Q3. A U.S.-based conglomerate has been a Zscaler customer since 2015 using our Business Bundle who has 2 dozen portfolio companies to protect 70,000 employees around the world. This customer purchased ZPA for 40,000 users to replace multiple remote access VPN solutions and made ZPA the standard solution across multiple portfolio companies. The driver: customer is moving its applications to SaaS and public cloud and needed a future-proof solution that provides secure and fast access to their applications. In addition, as this conglomerate actively acquires its new businesses, ZIA and ZPA will enable them to quickly integrate the acquired companies. This latest purchase resulted in doubling of the total customer annual spend with Zscaler.

A Fortune 500 bank with headquarters in Asia that purchased our Business Bundle for 38,000 users 2 years ago completed the addition of 12,000 users and upgraded all 50,000 users to the Transformation Bundle. The driver of this deal was the need to upgrade security posture for all employees at any location on any device using a cloud-based integrated platform. They also required granular policies to control access to certain applications for defined roles such as restricting web mail and chat access for traders during the trading window. In addition, they purchased our Data Loss Prevention solution to help meet stringent regulatory requirements.

Let me say a few words about the competitive landscape. As organizations increasingly make the shift to the cloud, traditional firewall and VPN vendors are finally acknowledging that their legacy security appliances can't secure the new digital enterprise and are attempting to build a security cloud using single-tenant software designed for on-premise appliances. Just like you can't create a Netflix service by stacking thousands of DVD players in the cloud, you can't offer an in-line high-performance security cloud by spinning up a bunch of virtual machines in a public cloud. This is a defensive strategy of cloud imitators, which, in our view, serves the self-preservation of the vendor, not the needs of the customers.

We believe we have a significant competitive advantage as a result of the technology, architecture and maturity of our cloud security platform, including: One, we were born in the cloud, for the cloud just like Salesforce and Workday. Two, we have a purpose-built globally distributed multi-tenant cloud for fast user experience. Unlike imitation clouds, Zscaler requires no backhauling from front doors to a central "compute" data center of a public cloud. Three, we perform SSL inspection at scale as a purpose-built proxy for better security. Four, we deliver Zero Trust Network Access that provides application access without network access, reducing business risk, unlike firewalls and VPNs.

And lastly, we have over 10 years of experience running a mission-critical in-line cloud for Global 2000 customers, processing 65 billion transactions a day. As someone said, there is really no compression algorithm for experience.

We continue to innovate and invest in maintaining our significant technology lead. Our latest fourth-generation large data centers provide multiple 100 gigabits per second links. We continue our strategy of targeted tuck-in acquisitions. Our previously announced TrustPath acquisition is already well integrated into the Zscaler platform, and their machine learning and AI technology is helping us deliver better threat detection. Just this week, we acquired Appsulate, a pre-revenue browser isolation company with a talented group of developers. This technology is highly effective for use cases where the Internet or application content should not be downloaded to the end point due to security or data protection concerns; instead, it should be rendered as pixels in the browser. We plan to incorporate this technology into our extensible cloud platform.

We remain focused on execution and are investing in our go-to-market capabilities. We are welcoming a new VP and General Manager in EMEA with substantial experience in selling to large enterprises to help us scale EMEA to the next level. We will be holding our annual Zenith Live Cloud Summit in Las Vegas on September 16 through 18 and Zenith Live Europe in Lisbon, Portugal on September 30 through October 2. We will have an inspiring lineup of keynote speakers to talk about cloud transformation.

In summary, we are very pleased with our strong Q3 results and continued growth in our business. We believe we are in the early innings of a significant market opportunity to disrupt traditional network security.

I would 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 Q3. Revenue for the quarter was $79.1 million, up 6% sequentially and 61% year-over-year. For the sequential comparison, recall that Q2 revenue was aided by $2.3 million in non-recurring revenue from a large public sector customer deploying our solution in as a private cloud. From a geographic perspective, for the quarter, Americas represented 51% of revenue, EMEA was 41% 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 55% year-over-year to $85 million. As a reminder, our contract terms are typically 1 to 3 years, and we primarily invoice our customers 1 year in advance. Excluding upfront greater than 1 year billings in both periods, billings growth was over 60%. Total backlog, which represents remaining performance obligations, was $497 million on April 30, up 63% from $305 million 1 year ago.

Please keep in mind that next quarter, we'll have a difficult comparison with a large public sector deal that closed in Q4 2018. This deal added $16.5 million to billings and $26 million to backlog in the July quarter, which will pose a difficult year-over-year comparison in Q4.

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 April 30. This compares to 120% a year ago and 118% 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. Given these factors, we feel 118% is outstanding and will vary quarter-to-quarter.

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

Turning to operating expenses. Our total operating expenses increased 18% sequentially and 38% year-over-year to $58.9 million but decreased on a year-over-year basis to 74% of revenue. The sequential increase in operating expenses is primarily due to increased headcount, compensation-related expenses, marketing expenses and professional fees. We increased our head count in Q3 by over 110 employees, and approximately 40% were in sales and marketing.

Sales and marketing increased 17% sequentially and 37% year-over-year to $38.8 million. The increase is primarily due to headcount increases, compensation-related expenses and marketing expenses.

R&D was up 15% sequentially and up 30% year-over-year to $12.3 million as we continue to invest to enhance product functionality and to offer new products. G&A increased 32% sequentially and increased 43% year-over-year to $7.8 million. The growth in G&A includes investments in building our teams, compensation-related expenses, professional fees, including acquisition-related expenses. G&A expenses exclude $6.2 million in litigation-related expenses, including the settlement of the Finjan lawsuit.

Our third quarter operating margin was a positive 8%, which compares to a negative 6% in the same quarter last year. Net income for the quarter was $7.4 million or non-GAAP earnings per share of $0.05. We ended the quarter with $353 million in cash, cash equivalents and short-term investments. Free cash flow was positive $4.6 million in the quarter compared to positive $3.7 million for the same quarter a year ago.

Please keep in mind in the quarter, we made a payment of $7.3 million to settle the Finjan lawsuit, and we had a positive impact from our ESPP program, which contributed $4 million to our free cash flow. The ESPP program does not impact our 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 fourth quarter, we expect revenue in the range of $81 million to $83 million, reflecting year-over-year growth of 44% to 48%; operating profit in the range of $0 to $2 million; income taxes of $700,000; and earnings per share of approximately $0.01 to $0.02, assuming 138 million common shares outstanding.

For the full year 2019, we expect revenue in the range of $298 million to $300 million or year-over-year growth of 57% to 58%; billings in the range of $379 million to $381 million or year-over-year growth of 47% to 48%; operating profit in the range of $17 million to $19 million; income taxes of $2.2 million; and earnings per share in the range of $0.16 to $0.18, assuming approximately 136 million common shares outstanding.

The acquisition of Appsulate is expected to have little to no impact on revenue either in Q4 or fiscal '20 as we are primarily acquiring technology and the development team. Our plan is to further develop this technology and incorporate it into our platform. The deal was all cash with a purchase price of approximately $13 million. We expect to incur approximately $7 million to $9 million in additional operating expenses in fiscal '20 related to the acquisition and to build up new services.

As reflected in our guidance, I would emphasize that our plans are not to maximize profitability or generate additional operating leverage in the near-term but to invest aggressively in our business to pursue our significant market opportunity. We plan to continue to invest in our sales organization and marketing programs as well as increase investments in our technology platform and cloud infrastructure. We're very proud of what we've 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 to secure cloud transformation. The right architecture for security cloud matters. On-premise, single-tenant architecture, whether deployed as appliances or as virtual machines in a public cloud will not allow enterprises to fully realize the benefits of cloud. These imitators cannot scale, leave gaps in security, are expensive and deliver poor user experience. With multiple tailwinds such as SaaS adoption, SD-WAN and application migration to public clouds, we believe the market is coming to us.

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 Credit Suisse.

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

Jay, Remo and Bill, congrats to you and the team on another great quarter. I mean 55% billings growth, over 60% excluding upfront deals is truly impressive. My question, Jay, at the risk of getting too deep into the technology, and you talked about this briefly in your prepared remarks, but I'm hoping you can help us understand your differentiation versus some of the competitors that are leveraging public cloud partnerships to compete with Zscaler. Why might this make sense or not make sense? And what are you seeing when you go head to head in proof of concept with these types of solutions? Are they able to perform and deliver on all the capabilities that you are?

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

Brad, thank you. Very good questions. Appliance vendors are having to compete for the cloud using technology that wasn't meant for the cloud. So when they are spinning these virtual machines on public cloud and claiming to have presence in 100 locations or more, it's totally misleading. Let me walk through a little bit on how these public clouds work. Google, AWS, they are very large centralized data centers in about 100 locations around the world. They call them regions. That's where applications run. That's where storage and compute actually runs.

Now in addition, they have 100-some locations. Some of them call them points of presence, others call them network edge locations. And these are front doors that collect information so that the thing can be sent to the regions, which are about 20 or so. So these clouds are built to run applications as the destinations, not an in-transit cloud. For example, take AWS data center in Ohio, AWS kind of staying away from Chicago, so the traffic goes there and comes back. Speed of light is speed of light. So the performance can't be good unless you build a cloud that's distributed to handle security to enforcement, hence the response time architecturally can't be good.

The second part of your question was about POCs. We actually don't really do our business through POCs. We are driving top-down cloud transformation through the CIOs. So none of this is impacting us from POCs point of view.

Bill Choi ***Zscaler, Inc. - VP of Investor Relation***

Yes. Brad, I want to clarify that Jay meant to say the true compute on these hyperscale are done on centralized data centers that really number around 20, and the 100-plus are really what they call point of presence or network edge locations. And they're where content is either pushed or, in inspection service like this, backhauled, so it's backhauling collection points.

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

And if I could just follow up one for Remo. Remo, I believe you went through this in your prepared remarks. But on cash flow, I think you might have come in a little bit lighter than some had been expecting, but you did settle the Finjan lawsuit and then there's also, I think, the offset from the ESPP. Can you just walk us through that clearly one more time? And also, as we go out to Q4, how should we think about cash flow seasonality?

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

Yes. Thank you, Brad. So we did pay the Finjan settlement in April for $7.2 million, which had a negative impact on free cash flow. As we've talked about, the ESPP program and once we hold funds from employees for the ESPP program, that's a positive impact, and that was about $4 million during the quarter.

As we go forward and you think about Q4 on a free cash flow basis, if you look at seasonality that we have, our Q2s and our Q4s are our largest quarters from a business and billings perspective. Our Q1s and Q3s are smaller. So the cash flow -- free cash flow impact for Q4 will be impacted by that.

In addition, with the Appsulate acquisition, overall cash flow will decline based on the payment we'll make and we have made in the last few days.

Operator

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

Patrick Colville ***Arete Research Services LLP - Analyst***

Congrats on an amazing quarter. Can I ask you about -- one of your competitors is having a lot of internal issues and just how Zscaler kind of react to that. Does it change your planning? Have you become more aggressive? Does it change the dialogue with customers? How are you guys reacting to your chief competitor being extremely weak at the moment?

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

Thank you for the question. If we were selling a security box or a proxy box in the same channel, looking for refresh opportunities, this will be a big impact. We have always said we have been selling top-down transformation. Our need is driven by applications like Office 365, projects like SD-WAN. So our core business comes from securing new local breakouts, which is a greenfield opportunity. But in almost all cases, when Zscaler is deployed, we end up replacing secure web gateway or web proxy that's generally sitting in centralized locations.

So weak competitors, does it help us generally? Yes. Does it change our sales process? Not really.

Patrick Colville ***Arete Research Services LLP - Analyst***

Got it. Got it. And can I ask about ZPA if possible. I mean that's a product that clearly has a ton of potential and I'd assume it's going to be one of the major growth drivers from here. I mean we didn't talk about that much in the quarter. Is that just because the business is being driven by ZIA right now, and that's where the kind of focus is? Or just any color on ZPA would be awesome.

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

Yes. So while ZIA platform is growing fast, ZPA is growing much faster. But it's hard for ZPA to catch up with ZIA. So if you think about the deals we talked about, a number of our large deals, ZIA, ZPA, they both came together. So we have seen more and more attach rate of ZPAs, and we are very bullish with the opportunity, but it's a relatively new technology in a relatively new market. But we're seeing very, very good traction and bullish about the opportunity.

Operator

We'll now move on to our next question from Alex Henderson with Needham & Company.

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

Was hoping you guys could talk a little bit about the degree to which you have any challenges in hiring of salespeople, what the environment looks like and how much of the spending is going into new hires to drive future growth. It seems like given the difficult market out there that, that may be a challenge to continue to scale at that rate. Is that an issue that we should be concerned about?

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

It is a competitive environment, Alex. This is Remo. However, I think we are doing well on the hiring front. It's something that we are investing in significantly, we're not giving out what our RSM count is. However, when you take a look at sales and marketing headcount, it remains in the 40%, 45% range of our total company head count. This last quarter, we added over 110 employees, approximately 40 were in sales and marketing. In some of the regions, it's easier than others. And I had a conversation with one of our VPs this morning who's bullish related to hiring.

So I think that Zscaler being a public company for about a year now as well as the momentum that we're having as well as the market continuing to come to us, with our performance, I think we're getting more visibility. And we're hopeful that we're going to do a good job in hiring our sales and marketing people as we continue to go forward.

As Jay mentioned, our focus is sales and marketing. In addition, we're a technology company. So we're looking to continue to do development through tuck-in-type acquisitions as well as growing our R&D organization.

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

So when you think about the sales expansion, are you starting to see any leverage as a result of increased recognition or other variables that would allow the productivity of your sales teams to start to see higher deliverables on a per capita basis?

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

Yes. For our tenured salespeople, we're certainly seeing that they're doing well on a quota basis. Overall, when we look at year-over-year, take a look at the sales productivity in Q3 of 2018 versus Q3 of 2019, absent anything related to the one-time large deal, the sales productivity is flattish to up, which is what we planned for, for the year. The reason for that is that we're trying to aggressively hire. We see this as a large market opportunity, and we understand that it comes down to execution.

From our perspective, we have the product, the market is there, and the need is there. Really, from our perspective, we just need to continue to hire salespeople, solution architects, CXOs and also to build our support organization to support the product both from a personnel perspective that support people, professional services as well as in our cloud operations.

Operator

We'll move on to our next question from Saket Kalia with Barclays.

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

Maybe first for you, Remo. First of all, thanks a lot for the updated billings guidance. You spoke about in your prepared remarks last Q4, we had a large multiyear upfront deal that swayed the sequential growth. Can you just talk about what sort of typical Q4 billing seasonality looks like if you exclude those maybe historically? And the corollary to that is can you just talk about the overall pipeline for multiyear upfront deals in general?

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

Good questions. So when you take out that public sector deal out of Q4, you look at the guidance that we are giving for this Q4, it implies a billings guidance of 46% to 48%, which is consistent to our revenue guidance, 44% to 48%. So typically, Q4 as you mentioned, is our strongest seasonal quarter, and Q2 and Q4 are our top 2 quarters.

From a pipeline perspective, we don't comment what our pipeline is. We take a look at things related to what we feel may be multiyear-type deals. Our methodology related to the guidance that we have given has not changed. So we feel that the guidance that we have, when you take out that large upfront deal from last year, at 46% to 48% on a year-over-year basis is very good.

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

Got it. Got it. Maybe for you, Jay, just to learn a little bit more about the ZPA offering. I guess the question is, do the number of subscribers for ZPA differ versus ZIA, in a typical deal that is? ZIA clearly has broad use cases for local Internet breakout. But do those same customers typically subscribe to a similar seat count for ZPA for VPN? Or is it typically lower? I'm just thinking about some of the examples that you gave in your prepared remarks. It felt like there were some differences in seat counts. Can you talk a little bit to that?

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

Yes. Saket, good observation. As we have always said, for ZIA, when customers buy the platform, they want to protect every employee in the company who goes to Internet or SaaS applications. So hence, it's almost always all employees. When you look at ZPA, it is about access to certain type of applications. So the number of ZPA subscribers is generally lower than ZIA.

If I were to give you a broad range, it ranges somewhere from 10% to 15% of the ZIA users so far. In some cases, if it's VPN replacement, that may be 30%, 40% of the total users. In other cases, it's M&A integration. It may be the number of employees they need to integrate from the company being acquired. So in the short term, the number will be a subset, probably 20%, 30%, 40%, 50% would be the range. But I think over time as everyone moves to the cloud, and you don't have a notion of "I must be in the office to access applications," eventually, everyone will need to use ZPA.

So ZPA starts with smaller number of users and grows over time.

Operator

We'll hear now from Andrew Nowinski with Piper Jaffray.

Andrew Nowinski ***Piper Jaffray Companies, Research Division - Principal & Senior Research Analyst***

Congratulations on another great quarter. I guess I just want to follow up on the billings guidance for Q4 just to make sure I understand this. I know you did have a tough comp. That $60 million deal, as you pull it out, it is in line with your normal seasonality. But you just put up 55% growth off of another very similar difficult comp, and your backlog continues to grow well above your billings growth rate. So I'm just wondering, is there any other factors in there other than just some conservatism that we should consider for the Q4 guidance on billings?

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

We like to be prudent with our guidance, and that's historically what we've done. And we continue to do that.

Andrew Nowinski ***Piper Jaffray Companies, Research Division - Principal & Senior Research Analyst***

Okay. I got it. And then as it relates to your large deals, can you guys give any color on the duration of the large deals that you cited in your prepared remarks and whether that duration of your large deals may be different than some of your other deals? Are they longer or shorter in duration?

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

So historically, for looking at the 4 quarter average for new customers, the duration of those deals has been in the 70% range, which are 3 years or greater. So that's remained relatively consistent since our public offering. So really no change in the duration. Related to the billing timing, from our perspective, we bill annually. And if customers pay upfront for the full 3 years, it's not something we compensate for. It's something done by the customer.

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

Right. So if I may add and clarify. We have never incented our sales force to go into multiyear deals for upfront payment. Multiyear deals generally are annual payments with some exceptions that we call out.

Andrew Nowinski ***Piper Jaffray Companies, Research Division - Principal & Senior Research Analyst***

Okay. That makes sense. Just actually, a quick clarification when you said you're not expecting to generate additional operating leverage presumably in the near term, does that mean on a margin basis or are those absolute dollar basis in terms of the operating expectations?

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

Yes. It's on a margin basis, and we'll be giving guidance on the next call both for the quarter and the full year for revenue, billings and operating profitability. So we'll give more clarity on that. However, we wanted to make that comment. And this is the comment we're staying consistent with since our public offering. We understand that we have a model that is highly leveraged. We know we have the ability to increase operating profitability significantly with 80% gross margin. We know that we can increase free cash flow significantly. That is not our intent. Our intent is to continue to grow the market and have the market come to us.

We strongly feel that we have the best solution in the market. What we need to do is execute. Part of that execution is going to come at a cost, and that cost is spending money or spending funds for R&D, sales and marketing, for branding and to continue to build the infrastructure of Zscaler. Jay and myself both have significant experience related to running companies over the last 34 years.

We have a finger on the pulse, and we are trying to maximize the value of the company for our shareholders, to build the presence of Zscaler, and to increase our market share.

The comment related to operating profitability and free cash flow is that I know it's important from a Wall Street perspective, but from a company perspective, it's important for us to grow the market and become the market leader as quickly as we can. That's our focus.

Operator

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

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

So maybe just a high level. So we've seen some fairly volatile results from the security space this quarter, particularly from more of the on-prem-focused vendors. Obviously, you guys had some good numbers. But just curious, have you seen any change in customer behavior or buying patterns? And then just how do you feel about the demand environment for the rest of 2019 versus last year?

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

Great. Thank you. Good question. Our solution delivers great ROI and lots of savings, which actually makes it very attractive even when the market spend slows down. And secondly, we are driven for helping customers do their cloud transformation, and transformation is a very high priority for CIOs. And our sales process is driven by that. We are not driven by "here's another security product that need to be sold, need to replace, need to refresh." So we aren't really seeing the impact of that slowdown. Remo, you want to add anything?

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

No. That's fine. Thank you.

Operator

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

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

My question more strategically, Jay, as you're talking to customers, maybe talk about how things are changing today versus even 6 to 9 months ago in terms of deals? And then maybe uphill versus downhill, are you getting more inbounds? Obviously, deal size continue to increase. Maybe you can just give some anecdotal commentary there to start off.

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

Yes. So a couple of comments I'll make in that area. A year or 2 years ago when I met with CIO, a number of them would say we're ready for the cloud, but still a good number of them will say we're still thinking, not quite sure. Today, it's hard to find a CIO or a CTO who doesn't want to embrace cloud, but they're worried about how to do it securely and how to do it without messing things up. So clear interest, the market movement is happening faster.

And when they realize that, we have a good solution. Things move faster than they would move otherwise. That's why we've seen a larger deal flow than we were seeing before.

Two, as the number of customers we have in the Global 2000 segment grows, these are large credible companies, these CTOs, CIOs are willing to speak publicly about the benefit they are deriving for security, for user performance, and cost savings. That's helping us quite a bit.

Three, I shared with you a couple of examples where our CXOs from our customers move to new customer, they're able to actually go in and say I'd like to bring Zscaler back. And so pleased with the environment. But as Remo said, we are just heads down focused on execution, but market feels good.

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

Great. When you think about just overall deal sizes and sales cycle, obviously, just given the nature of some of these larger deals, but are sales cycles changing or obviously are they shortening overall in terms of just getting deals closed? Are there any discernible changes that maybe Remo or Bill or Jay, you can comment there?

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

Yes. Good question, Dan. Not really. I mean for smaller deals, it's still 3 to 6 months; larger deals, 6 to 12 months after customers made the decision to go to the cloud and do transformation. From an average deal size perspective, we look at it for customers greater than 3,000 users. We're in the mid-300,000 range. It's increased every quarter, and it did increase in Q3 versus Q2. So we are seeing, from an average deal size, increases every quarter as we did this past Q3.

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

Yes. If I may add, the number of engagements and awareness have gone up. So that's obviously needed for us to deliver big numbers.

Operator

We'll now move on to our next question from Nick Yako with Cowen and Company.

Nicholas Yako ***Cowen and Company, LLC, Research Division - VP & Senior Analyst***

Jay, maybe one for you. There's certainly a growing awareness that legacy networks and security models don't really work in a cloud and mobile-first world, but do you have any sense of where we are in the adoption curve of local Internet breakouts today? And then along those same lines, any color you can provide around the percent of your own customers that have moved to local breakouts?

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

Very good question, Nick. So till SD-WAN initiatives came into market, the only vendor that was pushing for local breakout was Zscaler. So if you want to look at the size of the market of local breakout, our own market share is a good indication of that. We announced, I guess, last year, about 300 of the largest Global 2000 companies were our clients.

Now what percentage of Zscaler customers are doing local breakout was the second question. Actually, the #1 reason we are bought is to do local breakout. Now the customers who haven't done breakout with Zscaler, it's only because they haven't gotten around it, okay? But I would say almost all of our customers have bought us for local breakout.

And if you look at the SD-WAN market, we are one of the big reasons to deploy local breakout. We are the predominant vendor who secures the SD-WAN market. So if I were to give you my guesstimated answer, in large enterprises, that number of customer who have done local breakout is sitting in the mid-teens.

Nicholas Yako ***Cowen and Company, LLC, Research Division - VP & Senior Analyst***

Okay. That's really helpful. And maybe just a quick follow-up. I was just wondering if there are any metrics you guys could provide around ZPA, whether it's customer uptake or percent of revenue or new deals. And if not, then just maybe some of the common use cases you see gaining traction.

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

From a metric perspective, we'll give that on our next call. All I can say is that ZPA is our fastest-growing product, and we're happy with the growth. And we're looking forward to talking about it on our next call.

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

Remo, the metrics you gave last year was 10% of the new and up-sell business we got. And I think at the end of Q4, we'll update on an annual basis where the numbers are.

But your second question was about use cases. Lots of very interesting use cases. On a simple tactical front, replacing remote access VPN is a very popular use case because customers don't like VPN; they're slow. But more importantly, VPNs are a big security risk because they put users on the network. Imagine 5,000 people in 5,000 cities, including some sitting in Moscow or Croatia, they're on your network. VPN needs to be eliminated to make our enterprises and our country safe.

But second use case, big one, access to applications sitting in public cloud like AWS and Azure. Without a solution like ZPA, your users need to go back to data center, which is a choke point and then back to the public cloud. A silly thing to do, but that's what most customers do because that's all they know of.

Third interesting use case, which I used to think will be only a very small number of cases, M&A integration or divestitures. I'm surprised to follow how many companies are being merged and divested, and that's helping. Those are the use cases.

Operator

We'll move on to our next question from Melissa Franchi with Morgan Stanley.

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

Congrats on the quarter. Jay, I wanted to follow up on the Appsulate acquisition. It's interesting that you're adding browser isolation technology. Can you maybe add some more color on how that tech is complementary to what you're already doing from a web proxy perspective? And then what should we expect in terms of the timeline of getting that integrated?

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

Okay. Good. The browser isolation is a relatively new market and it's evolving, and it has special use case in certain verticals where security is very important: financial services, healthcare, maybe defense kind of areas. This, call it feature, call it a module, is very relevant for Zscaler because we're sitting in the traffic path. And simple example could be traffic going to certain known hyper sites. It could go direct using the technology Zscaler is using today. But there may be some unknown and fairly suspicious sites. You don't want all that traffic coming to the user end point, and those type of destinations are funneled through our browser isolation technology. So it becomes very, very complementary and very good fit. So that's the use case.

In terms of integration, what we bought is a young developers team, a very sharp team and a very innovative core engine. And that engine will be integrated into our platform and made sure it scales in the cloud. And that's the work we are doing in coming few quarters. And once we are comfortable with that, we make it available as an offering to our customers.

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

But we're not planning for any revenue -- or very little revenue in Q4 or in our fiscal '20. I think one of the key points is that one of the strengths of Zscaler is we have one code base. And we're putting this on our platform. We're going to integrate it into our platform, which I believe will give us a competitive advantage.

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

Yes. I have seen so many companies who go on a buying spree, and the products never integrate. They may put a UI in front of it, but customers complain about that type of stuff. So our focus of buy good code technology and properly integrate them so it's like one product, a single pane of glass, not just a facade pane of the glass.

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

Okay. That's helpful. And then one quick follow-up. Jay, it's been about a year since the COO role went vacant with the departure of Bill Welch. Just wondering if that role is still open and how you're feeling from a sales leadership perspective.

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

Yes. That is correct. We have retained search. We have lots of good candidates with lots of good interest. It's a very important role for us, and we're being very selective, but we will be filling the role. We are making progress on it.

Operator

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

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

I'm kind of curious if you could talk about the SP, SI contribution to ARR. I have in my notes that it was around 45% around the time of the IPO, so I'm just kind of curious how those channels have contributed to ARR since then.

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

Yes. On a revenue basis, it's a little bit higher. It's in the low-50% range currently. The traditional VARs, distributors in the low to mid-40% range and 2% or 3% direct. All our new business, though, is through SPs and SIs and VARs. We feel that SPs and SIs are very strategic for Zscaler. A lot of our emphasis is being put in that channel. However, we understand the importance of the VAR distributor channel. We plan to continue to invest in that channel as we go forward.

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

Can you talk about the impact that SP might be having on transformation in ZIA and the same thing with SI in ZPA?

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

Yes. SPs, service providers, are the folks who provide network and Internet connectivity to enterprises. So they are our natural partners for the sale of ZIA, and ZIA is a mature market -- sorry, mature offering from Zscaler. And SP channel is fairly mature. Systems integrators have a better fit for ZPA because they are the folks who move internal applications to public clouds. And along with that, we are working with them to bundle our ZPA offerings; so they not only do migration of applications, they also provide a secure and fast access to the customers.

And that's in an early stage. ZPA is young, so is the SI relationship, but we are pleased with the progress we're making in that area.

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

Right. Okay. My final question, secure SD-WAN is an alternative architecture to securing local Internet breakout. Some of the larger networking companies talk about that as a successful use case. Jay, could you just compare and contrast how you view secure SD-WAN versus ZIA.

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

Absolutely. SD-WAN's core thing starts being sophisticated cloud-managed branch 2.0 box that integrates routing and switching that gives you connectivity back to the data center over traditional MPLS or over the Internet. And that's one use case. We don't play into that use case.

The second part of the SD-WAN along with that is to be able to peel off Internet and SaaS-bound traffic at the source at each branch. So we can go direct over a broadband or whatever the connection may be. Now that location, that local breakout must be secured, either you build a local gateway with traditional network security appliances such as firewall, proxies, DLP and the like or you point the traffic to Zscaler ZIA. You can imagine hundreds of branches with solutions that are simply pointing the traffic to us. Now some SD-WAN vendors may say that we will build the functionality in each box. So if you got 1,000 branches, we'll put that functionality in 1,000 branches. This doesn't seem to make sense. The customers want the lightest footprint in each branch. So simply they do the network functionality, point the traffic to the cloud, and security can be done in the cloud. That's why most of the SD-WAN deployments we know of, we are the default platform that secures SD-WAN.

So could we see a few cases where SD-WAN vendor may be trying to add security in the box? In rare cases. But most of the time, it will be done in the cloud, and we are the biggest beneficiary of that.

Operator

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

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

I have one for Jay, and I have one for Remo. Jay, in your prepared remarks, I did notice the coincident of ZPA and ZIA deals has certainly increased over the last 4 quarters. So I'm wondering as, I guess, the de facto Head of Sales, if you have put in place any specific incentives or quota retirement targets from a go-to-market perspective to really drive that inflection in ZPA adoption that you were talking about.

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

Yes. Very good question, Fatima. So first of all, ZPA is maturing. We announced that we made it available over a year, 2 years ago. So obviously, there's more awareness. So it will be natural for us to expect ZPA in more deals. Internally, we do give financial incentives for ZPA sales. So it's a combination of maturity, awareness, well-trained sales team and some financial incentives.

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

That's very clear. And Remo for you, just on the gross margin front. You've been very efficient on your delivery costs. So just from a COGS perspective, you've held the line to show the gross margin -- strong gross margin performance. But I'm wondering if there's any other dynamics that are really enabling you to outperform on gross margins, whether it be pricing leverage or pricing increases within the base or anything beyond the cost front that you're doing that's helping gross margins. And that's it for me.

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

Yes. Thank you, Fatima. I think we just have a very efficient platform, to be honest with you. When you're driving 80-plus percent gross margin with the amount of traffic that we have going through and the amount of security applications that we run, it's got to start with the software and it's got to start with the strength of the platform that we've created.

In addition to that, we do look at pricing. We periodically increase pricing, and that's related to increased usage on the part of our customers, increased bandwidth that they're using. Our cloud operations group is outstanding. We have a very strong cloud operations group, which is very efficient that's created automated tools to help us manage our cloud.

From a technical account manager, professional services perspective, depreciation of capital equipment, those are all things that we manage on a literally weekly, monthly basis. And we stay on top of it. But it really starts with the strength of the platform, with the ability to scale our cloud to a level it is at these types of gross margins. And we're very proud of it.

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

Remo, if I may add. What Remo talked about platform, I would say it's a purpose-built architecture that we built that gives us the biggest advantage. Two, we have a highly optimized software we developed on our own without having to create any royalties to third parties. And third, a new point I'll mention is we have no money to pay to public cloud vendors to run our stuff in those public clouds.

Operator

Thank you. And that does conclude today's question-and-answer session. I would now like to turn the conference back over to Mr. Chaudhry for any additional or closing remarks.

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

Thank you. Thank you for your interest and time. We'll see some of you at the Bank of America Merrill Lynch Conference next week. Otherwise, we'll speak with you at our next earnings call.

Operator

Thank you. That does conclude today's conference. Thank you all for your participation. You may now disconnect.