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EDITED TRANSCRIPT
ZS.OQ - Q3 2022 Zscaler Inc Earnings Call

EVENT DATE/TIME: MAY 26, 2022 / 8:30PM GMT

OVERVIEW:

ZS reported 3Q22 revenue of $287m. Expects FY22 revenue to be approx. $1.078b and non-GAAP EPS, assuming approx. 147-148m fully diluted shares, to be $0.64-0.65. Also expects 4Q22 revenue to be $304-306m and non-GAAP EPS, assuming approx. 146-147m fully diluted shares, to be $0.20-0.21.

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PRESENTATION

Operator

Good day, and thank you for standing by. Welcome to the Zscaler Third Quarter 2022 Earnings Conference Call. (Operator Instructions) Please be advised that today's conference is being recorded. (Operator Instructions)

I would now like to hand the conference over to your speaker today, Mr. Bill Choi, Senior Vice President of Investor Relations and Strategic Finance. Mr. Choi, the floor is yours.

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

Good afternoon, everyone, and welcome to the Zscaler Fiscal Third Quarter 2022 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'll 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 share and 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. We will upload a copy of today's prepared remarks to the IR website when we move to the Q&A segment of the call.

I would also like to inform you that we'll be attending the following upcoming events in June: Loop Software Conference on June 1; Bank of America's Global Tech Conference on June 8; Mizuho Virtual Cybersecurity Summit on June 13; and we will also host an investor briefing focused on our latest innovations at the Zenith Live Conference on June 22.

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 are pleased to report another strong quarter. In Q3, we delivered 63% year-over-year revenue growth, 54% billings growth and 15% free cash flow margins, all while investing for high growth.

While most public SaaS companies are happy to get to Rule-of-40, we again exceeded the Rule-of-70 based on revenue growth and free cash flow margins. With our increased guidance today, we expect to achieve the Rule-of-80 for the full year. We are not only delivering excellent growth, we are also delivering strong profitability. We are disciplined in making investments for innovation and go-to-market scale.

With the breadth and depth of our ever-expanding Zero Trust platform, we can efficiently sell to our growing base of enterprise customers. We believe our clear focus on securing large enterprises makes us the partner of choice for our customers' Zero Trust security journey.

While there are broader macro challenges and economic uncertainties, we have seen an increase in large multiyear commitments for multiple product pillars of Zscaler platform as periods of uncertainty can act as a catalyst for change. This, coupled with growing cyber threats such as ransomware, are driving IT leaders to transform security from castle-and-moat security to Zero Trust architecture.

In this environment, customers cannot risk transformational and mission-critical projects with immature offerings from unproven vendors. As the pioneer and category leader in Security Service Edge or SSE with the widest and deepest offerings, Zscaler is the trusted partner for vendor consolidation, cost savings, increased user productivity and better cyber protection. We are adding new Global 2000 customers at a record pace. In the last 2 quarters, we added close to 80 G2K customers. Now 40% of the Fortune 500 and 30% of Global 2000 companies trust Zscaler to secure their digital transformation. Approximately half of our Global 2000 customers have both ZIA and ZPA, and I am excited to report that ZPA has surpassed over $200 million in annualized revenue.

In Q3, we had significant growth in new $1 million plus ACV deals across major geographies and customer verticals. We are seeing an acceleration in multiyear, multiproduct pillar deals as enterprises are racing to transform their business. We provide a path for large strategic customers to ramp into larger and longer commitments for our entire transformational platform, not just for elements of it. This is driving a strong growth in bookings with the total value of our committed future revenue reaching a key milestone. It has surpassed $2 billion.

Now let me highlight some customer deal wins during the quarter. As I mentioned before, I believe all customers will ultimately purchase ZIA, ZPA and ZDX for all users. This quarter, we have seen ample evidence that customers are buying ZIA, ZPA and ZDX together, providing Zero Trust security for users with fast user experience.

In a new logo win, a global 500 food services conglomerate headquartered in Europe, purchased ZIA ZPA and ZDX for all 100,000 users. Leveraging our globally distributed SSE platform, this customer is consolidating dozens of different vendors point products across hundreds of locations in 45 countries. The customer was most excited about having a single Zero Trust security policy framework for in-line inspection across its business units in every location.

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Given the significant cost savings, up-leveled security and improved user experience across the company, the CEO and CFO signed off on this non-budgeted, 4-year commitment. In addition, they started a paid pilot for our Zero Trust for workloads offering for their sizable AWS footprint, which we are very excited about.

Next, in an upsell deal, a Global 10 oil and gas customer headquartered in Europe, after deploying ZIA and ZPA for 100,000 users, purchased ZDX for all 100,000 employees. ZDX is delivering immediate value by reducing the customer's time to troubleshoot performance issues by 50 to 80%, while consolidating 40 legacy performance point products.

In addition, the customer upgraded to a newly introduced ZPA Transformation bundle that includes browser isolation, application protection and deception services. This is a 4-year deal that increased the customer's annual spend by over 70%. This customer's journey with Zscaler is remarkable. I remember sitting with the chief architect in their office, finalizing the purchase of our ZIA Professional bundle 6 years ago. Since then, the annual spend has increased over 14x to well over $10 million. Next, we look forward to working with them on Zero Trust for Workloads.

In an upsell win, a Fortune 500 bank in Asia that has deployed ZIA for over 50,000 users purchased ZPA and ZDX for all 50,000 employees. This is another example of a large customer buying ZIA, ZPA and ZDX for all users. While the immediate objective for this deal was to replace a legacy multi-vendor VPN infrastructure, ZPA was selected to implement Zero Trust access by establishing an application-level policy, where users connect to specific applications, not to a network, hence, achieving app segmentation without having to do legacy network segmentation.

ZPA did not just replace VPN. It's eliminating the need for the entire inbound DMZ including DDoS protection, app delivery controllers, and firewalls, generating a payback on their Zscaler purchase within 6 months. Because of this substantial ROI, even in a tougher macro, Zscaler can help reduce cost while driving transformation. Our integration with Microsoft's E5 suite across ZIA and ZPA was also an important decision factor for them. This latest purchase more than doubled the customer's annual spend.

ZIA, ZPA and ZDX together form a complete solution to implement Zero Trust for users. Our next immediate big opportunity is Zero Trust for workloads, powered by the same core ZIA and ZPA technology.

Let me highlight a few exciting wins in this area. An existing Fortune 100 financial services customer with ZIA deployed for 60,000 users purchased Zero Trust for Workloads to protect 50,000 workloads spanning across multiple data centers and public clouds. This eliminates the need for virtual firewalls and site-to-site VPNs. This multimillion-dollar ACV deal is our largest workload deal to date and more than doubles the customer's annual spend. The customer now protects both users and workloads under a single policy framework, enhancing their cyber protection, providing visibility and simplifying operations.

Lastly, let me discuss a new customer purchasing all 4 product pillars together. An elite research university purchased our comprehensive ZIA, ZPA and ZDX offerings for 35,000 users and Zero Trust for Workloads for over 3,000 workloads for their multi-cloud environment. Their CIO's top priority is to eliminate the risk of legacy VPNs and lateral threat movement as universities are increasingly becoming a target for ransomware and intellectual property theft. Also, a critical requirement for this win was our Zero Trust platform meeting the criteria of Zero Trust framework as recommended by NIST. We closed this 3-year, 8-figure deal through AWS marketplace. I'm very happy with our continued success in expanding our routes to market via cloud marketplaces.

Next, I'm excited to highlight U.S. federal government where we are having considerable momentum. Driven in part by the President's Executive Order, we are seeing increased interest in our Zero Trust Exchange across all levels of the government. We are excited to help our country dramatically improve our security posture while significantly reducing legacy IT costs. We have the highest level of FedRAMP certifications for ZIA and ZPA.

In addition, ZPA is the only Zero Trust solution with DoD IL5 certification. There are only a select few cloud companies that have this level of certification, and there's no other cybersecurity company at this level. IL5 certification is an important differentiator for us. Let me highlight 2 new customer wins this quarter where this was an important factor.

First, a defense contractor that purchased ZIA and ZPA in a 6-year, 7-figure ACV deal.

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Second, a DoD unit also purchased ZPA for secure access to SAP instances in AWS Gov Cloud.

Two important considerations for our ongoing success in the Federal market are:

First, ZPA is the only cloud security service with FedRAMP High authorization for Zero Trust remote access. We connect users to applications and not to the network, eliminating lateral threat movement, a core principle of zero trust architecture that can't be achieved by next-gen firewalls or cloud VPNs.

Second, ZIA's proxy architecture, which inspects TLS-encrypted traffic at scale, delivering superior security.

Our proven track record running the world's largest inline security cloud makes Zscaler the obvious and trusted partner of choice for governments and enterprises. We now have 288 customers exceeding $1 million in ARR, an increase of 77% year-over-year. We deliver a mission-critical service that requires unmatched reliability and availability for an in-line cloud. There is no compression algorithm for over 10 years of operational experience running such a cloud. An example of our proven scale is that Zscaler processes over 240 billion transactions inline per day, which is more than 20x the number of Google searches per day.

Now, let me share a few observations about our high net retention rates, which has exceeded 125% for the last 6 quarters. We made a number of investments in customer success services, technical account managers, partner services, and certification of partners, which together are driving a faster and greater adoption across our broad portfolio. We have a solid blueprint for accelerating value delivery, which is driving upsells. All of these investments result in happy customers, demonstrated by our Net Promoter Score or NPS of more than 70, which is more than 2x that of an average SaaS company.

Next, let me now highlight our rapid pace of innovation. After having built the most comprehensive platform to provide Zero Trust for users, we are now expanding it for Zero Trust for Workloads. Unlike scores of vendors who offer point products for cloud-native apps, Zscaler has developed a fully integrated CSPM, CIEM and infrastructure-as-code scanning with a common back end and fully correlated, actionable dashboard. Gartner calls this functionality CNAPP, but we have moved beyond CNAPP by integrating the threat and data awareness from ZIA and ZPA. We will be highlighting it and other innovations at Zenith Live, our annual cloud summit next month.

We enhanced our AI/ML engine for ZDX, our fastest-growing new service, to leverage billions of telemetry points from millions of users to improve digital user experience. It cannot only automatically figure out what and where performance issues are but can also provide information about the quality of voice, video and screen sharing due to our integration with Microsoft Teams and Zoom. We have also integrated ZDX with ServiceNow, making customer end user support far more efficient. ZDX also got certified and became available on our Federal cloud.

Our ThreatLabZ security research team is tracking over a dozen APT groups and getting better reconnaissance about their tools and behavioral patterns, resulting in higher order threat intelligence. This specific threat intel, coupled with our massive cloud effect from 240 billion transactions and 300 trillion signals per day, enables Zscaler to deliver better threat protection than other vendors.

Moving beyond users and workloads, we are now bringing Zero Trust to IoT and OT systems, a large emerging opportunity. Today, Siemens and Zscaler announced the availability of an integrated all-in-one solution to accelerate secure access to OT systems. Our joint development with Siemens brings the benefits of Zscaler to factory and industrial control systems. We are thrilled to have Siemens, a long-standing customer, as a development and go-to-market partner.

In closing, in spite of uncertain macro conditions, we continue to see strong demand for our services. We are in a strong financial position, and we will continue to aggressively invest in our business. We are focused on hiring and developing talent and creating a culture that rewards innovation at all levels.

We have grown our global organization to approximately 4,500 employees who are energized by our shared mission to secure the hyper-connected world of cloud and mobility. We grew our total sales and marketing head count by 54% year-over-year, and we remain focused on investing in our go-to-market machine.

In today's competitive hiring market, Zscaler is a destination for top talent. To drive continued growth in hiring and to build on Zscaler's high-performing hybrid work culture, this month, we welcomed Brendan Castle, Google's former global head of talent acquisition as our new Chief People Officer. Brendan has proven experience in building highly motivated and productive teams at scale.

With app transformation already mainstream, network and security transformation is also becoming mainstream, which we pioneered with our Zero Trust Exchange. We believe customers trust Zscaler more than any other provider for securing their cloud journey.

Recent uncertainty in the macro environment is driving customers to accelerate their network and security transformation with our integrated platform, resulting in reductions in cost, complexity and business risk. We are adding a record number of Global 2000 customers, now with 30% of Global 2000 and 40% of Fortune 500 customers trusting Zscaler. These demanding customers are making large multiyear commitments to our platform.

We are not just growing rapidly at any cost, we are also profitable and delivering efficient growth. We will continue our disciplined investment in innovation and growth to capture the large and growing opportunity ahead of us.

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

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

Thank you, Jay. As Jay mentioned, we are pleased with the results for the third quarter of fiscal 2022. Revenue for the quarter was $287 million, up 63% year-over-year and up 12% sequentially. On a year-over-year basis, revenue growth exceeded 60% for the third straight quarter driven by strong customer demand for our Zero Trust platform. ZPA product revenue was approximately 18% of total revenue, growing 87% year-over-year. From a geographic perspective, we had broad strength across our 3 major regions. Americas represented 52% of revenue, EMEA was 33% and APJ was 15%. APJ continues to be our fastest-growing region, with revenue growth of 105% year-over-year.

Our total calculated billings grew 54% year-over-year to $346 million, with billing duration comparable to a year ago and above the midpoint of our normal 10 to 14 months range.

Our remaining performance obligations or RPO, grew 83% from a year ago to $2.216 billion. The current RPO is 49% of the total RPO. Our strong customer retention rate and our ability to upsell the broader platform have resulted in a high dollar-based net retention rate, which was again above 125%.

We had 288 customers paying us more than $1 million annually, up 77% from 163 in the prior year. I'm very pleased with the pace at which we're adding these $1 million ARR customers. We increased by 37 customers in the quarter. The continued strength in this metric speaks to our large enterprise focus and the strategic role we play in our customers' digital transformation initiatives. We added 140 customers in the quarter paying us more than $100,000 annually, ending the quarter at 1,891 such customers.

Turning to the rest of our Q3 financial performance, total gross margin of 80.6% was approximately flat quarter-over-quarter and year-over-year. Our total operating expenses increased 11% sequentially and 70% year-over-year to $204 million. Operating expenses as a percentage of revenue was 71% compared to 68% in the year ago quarter due to a partial return of T&E.

Operating margin was 9% and free cash flow margin was 15%. We continue to expect data center CapEx to be around high single-digit percent of revenue for the full year. We ended the quarter with over $1.66 billion in cash, cash equivalents and short-term investments.

Now, moving on to guidance and modeling points. As a reminder, these numbers are all non-GAAP, which excludes stock-based compensation expenses and related payroll taxes, amortization of debt discount and amortization of intangible assets. We are once again increasing our guidance across all metrics.

For the fourth quarter of fiscal 2022, we expect:

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Revenue in the range of $304 million to $306 million, reflecting a year-over-year growth of 54% to 55%.

Gross margins of 79%. I would like to remind investors that a number of our emerging products, including ZDX, Workload Segmentation and CSPM, will initially have lower gross margins than our core products because we're more focused on time to market and growth rather than optimizing them for gross margins.

Operating profit in the range of $33 million to $34 million. We have more in-person events this quarter, including customer events, Zenith Live and RSA conferences.

Net loss on other income of $500,000.

Income taxes of $3 million.

Earnings per share of $0.20 to $0.21, assuming approximately 146 million to 147 million fully diluted shares.

For the full year fiscal 2022, we are:

Increasing our revenue guidance to approximately $1.078 billion or a year-over-year growth of 60%.

Increasing calculated billings to a range of $1.425 billion to $1.43 billion or a year-over-year growth of approximately 53%.

Increasing our operating profit to a range of $106 million to $108 million.

Increasing our earnings per share to a range of $0.64 to $0.65, assuming approximately 147 million to 148 million fully diluted shares.

Free cash flow of $215 million reflecting free cash flow margin of approximately 20% for the full year. With a revenue growth outlook of 60% and free cash flow margin of 20%, we expect to operate at the Rule-of-80 for the full year.

With customers increasingly adopting the broader platform with longer-term commitments, we plan to invest in capturing our large market opportunity. We have confidence in the durability of our business model, with very high contribution margins after the initial land and proven ability to retain and upsell to our enterprise customer base.

We will balance growth and profitability based on how our business is growing but we'll continue to prioritize growth, which we believe is in the best interest of our shareholders, employees, and customers.

Operator, you may now open the call for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from Andrew Nowinski of Wells Fargo.

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

Congrats on another amazing quarter. I wanted to ask about your Federal demand. Jay, I think you said you're seeing considerable momentum in the U.S. Federal this quarter, which seems to be an uptick from Q2, where I think it was maybe one of the underperforming sectors. So just wondering

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if you could comment on maybe what changed and what caused that uptick in demand this quarter ahead of their usual budget flush in calendar Q3?

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

Andrew, I'll start it. Last quarter, Q2, our federal was low single digit of new and upsell. And in Q3, it was mid-single digit, so definitely an uptick. Also, on a go-forward basis, we do see Federal as being an important contributor to Zscaler. We feel that we're well positioned in the Federal market. I'll let Jay speak more to that.

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

Yes. Andrew, as you know, President's Executive Order is to implement Zero Trust architecture, and it's well aligned. It actually aligns with what we have done. To be success in Federal, you need 2 things. One, you need the right architecture, Zero Trust, which we have. Two, you need FedRAMP certifications. And we have the highest FedRAMP certifications.

And now there's a timing issue as well. White House issued a memo setting a timeline for agencies to achieve Zero Trust architecture within 2 years. These plans are being submitted and more budgets are becoming available. All of this is positive long-term development from our point of view. However, Fed opportunities always take time.

Operator

Our next question comes from Alex Henderson of Needham.

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

I've been listening to a lot of people trying to get into this Zero Trust market. And one of the things that really strikes me is highly differentiated is, one, the policy implementation mechanics are so radically different than what you're doing versus the traditional perimeter defense.

And then second is the sharp increase in attacks that we're seeing in terms of encrypted traffic, received the report today talking about over a 300% increase in encrypted attacks over the last year.

Can you talk to the relevance of those 2 data points, or those 2 concepts, relative to your platform? And how you solve that better than, say, alternative vendors? And, in that context, can you just address Cloudflare's comments that they're getting more aggressive in this space?

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

Yes. Thank you, Alex. So, first of all, Zero Trust implementation. People sometimes build a little VPN replacement, then they call it Zero Trust. What we built with Zscaler Private Access is a platform that replaces the entire inbound DMZ. Literally, you need nothing between Zscaler and the workload and application running. And in fact, on top of that, we further expanded to add browser isolation, app protection, integrate deception, and AI/ML-based policy that can help you do segmentation. It's because of that we're winning ZPA deals big time. So that's one part.

The second part was attacks. So, first of all, for someone to attack, they need to find you. With our Zero Trust architecture, your applications hide behind Zscaler, they can't even find you. The next part of attacks, and this is encrypted attacks, for that, you need a proper proxy architecture that actually terminates connection, look at the packets and everything, decrypt them, find them and take care of them. For that, we have built a very, very highly scalable architecture that sets us apart, that scales like nothing else out there. So it's a combination of these things. With 10-plus years of experience running a massive inline cloud is what sets us apart from others.

Now regarding some of the competitors coming from CDN market or DDoS or DNS market, right, those guys generally have been focused on servers. We start focusing on users to start with. It takes a lot of time and experience to build the richness and breadth of functionality we have built with ZIA, ZPA and associated functionality. I think it will take a long, long time for someone to try to catch us. And we aren't sitting. We are innovating at a very fast pace.

Operator

Next, we have Hamza Fodderwala of Morgan Stanley.

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

So one question for Remo. I'm wondering if you can give us a little bit more color on how you're thinking about the margin trajectory going forward? It seems like you want to continue hiring against the market opportunity that you're seeing. Zscaler has obviously been more of a destination for talent in the last couple of years. And particularly the incentive structure around the stock, a lot of employees have done well. How are you thinking about that incentive structure between cash and stock going forward, given that we're probably going to be in a more difficult equity market in general and just the pace of hiring relative to what you've done in the last couple of years.

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

There are a lot of questions. Yeah, so let me see if I can go through and just kind of give you my view and maybe Jay can tell that also. Currently, we're at the Rule-of-80. That's what we're projecting for this year. And the way we define the Rule-of-80 is our revenue growth and also free cash flow margin. Our free cash flow margin this year, we're projecting to be 20%, it was 20% last year. So we're in a unique position to really take advantage of this market opportunity because we've got significant cash flow coming into the company as well as we're in the early stages of this market.

So we're going to continue to make investments as we go forward. Those investments are going to be across the board throughout the organization, and our goal is to get to a $5 billion ARR company. So we're building the infrastructure in place to do that.

And related to employees and incentives with stock options and just cash incentives. The cash incentives that we talked about on the last call related to the frothy environment, last quarter, with a lot of start-up companies and PE-backed companies having really big packages. So we adjusted our merit to get our employees at market levels. So from a cash compensation perspective, we're in pretty good shape.

Regarding stock. All companies basically have decreased stock prices and what we're doing is we're taking a look at that. No decision is made at this point regarding what we're going to do from a stock perspective.

But what I can say is our stock-based compensation, as we go forward, will decrease as a percentage of revenue. What happens is that when you get to a certain scale as a company and a very large company, their stock-based compensation goes down. We'll follow the same path as the large companies and you'll see our stock-based comp coming down over a period of time.

Regarding the pace of hiring. And again, we're seeing all the things that you're seeing related to the global macro environment. We're not seeing it. From our perspective, we are strategic for our customers. As Jay talked about, our deal sizes are getting large. Our strategic nature and our engagement with our customers is increasing.

So our plan is to continue the pace of hiring. And if we can increase the pace of hiring, we will. Now regarding color related to operating profitability and also growth, we'll put growth. Because #1, we are mindful. Jay and I are mindful of operating profitability, and we're old school, quite frankly. We look at the bottom line.

But we see a huge market opportunity, huge. We feel we're the leader in that market. We will continue to invest, and we'll do it on a prudent basis that we feel is the best interest of our shareholders and our employees.

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

If I may add 2 quick comments to what Remo said, with very high gross margins and unit economics, it becomes easier for us to invest in businesses. Secondly, the hiring environment is actually getting easier. We are hearing of high-flying companies that raise funding and multibillion-dollar valuations last year, they're starting to lay off people or freeze hiring, and companies that are spending to grow at any cost are now starting to slow down.

So we will keep on accelerating our plan because our customers want to leverage Zscaler to accelerate their transformation because they want to be competitive and agile.

Operator

And next, we have Matt Hedberg of RBC Capital Markets.

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

Congrats. Jay, what really stood out to me was the success in large deals and multiproduct sales. I think especially impressive given the partner momentum in some of these large deals. Can you talk about the importance of hyperscalers? I believe you called out one in an 8-figure deal. Is there even more that you guys can do to drive even faster partner contribution? Because it really does feel like that flywheel is really kicking in well.

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

Yes. So the partner momentum comes from 2 sides. One is partners like Microsoft, who have been helping us even without fulfilling through marketplace. That momentum has been leveraged for the last several years, now it has extended over AWS quite a bit. So that's one area.

The second area is being able to deliver orders through cloud marketplace. It is one more channel for us to revenue. Our business through both AWS and Azure has been steadily growing, and these current viewed as a part of a cloud transformation solution. So when it's fulfilled through a marketplace channel, it often comes out of an annual cloud spend that's already committed by the customer with a hyperscaler. So that makes it actually easier in many ways.

In Q3, with one of our largest deals through AWS marketplace. And if you recall, we did a very large deal last quarter through Azure Marketplace, and we are training AWS and Microsoft sales teams. And I think there's a good opportunity to create more leverage. And these are generally larger deals.

So you've seen our momentum in larger deals. In the last 2 quarters, we have added almost 80 Global 2000 companies to our portfolio. I mean that's pretty remarkable, and we don't see any slowdown.

Operator

Next, we have Patrick Colville of Deutsche Bank.

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

Thank you so much for having me on, and I echo everyone else's congratulations on a very impressive set of numbers. My question is on the billings guide, which to me was probably the standout metric of the quarter. And I think above probably where many investors were expecting, so very healthy there.

Can you just talk to what you guys are seeing in the pipes for fiscal fourth quarter, and the health that, I guess, you underline the confidence to give that strong billings guidance for the fiscal year?

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

Yes. I'll start it. And Jay, if you'd like to contribute anything. We have a strong pipeline. As we talked about, we're becoming more strategic. Our deal sizes are getting bigger. We review our pipeline with our sales organization. And based on our projections, we did give a strong guide, Patrick, which is basically up 6%, basically guide up. The key thing is that with the world that's changed, and it's been this way for a while, with applications in the cloud and users are mobile and workloads, both in the cloud and on-prem and other locations. The platform Zscaler created really addresses this market head on.

Also, the efficiency that we create for customers at a very attractive ROI. It's really what stands out. And so we're seeing with large customers that adopting more of the platform, as Jay has talked about, we're seeing that. So it is basically a review of the pipeline and review what we feel we're comfortable to guide to.

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

Yes. So I think what Remo said, our projection is always take into account our pipeline, our customer engagements. But at a qualitative level, as I talk to lots and lots of CIOs and CISOs, I mean there is a sense of uncertainty out there. And they're beginning to think about: how do I do my cost and complexity reduction, my consolidation. And that's where we start becoming pretty important. And for that, customers are driving transformation. We help them with it. On top of that cyber is a big issue.

So when you bring all these things together, we become more important for them, and they start a discussion with, "Jay, what all security products and networking products can I replace with you?" And now we are able to actually talk about a bigger set of products that need to be removed, which actually leads to a bigger part of platform to be bought.

Now, on top of that, it's interesting to see certainly on the high-flying private start-up companies, which would talk about all kinds of staff hiring, how many employees, all that stuff is getting tempered down. That means the unnecessary noise in the market, it's expected to slow down. And it's fascinating to see people calling us from those start-ups already. So we are bullish about the business.

Operator

Next, we have Joel Fishbein of Truist.

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

I'll echo the congrats on the great execution this quarter. Jay, I just want to ask about workload segmentation. I know it's early days. You're very excited about it and have some good uptake. I'm really interested in go-to-market around workload segmentation and actually IoT and OT. It doesn't seem like they're natural. They have different buying centers inside of organizations than ZIA, ZPA and ZDX. Love to hear how you're going to plan to go to market there and increase deal sizes around those specific areas.

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

Very good question. In Q2, we talked about how a number of our large customers are beginning to buy workloads, our Zero Trust for Workloads, but at a small scale. This last quarter, we start to see them actually buying some very large orders in this area. So that's very encouraging.

Now, in terms of the buyer and the products, the cloud protection products can be put in 2 broad buckets. One, what Gartner now calls CNAPP, is a collection of CSPM, CIEM type of stuff. It's API-based security. It's a new area for everyone. It's simpler to build, and we have a very good offering in that space. We revamped our CNAPP offering, which we'll be launching at Zenith Live next month.

And parallel with that is Zero Trust for Workloads, which is taking ZIA and ZPA technology and making it available for workloads, because workloads need to talk to Internet. That goes through ZIA engine. They need to talk to each other, which goes to ZPA engine. This is bringing Zero Trust to workloads. Bringing the 2 together, inline piece of it and API piece of it, sets us apart from any other vendor in the market out there.

Regarding buying centers, if you really look at it, if we were selling at a lower level, buying will be very different. No matter who buys the product, when it comes to security part, CISO is definitely involved. So our good relationships with CISO are helping us with Zero Trust workload and cloud protection. Our relationship with Head of Networking are helping us, because in the old world, you are extending your data center to cloud with all these dedicated links out there.

The area we are developing and building more relationship is the DevOps side of it. But since CISO relationships are strong, it is helping us.

We are not creating an overlay team, but we do have product specialists. You need overlay teams when you're selling point products at low level. When we have been selling platform at a high level, I don't need to overlay teams. I do need product specialists, which we are hiring to work with our broad sales team. Did that help?

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

Very much. Thank you so much.

Operator

And next, we have Fatima Boolani of Citi.

Fatima Aslam Boolani - *Citigroup Inc. Exchange Research - Research Analyst*

Remo, this one is for you. In Jay's script, a lot of anecdotes around the multi-land transactions in the 8-figure deal momentum in the $1 million customer momentum. So what I wanted to ask you was just from a booking standpoint, I think you've called out that you are seeing a bigger multi-year commitments from some of your customers.

So we're certainly not seeing that impact on billings in terms of your invoicing duration. But I'm curious if you can comment or share any sort of observations on your backlog. And if there's any duration impact in there that we should be thinking about more critically? Thank you.

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

Yeah, that's a great question. If you take a look at our RPO and CRPO growth on a year-over-year basis, those are committed deals. Our RPO growth was 83% and our CRPO growth was 75%. Related to duration, the duration was comparable on a year-over-year basis. There's no headwinds. We expect duration to be in that 10 to 14 months range.

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So, I mean, the key things from billings. Billings is calculated billings, which is calculated off of deferred revenue, so that's what we actually bill. But we look at the RPO and CRPO growth rates. RPO is 83% and CRPO is 75% growth rate on a year-over-year basis.

Now having said that, even though those metrics are outstanding, we still feel that billings is the best measure for Zscaler, because we found that duration period from 10 to 14 months. So I hope that answers your question. I believe that answers your question. But the actual commitment that customers are making to Zscaler is quite impressive.

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

And Remo, if I may add one thing. This is an outstanding quarter from lots of customers doing multi-product pillar deal for multi-years, which is very exciting.

Operator

Next question comes from Ben Bollin of Cleveland Research.

Benjamin James Bollin - *Cleveland Research Company LLC - Senior Research Analyst*

Good afternoon, thank you for taking the question. I wanted to go back to the topic around cloud marketplaces. Remo, can you quantify how much of the business is being transacted over cloud marketplaces today or how that has evolved? And then also interested in any way we should think about the margin implications of that business versus other sales channels. Thanks.

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

Yeah. I mean, not much business, currently, going through cloud marketplace. There is business going through, but we see that as a very important channel for us. And related to margin, we expect good margins through cloud marketplace.

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

Yeah. But one thing that business through cloud marketplaces has been steadily growing over time. So that is very good. For us, I don't think the driver is what's the fulfillment channel for us. I personally care about partners who actually helped me with strategic sales to the customer. When Microsoft's account execs and Zscaler's account execs are able to sit together with the CIO and talk through a large deal, it is extremely useful.

But it does help to get the cloud hyperscalers' sales team more engaged, because they actually do compensate it for the business that flows through cloud marketplace. So we actually are putting more focus on training AWS and Microsoft sales team, so, which helps them and helps us.

Operator

And next, we have Tal Liani of Bank of America.

Tal Liani - *BofA Securities, Research Division - MD, Head of Technology Supersector & Senior Analyst*

I have 2 questions. One, in general, I get this question a lot from investors. I'm trying to understand an economic slowdown, what's the impact on your business? It's a little bit of a philosophical question, but it's a question we're being asked a lot, and I would like to hear your view on this topic.

And second, we are at times of focus on cash flow and margins. And I look at your operating margin in the last 4 quarters, it went down from 13% to 8.7% in the previous quarter. And this quarter slightly recovered. And at the same time, your revenues went up by 50%, give or take. So we don't see much leverage on the margin.

And the question is if I pass forward 2 to 3 years, if I think about margin leverage and what needs to happen for you to have serious margin upside. Can you talk about the pros and cons of your operating margin?

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

I'll start with that. We absolutely do have leverage in the model. In a SaaS model with 80% gross margin, growing at the scale that we're growing, we absolutely have leverage. What we talked about is that, with this large market opportunity, it would be a disservice to our shareholders and our employees if we try to drive top line operating profitability at this stage.

Having said that, when you take a look at our free cash flow margin, last year, it was around 20% or over 20%. And we're projecting free cash flow margin this year at 20%. So when you have that kind of free cash flow margin at the scale that we are, making the investments that we're making, in the position that we are as a company, in this very large market, there's no better use of our cash for our resources than investing in the business and really executing and trying to drive our top line growth.

Having said that, we will be mindful, we will be mindful. If we wanted to drive operating profitability, it doesn't take much. But with our free cash flow margin where it is, we're very, very comfortable.

Now, from an economic slowdown perspective, security is important. The attacks are going to keep coming, and they're probably going to increase.

Also, companies going through this downturn have to find areas to save money. We are efficient. Our ROI is absolutely outstanding. It is significant ROI with the highest level of security down to the deepest level. And so from an economic slowdown perspective, we are not seeing it currently.

Now can that change? It can. But right now, based on our pipeline, based on what we're seeing, and what we talked about, we're going to continue to hire at pace.

Jay and I, as I mentioned before, have a lot of experience. We've seen 3 or 4 downturns actually in our lifetime, our careers. Zscaler is different. And we feel we're in a great position. We will take things into account, all things and driving operating profitability at this stage, we will increase operating profitability as we go. But we're going to be also trying to drive that top line growth. Jay?

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

Yes. Two quick comments. First of all, I do believe there's uncertainties helping us because we are going to help customers with cost reduction and complexity reduction. And on the other side, our flagship ZIA and ZPA products, they have reached significant scale and are generating good margins. But we are reinvesting that to drive the growth of new products. We have proven that when we brought ZPA on, we made it successful. You've seen we brought ZDX on. We're making it successful. It's growing even faster than ZPA did, and we have high expectations from workload protection as well. So I think with such a large platform, we expect that we'll keep on growing fairly efficiently.

Operator

Our next question comes from Roger Boyd of UBS Securities.

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

Congrats on the results. Just a quick question on SD-WAN. Historically, you've had some success tied to adoption there. I know Zscaler is agnostic to how customers ultimately onboard to the Zero Trust Exchange. But with some of the SD-WAN vendors facing some disruption and share losses and potential change of ownership, how do you think about those changes in terms of potential opportunities or risks?

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

Yeah. Before COVID came in, Zscaler used to start with, let's do network transformation. When COVID started 2.5 years ago, SD-WAN went out the door, there's nobody working in the branch office and customers start to roll out Zscaler by downloading a lightweight agent and here it goes. So with that, the role of any network or SD-WAN became really insignificant.

Today, most of our customers roll it out or laptop, mobile with a lightweight agent. They can work from home, they can work from office with SD-WAN, without SD-WAN. So we'll stay neutral to supporting SD-WAN vendors. Our sales processes are no longer led by SD-WAN. If a customer says, I'm rolling out SD-WAN, we are generally the preferred choice, and that's how we see it. So we don't really see any changes in the SD-WAN marketplace impacting us.

Operator

Our next question comes from Joshua Tilton of Wolfe Research.

Joshua Alexander Tilton - *Wolfe Research, LLC - Research Analyst*

I don't believe you mentioned it in the prepared remarks. But can you talk about any impact to the business you're seeing, either positive or negative, from the Russia/Ukraine prices?

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

Yeah, Russia, Ukraine. It was a bigger thing a quarter ago. I decided years ago not to sell in Russia. Hence, we do not have any revenue exposure in Russia or Ukraine, but cybersecurity is a global threat. It's not a regional threat.

Our threat research team is tracking heightened cyberthreat environment, which is making every CIO and CISO more nervous in this area. So this is driving the adoption of Zero Trust architecture, and it is increasing our engagement with customers. More so in Europe, actually European customers are more worried about it while Americans are, too. So we have some very large deals in Europe this quarter, including a couple of them I highlighted. We don't really see any negative impact of this conflict, and we remain engaged with our customers to drive the transformation. They want to become agile, competitive. We play a role there and then cyber on top of that. So I don't see any negative impact.

Operator

The next question shall come from Rob Owens of Piper Sandler.

Robbie David Owens - *Piper Sandler & Co., Research Division - MD & Senior Research Analyst*

I wonder if you guys could drill into the Siemens partnership a little bit. And I guess, Jay, more broadly, what you see is the opportunity in OT from where you sit?

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

OT plants and factories have been slow in changing. Typically plants take their own time, but all these critical infrastructure attacks and cyber threats have made it a priority. Vendors like Siemens are big providers of OT systems out there. They see this as an opportunity for really providing, or should I say, taking fiber and VPN-based security of OT systems to Zero Trust-based security, where you no longer connect these OT networks and IT networks, where you no longer need remote VPN to activate systems.

So Siemens has worked with us over the last year or so. They essentially chose us as a partner, we did joint development where we made our technology available on their hardened OT systems, and this combined solution of Siemens and ours is not available through our customers out there. So I think it's a good opportunity for us. I think it's a matter of time when all IoT OT systems will embrace Zero Trust, and we are positioned well for that opportunity.

Operator

And this concludes today's Q&A session. I should turn the conference back over to your CEO, Jay Chaudhry, for closing remarks.

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

Thank you. I want to thank you all for your continued interest in Zscaler. I also want to thank Zscaler employees, customers, and partners for delivering a strong quarter. We look forward to seeing many of you at Zenith Live, our annual cloud summit. Thank you.

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

Thank you.

Operator

This concludes today's conference call. Thank you all for participating. You may now disconnect, and have a pleasant day.

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