Good afternoon and thank you for joining us to discuss Zscaler’s financial results for the second quarter of fiscal 2019. With me on the call are Jay Chaudhry, Chairman and CEO; and Remo Canessa, CFO.

By now, everyone should have access to our earnings announcement. This announcement may also be found on our website in the Investor Relations section. In addition, a supplemental financial schedule was posted to the Investor Relations section of our website earlier today.

Let me remind you that we’ll be making forward-looking statements during today’s discussion, including, but not limited to, the company’s anticipated future revenue, calculated billings, operating performance, gross margin, operating expenses, operating income, net income, free cash flow, dollar-based net retention rate, income taxes, and earnings per share. These statements and other comments are not guarantees of future performance but rather are subject to risk and uncertainty, some of which are beyond our control. Our actual results may differ significantly from those projected or suggested in any forward-looking statements. These forward-looking statements apply as of today, and you should not rely on them as representing our views in the future. We undertake no obligation to update these statements after this call. For a more complete discussion of the risks and uncertainties that could impact our future operating results and financial condition, please see our filings with the Securities and Exchange Commission, as well as in today’s earnings release.

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

I would also like to inform you that we’ll be participating in Piper Jaffray’s Security Symposium in Chicago on March 14th. Now, I will turn the call over to Jay.

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

Thank you, Bill, and thank you, everyone, for joining us on our call today. I am pleased to share with you our record second quarter results. Our revenue grew 65% and calculated billings grew 74% year-over-year. In addition to our top line growth, we achieved another quarter of positive operating profit and free cash flow. Our operating margins improved 19 percentage points year-over-year to 13%. Our Q2 results demonstrate the leverage in our business model, and our ability to drive growth and profitability. Having said that, we will continue to aggressively invest in our business to pursue our significant market opportunity.

We are well-positioned to capitalize on the mega shifts in the data center and network architectures to support the secure adoption of
cloud. In the cloud world, applications can be anywhere, and devices and users can be anywhere -- the notion of "inside the network" or "outside the network" is disappearing. It is no longer a simple matter of defending a network perimeter, which has effectively disappeared. Designed for the world, which is no walls, the Zscaler Cloud acts as a business policy engine, deployed across more than 100 data centers to securely connect the right user to the right application: ZIA for Internet and SaaS applications, and ZPA for internal applications in your data center, the public cloud, or a hybrid cloud. With the Zscaler Security Cloud, there is no policy or trust assigned to the network level and, therefore, there's no need to maintain a complex, expensive private network and stacks of appliances that do network security.

Our comprehensive Cloud Security platform is being leveraged by our customers as they progress through various stages of the cloud adoption journey. Let me highlight several deals in the quarter that illustrate the diverse use cases.

A top global bank in Asia purchased Zscaler Business bundle for over 100,000 employees to scale capacity and up-level security. This customer experienced scaling issues with an on-prem web proxy as they piloted Office 365. Their existing appliances would not keep up with the surge in Internet-bound traffic from 1,200 offices worldwide. The incumbent appliance vendor offered hybrid cloud security. As we often see in the market, the hybrid solution failed to meet the customer's requirements. They are also up-leveling security by deploying SSL inspection, advanced threat protection, and sandboxing. In addition, they purchased our DLP solution to help meet regulatory requirements.

We talked to you about our entry into Japan last year, and I'm pleased to share with you that our business is growing well in this new market. For example, a Global 500 IT products and services company, which last year, purchased Zscaler entry-level Professional bundle and SSL inspection functionality for 135,000 users to replace on-premise web proxies, is now consolidating additional layers of the security stack with us. This quarter, they upgraded to our Business bundle and Cloud Sandbox for all 135,000 users, replacing the incumbent sandboxing vendor. The drivers: protection against highly targeted zero-day attacks that are almost always hidden in SSL traffic. SSL traffic has increased to more than 80% of the web traffic, and this traffic is not visible to traditional security appliances. Imagine 80% of luggage passing through airport security unchecked. You can't, because that would be unacceptable. But this is exactly what happens when organizations attempt to use next gen firewalls to protect users. Zscaler was natively designed as a full SSL proxy, which means our customers can inspect encrypted traffic without impacting user experience, leading to better security and reduced business risk.

Let me give another example where Zscaler was purchased to secure the transformation of a customer's network and security infrastructure. A Fortune 500 retail and manufacturing company purchased Zscaler Transformation bundle, which includes our firewall, IPS, and cloud sandbox, for all 25,000 users to secure hundreds of locations. In addition to helping Office 365 deployment, the customer will secure an upcoming SD-WAN initiative with local Internet breakouts. Zscaler will further enhance security with coverage for all users, including mobile, and improve user experience. As their on-premise DLP sitting in a few data centers becomes ineffective to local breakouts, the customer purchased DLP for all users to protect sensitive information from leaking no matter where the user is -- at the headquarter, or branch office, or on the road -- on a laptop or on a mobile device.

Another deal highlights our capabilities at M&A and business reorganization use cases. A global pharma is spinning off one of its divisions, driving the need to separate out its applications, network and security from its parent company. In the pre-cloud world, they would be moving their applications to new data centers, building a separate wide area hub-and-spoke network and a moat with security appliances, which can often take a year or 2. Instead, they pursued a full transformation to the cloud with Internet as its wide area network and Zscaler as the policy engine. They purchased Zscaler Transformation bundle for ZIA and ZPA for 24,000 users across 155 locations. Without building a new network and new security gateways, the customer is leveraging Zscaler to provide secure, fast and reliable access for any user from any location and device, at a lower cost of ownership and with greater operational simplicity. And this will take months rather than years.

Next, I will highlight a deal for Fortune 500 auto company that started with ZPA and quickly expanded to ZIA. In August, this customer purchased ZPA for 10,000 users, including 2,000 contractors for VPN replacement and M&A integration. With ZPA, our customer was able to provide access for specific users to specific applications without putting them on the corporate network and have full visibility into users, applications and traffic. This success led the customer to purchase ZIA Business bundle plus Cloud Firewall functionality for all
46,000 users across 350 locations less than 6 months after the initial purchase. This completes the full network and security transformation. This latest purchase resulted in quadrupling of the total customer spend with Zscaler.

Lastly, on our Q4 call, we discussed the largest deal in Zscaler’s history, which contributed $16.5 million to billings in the quarter. This quarter, this public-sector customer began the second stage of their security transformation project, resulting in an additional $11 million in billings. Over a 5-year period, we expect this deal to generate $50 million in revenue. Remo will discuss this deal further. This customer required a highly scalable policy engine that can handle 120 gigabits per second throughput, while inspecting SSL traffic for security. To give you a reference point, a majority of our Fortune [100] (corrected by Company after the call) enterprise customers need a few gigabits per second of sustained throughput. Zscaler cloud architecture allowed us to extend our cloud to the data center and deliver a hybrid solution.

These deals demonstrate the unmatched benefits that Zscaler delivers. While traditional firewall and VPN vendors are making more noise about their hybrid security cloud, their technology is fundamentally designed to protect the corporate network by building a moat around the corporate castle. In the cloud world, where will you build a moat? Yet, legacy network security vendors are trying to do what their technology can -- extend your corporate network to various public clouds where they will spin their virtual machines. This increases the attack surface, hence, increasing business risk. Legacy network security vendors’ hybrid cloud security is a defensive strategy, which, in my view, serves the self-preservation of the vendor, not the needs of the customer. It’s a single-tenant architecture that’s not designed for the cloud. Their message is “Keep on buying my boxes, but use my cloud service when the users are on the road or in a branch office.” In this hybrid cloud approach, who manages the on-prem boxes and who manages the cloud version? Where are logs, and how do you keep data private? It’s a disjointed solution. This equates to splitting a single application between the data center and the cloud. How many customers have deployed Siebel or Peoplesoft in the data center and a virtual version of it in the cloud? We know what happened to it. When was the last time you heard of them? With our born-in-the-cloud architecture, based on the used case, we extend Zscaler’s cloud to the customers’ premise, doing hybrid cloud the right way, where we have full responsibility for managing, scaling, and running the service.

We believe we have a significant competitive advantage as a result of the technology, architecture and maturity of our platform. As the world’s largest security cloud, we are inspecting 65 billion transactions each day. As part of ongoing expansion, our latest fourth-generation data centers provide multiple hundred gigabits per second links for a total peering capacity of over 1 terabit per second per site. The requirements for a security cloud that handles all of your Internet and cloud traffic is very high; hence, Zscaler delivers 5-9’s of availability SLA. We have over 10 years of operational experience running our security cloud at scale. As some have said, there really is no compression algorithm for experience.

As seen with some of our highlighted deals, ZPA is building momentum. Customers are exploring “zero-trust network” techniques to offer access to apps without granting access to the corporate network. As an early pioneer in software-defined perimeter, we have a mature, rich ZPA offering that’s running in production at hundreds of enterprises. While many imitators are coming out with access to web apps, ZPA was designed for secure and fast access to internal applications using all protocols and running on multi cloud and hybrid cloud environment. This allows us to address a wide range of use cases that others can’t.

I’m pleased to report that we are executing on our vision and making solid progress in the Global 2000 accounts. We remain focused on execution and investing in our go-to-market capabilities, and we expanded our workforce by approximately 100 employees this quarter, with half in sales and marketing. We are taking our Zenith Live Cloud Summit on the road with a series of regional events called Zscaler Academy World Tours.

At these events, we are providing hands-on labs, best practices, and customer case studies on how to enable IT cloud transformation securely. We are also strengthening our channel partnerships with large system integrators and global service providers, which contribute over 50% of our revenue.

In summary, we are very pleased with our strong Q2 results and continued growth in our business. We believe we are in the early innings of a significant market opportunity to disrupt traditional network security. I would like to now turn the call over to Remo to walk through our financial results.
Remo Canessa Zscaler, Inc. - CFO

Thank you, Jay. As Jay mentioned, we had a very strong Q2. Revenue for the quarter was $74.3 million, up 17% sequentially and 65% year-over-year. Q2 revenue was aided by $2.3 million in nonrecurring revenue from the large public sector customer deploying our solution as a private cloud. This amount was mostly comprised of private cloud infrastructure as well as recognition of deferred subscription revenue from Q1 as we achieved a project milestone. From a geographic perspective, for the quarter, Americas represented 53% of revenue, EMEA was 40%, and APJ was 7%.

Turning to calculated billings, which we define as the change in deferred revenue for the quarter plus total revenue recognized in that quarter. Billings grew 74% year-over-year to $115 million. This quarter, we benefited from a higher mix of upfront greater-than-one-year billings, including approximately $11 million from the public sector customer. As a reminder, our contract terms are typically 1 to 3 years, and we primarily invoice our customers one year in advance. Excluding upfront greater-than-one-year billings in both periods, billings would have grown over 50%. Total backlog, which represents remaining performance obligations, was $461 million in January 31, up 69% from $273 million one year ago.

Our strong customer retention and ability to up-sell have resulted in a consistently high dollar-based net retention rate, which is 118% for the period ended January 31. This compares to 122% a year ago and 118% last quarter. Our increased success selling bigger deals upfront, which start with the Transformation bundle and faster upsells within a year, while good for our business, can reduce our net dollar retention rate, which is calculated on a year-over-year ARR basis. Considering these factors, we feel 118% is outstanding and will vary quarter-to-quarter.

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

Turning to operating expenses. Total operating expenses decreased 1% sequentially and increased 27% year-over-year to $49.8 million, but decreased as a percentage of sales to 67%. The sequential decline in operating expenses is primarily due to the timing of our worldwide sales kickoff and Zenith Live European user conference in Q1. We increased our headcount in Q2 by approximately 100 employees.

Sales and marketing decreased 1% sequentially and increased 27% year-over-year to $33.2 million. As mentioned, the decline is primarily due to the timing of sales and marketing events. Even though we have a sequential decline in sales and marketing expenses, we are building our sales and marketing teams and investing in marketing programs. In Q2, we increased our sales and marketing teams by approximately 50 employees.

R&D was up 4% sequentially and up 23% year-over-year to $10.7 million as we continue to invest to enhance product functionality and to offer new products.

G&A decreased 8% sequentially and increased 37% year-over-year to $5.9 million. The year-over-year growth in G&A includes investments in building our teams, consulting and other expenses that we've made as we became a public company. The sequential decline in G&A is primarily due to lower professional fees. These expenses exclude $1.8 million in litigation-related expenses.

Our second quarter operating margin was a positive 13%, which compares to a negative 6% in the same quarter last year. Net income in the quarter was $11.6 million or non-GAAP earnings per share of $0.09. Given the positive earnings in the quarter, our EPS was calculated on a fully diluted basis of approximately 134 million shares.

We ended the quarter with $340 million in cash, cash equivalents and short-term investments. Free cash flow was positive $12 million for the quarter compared to negative $4.6 million for the same quarter a year ago. Our ESPP program reduced our free cash flow by approximately $5.6 million as we initiated our first stock issuance in December. The ESPP program does not impact our overall cash balance.
So now moving on to guidance. As a reminder, these numbers are all non-GAAP, which excludes stock-based compensation expenses, amortization of intangible assets, certain litigation-related expenses, and any associated tax effects. For the third quarter, we expect revenue in the range of $74 million to $75 million, reflecting the year-over-year growth of 51% to 53%; operating profit in the range of $0 to $1 million; income taxes of $600,000; earnings per share of approximately $0.01, assuming 135 million common shares outstanding.

For the full year 2019, we expect revenue in the range of $289 million to $291 million, or year-over-year growth of 52% to 53%; billings in the range of $365 million to $370 million, or a year-over-year growth of 42% to 44%; operating profit in the range of $11 million to $13 million; income taxes of $2.1 million; and earnings per share in the range of $0.11 to $0.13, assuming approximately 135 million common shares outstanding.

Looking forward, our plans are not to maximize profitability or to generate additional operating leverage, but to invest aggressively in our business to pursue our significant market opportunity. With our CMO and Senior VP of Customer Experience and Transformation on board, we'll be stepping up our marketing investments in the coming quarters. In addition, we'll increase investments in our technology platform and cloud infrastructure.

And as you model billings, I want to remind you that, historically, Q2 and Q4 have been our strongest billings quarters with sequential declines in Q1 and Q3 quarters, respectively. This sequential decline will be accentuated by the multiple greater-than-one-year billings we had in Q2, including $11 million from the public sector customer. Also keep in mind that we have a large upfront billing of $16.5 million in Q4 of 2018 that will pose a tough year-over-year comparison in Q4.

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

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

Thank you, Remo. We believe we are the best choice for securing the cloud and mobile-first world. The right architecture matters. On-premise single-tenant architecture, whether deployed as appliances or as virtual machines spun up in a public cloud will not allow enterprises to fully realize the benefits of cloud. These imitators can't scale, leave gap in security, are expensive, and deliver poor user experience. With multiple tailwinds, such as SaaS adoption, SD-WAN and app migration to public clouds, we believe the market is coming to us.

We thank you for your interest in Zscaler and look forward to reporting on our progress in the future.

Operator, you may now open the call for questions.

QUESTIONS AND ANSWERS

Operator

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

So it sounds like, obviously, Zscaler is enabling a transformational sale, particularly with ZIA but also ZPA. Just given your results, it does seem like perhaps a transformational sale is becoming a little bit more mainstream. If that correct and it is becoming a more mainstream, what are you seeing in terms of the sales cycle? Are you seeing a shortening of sales cycles as enterprises are getting more comfortable with this approach?

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

Thank you, Melissa. As we have said in the past, our sales cycle for smaller accounts is about 3 to 6 months; for larger, it’s about 6 or 12 months. I would say the number of deals are growing rapidly, hence the pipeline is going up. That’s why we are closing more deals. But some of the transformations do take time, so it’s probably moving to the lower end of the range we talked about, but I won’t say it’s being cut down into a few months. I would still say probably 6 to 12 months, more on the lower side than the upper side.
Operator

Our next question comes from Brad Zelnick from Crédit Suisse.

Brad Zelnick Crédit Suisse AG, Research Division - MD

Jay, so much of the legacy approach to security is tied to infrastructure. Like, you said in your prepared remarks, building moats, and what we've protected things in the past, like networks and endpoints. But now, the world is hyper virtualized and dynamic, which is really driving your success. But just in the last couple of days, you've seen 2 major legacy security players rattling savers as it relates to endpoints, and we're also seeing a battleground emerge around data analytics and orchestration as the next platform play. So my question is in the past, you've talked about endpoint players being natural partners for Zscaler. Does that ever change? And as well -- as for becoming the data orchestration layer, it would seem Zscaler has a natural advantage if you wanted to participate. How do you see the future shaping up in this regard, and what role might Zscaler play? And I've got a follow-up for Remo.

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

Okay. It's a good question. It is true that there are lots of security vendors out there, and enterprises do want consolidation. But I believe real consolidation is done by building an extensible platform from a clean slate, and that's what we are doing about network security, by sitting in the traffic path and consuming -- subsuming all that functionality. Now, having said that, I don't believe you'll see a god security vendor who consolidated all functionality from endpoint to analytics to identity and the like. So there needs to be a natural ecosystem of partners where you know where your strengths are. You talked about endpoint. Let's look at endpoint. We think the core competencies and technologies for endpoints are very different from in-line traffic inspections. You have seen in the past many network security vendors have tried to sell endpoint protection for years. How much progress have they made? We believe in being partners with endpoint vendors. Now security analytics and orchestration. It is an interesting area. We actually partner in this area. You don't just need logs from in-line traffic inspection, you need it from endpoints, identities, servers, applications like Office 365. I personally believe that large, non-network security vendors who have "competency" of cloud scaling databases and machine learning will do a better job. So we are partnering with those vendors. I think we have talked to you in the past, between ZIA and ZPA, together eliminating entire in-line policy enforcement, is about an $18 billion TAM, and it seems to be growing. So a long answer, but do we want to compete in the endpoint or security analytics? Not really. We have good partnerships there.

Operator

Our next question comes from the line of Dan Ives with Wedbush Securities.

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

So my question is in terms of the transformation going on in terms of sales cycles, I mean, are you seeing the transformation on a particular vertical or kind of across the board in terms of this kind of acceleration that we're seeing in terms of the strategic deals?

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

Yes, Dan. Good question. So the transformation lies along the lines of which verticals are embracing cloud sooner than others. Manufacturing sector actually embraced cloud before many others, and they also needed to do local Internet breakouts. So that's where we got GE and Siemens of the world out there. The companies that are a bit slow in embracing cloud -- financial services were slow, but now, they are picking up. Healthcare was slow, but they are picking up. So it's a bit along the vertical lines, but it's hard to meet a CIO who says I don't embrace cloud. Once you embrace cloud, you must transform your network and your legacy security. So we are seeing increased interest, but a little bit on the timing of the sales cycle. See, transformation requires the CIO, CTO, CISO, architects to come along together. So it does take some time. It's not a matter of here is a cool new security box. It has better feeds and speeds, and let's replace one with other. It is an architectural transformation, that's why it takes a bit longer time and a different kind of technology.

Operator

Our next question comes from Andrew Nowinski with Piper Jaffray.

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

So you talked about winning a deal against an on-premise web proxy vendor, and this customer was trying to use that to support their Office 365 roll out. I'd assume that the scalability issues that you highlighted are likely not specific to that customer's environment,
meaning other potential customers deploying Office 365 would likely face similar issues. So I was just wondering if you could give us your estimate of how far along we are with regard to the tailwinds from the migration of Office 365?

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

So a very good question. You are correct that this issue wasn't specific to this customer and the web proxy. This is what happens. When you move your exchange server to the cloud, 80% of the e-mail traffic and calendaring traffic that used to stay within your company, only 20% used to go out. Now all traffic, every e-mail, every calendar entry, has to go out to the cloud and come back. So the amount of traffic, with all the file attachments and everything, grows significantly. What we are finding is once you go to the (technical difficulty) simply increases your total Internet traffic to double or triple. Now that not only creates problem for web proxies; it creates problems for firewalls. And because each Outlook client creates 15 to 20 persistent connections, you run out of connections, you have to upgrade the security equipment out there, and then the bandwidth cost and MPLS. So Office 365 doesn't just work through simple proxies and firewall, it has a lot of IP address management issues. There's some bandwidth quality of service issues. We have worked with Microsoft over the past 3 years with single click deployment and handling quality of service and the like. So we're well-positioned to handle Office 365. Now the second part of the question is how much deployment? What's going on with Office 365? Office 365 has actually been bought by probably majority of the enterprises we deal with. And those who haven't bought, they're probably in the early stage of piloting and the like. So to give you a perspective -- today, about 22% of the traffic that goes through Zscaler cloud is Office 365 traffic. 3 years ago, the number was 2%. As it goes up, the number will keep on going up. I believe we have probably about 25% of Office 365 customers, of our customers on the cloud, but there's plenty of headroom for us where Office becomes a catalyst for us to drive transformation.

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

That's great. And then one question with regard to the marquee public sector customer you referenced on the call. Do you think that win establishes Zscaler somewhat the vendor of choice in the public sector, that you can leverage that win across other agencies perhaps?

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

It definitely does. The interesting point is, when the customer put out the requirements, we were the only vendor who could really meet the requirements. I think we're well-positioned, but still, you have to go and engage and win the deal, but very well-positioned for others.

Operator

The next question comes from Gray Powell with Deutsche Bank.

Gray Powell  
Deutsche Bank AG, Research Division - Research Analyst

So I was curious, I know that you're selling a much broader platform, but I'd love to hear what your view is on the overall growth of the secure web gateway market. And then within that, do you think -- or how fast do you think that cloud form factors are growing versus appliance form factors?

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

So we don't track the growth of appliance form factor. I'm not even sure there is a growth in appliance form factor. But having said that, every deal Zscaler wins actually has some kind of web proxy out there, because it's hard to find an enterprise that doesn't have web proxy for outbound traffic. Web proxy has been the standard for user traffic going to the Internet. But as you saw in most of our deals, something may start with web proxy, but evolves to the next and the next level. Our web proxy equivalent bundle is actually our Professional bundle, which is a very small number of probably, Remo, about 5% of the business?

Remo Canessa  
Zscaler, Inc. - CFO

That's correct.

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

That comes from essentially web proxy replacement. The remaining from Business bundle, which has a lot of advanced functionality, including bandwidth control-type of stuff that's needed; and Transformation bundle, which obviously includes firewall and cloud
sandboxing and the like. The point I'll make is I don't think our business is driven by replacement of a web proxy or a firewall. Our business is driven by a CIO saying I am embracing cloud, which is driving to do network transformation, which essentially requires local Internet breakouts and they must be secured, and we are the purposeful solution for securing the local breakouts.

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

Got it. That's really helpful. And then one for Remo, if I may. Just kind of looking at sequential trends, if I back out the onetime item from revenue, you grew revenue by about 14% in the January quarter from the October quarter. Any reason we should expect growth to be more like 3% to 4% sequentially in April?

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

Well, I mean, you've got our guidance. So we're comfortable with our guidance. And again, we feel prudent with the guidance that we've given.

**Operator**

Our next question comes from Gabriela Borges from Goldman Sachs.

**Daniel Church Goldman Sachs Group Inc., Research Division - Associate**

This is Dan Church on for Gabriela Borges. I guess, just to start, it certainly sounds like customers are coming onto the platform at higher AOVs. Maybe just if you can walk me through some of the puts and takes of what AOVs look like relative to a year ago when you IPO-ed, and what that the puts and takes to upsell opportunity from there, and how that's been trending.

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

What is an AOV?

**Daniel Church Goldman Sachs Group Inc., Research Division - Associate**

Average order value, sorry, or initial order value.

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

Got it.

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

What we call average sales price.

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

Yes, average sales price. Yes, it's been increasing on a quarter-over-quarter basis. It -- currently, 4 customers have -- and we look at the larger customers of greater than 3,000 users -- it's in the mid-300,000 range. It has gone up year-over-year, and it has gone up consistently quarter-over-quarter.

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

Probably at the IPO time, it was less than 300,000 for the same type of customers.

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

Yes, that's correct. At the IPO time, it was below 300,000.

**Daniel Church Goldman Sachs Group Inc., Research Division - Associate**

I guess just as a follow-up there, there’s a handful of appliance vendors out there talking about SD-WAN. Maybe how have your conversations with customers been changing? And how are customers thinking about a transformative switch to Zscaler versus scaling with another appliance vendor and maybe some of the puts and takes? And if you think, given the ROI and lower MPLS cost, customers are willing to invest in these transformations irrespective of a more challenging macroenvironment?
Jay Chaudhry, Zscaler, Inc. - Co-Founder, President, CEO & Chairman

Yes. Good question. We actually are the natural choice for SD-WAN, securing the SD-WAN. As I said in some of my earlier comments, that network transformation is driving local Internet breakouts, and those breakouts need to be secured. SD-WAN vendors are consolidating the functionality at the branch level - switching, routing functionality - but they really don't have security built in. And some of them are trying, they will try to do so, but it's very hard to do top-notch security. So the way I look at it, as SD-WAN market accelerates, it becomes a stronger and stronger tailwind for us. Now ZIA sales does not require SD-WAN. Traffic can be sent to Zscaler from any router, but SD-WAN makes deployment and management of the branch network easier. By doing local breakout, it can save money, but it still needs security, and that's where we play in. So we believe that SD-WAN wave will keep on helping us. And also, we're working with all of them. In fact, we've done integration, where literally, with a single click on the console configuration, the traffic can be sent to us through APIs, and monitoring can be done. Very excited and comfortable with that opportunity.

Operator

Our next question comes from Tal Liani with Bank of America.

Daniel Bartus, BofA Merrill Lynch, Research Division - Research Analyst

This is Dan Bartus on for Tal. Kind of a follow up to the last one, but I wanted to focus on pricing. And so you guys have obviously discussed a lot of the tactical advantages, but when we look at your competitors that can bundle SD-WAN, meaning mainly Cisco Umbrella and Fortinet's SD-WAN. Ignoring those architecture differences, do you think Zscaler would still potentially be a lower cost option there?

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

Do you think Zscaler would be a lower cost option there? So first of all, even before SD-WAN, I was talking to one of the Cisco execs a couple of years ago, 70% of the traffic that came to Zscaler came from Cisco devices. 70%. In fact, he smiled and said, “Oh, that's in line with my market share. 70% of the routers in my market are my routers.” So what you're really seeing is we have all these customers we have out there, from these big network vendors, the traffic is still coming to us. And the reason is the following. The Zscaler security is not bought as a part of the network stuff. Zscaler is truly a transformation sale, top down-driven. It creates a need for securing the local breakout, and when the customer selects the SD-WAN and all, we become the natural player. So the other point I'll mention is in all these large enterprises, security becomes a functionality, the richness, ability for policy to move around, ability for logs to come back, GDPR compliance. The requirements are so high that some of the solutions that are not designed for the cloud world, they just don't work very well. So do those things concern us? Not really.

Daniel Bartus, BofA Merrill Lynch, Research Division - Research Analyst

Okay, great. Makes sense. And then really quick. If we can get any metrics on the breakout of percent of sales that are direct or through the channel or managed through service providers? Just trying to get a feel for where the momentum is shifting, and the go-to-market strategy as well.

Remo Canessa, Zscaler, Inc. - CFO

Yes, yes. So Direct is under 5%. Those are legacy deals we've got. Everything is going through the channel currently for new business. And it's pretty close to split 50-50 between SPs and SIs at 50% and 50% through the VAR channel.

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

If I may add, having done appliance companies before, typical appliance vendor, about 85%, 90%, 95% of the business go through traditional VARs. And SPs and SIs are a very small percent because they don't like to resell boxes. In our case, to have over 50% of revenue come from SP and SI is a good differentiation because those drive transformation.

Operator

And our next question comes from Alex Henderson with Needham.
Alexander Henderson Needham & Company, LLC, Research Division - Senior Analyst

So priced for perfection, and you delivered it. Nice job. I got just housekeeping things I'd love to take care of. Can you give us some sense of what the uptake around ZPA was in the quarter, what the mix in bundles was? And what was the increase in sales staffing percentage-wise sequentially? I think it's 15%. Am I doing that math, right?

Remo Canessa Zscaler, Inc. - CFO

So I mean, the increase related to Transformation and ZPA, what we said is that we give metrics out on that when we had meaningful changes. All I can say is that ZPA is doing very well and business has been increasing on a quarter-over-quarter basis. Transformation also. As companies are recognizing the need to adopt a transformational strategy, our Transformation sales are also increasing. We will give you an update certainly at the end of our fiscal year for that. Related to the sales increase and sales mix and so forth, we increased our headcount overall in the company by approximately 100 employees in Q2. And about half of those were in sales and marketing. So we see the large market opportunity that we have in front of us, and we are aggressively hiring.

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

If I may add on ZPA, Alex. It's the fastest-growing product for us, and we're very bullish on it.

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

I got the 50 hires. I was just trying to figure out what the base was compare to that. Is that 15% to 20% increase sequentially in staffing and headcount?

Remo Canessa Zscaler, Inc. - CFO

We haven't given those metrics out related to what the increase is.

Operator

That concludes today's question-and-answer session. CEO, Jay Chaudhry, at this time, I will turn the conference over back for your closing remarks.

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

Thanks. Well, thank you all for your interest and time. Hope to see many of you at the RSA Conference. Otherwise, we'll talk to you at the next quarter's earnings call. Thank you again. Bye-bye.

Remo Canessa Zscaler, Inc. - CFO

Thank you.

Operator

This concludes today's call. Thank you for your participation. You may now disconnect.

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