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ZS.OQ - Q3 2018 Zscaler Inc Earnings Call

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JUNE 06, 2018 / 8:30PM, ZS.OQ - Q3 2018 Zscaler Inc Earnings Call

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PRESENTATION

Operator

Welcome to the Zscaler Third Quarter 2018 Earnings Conference Call.

Today's conference is being recorded.

At this time, I would like to turn the conference over to Bill Choi.

Bill Choi - Zscaler - VP, IR

Thank you for joining us to discuss Zscaler's financial results for the fiscal third quarter 2018. 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 Web Site in the Investor Relations section. In addition, a supplemental financial schedule was posted to our Web Site 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, operating performance, gross margin, operating expenses, net loss, pro forma net loss per share, free cash flow and dollar-based net retention rate.

These statements and other comments are not guarantees of future performance, but rather are subject to risk and uncertainty, some of which are beyond our control. Our actual results may differ significantly from those projected or suggested in any forward-looking statement.

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.



JUNE 06, 2018 / 8:30PM, ZS.OQ - Q3 2018 Zscaler Inc Earnings 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 Web Site for a reconciliation of GAAP to the non-GAAP. For historical periods, the GAAP to the non-GAAP reconciliations can be found in the supplemental financial information referenced a few moments ago.

We would also like to inform you that we will be participating in the Bank of America Merrill Lynch Conference in San Francisco tomorrow on Thursday, June 7th.

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

Jay Chaudhry - Zscaler - Chairman, CEO

Thank you, everyone, for joining our first earnings call as a public Company. I'd like to thank our customers, partners and investors, who have been essential to our success to date. I'd also like to recognize the employees at Zscaler who have been instrumental to our growth and success.

I am pleased to share our strong third quarter results with you today. We posted strong revenue and calculated billings as we continue to experience rapid growth in our business with total revenue growing 49% year over year to \$49.2 million and calculated billings for the quarter growing 73% year over year to \$54.7 million.

In addition to our top line growth, we had healthy operating performance. Our operating margins improved nine percentage points year over year, and we generated positive free cash flow for the quarter.

We believe these results demonstrate Zscaler's increased adoption in the marketplace as organizations embrace cloud transformation, as they are increasingly relying on the internet and cloud for business. They're adopting new SaaS applications such as Microsoft Office 365 for critical business functions and moving their internal applications to the public cloud.

Cloud transformation is breaking the traditional perimeter-based security appliance-oriented approach. In the traditional architect, organizations built hub-and-spoke network to backhaul branch office traffic over dedicated wide area networks to the data center in order to apply security checks and access controls. Then they built a mode of security appliances that established a perimeter around the corporate network to secure the network. That's why we call it network security.

In the cloud world, where the perimeter has disappeared and the internet is becoming the corporate network, where would you deploy security appliances? Our cloud platform eliminates the need for traditional on-prem security appliances that are difficult to maintain and require compromises between security, cost and user experience.

Zscaler security cloud is a purpose-built, multi-tenant platform deployed across 100 plus data centers globally that secures access for users and devices to applications and services, regardless of their locations.

Zscaler delivers advanced security and policy enforcements no matter where the users are, connecting users to the nearest Zscaler data center, hence taking the shortest path to the application. Compute, storage and applications are moving to the cloud which requires a fundamental change to the network architecture and security.

In a cloud and mobile first world where applications are in the cloud and users are everywhere, security needs to be done in the cloud. We have the opportunity due to replace the inbound and outbound gateways of a traditional castle and moat security.

Based on our analysis using IDC data, \$17.7 billion annually is spent on various security appliances to perform the functions we offer in our platform. Additionally, deploying Zscaler results in reduced spend on bandwidth and network equipment costs.



JUNE 06, 2018 / 8:30PM, ZS.OQ - Q3 2018 Zscaler Inc Earnings Call

We believe we are the solution to secure the cloud-first mobile-first world. We have 10 years of operational experience running our security cloud at scale. We process in excess of 45 billion internet requests per day during our peak periods.

Each day, we detect and block over 100 million threats and perform more than 120,000 unique security updates. This cloud effect delivers far superior security than traditional appliances for all of our customers.

In Q3, we saw strong growth in our platform adoption. Broadly speaking, Zscaler platform offers two complementary services. First, Zscaler Internet Access or ZIA for secure and fast access to SaaS applications and the internet. ZIA is designed to ensure malware doesn't reach the user and valuable corporate data does not leak out.

Second, we have Zscaler Private Access or ZPA for secure access to internal applications in enterprise data centers or the public cloud. ZPA connects a specific user to a specific application based on business policy without bringing the user on the network resulting in better security while delivering the best user experience. This is how enterprises want to access applications on the public cloud without having to go through their data center.

I would like to highlight a few noteworthy new customer wins in Q3. A Fortune 500 medical equipment Company with headquarters in the U.S. purchased our transformation bundle that includes Cloud Firewall, Sandbox and Data Loss Prevention or DLP for 40,000 users and ZPA for 30,000 users.

This customer is embracing a move to the cloud-first approach and is deploying Office 365. A key driver for this customer was to securely enable network transformation which will deliver a good user experience while reducing MPLS networking costs.

The cost effectively and efficiently provided superior security across a large number of office locations. While they're keeping the data center firewalls for protecting their servers, all traffic headed to the Internet and SaaS applications from all locations goes through Zscaler's Cloud Firewall.

For ZPA, the driver was to integrate a new acquisition rapidly and securely. M&A is an elegant use case for ZPA. Rather than connecting two complex networks together which can take nine to 12 months or more, ZPA can provide secure application access based on business policy across both companies in days.

A European global bank purchased business bundle with SSL Inspection and DLP for over 70,000 users, driven by the business moving to Office 365. The customer needed a modern cloud security platform that included a best-in-class DLP.

We worked closely with the service provider partner who will manage the Zscaler service for this customer and enabled the customer to have a compliant solution for the stringent EU data privacy requirements. Additionally, this SP now offers Zscaler as a part of their managed service to other customers.

In summary, we are making significant progress in winning new enterprise customers across various verticals. We also had a number of notable upsell wins in Q3. A Fortune 500 tech Company, which purchased our transformation bundle for 20,000 employees and contractors just six months ago, purchased an additional 25,000 seats and now have all 45,000 employees protected by Zscaler.

They also purchased Zscaler DLP module. The driver for this deal was migration from an on-prem HR application to a SaaS application. Zscaler worked closely with the systems integrator partner to win this project and to ensure secure access to internet and SaaS applications.

Now, I want to share an example of a deal where the customer simply wanted to replace an existing on-premise web proxy due to budget constraints. This is a global 500 IT services and products Company in Asia that purchased our entry level professional bundle for 10,000 users in Q2.

In Q3, they expanded the same bundle for over 130,000 users domestically. Recognizing that threats often hide behind SSL, they also purchased SSL Inspection functionality.



JUNE 06, 2018 / 8:30PM, ZS.OQ - Q3 2018 Zscaler Inc Earnings Call

Here is an upsell to a long-term customer, a Fortune 200 professional services Company that has been a customer since 2014 for 10,000 North American users, decided to purchase an additional 28,000 licenses for its international users.

In conjunction with the expansion, they upgraded from business bundle to the transformation bundle and DLP. They also purchased 10,000 ZPA licenses.

We believe these upsell examples demonstrate the continued adoption of the Zscaler platform by our existing customers as they increasingly rely on us for their transformation journey. Our dollar-based net retention rate in Q3 was 120% and was driven by upsell activity for a high-end transformation bundle, which includes the Cloud Firewall and Sandbox functionality.

Recently, I spent 10 days on the road visiting our customers, partners and field officers in Japan, India and France. I came back from that trip more excited because the level of engagement we're having with CxOs and large service providers and systems integrators.

We feel the world is coming towards us. I will highlight three key trends. Number one, an increasing adoption of SaaS applications and Microsoft Office 365 in particular; number two, SDRAM projects that transform the legacy hub-and-spoke network; and number three, application migration to public cloud by AWS, Azure and Google.

With these secular trends as tailwinds, our focus is on our execution. We have a strong team in place to execute our vision. Following the departure of our COO, I have spent the past month engaging even more closely with our sales teams and sales leadership.

With strong sales leaders in place for Americas and international markets, I am confident that our momentum will continue. We're investing in our unique go-to-market capabilities, which enable us to sell top down at C level.

A strategic advantage for us is the channel partnerships with large SIs and global SPs. We will continue to train and enable our partners to create leverage and accelerate our sales.

I mentioned that I also visited our India office on my trip last month where we have one third of our employees. Our talented staff in India keeps our business running smoothly for 24 by 7 coverage for customer support, cloud operations and development.

In summary, we are pleased with our results this quarter and we appreciate your interest in Zscaler. We're at the beginning of a significant market opportunity and look forward to reporting our success in the future.

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

Remo Canessa - Zscaler - CFO

As Jay mentioned, we're very pleased with our results for the third quarter. I'd like to start with the brief overview of our financial model then I'll go through our fiscal third quarter results before moving to our guidance.

Zscaler has demonstrated strong revenue growth. Our cloud subscription platform provides visibility and predictability and also allows for attractive gross margins. We recognized subscription revenue ratably over the life of contracts, which is generally one to three years. Our subscription pricing is calculated on a per user basis.

Our gross margin was 81% for the quarter. We were able to achieve a high gross margin because our security platform is based on a purpose-built, multi-tenant architecture that is optimized for high throughput, which reduces our capital expenditures, bandwidth and operational costs.

Our cloud operations are also highly automated and our ability to peer with leading internet exchanges also reduces our expenses. We focus our sales and support resources on marginal prices.



JUNE 06, 2018 / 8:30PM, ZS.OQ - Q3 2018 Zscaler Inc Earnings Call

Our channel strategy provides us with significant reach and leverage and potential for meaningful operating margin expansion as our business scales. Most security companies sell through VARs and distributors. Our service provider and system integrator relationships give us differentiated access to customers which is relevant for transformational platform.

We had a very strong third quarter and are pleased with the results we achieved. Revenue for the quarter was \$49.2 million, up 9% sequentially and 49% year over year.

From a geographic perspective, Americas represented 46% of revenue and grew 48% year over year; EMEA was 46% of revenue and grew 51% year over year; and APJ was 8% of revenue and grew 49% year over year.

Turning to billings and deferred revenue, we define calculated billings as a change in deferred revenue for the quarter plus total revenue recognized in that quarter. Billings grew 73% year over year to \$54.7 million in the quarter.

This quarter, we benefited from a strong mix of upfront billings of multi-year deals. Even after excluding the upfront billings in both periods, billings would have grown over 60%.

As a reminder, our contract terms are one to three years, and we typically invoice our customers one year in advance. Some customers prefer to pay us upfront for the full contract term. And when looking at our billings for Q4 '18 on a year-over-year basis, please keep in mind, there were a few large deals paid upfront last year.

Our strong customer retention and ability to upsell have resulted in a consistently high dollar-based net retention rate, which is 120% for the trailing 12 months ending April 30, 2018. This compares to 115% a year ago and 122% last quarter. We expect it will vary quarter to quarter depending on the timing and size of upsells and new customer additions.

Our net retention rate is largely based on sales of ZIA product to our customers. Customers can add additional users and move to higher price bundles with more functionality. In addition, ZPA which was released last fiscal year can be additive as a cross-sell to our existing customers. ZPA has similar pricing to ZIA.

Total gross margin was 81%, up 2% compared to Q3 last year and flat sequentially. The year-over-year increase was driven by an increased mix of higher price bundles with more functionality as well as operational efficiencies.

Turning to operating expenses, our total operating expenses grew 9% sequentially and 38% year over year to \$42.8 million. We believe our large market opportunity justifies the investments that we are making.

Sales and marketing increased 9% sequentially and 43% year over year to \$28.4 million. We've been building our sales team to drive growth. We incurred significant sales and marketing costs initially to sell our products and after first year, our sales and marketing costs declined significantly, as our commissions and marketing efforts are concentrated on initial sale.

R&D increased 3% sequentially and 20% year over year to \$8.9 million as we continue to invest to enhance product functionality and to offer new products. G&A increased 27% sequentially and 50% year over year to \$5.5 million. These expenses exclude \$2.8 million in litigation-related expenses. The growth in G&A includes investments of headcount, consulting and other expenses that we have made as we became a public Company.

Our third quarter operating margin was a negative 6% which compares to a negative 15% in the same quarter last year. Net loss in the quarter was \$2.6 million or pro forma net loss per share of \$0.02.

We ended the third quarter with \$287 million in cash and cash equivalents. We raised \$205 million in net proceeds from our public offering.

Free cash flow was positive \$3.7 million in the quarter which compares to negative \$1.8 million for the same quarter last year. We started the ESPP program in March which contributed approximately \$1 million to our free cash flow.



JUNE 06, 2018 / 8:30PM, ZS.OQ - Q3 2018 Zscaler Inc Earnings Call

Now, moving on to guidance, as a reminder, these numbers are all non-GAAP, which exclude stock-based compensation expenses and significant litigation-related expenses.

For the fourth quarter, we expect revenue in the range of \$50 million to \$51 million, gross margins of approximately 80% to 81%, non-GAAP operating loss in the range of \$6 million to \$7 million, non-GAAP taxes of \$500,000, pro forma non-GAAP net loss per share in the range of \$0.05 to \$0.06, assuming approximately 120 million common shares outstanding.

Over the full year 2018, we expect revenue in the range of \$184 million to \$185 million, non-GAAP operating loss in the range of \$19 million to \$20 million, non-GAAP taxes of \$1.5 million and pro forma non-GAAP loss per share in the range of \$0.17 to \$0.18, assuming approximately 110 million common shares outstanding.

In the share count, we assume that the conversion of preferred stock occurred at the beginning of the fiscal year and not upon the effectiveness of our IPO. Recall that our IPO was completed in the middle of Q3 and we issued 13.8 million shares including the green shoe. We are very proud of what we achieved and look forward to building on our opportunity.

Now, I will hand the call back over to Jay.

Jay Chaudhry - Zscaler - Chairman, CEO

I'd like to close with a reminder that we are holding Zenith Live, our Inaugural Customer and Partner Cloud Summit. It will be on June 26 and 27 in Las Vegas. We have an impressive lineup of keynote speakers to talk about the cloud transformation. Hopefully, we'll see you all there.

Operator, you can now open the call for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

Melissa Franchi with Morgan Stanley.

Melissa Franchi - Morgan Stanley - Analyst

Great. Congrats on the quarter, and hi, guys. Jay, so it's clear that there is a lot of secular drivers that's impacting your business today and you've mentioned a few of those drivers. But the acceleration in billings is pretty notable even if you take out the long-term deferred.

I'm just wondering if you can maybe put a finer point on what were like the one or let's say two to three different factors in the quarter that drove that level of acceleration relative to what we've seen in the past few quarters.

Jay Chaudhry - Zscaler - Chairman, CEO

Melissa, thank you. I mean, there's no one or two big deals that are kind of changing it. This is the normal course of business. We are seeing great momentum across the board and that's what has resulted in good billing revenues. Remo, you want to add any color to it?

JUNE 06, 2018 / 8:30PM, ZS.OQ - Q3 2018 Zscaler Inc Earnings Call

Remo Canessa - Zscaler - CFO

No. I agree with Jay. We've got a strong business. We're seeing good momentum across all our geos. All our geos on a year-per-year basis have increased 45% to 50%.

The market we feel is coming to us. We've got tailwinds as we've talked about before, the Office 365 and SD-WAN. It's a good place to be.

Melissa Franchi - Morgan Stanley - Analyst

Okay. Got it. And then I'm just wondering if you can maybe add a little bit more color around the expense which you are displacing, web security gateways which is a pretty obvious opportunity for you. But is that opportunity relative to addressing other areas of security?

I know you gave some examples, but I'm particularly interested if the opportunity to displace firewalls is now a meaningful opportunity or is that still sort of on the con?

Jay Chaudhry - Zscaler - Chairman, CEO

Good question, Melissa. As we said, we really don't lead in with displacing either web security gateway or replacing firewall. Our number one focus is lead with transformation and when you lead with transformation, it's a holistic approach.

It is true that in a lot of those approaches, secure web gateway is often the first party that gets removed because they're looking for internet bound traffic. On the firewall side, as you saw during summary comments, we are selling a number of transformation bundles, which include Cloud Firewall as well as Cloud Sandbox.

Now, we don't go in and say let's replace your firewalls. What happens is, typically, customers have firewall sitting in the main data center and a couple or three for regional data centers.

And believe me, majority of the enterprises still have different branches coming back to the data center. When we do these transformation bundles, let's say there's no firewall, there's no egress point, there's no gateway in most of these branches. It is green field, it is add-on opportunities.

Now, when we replace those, we do end up taking whatever outbound gateway boxes they have in the data center as well. But we aren't really doing head on to say let's remove this. It's quite -- I think we do see some of the retail guys having more local breakout of branch firewalls. But generally, the field is clearly wide open for us and we're going as green field add-on in most of the cases.

Melissa Franchi - Morgan Stanley - Analyst

All right. Okay. Awesome. Thank you.

Operator

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

Gabriela Borges - Goldman Sachs - Analyst

Hi. Good afternoon. Thanks for taking my question and congrats on your results. Either for Remo or for Jay, I remember coming into the year, you all have thought that it was prudent to assume productivity goes down with some of the sales force because you were hiring at an elevated pace.



JUNE 06, 2018 / 8:30PM, ZS.OQ - Q3 2018 Zscaler Inc Earnings Call

How you're feeling about the productivity of the sales force at this point? Are you close to normalized levels and then how do you continue focusing around things? Thanks.

Jay Chaudhry - Zscaler - Chairman, CEO

Our productivity is essentially flat to slightly up. As you mentioned, we are hiring at a fairly rapid pace and we do expect productivity to get better as average tenure increases.

And as we are driving the strategic and transformation sales, our price points are going up that actually also helps us increase our productivity. Remo, do you want to add things to it?

Remo Canessa - Zscaler - CFO

Yes. So, basically, also, we're in the early stages relative to the acceptance of our product and our penetration. As Jay mentioned, our sales productivity on a quarter-over-quarter basis has been relatively flat. We would expect that to go up over time. However, what we've talked about before is that we're going to continue to invest in our business and build our sales and marketing organizations.

We see this as a very large opportunity. We were able to achieve free cash flow, positive free cash flow the last quarter. We chose the leverage we have in the model.

Our concerns aren't related to getting to profitability or free cash flow or sustaining that on a long-term basis. Our focus is going to be to invest in our business and to grow our business on the top-line in a prudent manner. One of the things we've talked about before is that we plan to be as sustained, free cash -- positive free cash flow and also positive operating profitability on a non-GAAP basis, sometime in fiscal '20. We're going to keep on running the business with that in mind because of the large opportunity we see in front of us.

Gabriela Borges - Goldman Sachs - Analyst

That's helpful color. Thank you. And as a follow up, if I may, since the IPO, have you noticed any change in your customer conversations either with respect to the credibility that you're able to have as public Company or perhaps with region? Now that's it's been a couple of months since the IPO, are you seeing any change in those conversations and the ability to open doors? Thank you.

Jay Chaudhry - Zscaler - Chairman, CEO

Yes, we have. Actually, in fact, I was telling some folks that before when I try to reach a number of CIOs who I had not met versus now, the feedback and the response is a lot better now than it used be. As I go and talk to customers, I'm surprised how many of these customers actually know that we have gone public. So, quite often, when I start, they say congratulations on being a public Company.

We are seeing that better awareness. Yes, that's -- and leading to better leads. Can I quantify at this stage? Probably not. Okay. Do we think we have better close rate? I think I would say yes. But I think it's a little bit too early to quantify it, but it's a positive momentum and we are very pleased with it.

Gabriela Borges - Goldman Sachs - Analyst

All right. Good. I appreciate the color. Thanks.



JUNE 06, 2018 / 8:30PM, ZS.OQ - Q3 2018 Zscaler Inc Earnings Call

Operator

And we'll take our next question from Brad Zelnick with Credit Suisse.

Brad Zelnick - Credit Suisse - Analyst

My first question for you Jay, firewall competitors are out there talking about their cloud offerings replacing branch firewalls and even calling out competitive wins against you guys. Can you just help us fundamentally understand why what you do won't be consolidated into the firewall platform like so many other network security features have over the last several years?

Jay Chaudhry - Zscaler - Chairman, CEO

Okay. So, Brad, thank you. First of all, I would say I am flattered that some of the big guys are beginning to call us out.

Secondly, if you look at how cloud security has to be done, there are some basic things that are needed. Multi-tenant architecture that can take traffic from anywhere. The policies have to move around, logs have to come back together. There are some very critical requirements that single-tenant appliances don't really meet.

It would -- I would be surprised if traditional appliance vendors do not offer a cloud security solution into an SDN world because that's what every customer is asking for. The easier sense for us is to really spend a bunch of VMs in the cloud for each customer in each of the data centers because you're not just a destination.

With the kind of solution we offer, you are in the traffic path across cores of locations. And we don't believe the technology scales and works, at least we haven't seen that out there yet. We've also seen this movie before where CRM dominant player Siebel competed with Salesforce and PeopleSoft compete with Workday. We know the outcome of that.

We are comfortable with the technology we have built and we think we'll keep on increasing our distance. That's one point.

The second point I'll also mention that we are leading our sales from transformation. And when you do transformation, you don't really see firewall vendors and alike.

From a security point of view, it is interesting that SSL interception is becoming a very important area. So, enterprises, when they look for securing internet traffic, large enterprises, all standardized on proxy architecture. And we don't see a lot of firewalls handling outbound traffic on the large enterprises, though we see a number of them on the lower end.

Brad Zelnick - Credit Suisse - Analyst

And Remo, if I could just have a follow-up for you. Duration seems to have benefited from upfront billings in the quarter, which I imagine reflects the strategic commitments customers are making to Zscaler. But, can you help us understand what other factors might be at play driving long-term versus short-term deferred revenue growth? And how should we think about that trend going forward?

Remo Canessa - Zscaler - CFO

Yes. There's parts to that. One is the contract length. And over the past four quarters, for our new business, 75% of our customers' contract length is three years or greater. So that's a very positive sign, showing that our customers are putting the confidence into Zscaler.

The other part is the billing. So, even though the contract length is increasing two, three years for new business, our billings are still annual. We bill annually.



JUNE 06, 2018 / 8:30PM, ZS.OQ - Q3 2018 Zscaler Inc Earnings Call

Customers though -- some customers make decisions for budgetary reasons where they have funds available that they want to pay upfront. We don't give incentives for upfront cash. We do give incentives to our sales organization to get into longer term contracts because that increases the stickiness and shows the confidence that the customers have in Zscaler.

Operator

Alex Henderson with Needham.

Alex Henderson - Needham - Analyst

I was hoping you could talk a little bit about the mix of business in the current quarter in terms of revenues that came in from ZIA versus ZPA and how that might look different relative to the contracts that you're winning today for future business? How much of a shift towards ZPA or we seeing in the current flow?

Remo Canessa - Zscaler - CFO

So, Alex, I'll take that question. Our ZPA still represents less than 5% of our revenue. However, our third quarter was our largest quarter for ZPA, and it is increasing fairly substantially.

Now, the revenue is less than 5% because we recognize business -- recognize revenue on raffle basis. When you take a look at the actual business coming in, it's doing well. And the increase in ZPA for new business and upsell this last quarter was the highest that it's been in the Company's history.

Jay Chaudhry - Zscaler - Chairman, CEO

If I may additional, Remo, ZPA is the fastest growing new product in Zscaler's history. And also, we're pleased that we had our first 7-figure annualized revenue deal from ZPA this past quarter.

Alex Henderson - Needham - Analyst

At the risk of asking a second question and looking forward a little bit, as you've got this major conference coming up, what's the size and scale of it? Have you been surprised that the amount of people signing up to come into the conference? I mean, can you give us any sense of what that looks like?

Jay Chaudhry - Zscaler - Chairman, CEO

Of course, this is our cloud summit, we call it Zenith Live. It's focused on cloud transformation. We had not focused on trying to get a message out there.

It's clearly people who are driving transformation to our target. It's about 400 to 450 total people. About 25% of them are expected to be C level or VP level people.

And we got some great keynote speakers as well. We got Scott Guthrie of Microsoft coming as a keynote along Satya doing a video message. We've got Pat Gelsinger, CEO of VMware as a keynote, and we got Michael Dell delivering a video message.



JUNE 06, 2018 / 8:30PM, ZS.OQ - Q3 2018 Zscaler Inc Earnings Call

And we got some great customer keynote as well, the CTO of GE, General Electric, will be there in person; and the Head of Global Infrastructure for Siemens will be there as well. So, very excited, but focus will remain on transformation and smaller focused audience rather than trying to get thousands of people.

Alex Henderson - *Needham - Analyst*

Okay. Thank you.

Operator

And moving on, we'll take our next question from Joel Fishbein with BTIG.

Joel Fishbein - *BTIG - Analyst*

Good afternoon and congrats on the great quarter. I just want to follow-up on Brad's question and I have a question for Jay.

Jay, you mentioned the Fortune 500 medical device Company win. And I guess, obviously you have had several wins in the quarter, but it would be great to hear about either competitive dynamics of that win and if there was a bakeoff and how that actually manifested itself?

Jay Chaudhry - *Zscaler - Chairman, CEO*

Great question. I think that's a good example to show this is a significant deal. There is no bakeoff. There is no competition.

This was driven by CIO embracing the cloud. And from CIO, it got to ahead of networking, head of security. And we fit in their architecture where they did not really want a mix of appliances and then partially cloud -- in fact, the CIO said, I do not really want any more security appliances in my enterprise. Now, obviously, there are still keeping the firewalls are like sitting in their data center. But every office out there or every road warrior sitting on the road, essentially the traffic that's funneled through Zscaler's data centers offering them same policy, same protection.

We really did not compete with anybody in this opportunity. And there are lots of opportunities like that if we compete. To me, I tell my sales team, if you're competing with someone head on, you aren't doing the right sales execution.

Joel Fishbein - *BTIG - Analyst*

And one quick follow up for Remo if I may. Remo, you called out the tough compare in billings in 4Q. Can you just give a little quantification around it, so that we know exactly -- I know, you signed some big deals last 4Q, just so we have that model correctly?

Remo Canessa - *Zscaler - CFO*

Yes. There is a few large deals in fourth quarter 2017. We called out before one deal, which is about \$4.5 million. But, there are a few others. That's the reason for the tough compare. It's that \$4.5 million plus some additional long-term deals.

Joel Fishbein - *BTIG - Analyst*

Great. Thank you so much.



JUNE 06, 2018 / 8:30PM, ZS.OQ - Q3 2018 Zscaler Inc Earnings Call

Operator

And moving on, we'll take our next question from Gray Powell with Deutsche Bank.

Gray Powell - Deutsche Bank - Analyst

Great. Thanks for taking the question. Just a couple, if I may. You showed excellent growth in operating margin leverage. You actually flowed through all of revenue upside to the gross margin line and even more to the operating line. Can you talk about the main drivers there?

Jay Chaudhry - Zscaler - Chairman, CEO

You got cut off. Could you please repeat that, Gray?

Gray Powell - Deutsche Bank - Analyst

Sure. Can you hear me better now?

Jay Chaudhry - Zscaler - Chairman, CEO

Now, I can hear you.

Gray Powell - Deutsche Bank - Analyst

Okay, great. So, just in the quarter, you guys showed excellent growth in the operating margin leverage. You actually flowed through all of the revenue upside to the gross margin line and then even more to the operating line. I'm was just wondering if you could talk about the main drivers there?

Remo Canessa - Zscaler - CFO

Our business is strong. We kept our expenses under control. We're able to maintain good gross margins. With the business that we build during the quarter as well as the waterfall that we have from prior quarters with the expense control that we have, maintaining the high gross margins gave us the ability to show positive operating margins. From a cash flow perspective, the reason we're able to beat our free cash flow initial projections is that we had better collections, the strong gross margins, lower CapEx, lower operating expenses. And as was mentioned before, related to the ESPP that we withhold from employees which gets -- put into accrued liabilities, that have a positive impact of a \$1 million.

Gray Powell - Deutsche Bank - Analyst

Got it.

Jay Chaudhry - Zscaler - Chairman, CEO

Yes. If I may add, as a strategy overall, or number one focus is top line growth and we'll manage the bottom line, but we keep on looking for opportunities in sales and marketing of business development where we can invest smartly to keep on growing our top line.

JUNE 06, 2018 / 8:30PM, ZS.OQ - Q3 2018 Zscaler Inc Earnings Call

Remo Canessa - Zscaler - CFO

I think that's an important point that Jay is making. And we see this as just a -- as I mentioned before, a very large market opportunity. One of the things we've talked about when we went public is we have a leverage model; we have the ability to show high-operating profitability, increased free cash flow. We can do that relatively quickly.

We feel that because of the opportunity that we have, in the best interest for our shareholders and the Company is to continue to focus in that -- on that top-line in a prudent manner and grow the business. That's what we are doing.

Gray Powell - Deutsche Bank - Analyst

Understood. That's helpful. And then, just one more, if I can. Have you seen any changes in the level of discounting at your appliance-based peers over the last three to six months? And then, does that even matter in your conversations with customers?

Jay Chaudhry - Zscaler - Chairman, CEO

If I were to have lots of competitive peer cost, I would see a lot of that in my transformational business since I don't really see a whole lot of them, I don't. I do have some transactional business that we've described in the road show where these are tactical things. And this is largely coming through VARs who'll say this box need to be replaced and the customer is asking for a cloud-based solution. We do some of that.

We haven't seen broad based stuff but I will mention that it is one proxy-by-proxy vendor who has standing constructions with the sales field that if you see Zscaler replacing us, drop whatever price they want to drop and try to keep it. But obviously, most customers don't just buy for price; they want a better functionality, they are moving their business for cloud.

Across the board, haven't seen broad things, but we have seen some web proxy vendors reacting to us and trying to save their business whatever way they can.

Operator

Saket Kalia with Barclays Capital.

Saket Kalia - Barclays Capital - Analyst

First, maybe for you, Remo. Can you talk a little bit about the preference for different bundles that customers are opting for? I know that there were multiple point examples of customers opting for transformational bundles in the prepared remarks, but can you just give us some broad brushes about how that perhaps looks across the base?

Remo Canessa - Zscaler - CFO

That's a good question. We haven't given any percentages related to where customers are buying currently with professional business and transformation. What I can say, though, is that transformation is increasing. Also, on our Q4 earnings call, we'll give a breakout on a percentage basis where we currently are on an ARR basis with those bundles. But there has been a shift towards transformation.

Jay Chaudhry - Zscaler - Chairman, CEO

Yes. I would add the same thing. But I would say, I was a little surprised to see how fast the shift to transformational bundle is happening. It's helping on average price as well.



JUNE 06, 2018 / 8:30PM, ZS.OQ - Q3 2018 Zscaler Inc Earnings Call

Saket Kalia - *Barclays Capital - Analyst*

Jay, may be a follow-up for you. You talked about the COO departure and the strength of your bench. Could you just talk to us a little bit about how you are thinking about sales leadership?

And perhaps a joint question for you as well, Remo, whether you've contemplated any potential disruption from that departure in your 4Q guide?

Jay Chaudhry - *Zscaler - Chairman, CEO*

Yes. As I mentioned, I mean, we do have strong geo leaders running Americas and international. That's why we don't feel this will have any impact on our momentum. Are we changing our guidance because of this? We aren't, because we don't really see an impact of it. We are starting our [retail] search. It's a very important role and we'll find the right person.

Remo?

Remo Canessa - *Zscaler - CFO*

Yes. Let me follow-up with Jay. We've got really strong geo leads in our regions -- APJ, EMEA and Americas. And related to the fourth quarter guide, really not seeing any impact related to the departure of our COO.

Operator

Jonathan Ruykhaver with Stephens Incorporated.

Jonathan Ruykhaver - *Stephens Incorporated - Analyst*

I have a question regarding ZPA and the competitive landscape. But, I believe Akamai introduced an application, access solution last year and I believe CloudPlayer also announced offering more recently. Can you talk about how you differentiate competitively and why competition won't be a potentially with you longer term?

Jay Chaudhry - *Zscaler - Chairman, CEO*

Yes. This is a relatively young market. You can look at our ZPA as two opportunities.

One opportunity is transformation for application access, how applications are accessed in the data center versus how they should be accessed when they move to a public cloud. And that's where it gets very interesting.

Traditional VPN products don't fit well when you need to access applications in public cloud. We are driving that push. We aren't seeing a whole lot of competition there yet. There are bunch of new companies that are coming around, but it's a very nascent market.

When it comes to VPN replacement, we can sell and we do sell ZPA for VPN replacement as well. And that's where we typically actually compete more so with incumbent that we are trying to replace. That's typically the Pulse Secure and Cisco's of the world there.

Again, two approaches. One has incumbent competitors; and second, really, don't have a whole lot. But we're rarely seeing some of the new guys out there yet. And I'm not surprised, because it's a relatively young market and the market opportunity is big out there.

JUNE 06, 2018 / 8:30PM, ZS.OQ - Q3 2018 Zscaler Inc Earnings Call

Did I answer your question?

Jonathan Ruykhaver - *Stephens Incorporated - Analyst*

Yes. I just wanted to understand one other thing on ZPA. The use case you're seeing as driving the growth today, is it more access to the applications, the private data side or is that a cloud application in this case?

Jay Chaudhry - *Zscaler - Chairman, CEO*

It's actually a good mix of two; it's the same product and offer both benefits. When we drive top down sale of ZPA, it is really bought for access to applications of Azure and AWS and Google cloud. And VPN replacement ends up being a side effect of it.

When we go in a tactical thing, when somebody says, I hate my VPN, please come and help, then, it actually goes in as a VPN replacement and then we kind of sell them a vision that this can also be used for access to your public cloud applications.

And the mix is a pretty good mix. I would say it's pretty good mix; neither side is dominating right now. But we'll learn more over time.

Jonathan Ruykhaver - *Stephens Incorporated - Analyst*

This might be more of a Remo. But, could you help us understand the seasonal impact around net retention? I believe, it was down slightly in 3Q, but how does seasonality impact net retention in 4Q? And then, also as we look in the first quarter of '19?

Remo Canessa - *Zscaler - CFO*

We feel that 120% is very good. But it's important to understand how we calculate net retention rate.

It's calculated based on comparing the change in AR for customers from a year ago to the current period which takes in account of sales and churn. Our churn has been relatively flat for several quarters. And if you take a look at Q3 versus Q2, the amount of new business and upsell was basically 50-50. There is a slight shift in Q3 to more new versus upsell.

It's going to vary on a quarter-over-quarter basis. We feel that the net retention rate is strong. We feel that longer term, with the ZPA and the customers going to the transformation bundle, there is an opportunity for it to go up. But making any projections related to net retention rate, it would be difficult for us to do.

Operator

Fatima Boolani with UBS.

Fatima Boolani - *UBS - Analyst*

Maybe a big picture question to start with Jay. Jay, for a Company of your size, you have pretty pronounced international presence. I'm curious to get your perspective on some of the demand drivers and distribution leverage that you have between India and APAC relative to the Americas. If you can compare and contrast?

And then follow up for Remo.



JUNE 06, 2018 / 8:30PM, ZS.OQ - Q3 2018 Zscaler Inc Earnings Call

Jay Chaudhry - Zscaler - Chairman, CEO

Yes, we do have strong international presence. And that is attributed to a couple of things. One, I have put the same sized team outside the U.S. that I have got in the U.S. when I started the Company. And two, Zscaler was architected with data privacy in mind. We are probably the most data privacy friendly security Company out there. Because we are the only Company that doesn't write logs in every location where traffic is processed.

All these appliance guys, whether they put a VM in the cloud or whatever they do, wherever they're going to spin up a VM, the logs will be sitting there. They'll be figuring out how to do a batch push of those logs. In our case, the logs only go to one place, and that is in EU. That's why some of the biggest European companies have embraced us. That is the product side of it.

If you look at some of the demand drivers, I used to think that cloud will be embraced by the U.S. first and Europe will be a bit slow in embracing it. And I have been in Europe every month for the last six months. And every large customer I talk to, they are deploying Office 365, Salesforce, Azure, AWS. I see the same kind of demand in Europe that I see in the U.S. as well.

Your second part of the question was the kind of leverage we are getting. So actually, we get more leverage from service providers in Europe than we get in the U.S. [You would think], why that's the case? There are many service providers in Europe ranging from OBS, a great partner, to BT to T-Systems to Telefonica. All these partners are actually embracing cloud and they are Zscaler partners.

So good leverage. We will see a good growth coming from international market.

Fatima Boolani - UBS - Analyst

And, Remo, a follow-up for you. As I think about the dollar net retention pattern looking forward and I think about some of the inputs around customers graduating or upsizing themselves within the bundles, maybe pure pricing increases that you pass through, ZPA adoption and also just [ZPA-based] increases. Amidst those factors, what do you feel is going to provide the most upside to price or upward pressure to the dollar net retention on ARR front?

Remo Canessa - Zscaler - CFO

I would say, number one, transformation. Customers are moving up to the transformation bundle.

We have talked about before, on our road show, that about 10% was professional, 70% is business and 20% is transformation. There's an opportunity. And the pricing of each of those -- as we look at professional 1x, business at 1.5x and transformation of 3x off of that professional -- the opportunity as customers move up, there's a couple of benefits. One is pricing but also stickiness. Once you go to the transformation, you've made the decision that you're going to go with a cloud security Company basically as you're in security.

In addition, ZPA is going to have an impact also. But related to net retention, it's going to be mix; it's going to be based upon our new and upsells in each quarter and that's going to vary. Some quarters are going to have really strong upsell, other quarters not; some quarters going to have really strong new and some quarters not. But if you take a look at the levers that we've got in the Company related to selling new as well as selling upsell, really, to selling increased bundles and increased products like ZPA, it's something that's going to vary, as I mentioned, quarter-to-quarter.

Operator

And that does conclude today's question-and-answer session.

I'd like to turn the call back over to CEO, Jay Chaudhry, for any additional or closing remarks.

JUNE 06, 2018 / 8:30PM, ZS.OQ - Q3 2018 Zscaler Inc Earnings Call

Jay Chaudhry - Zscaler - Chairman, CEO

Well, thank you, all, for joining us. We are excited about the opportunity and we thank you for the time you've taken us. We will be talking to you in the coming quarter and definitely during our next quarter's earnings call. And I hope you can join us at the Zenith Live.

Operator

Once again, that does conclude today's conference. Thank you for your participation. You may now disconnect.

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