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PRESENTATION

Operator

Good day, everyone, and welcome to the Palo Alto Networks fiscal second quarter 2017 earnings conference call. Today's conference is being recorded. At this time, I'd like to turn the conference over to Kelsey Turcotte, Vice President Investor Relations. Please go ahead, ma'am.

Kelsey Turcotte ***Palo Alto Networks Inc. - VP of IR***

Thank you. Good afternoon and thank you for joining us on today's conference call to discuss Palo Alto Networks' fiscal second quarter 2017 financial results. This call is being broadcast live over the web, and can be accessed on the Investors section of our website at investors.paloaltonetworks.com. With me on today's call are Mark McLaughlin, our Chairman and Chief Executive Officer, and Steffan Tomlinson, our Chief Financial Officer.

This afternoon, we issued a press release announcing our results for the fiscal second quarter ended January 31, 2017. If you would like a copy of the release, you can access it online on our website.

We would like to remind you that during the course of this conference call, Management will make forward-looking statements. Including statements regarding our financial outlook for the third quarter and full year FY17, our competitive position and the demand and market opportunity for our products and subscriptions, our ability to drive outside growth rates. Trends in certain financial results and operating metrics, our initiatives, plans and investments regarding our sales productivity, success and timing of integration of our newly acquired products, and innovations in our product, subscription and support offerings.

These forward-looking statements involve a number of risks and uncertainties, some of which are beyond our control, which could cause actual results to differ materially from those anticipated by these statements. These forward-looking statements apply as of today, and you should not rely on them as representing our views in the future, and we undertake no obligation to update these statements after this call. For a more detailed description of factors that could cause actual results to differ, please refer to our quarterly report on Form 10-Q filed with the SEC on November 22, 2016 and our earnings release posted a few minutes ago on our website and on the SEC's website.

Also, please note that certain financial measures we use on this call are expressed on a non-GAAP basis and have been adjusted to exclude certain charges. For historical periods, we have provided reconciliations of these non-GAAP financial measures to GAAP financial measures in the supplemental financial information that can be found in the Investors section of our website located at investors.paloaltonetworks.com.

We would also like to inform you that we will be presenting at the Morgan Stanley Technology, Media and Telecom conference on Thursday, March 2, and the Raymond James and Associates 38th annual Institutional Investors conference on Tuesday, March 7. And finally, once we have completed our formal remarks, we will be posting them to our Investor Relations website under Quarterly Results. And with that, I'll turn the call over to Mark.

Mark McLaughlin ***Palo Alto Networks Inc. - Chairman & CEO***

Thank you Kelsey, and thank you, everyone, for joining us today on the call to discuss our fiscal second-quarter results. In the second quarter, revenue grew 26% year over year to $423 million and billings grew 22% year over year to $562 million. We generated free cash flow of $170 million, up 24% year over year, and reported non-GAAP earnings per share of $0.63, up 47% year over year.

There are a lot of very positive things to discuss from the second quarter which I'll do later in my remarks. But I wanted to start off by noting that we're disappointed in our Q2 revenue results and guidance for the balance of the year. Up front, I want to discuss what is happening, what we're doing about it and then Steffan will discuss the impact to us for the second half of our fiscal year.

As far as what is happening, we believe that our weaker performance is primarily caused by go-to-market execution issues that are becoming more evident as we progress through the year. The impact from these issues is lower productivity than we planned for in the year with a broader base of slower pipeline conversion than what we started to experience in the first quarter. Why would this be?

For several years now, we've been running a playbook that has resulted in high growth rates. The basic components of that playbook are that each year we split territories, continually segment the market both vertically and by customer size, and forward invest in sales and marketing resources. These actions are of course designed to drive productivity. We've had very good results with this playbook for some time, and continued with it in our FY17 planning but are not seeing the expected return on investment.

In drilling into why, our initial analysis is that we over complicated our go-to-market motion with a lot more territory splits and segmentation than we have done in the past. This appears to have been too much too fast as we changed the coverage model for many customer relationships, resulting in lower productivity and less accuracy in forecasting. So what are we doing about it?

We're working diligently and quickly to identify the actions to adapt at the midpoint of the year, and are focused on the following things right now. First, we are reorganizing our account coverage model to drive more accountability and clarity. Second, we are recalibrating investments in our sales and marketing resources to better support this revised coverage model. And third, we are updating our second half plans to better reflect our mid-year forecast assuming near-term disruption as we make the moves necessary to get back to the productivity levels we expect of our investments.

While we continue to grow very quickly, I've stated many times, both in the Company and externally, that quality execution at rapid scale is very important for the success of the Company. We are accountable for the issues, and believe we can fix them.

Because we want to ensure that we do that in a thoughtful fashion and so that we can answer all the questions I'm sure you will have as we progress through that work, we're going postpone our investor day currently scheduled for March 16 until September 27, 2017. This will allow us to be as thorough and definitive as possible when we gather in New York.

Despite these execution issues, we continue to capture market share at higher rates. In Q2, we added approximately 2,000 new customers and are now privileged to be serving more than 37,500 customers worldwide. Customer wins and competitive displacements in the quarter included a Cisco and McAfee replacement to standardize all security at a large multi-national business services company that included all attached and non-attached subscriptions including a significant Taps investment.

A competitive win against Cisco to secure the data center and perimeter at one of the world's most largest physical security companies that included all attached subscriptions. A Cisco replacement and competitive win against Check Point for a data center project at a major North American healthcare provider that included a significant investment in both hardware and subscriptions. A Check Point replacement to secure the retail network at a large North American retailer, including our VM-Series and AutoFocus, and a competitive win against Cisco and Check Point to secure the private cloud of a bank raised in Europe.

Adoption across our platform also continues to drive lifetime value growth. All of our top-25 lifetime customers again made purchases in the second quarter. And to make this list a customer had to have spent a minimum of $16.6 million in lifetime value, a 46% increase over the $11.4 million in Q2 of FY16.

Customers are choosing Palo Alto Networks because our platform provides high degrees of automation, ever increasing leverage from our large and growing ecosystem of customers. Consistency of security regardless of where our data resides from network to end points and the cloud, and the power that comes from the increasing analytic capabilities we're applying to the petabytes of data we now process. These are the hallmarks of a true platform, and customers are seeing the results in better security, less complexity and a better total cost of ownership.

And in looking at the offerings in the platform, we continue to see momentum across the balance of our attached subscriptions. Including WildFire, where we added approximately 1,300 new customers, bringing our total WildFire customer account base to approximately 15,500. Our non-attached services which include Traps, VM-Series, Aperture and AutoFocus are also growing very well, and in the second quarter were on a combined annualized run rate of over $100 million in sales growing greater than 100% year over year.

Traps, our advanced endpoint protection, provides customers with prevention capabilities on endpoints, seamless understanding of the threats across the network and endpoints. And the leverage inherent in our very large and growing customer ecosystem across their entire environment.

In the second quarter, we grew the Traps customer base more than 35% sequentially to 875 customers, and saw significant increases in deal sizes. A recent survey of our Traps customer base indicated that over 70% of those surveyed chose to replace legacy antivirus with Traps due to its superior protection from malware and exploits, combined with integration with our next-generation security platform.

Our VM-Series cloud security offerings are growing very quickly as well, due to our unique abilities to provide superior and consistent security across all cloud and on-premise environments. And deep integration with cloud automation and orchestration. This evident with the success of our VM-Series, where we now have well over 2,500 customers with increasing deal sizes.

To continue accelerating success in cloud security, we now have all technical sales engineers trained on cloud with a growing number of cloud specialists dedicated to these opportunities. And with our expanded lineup of VM-Series offerings and continued deep integration with leading private and public cloud platform providers, we're well positioned in cloud security.

For Aperture, our SaaS security offering, we increased our customer count sequentially by over 40% and are quickly expanding the number of applications we can protect. The latest Aperture release now supports complete automation for data leakage and threat risk remediation, with the ability to instantly quarantine malware and remove sensitive data sharing in violation of policy. To protect the network and enforce compliance on SaaS applications.

And on the machine learning front, we continue to make good process with AutoFocus, with over 150 customers including some of the world's largest organizations. AutoFocus was our first subscription developed to leverage the massive amount of data we're now ingesting, and take advantage of our analytics and machine learning capabilities to make high-quality predictive and proactive security decisions that can be automatically enforced across our entire next-generation security platform.

Along those lines, we're very pleased to be announcing today the acquisition of Light Cyber, the leading company in the behavior analytics space. We have spent quite some time evaluating the players in this fast-growing space, and are very impressed with the capabilities and team at LightCyber. The LightCyber offering will continue to be sold as is for now, and will be integrated into the platform and offered as a subscriptions service by the end of this calendar year.

And we're accelerating the platform advantage. We are very excited about the new product launch we held on February 7, where we had more than 20,000 participants attend both live and through our webcast.

At the event, we introduced PAN-OS 8.0, our newest operating system with more than 70 new features and many new products and unique capabilities. Including six new hardware appliances designed to enable customers to deploy next-generation security from large data centers to small branches, all managed centrally by a new and faster version of Panorama. These appliances provide faster performance for deep visibility into and control over all traffic, including encrypted traffic which is becoming an increasingly strategic need for effective security.

Three VM-Series models to add to the existing four we currently offer, creating the broadest range of cloud security offerings in the market. This enables a wider range of deployment types, and even greater integration with Amazon web services, Microsoft Azure and VMware and NSX to deliver scale, redundancy and automation that allows customers to easily build cloud centric architectures. The industry's first multi-method scalable and automated approach designed to prevent credential-based theft and abuse by attackers.

Credential theft has become an increasingly popular tool for attackers, as it often allows them to bypass a number of other difficult steps in the attack lifecycle. Our new capabilities include the unique ability to prevent sending password-based corporate credentials to unauthorized sites, and an innovative approach to policy-based multi-factor authentication enforced at the network level to present the reuse of stolen credential.

And several new threat-prevention capabilities. Including automatic command and control signature generation, a new custom built from the ground up advanced hyper visor and bare metal analysis capabilities in WildFire, and MindMeld integration with AutoFocus. Allowing for third-party feeds to be easily correlated with their data for deeper analysis and automated protection using groundbreaking machine learning.

In summary, we continue to see positive reaction to our approach and our platform, and strong market traction. And we believe in our ability to address the execution issues I noted earlier, allowing us to continue to drive outsized market share gains. And with that, I'll turn the call over to Steffan.

Steffan Tomlinson ***Palo Alto Networks Inc. - CFO***

Thank you, Mark. Before I start, I'd like to note that except for revenue and billings figures, all financial figures are non-GAAP and growth rates are compared to the prior-year periods unless stated otherwise.

Let me start by saying we were disappointed that we fell below our revenue guidance range for Q2. In the quarter, we reported revenue of $422.6 million, an increase of 26%.

Looking at the geographic mix of revenue, the Americas grew 28% and accounted for a 69% share. EMEA grew 27% and accounted for a 19% share, and APAC grew 14% and accounted for a 12% share.

Product revenue of $168.8 million was essentially flat compared to the prior year. We anticipated that Q2 product growth would be weak due to a difficult year-over-year comparable, but product revenue fell below our expectation due to the execution issues Mark discussed. As well as some customers, more than we anticipated, delaying purchasing decisions based on the significant product release in early February.

Subscription and support revenue is now on an annual run rate north of $1 billion, and continues to grow at very high rates. Q2 SaaS based subscription revenue of $134.3 million increased 59%. Attach rates grew to 2.6 subscriptions per device shipped, up from 2.3 in the prior-year period and subscription renewal rates are greater than 90%.

Support revenue of $119.5 million increased 48%, and we enjoy approximately 100% renewal rates on support. In total, subscription and support revenue of $253.8 million increased 54%, and accounted for a 60% of share total revenue.

Turning to billings. Q2 billings of $561.6 million increased 22%. The dollar weighted contract duration for new subscriptions in support billings in the quarter was three years, compared to 2.7 in the prior-year period as customers increasingly commit to our platform as their long-term security architecture.

For the first half of FY17, billings of $1.1 billion increased 27% year over year. Product billings were $334.3 million, up 6%, and accounted for 31% of total billings. Subscription billings were $395.9 million, up 41%, and support billings were $348.3 million, up 39%.

Subscription and support billings accounted for 69% of total billings in the first half of FY17, compared to 63% in the first half of FY16. In Q2, total deferred revenue of $1.5 billion increased 61%.

Moving on to margins. Q2 gross margin was 78.6%, an increase of 140 basis points compared to last year. The increase was driven by improvements in recurring subscription and support gross margins, offset by a product gross margin decline of 50 basis points year over year. Looking forward, we expect there will be fluctuations in product gross margin, particularly with the recent introduction of our new products when we typically see decline in product gross margin for a few quarters.

Q2 operating expenses were $249 million or 58.9% of revenue. Operating margin was 19.7% in Q2, representing 120 basis points of improvement year over year. Net income for the quarter grew 51% year over year to $59.6 million.

Non-GAAP EPS grew 47% to $0.63 per diluted share. On a GAAP basis for the second quarter, net loss was $60.6 million or $0.67 per basic and diluted share.

Turning to cash flows and balance sheet items. Q2 cash flow from operations of $214.3 million increased 39% year over year. Capital expenditures in the quarter were $44.7 million, including $31.1 million of CapEx related to our new headquarters.

Free cash flow for Q2 was $169.6 million, up 24%, at a margin of 40.1%. Excluding CapEx related to our new headquarters, free cash flow was $200.7 million, up 46% year over year at a margin of 47.5%.

We finished January with cash, cash equivalents and investments of $2.1 billion. And I'm pleased to announce that the Board of Directors has authorized a $500 million increase to our existing share repurchase program, and extended the end date of the program to December 31, 2018. This brings the total amount authorized under the current program to $1 billion.

During the second quarter, we purchased approximately 900,000 shares of common stock at an average price of $132 a share, leaving a balance of approximately $830 million available for ongoing repurchases. DSOs were 78 days, within the previously provided range of 70 to 80 days.

As we look toward the future, we remain committed to our long-term strategy to capture market share within our financial framework of growth and profitability. We're not satisfied with our productivity, and know we have work ahead of us to maximize our potential.

Turning to guidance and modeling points. This afternoon, we announced that we have acquired privately held LightCyber for $105 million in cash. LighCyber expands our next-generation security platform with its highly automated and accurate behavioral analytics technology.

And while we will continue to offer the LightCyber products and to support existing customer implementations, we expect to make LightCyber available as a non-attached subscription by the end of the calendar year. For FY17 LightCyber's contribution to revenue will be immaterial, and we expect to invest approximately $5 million per quarter in both Q3 and Q4, primarily in R&D and platform integration.

For the third quarter FY17, our guidance anticipates that there will be some disruption as we implement changes to our go-to-market playbook, and as a result sale productivity will remain below our originally planned productivity levels in the second half. We expect revenue to be in the range of $406 million to $416 million, an increase of 17% to 20%.

Incorporating the approximately $0.04 earning-per-share impact from LightCyber, we expect non-GAAP EPS to be in the range of $0.54 to $0.56, an increase of 17% to 22% year over year. Excluding the LightCyber impact, non-GAAP EPS is expected to be in the range of $0.58

to $0.60, an increase of 26% to 30% using 93 million to 95 million shares. We expect Q3 product revenue to be in the range of $145 million to $148 million.

Base on our current pipeline analysis, we anticipate billings growth to trail revenue growth in each of Q3 and Q4 by approximately 10 to 15 percentage points. Our current view for the full FY17 is an annual revenue growth of approximately 25%, and essentially flat product revenue growth for the year.

We anticipate annual non-GAAP operating margin to increase approximately 170 to 180 basis points relative to FY16 non-GAAP operating margin of 17.3% as reported. Included in the 170 to 180 basis point improvement is at least 100 basis points of organic operating margin expansion, and 130 to 140 basis points positive impact from the deferred commissions change, offset by approximately 60 basis point headwind from LightCyber.

We expect full-year non-GAAP EPS to be in the range of $2.45 to $2.50, which includes a $0.07 impact from LightCyber and a share count of 94 million to 96 million shares. And we expect CapEx and free cash flow margin to be in the range of $160 million to $170 million and 35% to 40% respectively, which includes approximately $100 million related to our new headquarters of which we expect approximately $35 million to fall into Q3.

Excluding CapEx from the new headquarters, free cash flow margin is expected to be at least 40%. Structurally, our hybrid SaaS model combined with operational discipline continues to drive strong deferred revenue, revenue and free cash flow generation. With that, I'll turn the call back over to Mark.

Mark McLaughlin ***Palo Alto Networks Inc. - Chairman & CEO***

We appreciate you being on the call today. In summary, while we're excited and confident about the future, we know we have work to do to improve our execution and operational discipline. We will navigate the near-term challenges while executing on our strategy of being the leading global enterprise security provider. And with that, we'll open up the call for questions. Operator please go ahead.

QUESTIONS AND ANSWERS

Mark McLaughlin ***Palo Alto Networks Inc. - Chairman & CEO***

Thank you.

(Operator instructions)

Matt Hedberg, RBC Capital Markets.

Matt Hedberg ***RBC Capital Markets - Analyst***

Thanks for taking my questions. Mark, in your prepared remarks, you talk about reorging in your go-to-market model. I'm wondering if you could talk a little bit more specifically about changes you plan to make, and maybe and how long should we expect some of these to start producing the desired results?

Mark McLaughlin ***Palo Alto Networks Inc. - Chairman & CEO***

Sure, Matt. Thanks, good question. So we need to do to three basic things here from a go-to-market perspective on the items I talked about. The first is we have to go back and do account mapping or remap the accounts from a coverage perspective, because we have the account coverage blurred right now in a way that's not helping us.

The second thing we're going to have to do is reallocate the resources to properly align with that account coverage. And then the third thing is to make sure we've got the right people with the right skills in the right seat. So it's a pretty big effort we have to undertake here.

We've started it already. We expect to be working through that in the second half, and hopefully to see the benefits of that as we come out of the back half of the year into FY18.

Matt Hedberg ***RBC Capital Markets - Analyst***

That's great, I'm sure we'll hear more about it as we move. And maybe drilling down specifically on the sales and marketing line item. I'm curious what you were talking about -- what you think in terms of capacity adds here? I know productivity is lower than you expect here, but would you still expect to add capacity maybe at a lower rate to map to the billings growth or just trying to get a sense for capacity adds?

Mark McLaughlin ***Palo Alto Networks Inc. - Chairman & CEO***

Yes, Matt. So what we're very focused on is productivity at this point. So we've brought a lot of people in in the tail half of FY16, twice as many as we've done before.

So we're going to continue to add some heads into this from a go-to-market perspective. We'll slow that rate down in the back half the year, but we're primarily interested in increasing the productivity and the conversion in the pipeline. So that's our main effort.

Operator

Michael Turits, Raymond James.

Michael Turits ***Raymond James & Associates, Inc. - Analyst***

I'm trying to understand exactly how you think the sale strategy was wrong. Because it seems like it made sense to the extent that you were increasing the breadth of the product portfolio, and you were going through a very staged process of first adding vertical overlays and then getting rid of them and then integrating those new product sales capabilities into the existing salesforce.

Which seems like a very deliberate process strategy for what you've been doing. So what really was the disconnect and how are you planning to do things to differently?

Mark McLaughlin ***Palo Alto Networks Inc. - Chairman & CEO***

Michael, it's Mark. So we have been running our playbook very successfully for quite some time, as I said, and we continue to run that in FY17. What we did incorrectly as we look back on this and it's biting us now is just the magnitude of what we did coming out of 2016 into 2017 and the rate of territory splits, and I'll give you some other examples as well.

We moved in the hopes of driving higher productivity on investments. We've moved broad swaths of customer base into inside sales and resourced that accordingly, that turned out to not be producing the productivity we thought. So as an example, we had to bring big swaths of customer accounts from a mapping perspective back into territories, and have the right people in the chairs in order to execute on those.

So we know the playbook has worked for us in the past. And we think we realize what we've done incorrectly with that playbook, and we're going to go fix it.

Michael Turits ***Raymond James & Associates, Inc. - Analyst***

And I guess just to continue in the same bent, any change in the channel strategy relative to this?

Mark McLaughlin ***Palo Alto Networks Inc. - Chairman & CEO***

No, we like our channel a lot. The channel has been very good to us, and we have got great relationships with the channel. So we're not going to be changing that strategy.

Operator

Pierre Ferragu, Bernstein.

Pierre Ferragu ***Sanford C. Bernstein & Co. - Analyst***

Hello, thank you for taking my question. Mark, what gives you confidence and what's your level of confidence that like your disappointing productivity and disappointing sales performance is an issue that really comes from internal problems, and that it is not simply related by just the fact that maybe your competitive environment has been evolving and you're facing competitor who are catching up and putting their game together?

And then on the productivity front, so if you had product sales this quarter that were about in line with where they were last year, you have a significantly higher number of sales people in the organization today. Could you give us a sense of how much bigger you are today in terms of sales organization compared to one year ago?

And then if you could maybe give us a sense of how the salesforce basically waste this productivity? So where did the time go? Where did the efforts go, and which led them to this lower productivity?

Mark McLaughlin ***Palo Alto Networks Inc. - Chairman & CEO***

Yes sure, Pierre. Let me see if I can track all that. Let me start with the first one.

On the competitor front, we watch that very closely. We believe and have believed for some time that we have the best technical leadership in the market today. We vastly increased that with the new product launch we did on February 7 which was very well attended, and the addition of the LightCyber is an example under the family as well.

The issues that we're dealing with I think are primarily execution oriented and that we can go address those things. We've seen continued progress in the market. We just did another quarter of 2,000 net new customers increasing lifetime value as well, very, very high customer sat scores and Net Promoter scores as well. So the feedback from the market seems very positive. This is something that appears that we've done to ourselves and something that we can fix.

On the side of the salesforce, to give you some example. We brought in more than twice as many folks into the sales organization as we progressed through FY16 than we did in 2015, and added some more in Q1 of 2017 as well. So the rate and pace was a lot higher, and in hindsight realized the debt is something that has created challenges for us, and we're going to go fix that.

And on your last question as far as what are people working. Everybody is working very hard and very diligently, but the amount of relationship changes that occurred with these various account coverage moves that we've made is very high.

So when you're moving relationships around and trying to build on those relationships, it's hard. And at a minimum, we would see something like we're seeing now. We should have seen this earlier, but inaccuracies and forecasting about where things are in the pipeline as people are getting closer and closer to that customer over time.

Pierre Ferragu ***Sanford C. Bernstein & Co. - Analyst***

Thanks, Mark.

Mark McLaughlin ***Palo Alto Networks Inc. - Chairman & CEO***

Thank you, Pierre.

Operator

Andrew Nowinski, Piper Jaffray.

Andrew Nowinski ***Piper Jaffray & Co. - Analyst***

Thanks. I want to ask about what you mean about the delayed purchase decisions that customers made with regard to the new product that you launched in the quarter. Given the performance improvements in the new products, you would think that it would compel those customers to move forward with Palo Alto but your guidance suggests the opposite. So I guess can you help us understand why the deals that were delayed due to the new product launch would not come through in the April quarter?

Mark McLaughlin ***Palo Alto Networks Inc. - Chairman & CEO***

Hey, Andrew. It's possible that they may and the new products have been received very well from customer feedback. So far we had a fantastic launch and feel really good.

As Steffan mentioned, we did see some customers delaying purchases we got to the end of this second quarter in January. You're always trying to walk a very fine line on bringing new products to market, and when you do that we certainly wouldn't want to bring to market at the end of the quarter. So we brought them out right in the beginning.

You may have noticed we did a lot of advertising, not specifically about the products but that something big was coming. So it's always hard to get that right towards the beginning of a launch.

As far as folks coming into the third quarter, we expect the products to sell very well and we think they're fantastic. Unfortunately, what we have is the execution issue is going to overweight any goodness in that for some time, and we have to work through those execution issues.

Andrew Nowinski ***Piper Jaffray & Co. - Analyst***

Okay. And then given all the new products and virtual solutions you launched a few weeks ago, can you just give us your thoughts on the impending refresh cycle this year and how we should think about that with regard to your expectations for the remainder of the year?

Mark McLaughlin ***Palo Alto Networks Inc. - Chairman & CEO***

Yes, as we've said in the past, we think we have a very significant refresh opportunity in front of us and that of course hasn't changed. I think the new product is just going to help on that. It's going to be up against the headwind of the execution stuff we just mentioned.

But putting that in perspective, so if you look at all the cohorts or classes of customers ours from 2008 to 2012, it's about a little over 8,000 total. The 2013 class in and of itself is 6,000 and it grows from there. So I think we've got a lot of refresh opportunity in front of us, that hasn't changed, and we are confident about that but we have got to work through these other issues to really get the benefit of that.

Operator

Philip Winslow, Wells Fargo Securities.

Philip Winslow ***Wells Fargo Securities - Analyst***

Hey, thanks, guys. Just to build on that, you had two questions I guess. On the refresh side, how do you think the changes to the go-to-market strategy may be affected, the timing of that refresh at all? And obviously it averages about call it five years, but things can slip.

Did any of the changes impact call it existing customers and you're thinking your cadence and refreshing those? And then also, one of the things you talked about in the past too was service provider wins. Wondering if you could just double-click on that space a little bit, what's happened year to date, how are you thinking about the second half?

Mark McLaughlin ***Palo Alto Networks Inc. - Chairman & CEO***

Yes, sure, Philip. On the first question on the refresh, well having execution headwinds doesn't help at all of course but we're very confident that people are going to want a better refresh on the new product line. The new product line is really good and it provides three or four different opportunities from a refresh perspective, and it was clearly designed to do it that way.

But again, it's going to be up against this getting our act together from a go-to-market perspective and implementing the changes we need to implement. I'll let Mark Anderson answer the service provider question.

Mark Anderson ***Palo Alto Networks Inc. - President***

Hey, Phil. As you know, we started focusing on service provider about a year and a half ago, and it's going very well. Especially given the new product map that we have for virtualized products going much smaller and much bigger is really going to help us quite substantially in our managed services business with those customers. So we feel very good about where we are, and the team is ramping very nicely.

Philip Winslow ***Wells Fargo Securities - Analyst***

Got it. Thanks, guys

Mark McLaughlin ***Palo Alto Networks Inc. - Chairman & CEO***

Thanks, Phil.

Operator

Jayson Noland, Baird.

Jayson Noland ***Robert W. Baird & Company, Inc. - Analyst***

Okay, great. Mark, I wanted to ask your thoughts on the industry backdrop coming out of RSA. Does it seem like how 2017 budgets are getting better year on year, and then clarity, there's a lot of new players in the industry. It seems crowded and combative at some points. Maybe if you could talk about budgeting and then how people are going to spend their money. Thanks.

Mark McLaughlin ***Palo Alto Networks Inc. - Chairman & CEO***

Sure, Jayson. Lots and lots of vendors up there and lots of people showed up at RSA, which is I think a good thing in the sense of there needs to be a lot of innovation in the security industry. But I'll answer your question two different ways.

First from a backdrop perspective, it seems like security still remains a priority and spending is good on security. So what we're facing here is things that we've created ourselves here, not so much a spending issue in security.

I think on the second front, it's becoming more apparent and I can see it at up a RSA about the what the consumption model of all that innovation is going to look like over time. And what I mean by that, it's very clear that the age of the platform for security we invented that in the first place and we're doing very well against that.

And I think people are going to increasingly consume all that innovation through platforms, there's going to be less and less platform companies out there. And a lot of the smaller companies who are highly innovative will become parts of those platforms, evidence LightCyber acquisition this afternoon, whether it's through acquisition or partnerships. I think more and more that's going to happen over time.

Jayson Noland ***Robert W. Baird & Company, Inc. - Analyst***

Thank you.

Mark McLaughlin ***Palo Alto Networks Inc. - Chairman & CEO***

Thank you.

Operator

Ken Talanian, Evercore ISI.

Ken Talanian ***Evercore ISI - Analyst***

Hey, guys, thanks for taking my question. First off, just wondering could you give us a sense if there are any changes that you've noticed in the go-to-market approaches by your competitors, and really I am thinking about Cisco here in particular?

Mark McLaughlin ***Palo Alto Networks Inc. - Chairman & CEO***

No, the competition has been fierce for a long time, Ken, and I think it will continue to be that way. People buy usually on three angles, security, a reduction in complexity and cost. And different players in the market have gone after different levels there.

Ours is coming top down which is security, reduction in complexity and at a very good cost. Other people approach it from a different angle. But I haven't noticed anything different from the competitive landscape in that regard.

Ken Talanian ***Evercore ISI - Analyst***

Okay. And then also, based on your guidance for next quarter, it looks like product growth might actually decline both sequentially and year over year. So one, just curious if that's directionally correct? And then if you could just give us a sense for what product growth will do in FY17 overall?

Mark McLaughlin ***Palo Alto Networks Inc. - Chairman & CEO***

Yes, sure, Ken. Of course we anticipated and we've said this before that we thought that Q2 would be the low point from a product growth perspective year over year, and unfortunately we were inaccurate that regard because of the things we're facing here. But we also believe those things are within our control and we can fix them, and that we will be able to get back on track from a product growth perspective.

Operator

Sterling Auty, JPMorgan.

Sterling Auty ***JPMorgan - Analyst***

Yes, thanks. Hello, guys. Would you say that the execution issues were evident throughout the quarter, or did they manifest later in the quarter? And the reason I'm asking just given the good results we saw out of off quarter companies like Barracuda and the December quarter earnings from everybody else, did this manifest late in the quarter?

Mark McLaughlin ***Palo Alto Networks Inc. - Chairman & CEO***

Yes, Sterling. Let me actually back it up a little further on from a Q1 perspective and what we saw in Q1 which we had talked to you guys about as well. Which was the first few months being on track and then seeing some slowdown in month three, and that case is specific to some large deals. In hindsight looking back on that and looking for a pattern in that, and that's what we saw play out in Q2 as well.

We had good November, right on track. We had a good December, right on track, and then we saw slow down but on a much broader base in January. So that's what it looked like is as far as the Q2 playing our from a linearity perspective.

Sterling Auty ***JPMorgan - Analyst***

And even though you said the sales execution changes would out weigh any pickup from stuff that was frozen waiting for the new products, is there a way to at least quantify how much business you felt froze and waited for the new appliances and PAN 8 launch?

Mark McLaughlin ***Palo Alto Networks Inc. - Chairman & CEO***

Yes, I don't think it was that much. If you look at -- we're not happy that we came in under the guide in Q2 on that, but we weren't that far away from it so it's not that much and it's also very hard to tease through what's related to the execution and what people are saying specifically on product delays. So it's a little bit difficult to say.

Sterling Auty ***JPMorgan - Analyst***

Got it. Thank you.

Mark McLaughlin ***Palo Alto Networks Inc. - Chairman & CEO***

Thanks, Sterling.

Operator

Gregg Moskowitz, Cowen and Company.

Gregg Moskowitz ***Cowen and Company - Analyst***

Okay, thank you. I had a question for Steffan. If I recall correctly, at your last analyst day you talked about Palo Alto being in high growth mode and put out expectations to continue to grow 30% or more for the foreseeable feature. Obviously you've guided to 25% growth for FY17, and the question really is did these results change your view looking forward of where Palo Alto sits on the growth and maturity sense?

Mark McLaughlin ***Palo Alto Networks Inc. - Chairman & CEO***

So we just came off a quarter where we posted 26% year-over-year growth, and clearly we're not satisfied with that. We've identified execution issues that we're in the process of working through, and we have a high level of confidence they're within our control and we can fix them. We need to get through that work before we call the ball on future levels of growth, but I can tell you that we feel very confident in returning to growth and we get these execution issues fixed and we'll be in a much better position going forward.

Gregg Moskowitz ***Cowen and Company - Analyst***

Okay. Thank you.

Operator

John DiFucci, Jefferies.

John DiFucci ***Jefferies & Co. - Analyst***

Thank you. From our calculations anyway, new business growth was very modest for the second consecutive quarter, and I know you're talking a lot about your misexecution. But you are really not the only ones to have some challenging quarters over the last year or so.

Even Check Point has had a couple of quarters -- had some challenging periods before that. I guess, Mark, if there's anything else other than misexecution? What else might be happening out there that could be affecting your results?

Mark McLaughlin ***Palo Alto Networks Inc. - Chairman & CEO***

So I think-- well couple of things on this. One on the new business side, we have to acquire new customers and we have to expand in our existing customer base as well. So we always watch both of those, and the bulk of the business obviously as we get bigger will come from expansion. We just acquired 2,000 new customers in the quarter, so it seems like from a customer acquisition and win rate perspective, it's been healthy, and it continues to be healthy.

And what we're seeing now is the slow down from a conversion perspective on the expansion downstream, which makes sense as we look back on the go-to-market motions we made about changing those relationships around. So existing relationships can change around a lot with 2, 3 different times within a short period of time is going to create some anxiety from the customer account coverage perspective. And that's where we see the slow down in the conversion is down through the expansion business.

John DiFucci ***Jefferies & Co. - Analyst***

Okay. And then one area in particular that we've been hearing more about is just trying to protect the east-west traffic, which as you know is a -- it's not something that everybody does and it's not something that everybody does broadly. But I think it's generally thought of at that Palo Alto Networks actually does it very well compared to others.

At the same time, it's an area where we do hear people questioning how much they're going to need to do that, especially if they start to move workloads to the cloud. Are you seeing anything around that today?

Mark McLaughlin ***Palo Alto Networks Inc. - Chairman & CEO***

Yes, we're actually seeing an increase in east-west traffic interest in protection. And it's actually is related to the cloud as well. Because at the same time people are on a journey to the cloud, they're also doing lots of data center work to virtualize and optimize data centers. When they do that, they use a lot of virtualization inside those data center environments.

Which means that they're going to micro segment all those environments inside that data center, which is great but then you have to also be able to protect the information that traverses the east-West through those micro segments not just north-south. So we're actually seeing a continually building use case for that, ever since we started off with that with the VM-Ware and S-X which has been pretty successful for us.

Operator

Gabriela Borges, Goldman Sachs.

Gabriela Broges ***Goldman Sachs - Analyst***

Great, thanks for taking the question. Maybe just a little more on the assumptions that are going into guidance for the back half if I could.

Steffan, you mentioned that you are accounting for sales productivity being below the originally planned productivity levels. But how does that compare to the productivity levels you're seeing today? And similar question for the timing of deal cycles and how long you're assuming deal cycles take to close? Thank you.

Steffan Tomlinson ***Palo Alto Networks Inc. - CFO***

When we were looking at sales productivity relative to our plan, we were looking at a high single digit delta between what the planned productivity was and what is actually forecasted it would be. And we're factoring that into our guidance for the second half. And we're purposefully being prudent and cautious around the guide because we understand that the execution issues will take a while to get through.

We're actively working on those remediations right now, and we factor that into the guide. And when you look at timing of sales cycle elongation, we've seen elongating sales cycles. We called that out in Q1.

We saw an extension of that in Q2, but on a much broader base. So we're clearly not satisfied with the year-over-year growth that we're posting, and we feel like after we make the execution fixes, sales elongation should contract a little bit and sales productivity should increase.

Operator

Walter Prichard, Citi.

Walter Pritchard ***Citigroup - Analyst***

Thanks. Mark, I guess a question for you. I look at the metric on new customer adds, 2,000 looked pretty good. I'm wondering as we look at the results in the context of the new customer adds and the sales changes or the sales disruption, it would seem like the sales disruption might impact your ability to bring in new customers and yet that metric was good. Could you give us some color on how you saw you saw the impact here ripple across the existing customer base, the new customer base and maybe there was a deal size issue with that was part of it as well? Just trying to round that altogether.

Mark McLaughlin ***Palo Alto Networks Inc. - Chairman & CEO***

Yes, sure thing, Walter. So we just put up another 2,000 net acquisition quarter which is good. We have to make some assumptions as we play out the second half of the year with the execution issues as to how that would impacts things. We'll see how that plays out, it's a little too early to call that right now.

But as I was telling John a little earlier on his question as well, we have to get two things right. We have to get the net new customer acquisition right, and then even more importantly we have to get the expansion right in the existing customer bases. And if you move the relationships around inside of there, it can create longer timeframes to know what's happening from a deal perspective and accurately forecast when you're going to get the ball over the line. And I think that's the area where we broke and we're going to go fix them.

Walter Pritchard ***Citigroup - Analyst***

And then just a follow up for Steffan, on the duration you talked about three years which it sounds like is an average. Did you open up a program or anything that drove -- because if three is the average it sounds like there could be a substantial number of customers who are actually signing duration that's longer than three years. Was there something that was done programmatically this year in the quarter to drive that higher?

Steffan Tomlinson ***Palo Alto Networks Inc. - CFO***

There was nothing done programmatically to drive it higher. It was a dollar weighted calculation, not a simple average or just number of customers.

So we always see that customers -- we've been seeing this trend over time. Customers are asking us to standardize for multi-year periods on our architecture. We view that as a positive indicator of our technology lead, and so there was nothing new from an incentive standpoint to encourage that behavior, it's more customer driven.

Operator

Karl Keirstead, Deutsche Bank.

Karl Keirstead ***Deutsche Bank - Analyst***

Thank you. I've got two questions, both on the guidance. First, your guidance suggests the second half of FY17 should see about 20% growth, and maybe I'll throw this one to Mark. Do you think that is a realistic target for FY18? So you think you can hit 20% growth next fiscal year?

And then the second one is for Steffan. Steffan, you I mentioned that, if I heard you correctly, billings growth should be less than revenue growth by 10 to 15 percentage points in the back half. So if the back half revenue growth is 20%, you are suggesting that the billings growth should be 5% to 10%.

And given that your subscription and maintenance billings are tracking close to 40%, it's almost hard to get the billings growth all the way down to 5% to 10%. And maybe I'm missing something you could help me with. Thank you.

Mark McLaughlin ***Palo Alto Networks Inc. - Chairman & CEO***

Yes, I'll take the first one, Karl. We're not happy with the guidance we've put out there, and we're working to fix that of course. And we have a number of issues we have got to go work on.

We're going to progress through that through the back half of the year, and expect to that will get us back on track. We need to go sort that out, and we'll come back to you as fast we can with much better answers on a long-term basis for FY18. We don't think that would be prudent right now to set that out there.

Steffan Tomlinson ***Palo Alto Networks Inc. - CFO***

From a billings growth standpoint and you look at how that translates to revenue, let me start by saying it all really begins with sales productivity. And with sales productivity tracking high single digits below our plan, that translates into much lower billings growth. Remember, if you look at the composition of our billings, we get in the first half of 2017 about 69% was subscription support and renewal.

When you look at revenue, we're effectively indicating that product revenue is going to be flat for the full year FY17 versus 2016. We're still anticipating high levels of subscription and support growth from a revenue standpoint.

But because sales productivity is tracking so far below where we had originally planned and we're intentionally taking corrective steps to fix that problem we're anticipating much lower billings growth during this transition period as we're trying to correct the problems. And after we correct the problems, we should see a return to much healthier billings growth than what we're seeing today and what we're forecasting for the balance of the fiscal year.

Karl Keirstead ***Deutsche Bank - Analyst***

Got it. Okay, thank you both. That's helpful.

Mark McLaughlin ***Palo Alto Networks Inc. - Chairman & CEO***

Thanks, Karl.

Operator

Catherine Trebnick, Dougherty.

Catharine Trebnick ***Dougherty & Company - Analyst***

Hello, thank you so much for taking my question. You had said that the product revenue growth was expected to be now flat year over year. Outside the execution issues you discussed, how much of that flat growth would be attributed to your VM-Series and the rapid adoption of migration of the cloud by your enterprise customers?

And then the second piece of that, did I hear you correctly that you said the channel was okay? So am I to assume that your competing overlay sales teams perhaps caused some of the execution issues in accuracy in your reporting? Thank you.

Mark McLaughlin ***Palo Alto Networks Inc. - Chairman & CEO***

Hey, Catherine. It's always good to hear from you. On the cloud side, I don't think the product growth for the second half has anything to do with the cloud but. That's actually been a good opportunity for us, in a lot of ways a lead generator as always when there's something new, whether it's virtualization or cloud in this case or mobility.

We've been able to exploit that opportunity as another reason to talk to Palo Alto networks for somebody who may not otherwise. And start doing business with them in the first place, and do more business over time and what we've seen. So we're not happy about the product guide for the second half of the year, but I don't believe that's due to the cloud. I'm going to let Mark Anderson take the channel question.

Mark Anderson ***Palo Alto Networks Inc. - President***

Let me just add on a little bit to what Mark said. Firstly, the overlay team, there's no confusion, Catherine, in what our overlay teams are doing. It's primarily technical sales overlaying our core sales teams to help them sell Traps, sell into the cloud environment, sell Aperture and AutoFocus. And we're very happy with the way that's going.

I think as far as the channel goes, the channel is a very good channel, as we've said before. There executing very well. We're onboarding new channel partners like AWS and Microsoft Azure, our service provider channels continues to get better. All of this execution rests on the sales team, and we definitely what we're doing to fix it and we're going to be fixing it as we go on through the fiscal year.

Operator

Jonathan Ho, William Blair.

Jonathan Ho ***William Blair & Company - Analyst***

Hey, guys. Just wanted to understand with a little bit more granularly, where there any particular geographies or market segments that we should be on the watch for where the sales execution challenges were more pronounced?

Mark McLaughlin ***Palo Alto Networks Inc. - Chairman & CEO***

Hey, Jonathan. No, this is across the board, but it may be obvious but I'll state it anyway. That with the Americas being such a large contributor to the business today, that's where we would see the most impact.

Jonathan Ho ***William Blair & Company - Analyst***

Got it. And then just in terms of the account coverage shift, how long do you expect that to take to really reestablish the results, and do you see the potential to get back to growth once these issues have been corrected?

Mark McLaughlin ***Palo Alto Networks Inc. - Chairman & CEO***

So from a timing perspective, we are underway with the activities that I talked about a little earlier. We'll be prosecuting those through the back half of the year, and we would hope to have them all finished by the back half of the year and be able to come out of the year and into FY18 in a better position than we are.

So I was saying a little earlier, we got a lot of stuff to sort out here. We know we can do better than we are today and what we're guiding, but it would be too early for us and really not prudent to try to call out what it may be into next year.

Jonathan Ho ***William Blair & Company - Analyst***

Got it. Thank you.

Mark McLaughlin ***Palo Alto Networks Inc. - Chairman & CEO***

Thanks, Jonathan.

Operator

Fatima Boolani, UBS.

Fatima Boolani ***UBS - Analyst***

Hello, thanks for taking the question. Question for you, Mark, just with respect to the new product lineup. It was obviously one of the bigger launches you've had in the last couple of years, and you did talk about some purchasing positives with respect to the customer base. I'm wondering if you can help us drill down on how you are managing the forecast for any potential trade down effect or just generally how you're thinking about that?

Mark McLaughlin ***Palo Alto Networks Inc. - Chairman & CEO***

So whenever we introduce new hardware, we're expecting movement from existing hardware products to new ones. So in all these case, some so customers are going to move up, some will move across, some are going to move down. It's just inevitable that it's going to occur.

So we have to try to take all that into account when we're forecasting. So with the introduction of the PAT 20 the 800 and the 5200 series, those are the main things we just brought to market. We expect we're going to see a lot of movement to the new hardware platforms, and we're going to see two incremental opportunities. One is going to be the refresh as we were talking about a little earlier, and they also give us a chance to just get new competitive wins with the hardware capabilities.

Just I think something we have to think about, we have here is that when you are thinking through trade down impacts, we want to make sure that's minimal. So it's our job to make sure that we're offering customers a really compelling reason to want a higher capacity. And performance for us, we see our very high attach rates and user subscriptions.

We're seeing increasingly growing need for SSL decryptions, so the customers are looking for a lot more powerful systems like the ones that we just introduced. So that's art and science there, we hopefully get both of them right.

Fatima Boolani ***UBS - Analyst***

And a quick follow up if I may. You still demonstrated a fair bit of confidence around the installed base refresh dynamics. Could you parse out qualitatively for us to what extent that confidence is tied to the base doing upsizing on the hardware refresh versus incremental subscription attach rates, and this is just in the context of the 2.6 attach rate which didn't really change much versus the past six months?

Mark McLaughlin ***Palo Alto Networks Inc. - Chairman & CEO***

Sure so let me -- they're related very much, so we have the attach rates being up year over year from 2.3 to 2.6 and of course they're attaching to the hardware device itself. So when we think about refresh opportunities, we're giving customers a lot to progress towards from a refresh perceptive and we're also hoping that as it's happened in the past if people would attach subscriptions at very high rates when they do that. And then also we also have a great opportunity just to win new business as well with the new hardware, along with the growing capabilities of the platform as well.

Operator

Saket Kalia, Barclays.

Saket Kalia ***Barclays Capital - Analyst***

Hey, guys, thanks for fitting me in here. Hey first, Mark, maybe just for you. We've obviously talked about executing challenges a bunch impacting pipeline close rates, but you can you just qualitatively talk about overall pipeline growth in the second quarter?

Mark McLaughlin ***Palo Alto Networks Inc. - Chairman & CEO***

So from a pipeline perspective, we have done in the past, we continue to do a very nice job in demand generation. So we have a very good pipeline in terms of the size of the pipeline. We think the quality of the pipeline is very good as well.

What we're seeing though is a conversion of the pipeline. So it's not really a demand generation issue, it's really just making sure that we get it converted in the timeframe it's going to get it converted. But the pipeline is good.

Saket Kalia ***Barclays Capital - Analyst***

Got it. And then for my follow up, it sounds like maybe one of the execution challenges besides increasing segmentation was maybe moving some accounts to inside sales, which might have created some noise. I'm sure that there were a multitude of things with as complex of a sales organization as you have. But would you say that that was maybe one tangible item that contributed to some of the challenges this quarter?

Mark McLaughlin ***Palo Alto Networks Inc. - Chairman & CEO***

Yes, there are multiple things there, but that's an example of, I can't remember who asked that question before, but it's an example something that we've always done in running this playbook was increasingly segment the market. In this case in trying to drive increasingly high levels of productivity and better return on investment, we moved a broad swath of customers into the inside sales organization and resourced that accordingly.

The folks who used to be in what we called, in the territory, so just think of it simply along those ways. And that's really not working out. So now we need to, as just one example, things we need to do is we need to map those accounts back from where they were back into those territories, make sure we got the right people focused on them and make sure we realign the resources appropriately.

Saket Kalia ***Barclays Capital - Analyst***

Got it. Very helpful. Thanks, guys.

Mark McLaughlin ***Palo Alto Networks Inc. - Chairman & CEO***

Thank you, Saket.

Operator

At this time, I'd like to turn the conference back over to Mr. Mark McLaughlin for any additional or closing remarks.

Mark McLaughlin ***Palo Alto Networks Inc. - Chairman & CEO***

Thanks, operator. I appreciate that.

Before I close, I'd like to thank the Palo Alto Network's team for their dedication and our customers and partners for the opportunity to work with them. And I'd really like to welcome the LighCyber team to the Company. We take the responsibility of helping the world's largest organizations solve their most critical security challenges very seriously, and we appreciate your support. Thank you very much.

Operator

Thank you. And, ladies and gentlemen, again that does conclude today's conference. Thank you all again for your participation.
