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PANW - Q3 2017 Palo Alto Networks Inc Earnings Call

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PRESENTATION

Operator

Good day, everyone, and welcome to the Palo Alto Networks Fiscal Third Quarter 2017 Earnings Conference Call. Today's conference is being recorded.

And at this time, I'd like to turn the conference over to Kelsey Turcotte, Vice President of Investor Relations. Please go ahead, ma'am.

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

Great. Thanks, Tom. Good afternoon, and thank you for joining us on today's conference call to discuss Palo Alto Networks' fiscal third 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; Steffan Tomlinson, our Chief Financial Officer; and Mark Anderson, our President.

This afternoon, we issued a press release announcing our results for the fiscal third quarter ended April 30, 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 guidance, modeling points for the fiscal fourth quarter and full year '17; 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; innovations in our product, subscription and support offering. 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 March 1, 2017, 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 Bank of America Merrill Lynch 2017 Technology Conference on Tuesday, June 6, and hosting Investor Day 2017 on Wednesday, September 27 in New York City.

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 D. McLaughlin - *Palo Alto Networks, Inc. - Chairman and CEO*

Thank you, Kelsey, and thank you, everyone, for joining us on the call today to discuss our fiscal third quarter results.

In the third quarter, revenue grew 25% year-over-year to $432 million and billings grew 12% year-over-year to $544 million. We generated free cash flow of $163 million and reported non-GAAP earnings per share of $0.61, up 33% year-over-year.

As many of you know, we initiated a salesforce reorganization at the outset of our fiscal third quarter. We are making solid progress in these efforts and are on track with our project plans. While we have much more to do and will take time to fully realize the impact of these changes, early feedback from customers, partners and our sales teams has been good.

Now turning to the quarter. In Q3, new customer adds were the second-highest in the company's history. We are now privileged to serve more than 39,500 customers worldwide, including 86 of the Fortune 100 and approximately 1,200 of the Global 2000, 40 of which we added during the quarter. Feedback on our technology, approach and strategy is very positive, as evidenced not only by high rates of customer acquisition, but also by external recognition. For example, customer satisfaction is very high as measured by our Net Promoter Score of 73, which is more than 20 points higher than what is considered a best-in-class Net Promoter Score of 50. And in Q3, we were privileged to earn the SANS Best of 2016 award for next-generation firewalls, which was voted on by the SANS community of security operations professionals and security managers from around the world who have used our technology to increase the effectiveness and efficiency of their cybersecurity programs.

In Q3, we continue to see strength not only in new customer acquisition, but also in increasing wallet share of existing customers for our next-generation security platform. In the quarter, all of our top 25 lifetime value customers again made purchases. And to make this list, a customer had to have spent a minimum of $20.1 million in lifetime value, a 61% increase over the $12.5 million in Q3 of fiscal '16.

Specific examples of customer wins and competitive displacements in the quarter included a Check Point data center replacement at one of the world's largest retailers, an 8-figure deal to replace Check Point in a large U.S.-based auto insurance provider, a 7-figure Cisco replacement that included all of our attached subscriptions where we became the security platform for one of the world's largest travel companies based in Europe, a 7-figure Cisco replacement with our PA-7080 chassis and new PA 5200 series devices at a multistate network of physician clinics, outpatient centers and hospitals in the United States; a 7-figure deal to become the security architecture for one of the largest insurance companies in the United States, including securing their cloud initiatives and 2 large antivirus replacements with Traps in one of Southeast Asia's largest banks as well as the U.S.-based health care provider.

We're able to win at very high rates in a very competitive market because of the unique capabilities of our platform. As the recent WannaCry global attack illustrated, the need for integrated and automated security is growing quickly. We are always pushing the innovation curve to keep customers safe across their entire architecture, including on-premise, endpoints, third-party SaaS applications and public and private cloud deployments. And this approach is constantly enhanced by the network effect of tens of thousands of customers in our technology partner ecosystem, providing leverage to each other through our platform. Our continued innovation has been well received by the market.

Our new hardware generated very high interest in the quarter, and we are pleased that demand for these new products exceeded our internal forecast. Also, market reaction was very positive for the introduction of our new high-performance virtualized firewalls as well as our new 8.0 operating system with more than 70 new security features that enhance all aspects of our next-generation security platform.

Momentum with our attach subscription services was also evident in Q3, including WildFire, where we added approximately 1,500 new customers. We have been adding over 1,000 WildFire customers per quarter for over 3 years and are now serving approximately 17,000 WildFire customers. WildFire is a great example of how our integrated and automated approach to enterprise security not only improves prevention outcomes, but also drives operational efficiencies for customers overwhelmed by the numbers, cost and complexity of legacy tools and point products.

With the size of our customer base and capabilities deployed, we are also using analytics to provide differentiated tools and actionable intelligence. We saw strong customer growth in AutoFocus as well as a high degree of interest in our newly acquired LightCyber technology. We remain on track to have LightCyber integrated into our platform and offered as a subscription service by the end of this calendar year.

In addition to analytics, cloud security is top of mind for our customers and we continue to see solid uptake on our cloud offerings due to our unique ability to provide not only cloud specific security capabilities, but also the consistency of security wherever data resides or is computed.

In Q3, we saw strong sequential growth for Aperture, added hundreds of VM-Series customers and are continuing to expand our market reach by leveraging our partnerships with all leading cloud infrastructure providers. And traction continues to grow nicely for Traps, where hundreds of channel partners are now selling Traps and we are serving over 1,000 customers.

In early May, we announced the latest release of Trap's endpoint technology. Enhancements in this 4.0 release include the addition of support for macOS and a beta for Android, plus several new prevention modules designed to detect and stop ransomware and other advanced threats. When implemented with our next-generation firewalls, customers can now correlate endpoint and network security events in our network security management tool, Panorama. In just a couple weeks, we are expecting thousands of guests join us in Vancouver for Ignite, our annual user conference. This is proven to be a great and highly anticipated event by our customers and partners, and we hope to see you there. Registration information can be found on the Palo Alto Networks website.

And with that, I'll turn the call over to Steffan.

Steffan C. Tomlinson - *Palo Alto Networks, Inc. - CFO and EVP*

Thanks, 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 were compared to the prior year periods unless stated otherwise.

In our third quarter, we saw some early positive indicators of the changes we're making in the go-to market portion of our business. Sales productivity improved sequentially, with product revenue coming in better than we had expected as customers invest in our next-generation security platform.

We delivered record revenue, strengthened our balance sheet and generated strong cash flows.

Turning now to the financial highlights for the quarter. New customer acquisition and expansion within our existing customers drove revenue growth of 25% to $431.8 million. Looking at the geographic mix of revenue, the Americas grew 22%, EMEA grew 32% and APAC grew 33%.

Product revenue of $164.2 million grew 1.3% compared to the prior year. Increasing adoption of our 8 subscriptions and high renewal rates continue to drive sales in the recurring portion of our business. Q3 SaaS-based subscription revenue of $143.2 million increased 55%. Support revenue of $124.4 million increased 37%.

In total, subscription and support revenue of $267.6 million increased 46% and accounted for a 62% share of total revenue. Billings of $544.1 million increased 12% and contract duration was unchanged compared to the prior year. Total deferred revenue of $1.6 billion increased 51%.

Moving on to margins. Q3 gross margin was 76.4%, a decrease of 150 basis points compared to last year and within our target range of 75% to 78%. The decline was primarily attributable to the new products we introduced in the quarter. As we indicated on last quarter's call, new products typically have a higher initial cost of goods sold, which will improve over time.

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 a decline in product gross margin for a few quarters. And in the quarter, discounting decreased sequentially and was essentially flat year-over-year.

Q3 operating expenses were $250.8 million or 58% of revenue. Operating margin was 18.4% in Q3. Net income for the quarter grew 35% year-over-year to $57.1 million. EPS grew 33% to $0.61 per diluted share.

On a GAAP basis for the third quarter, net loss was $60.9 million or $0.67 per basic and diluted share. We finished April with cash, cash equivalents and investments of $2.1 billion.

During the third quarter, we purchased approximately 1.1 million shares of common stock at an average price of $113 per share, leaving a balance of approximately $705 million available for ongoing repurchases.

Q3 cash flow from operations of $211.2 million increased 24%. Capital expenditures in the quarter were $48.6 million, including $32.8 million of CapEx related to our new headquarters. Free cash flow was at $162.6 million, up 8% at a margin of 37.7%. Excluding CapEx related to our new headquarters, free cash flow was $195.4 million, up 29% at a margin of 45.3%. DSO was 78 days within the target range of 70 to 80 days.

Turning now to guidance and modeling points. This guidance takes into account the type of forward-looking information that Kelsey referred to earlier. It also takes into account the work we still have to do on the go-to-market changes we introduced last quarter.

For fiscal Q4 '17, we expect revenue to be in the range of $481 million to $491 million, an increase of 20% to 23%. And we expect non-GAAP EPS to be in the range of $0.78 to $0.80 using 93 million to 95 million shares.

In addition, we expect the following modeling points for Q4 '17. Billings to be in the range of $625 million to $645 million, product revenue to be in the range of $188 million to $191 million and CapEx to be approximately $55 million, including $30 million related to our new headquarters.

And for the fiscal year, we expect non-GAAP operating margin to be 19.5% to 19.6%, which is an increase of 220 to 230 basis points relative to FY '16 non-GAAP operating margin of 17.3% as reported. Included in the 220 to 230 basis point improvement is approximately 100 basis points of organic operating margin expansion and 180 to 190 basis points positive impact from the deferred commissions change, offset by an approximately

60 basis point headwind from LightCyber. And we expect fiscal '17 free cash flow margin, excluding our headquarters investment, to be at least 40%.

With that, I'll turn the call back over to the operator for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) We'll take our first question today from Gabriela Borges with Goldman Sachs.

Gabriela Borges - *Goldman Sachs Group Inc., Research Division - Equity Analyst*

May I just start off, Mark. You mentioned in the prepared remarks a little bit on the progress you've made with the sales force and then there are still some work to do. Maybe you could just give us a little more detail there and what you feel you've accomplished thus far into the second half of the fiscal year and what are some of the milestones that you're looking to achieve with productivity and other internal metrics as you go through fiscal year into the next fiscal year.

Mark D. McLaughlin - *Palo Alto Networks, Inc. - Chairman and CEO*

Sure, Gabriela. Thanks for being in the call. As we mentioned last quarter with the reorganization, we are taking a 4-step approach because we needed to design what we wanted to do differently. We want to communicate that to everybody. We needed to do account mapping exercises with the accounts in the right place, coverage-wise. Make sure everything's in the chairs to cover that, then we have to run it that way. So over the course of the last quarter, we got the design work finished, the communication work finished. We've mapped all the accounts and we need to make sure that the folks are in the chairs to cover the accounts and that other folks of just picked up accounts are working as fast and as hard as possible with our help to build those relationships in those accounts as well. That's where we are right now, we'll be continuing that through the fourth quarter, for sure. Hopefully you see positive impact from this through fiscal '18.

Gabriela Borges - *Goldman Sachs Group Inc., Research Division - Equity Analyst*

That's helpful. And as a follow up, if I could. Just on the comment that discounting activity has moderated year-over-year. Just your thoughts on what you think is driving that, is it a function of some of the new products? Is it a function of competitive environment or FX, anything that would be helpful.

Mark D. McLaughlin - *Palo Alto Networks, Inc. - Chairman and CEO*

Well, the -- different folks in the market have different go-to-market motions. Ours has always been to really focus on security, reduction of complexity and then of course, we want to deliver that in a way that is within the cost envelope of what customers have, other folks have come at it from the bottom of that stack and really decided to go from a cost perspective and work their way up. That's not really been our go-to-market motion, so we believe there's a lot of value in the problem. We train our salespeople and talk very consistently to the value proposition that's going to provide for security, reduction in complexity and better total cost of ownership. And we think, as a result of that, we've been able to maintain pretty good discounting discipline through the company's history, and you can see that in this quarter as well.

Operator

And we'll take our next question with Gregg Moskowitz with Cowen and Company.

Gregg Steven Moskowitz - *Cowen and Company, LLC, Research Division - MD and Senior Research Analyst*

Mark, just a follow on Gabriela's first question. If we could apply the overused baseball analogy to the progress made with respect to your sales reorg, what inning would you say that we're in right now.

Mark D. McLaughlin - *Palo Alto Networks, Inc. - Chairman and CEO*

I'd say bottom of the second, top of the third.

Gregg Steven Moskowitz - *Cowen and Company, LLC, Research Division - MD and Senior Research Analyst*

Okay, that's helpful. And then just for Steffan, any color that you can provide on the percentage of units roughly that were shipped this quarter that came from the new product family. And then if you had any commentary just as it relates to ASPs for the new product sales, vis-a-vis, the prior ones.

Steffan C. Tomlinson - *Palo Alto Networks, Inc. - CFO and EVP*

Well, we are very pleased with the adoption of our new products. They fill a need in the market and also fill a need in our overall product lineup. We don't give exact percentages of what percent products were shipped coming from different units. I can tell you that adoption was very strong. As far as ASPs are concerned, it -- the ASPs were very healthy, kind of in-line with what we thought. Anytime you have a new product introduction, you're going to have a trade up, trade down, new incremental opportunities presenting themselves. And we see -- we saw all of that, and overall, it was a net positive for our business.

Operator

And we'll take our next question from John DiFucci with Jefferies.

John Stephen DiFucci - *Jefferies LLC, Research Division - Equity Analyst*

I guess, my question is about the new product that came out. And do you think that, I mean, I know you had talked a lot about the sales reorg and it sounds like that's going well. But there also seems like there's most likely some pent-up demand sort of waiting for these new products. Do you think that, that had ended up looking in hindsight, had an impact that was material results last couple of quarters?

Mark D. McLaughlin - *Palo Alto Networks, Inc. - Chairman and CEO*

John, it's Mark. It's always hard to tell, right? When you have new product introductions, we have to assume that there would be some slippage from one quarter into the next as folks even hear what the new products are about. So we assume when we came out of the second quarter, that we might have seen some of that fall into the third quarter. And I have to assume that's some of the overage in the third quarter is associated with that as well. I don't think that, that was the majority of the overperformance from what we guided there, but -- and it's very difficult like to tell the exact amount one way or the other, but assume there's some of that in there, of course.

Operator

We'll go next to Matt Hedberg with RBC Capital Markets.

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

Growth in EMEA was particularly strong. I'm curious, is that more a function of easier compares? Or are European customers starting to talk more about the breach notification going live next year?

Mark D. McLaughlin - *Palo Alto Networks, Inc. - Chairman and CEO*

Yes, Matt, it's Mark. A couple of things on that. One is just as the a size of market, EMEA is a large market. And when you look at just the dollars we're doing in that market, we think we have a long way to go and grow in that market. So I would expect to be able to grow very healthfully in that market for some period of time. Sure, we'd like to see -- 3 handles are better on the growth, so we'd like to see that in the quarter. But the GDPR, which is the legislation you're talking about, there are certainly a lot of attention and focus on it. That basically is legislation that's going to present companies with some pretty large fines if they are found to be lacking in their duties of using state-of-the-art technology, which is not a defined terms in the legislation, but it talks about it that way, state-of-the-art technology. So there's a lot of focus from companies and Board of Directors to say, are we doing that, right? And I think that's really driving a lot of interest in getting off of legacy technology and certainly a great opportunity for a platform provider like ourself.

Operator

And we'll take our next question from Philip Winslow with Wells Fargo.

Philip Alan Winslow - *Wells Fargo Securities, LLC, Research Division - Senior Analyst*

I have a question about just the aging of your installed base. The last Analyst Day, you all talked about just the potential wave of appliances coming up for renewal. I wonder if you can give some more detailed to sort of what you saw this quarter, maybe compare that to the prior few quarters if that wave starting to come on or if that's still on to come.

Mark D. McLaughlin - *Palo Alto Networks, Inc. - Chairman and CEO*

Yes, it's Mark. I think that the majority of what I would call that, the refresh potential for us, is in the future, and that's just simple math. I'm looking at the classes. So we consider our classicist cohorts and do them by year. And if you look at how the cohorts build over time, each year is getting a substantially bigger. So when we -- if you think of like 4- to 7-year average refresh cycle, somewhere in there, the big, big, big part of our customer base is going to be in refresh cycles in a coming couple of few years time versus the last couple of few years time. So we think that that's something that should provide a tailwind for us in the go forward.

Philip Alan Winslow - *Wells Fargo Securities, LLC, Research Division - Senior Analyst*

Got it. And then just one quick follow-up to that. I mean, in terms of just the new products we all launched in February, how do you think that influences either which way just the timing of people refreshing the installed base considering you just have a new set of virtual and physical appliances out.

Mark D. McLaughlin - *Palo Alto Networks, Inc. - Chairman and CEO*

Right. Yes, I think it would be helpful. Maybe an obvious point that when you have new capability sets in the market, it gives the customers more choices. We like the lineup of technologies we had prior to the new products we launched. We just complemented them with a whole set of new products as well. So when customers are thinking about what their needs, price performance needs are, throughput needs are, and we've got a very full lineup now of capability sets and lots to upgrade or refresh you with -- when they're so inclined when they reach that sweet spot in the refresh cycle.

Operator

We'll take our next question from Saket Kalia with Barclays Capital.

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

First, maybe for you, Steffan. You said last quarter that billings should lag revenue growth by about 10 or 15 points at least for the back half of this year. And it looks like that relationship will hold here in the fourth quarter as well. Realizing that you're not ready to give us guidance for fiscal '18 yet, can you talk qualitatively if that relationship between billings and revenue should maybe be consistent or perhaps widen? How do you think about that going forward?

Steffan C. Tomlinson - *Palo Alto Networks, Inc. - CFO and EVP*

Thanks, Saket. So last quarter, we did say that the billings growth rate will trail the revenue growth rate by about 10 to 15 points. And in Q3, we came right about the midpoint of the range. Our Q4 guidance actually indicates that the range is improving and the range, if you -- if you are at a benchmark, get off of the midpoint of our revenue guide, it's about -- billings growth rate is about 8.6% to 12.1% below revenue growth. So that range is actually improving. And it's too soon to call what's going to happen in 2018, but we're definitely -- we're doing everything that we can to improve the growth profile of the company.

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

Got it. And then maybe for a follow-up here quickly for you, Mark, and maybe more philosophically, how do you think that's last quarter's experience is going to change that playbook in sales that's been successful for so long in terms of splitting territories, allocating resources? How do you think about that playbook changing perhaps after last quarter's experience?

Mark D. McLaughlin - *Palo Alto Networks, Inc. - Chairman and CEO*

I think that some of the chapters in the book are good and some of the chapters have to be modified, right? So the -- we will continue to split territories. We wouldn't do it at the rate and pace that we had done it in the past. I think we talked about that on the last call. And then we will continue to do market segmentation, but we will be -- we won't be making assumptions about what the capability sets are from a CL team perspective on various customers that they would cover. So there are things that I would say, well, are somewhat timeless when you think about sales playbooks. Then there's the execution implementation on which maybe unique for each company, so we learned the lesson on that stuff and were going to apply that fiscal 18 and beyond.

Operator

We'll take our next question from Jonathan Ho with William Blair.

Jonathan Frank Ho - *William Blair & Company L.L.C., Research Division - Technology Analyst*

Can you just talk a little bit about maybe shift or acceleration of virtual appliances and what you saw this quarter essentially relative to the public cloud?

Mark D. McLaughlin - *Palo Alto Networks, Inc. - Chairman and CEO*

Jonathan, it's Mark. Yes, we continue to see really nice adoption from the VM-Series, and a lot of that's being used in the public cloud environment as well as private cloud or NSX is doing very well. We've had that relationship for quite some time. We're seeing hundreds of customers in that public cloud environment using the VM-Series as well, and we would expect that to grow over time. There's a lot of different angles on that, that will look at. One lead generation. We're seeing some customers use us for the very first time in AWS, for example, and then we get the lead in order to follow up to see if we can drive additional security outside of just that public cloud infrastructure throughout their on-prem, through endpoints and things along those lines. See lots of people taking their own licenses out there and we see increasing sales in the marketplace just using AWS. We're seeing that for Azure, Google, other infrastructure providers as well. But it seems like it's solid growth for us.

Jonathan Frank Ho - *William Blair & Company L.L.C., Research Division - Technology Analyst*

Got it. And then just relative to WannaCry, are you seeing any sort of impact from the increased attention around breaches? Or do you think this is just more sort of support and removal of friction around the spending?

Mark D. McLaughlin - *Palo Alto Networks, Inc. - Chairman and CEO*

Yes, sure. A couple of things in that. The first is WannaCry certainly got a lot of public attention. There's going to be another attack like that. Can't say what it is, don't know when it's going to be, right, but there's always going to be the next one. I think the WannaCry has raised a lot of awareness and anxiety, one, because it really kind of focused in the health care community first. It moved out of there, so further evidence of, I'll call it, critical aspects of a society that relying on digital age of technology being at risk, and certainly would capture folks' attention. The other thing I think it highlighted for us as well in this opportunity is the increasing need for platforms. I think WannaCry was looked at primarily as, I think, an endpoint problem, but it's broader than that. Once it gets into an organization, it moves around. It had the ability to spread. So platforms like ours are uniquely able to handle that stuff. So Traps, for example, would have stopped it on the endpoint if it were in the network. WildFire would have picked it up if it was somebody who was going to download it from a malicious URL. PAN-DB would have stopped that. Threat Prevention would have stopped lateral movement and the internal spreading of the infection. So it really helps to have multiple ways to defeat these attacks, and WannaCry is a great example of how -- a good position you'd be in if you had all those capability sets.

Operator

We'll take our next question from Michael Turits with Raymond James.

Michael Turits - *Raymond James & Associates, Inc., Research Division - MD of Equity Research and Infrastructure Software Analyst*

Two questions. First, you had talked in the past about the back half of the calendar year getting some tailwinds both from the product refresh in general as well as the new product cycle. Does that still look like something that could be an accelerant to growth at this point?

Mark D. McLaughlin - *Palo Alto Networks, Inc. - Chairman and CEO*

Michael, yes, as we had talked about -- we certainly talked about that in the beginning of the year, and we had laid out a number of reasons why we believe the product growth would accelerate, partly due to the ramping capabilities of the sales force, partly due to the assumption there will be new product introduction, service provider business, increasing productivity. And a lot of that holds true, but we have the crosscurrent of the sales force reorganization and things that we're dealing with. So there's puts and takes on both sides of that. We're happy to see the product revenue come in where it did in the Q and the third quarter, but frankly, we're not satisfied with where we are. And we think we can do better and we aim to do better.

Michael Turits - *Raymond James & Associates, Inc., Research Division - MD of Equity Research and Infrastructure Software Analyst*

Okay. And then second question, a bit more specifically on the VM-Series. One of the important things about the new release was the increase in throughput or capacity for the new Virtual. So what's been -- there had been a measurable impact from that both in terms of cloud adoption and utilization and as well perhaps in the on-prem or in the private cloud with people thinking about it relative to what are the trade-offs of using Virtual versus using physical box.

Mark D. McLaughlin - *Palo Alto Networks, Inc. - Chairman and CEO*

Well, I think there's -- well, here's how we think about it. I think a lot of customers are thinking this as well, which is it's really kind of use case specific. So your data is going to reside in different places. It's going to be computed in different places. It's going to move back and forth very -- hopefully very efficiently and without friction. And that's really what we're trying to do with the platform, is provide the consistency of security in all those places. So when you talk about the cloud and use cases, for example, like East-West traffic in a highly virtualized data center, one of the things you're going to see there for sure is just an ever-increasing amount of throughput requirements because volume is growing from a number of applications, number of third-party's applications being used from encryption and decryption capabilities or decryption needs, for example. So throughput is going to continue to rise over time. So I think that in the case -- just like we did with our hardware of having much higher performance, same with the virtualized firewalls as well where we quadrupled the performance there, we're going to keep growing that performance because those use cases, whether they're physical or in the cloud, are going to demand higher and higher throughputs.

Operator

We'll take our next question from Andrew Nowinski with Piper Jaffray.

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

Just a question on the product guidance -- product revenue guidance. You had great upside in the quarter. You had 1% year-over-year growth off a tough comp. I guess why aren't you expecting that momentum to continue in the July quarter since your guidance suggests that product revenue will decline on a year-over-year basis? Is that just you being more conservative than usual?

Mark D. McLaughlin - *Palo Alto Networks, Inc. - Chairman and CEO*

Andrew, so when looking at the product side, we're happy to see where we came in, in the third quarter. Of course, like I said, we're not satisfied big picture of where we are and we aim to do better than what we're doing. When we look at the third to fourth quarter, we're still looking at like a 15% sequential increase from the third to the fourth quarter is the guide we gave. So it's a big increase. It's a doable increase for sure, we think, and expect to get that done. But we're kind of looking at that on a relative basis sequentially. And when we're looking on a year-over-year basis as well, we're coming off of very, very high comp for the fourth quarter of last year.

Steffan C. Tomlinson - *Palo Alto Networks, Inc. - CFO and EVP*

And we're still in the midst of going through the sales force reorganization. So that also is a crosscurrent.

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

That's right. Okay, got it. And then with regard to Traps, it still -- you certainly continue to add more customers but still has, I think, a penetration rate of less than 3% in your installed base. When do you think it's going to start to gain a little bit more traction? When do you think we'll start to see that penetration rate increasing at a faster clip?

Mark D. McLaughlin - *Palo Alto Networks, Inc. - Chairman and CEO*

Sure. That's actually an area of an intentional focus for us, Andrew, which is given that we've been in the market for about 3 years now as one of the next-gen providers after AV replacement budgets like everybody else's, we've been very intentional in targeting new customers as well as our existing customer base for larger customers and larger deployments of endpoints. And that's what we're accomplishing. So we're very happy to have over 1,000 customers now. Rate of customer growth is good. We would expect the penetration rates to go up faster later, but we're -- as we solve for all this referenceability that we're getting now an increasing technical capabilities like with the 4.0 release. I think that with all that focus in mind, we're getting where we want to go. And when you think about the next-gen AV providers in the market today, based on what we know about, we think we're one of the biggest from a sales perspective.

Operator

We'll take our next question from Michael Kim with Imperial Capital.

Michael Wonchoon Kim - *Imperial Capital, LLC, Research Division - SVP*

Just a follow-up on Traps. Are you seeing an increase in head-to-head evals and any early feedback on win rates? And out of that 1,000 customers -- 1,000 odd customers that you accumulated, are majority of those existing or net new logos?

Mark D. McLaughlin - *Palo Alto Networks, Inc. - Chairman and CEO*

Yes, sure. So we're doing lots of head-to-head. That's what we're trying to do, right. We're focused on trying to take the AV budgets from legacy AV providers when a lot of people are dissatisfied with them. So we're certainly seeing them head-to-head. And then in a lot of those situations, not surprisingly, a lot of the next-gen folks are being evaluated. And kind of as a side note to that, Michael, one of interesting things that we found with the customers that we've acquired so far, when we survey them, that well more than half of those customers, when asked why are you buying Traps from Palo Alto Networks, in addition to saying it's a great best-of-breed next-gen endpoint security capability, are saying because it's actually very well integrated with my network security capabilities and increasing cloud security capabilities. So that consistency is very important and that approach that we're driving is very important. So can you remind me your second part of your question?

Michael Wonchoon Kim - *Imperial Capital, LLC, Research Division - SVP*

Yes. I was curious, out of the 1,000 odd customers you have today, how much -- how many of those were net new logos to Palo Alto versus existing customers? And curious kind of what the initial uptake has been.

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

Yes, Michael, Mark Anderson here. It's actually a pretty good balance that we have. I'd say close to 50-50. And the great thing is our core sales team is getting better and better enabled each quarter at being able to integrate the Trap story into their next-generation network security story and prove the value of these 2 things working closely together. So whenever we do get a Traps customer that's a first time buy, we're able to go back in and very seamlessly help sell network security as well.

Operator

We'll take our next question from Pierre Ferragu with Bernstein.

Pierre C. Ferragu - *Sanford C. Bernstein & Co., LLC., Research Division - Senior Analyst*

We talked a bit about like the refresh opportunity and I eventually got confused about how much refresh do you have in product revenue is reported this quarter. Is that like -- am I right in thinking it's still like a very, very negligible, very small part of your business and most firewalls you're selling today are still like adding up to your installed base? Or is the refresh business already something fairly sizable? And will you have an idea of what percentage of your product revenues will be refresh already to date? And then I had just like a very quick follow-up on sales cycle. We've heard a lot over the last 6 to 9 months in the industry that sales cycle were getting a bit longer. Clients were taking more time to figure out what they want in terms of network security. If you could give us like the latest update on that front as well.

Mark D. McLaughlin - *Palo Alto Networks, Inc. - Chairman and CEO*

Yes, Pierre, it's Mark. I'll take the first and pass off the second one to Mark Anderson. On the refresh side of it, we don't break out the percentage of what portion of product is coming from new of expand versus refresh. What I can say on the refresh side is the -- refresh for us has been strong in the past through our cohorts, which is great, and kind of get a sense of that when you think about our renewal rates, our NPS scores, all these other externalities that point to customers really like Palo Alto Networks and they tend to refresh with us as well. Back to the cohort thing I was talking about earlier, the percentage of the business that's coming from the refresh has been increasing just kind of naturally mathematically as we graduate years, if you will, through those cohorts. And we would expect it to increase into the future.

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

(foreign language) Pierre, so as far as the sales cycles go, I think the new normal is that these sales cycles are taking longer. Clearly, security continues to be a board level, #1 or #2 priority for customers at every level. And there's also copycats out there in the market that are mimicking the value proposition that Palo Alto Networks kind of pioneered. And really, that's getting our sales teams trying to work hard to solve to a technical proof of concept because when we get a chance to demonstrate in their -- with their live network traffic how differentiated we are, we typically win. So that does take a little extra time. We've sort of factored that into our forecast and guidance each quarter. And certainly, our sales teams have kind of factored that into their campaigns to win customers to really get to that technical proof of concept.

Operator

We'll take our next question from Shaul Eyal with Oppenheimer.

Shaul Eyal - *Oppenheimer & Co. Inc., Research Division - MD and Senior Analyst*

Mark, how's the LightCyber integration has been coming along so far? I don't know if you can quantify or provide us with some color there, some potential contribution this quarter.

Mark D. McLaughlin - *Palo Alto Networks, Inc. - Chairman and CEO*

Sure. Let me take that financially first and technically second. On a financial basis, contribution was de minimis from a top line perspective when we gave some guidance last quarter from the impact from an operating margin perspective, which Steffan went over. On the technical basis, the integration is going as planned. We're on our project launch on that, which is fantastic. We expect that will be a subscription-based service, like I said, before the end of the calendar year. Just as a kind of a side note on that, and you'll hear more about this at Ignite if you attend Ignite, that's an example of capability, which is a really great technical capability, highly innovative for network behavior analytics that when it is integrated in the platform, will take something that has historically been a product sales, buy product and deployed everywhere to something that is a -- as a software. So as a subscription services without having to deploy additional hardware. So the feedback from the customer base on that model and what we're demonstrating there with LightCyber has been very positive so far feedback-wise. And they also like the service itself. It's a very important service to find anomalies when somebody is moving through your network and they're looking for just getting that best-of-breed capabilities while inside the platform.

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

If I can just add to that, Mark. I think from a people standpoint, we're really impressed with the quality of the people that came over with LightCyber. They've co-located with our Tel Aviv team in Israel and it's a really good fit.

Shaul Eyal - *Oppenheimer & Co. Inc., Research Division - MD and Senior Analyst*

Got it. And then in the latter part of calendar '16, if I'm not mistaken, you've established a telco-related type of activity or maybe telco-related group. Just interested, Mark, around how the ramp-up has been coming along so far.

Mark D. McLaughlin - *Palo Alto Networks, Inc. - Chairman and CEO*

Sure. Yes, that's a service provider group. We talked about that a couple years ago, actually, saying we wanted to be very focused on that more so than the past in the service provider because it had been a couple years ago of relatively untapped market for us, right. The service provider market has some very specific technical needs and capabilities. It also has some very specific go-to-market requirements where you have to understand them, you have to talk their talk, you have to know what their needs are, and relationships really matter. So over the course of the last couple of years, we've been building up the service provider team that has been built up very well, and they're contributed very nicely to the business. We expect that business to grow over time for us.

Operator

We'll take our next question from Catharine Trebnick with Dougherty.

Catharine Anne Trebnick - *Dougherty & Company LLC, Research Division - VP and Senior Research Analyst*

Mark, I have a question regarding your virtual firewalls. It seems to me -- you said earlier in your commentary several hundreds this quarter. How -- could you explain how differentiated you are with your virtual firewall versus Check Point in the AWS cloud or Azure? It seems to be rapid migration to cloud right now. And where do you see fitting into this migration? And how fast is this possibly replacing some of your core hardware products?

Mark D. McLaughlin - *Palo Alto Networks, Inc. - Chairman and CEO*

Let me comment on that backwards, Catharine, for a second, which is so far, and we think this will continue into the future. We've seen the cloud in general and then our VM-Series and other cloud aspects like Aperture be additive. So we think that's a lead provider for us and a growth provider for us for new use cases. As far as differentiation relative to any of the competitors, really kind of 3 things going on. The first is that our VM-Series does exactly everything that our physical capability set would do. And the physical capabilities, as you know, the hardware capabilities are highly differentiated on what we do with app ID, content ID, user ID, plus all the subscription services that you're able to run on that. So we virtualized all that quite some time ago. So the differences that customers really loved and appreciated in the physical world, they get all those in the virtual world as well. So that's a starting point, a very important point. The second part of that is just part of the platform. So you don't have to give up or accept different or lower security capabilities when you go to the cloud with Palo Alto Networks. You get to have all those capabilities seamlessly from endpoints to network, to cloud, to private cloud, third-party SaaS applications. It's exactly the same outcome, and customers really love the orchestration, the automation that you get as a result of that as well. So those are the fundamental to kind of differences on a competitive aspect that people really appreciate when they look at our VM-Series.

Operator

We'll take our next question from Ken Talanian with Evercore ISI.

Kenneth Richard Talanian - *Evercore ISI, Research Division - Analyst*

So first off, have you seen any changes in the customer's desire to do multiyear deals? And then can we -- along with that, can we expect contract duration to remain relatively constant going forward?

Steffan C. Tomlinson - *Palo Alto Networks, Inc. - CFO and EVP*

Over the years, we've seen a slight uptick in contract duration, and that's really been customer led. And it's indication of the value that we're bringing to the table in that customers want to standardize on us for a multiyear period and also renew at very high rates. Contract duration has been stable year-over-year. It's hard to predict where contract duration is going to go, but at this point, from our own internal modeling standpoint, we're not assuming any wide variation in contract duration on a go-forward basis. Time will tell.

Kenneth Richard Talanian - *Evercore ISI, Research Division - Analyst*

Okay. And this is a follow-up. I know we've sort of touched on this before on some of the prior questions. But I'm just curious, what -- which of the new appliance families demonstrated the most traction in the quarter?

Steffan C. Tomlinson - *Palo Alto Networks, Inc. - CFO and EVP*

Well, we saw great retraction from the PA-5200 Series and also the PA-220. And the 800 was also good, too. So it's really kind of across the board, we saw really already nice adoption.

Operator

And we'll take our next question from Walter Pritchard with Citi.

Walter H Pritchard - *Citigroup Inc, Research Division - MD and U.S. Software Analyst*

Question on your product revenue. You've had pretty dramatic difference in growth rates over the last couple of years, and your billings are growing probably in line with the industry. Your product revenue probably growing below the industry although, as many pointed out, off of tough comps. I'm wondering how you think about that going forward. Just roughly, you generate a lot of subscription attached. You have the unattached subscription. And I'm wondering if we'll continue to see a total business grows well in excess of product or if you think those will converge as things start to normalize here.

Mark D. McLaughlin - *Palo Alto Networks, Inc. - Chairman and CEO*

Walter, yes, a few thoughts around that. One is, like I said earlier, that we were happy to see we got the product revenue from the third quarter perspective. General matter, we think we can do better. We plan to do better along these lines. When we think about the industry, it doesn't look as though people really break out product or what's hardware specific in the industry. One of the things we look at is just how much money gets spent by everybody that they report on the hardware side, and we continue to take more than our fair share on that from a product perspective. We also know, of course, there's relationships between the products or the hardware and the attached services as well. So as we work to improve the product revenue growth over time, then that would have some impact on the attached subscription services. And we're doing very well on the non-attached as well from a growth perspective. That's a small part of the business we're growing very quickly. So we expect that to do better over time as well. So there's a lot of things into the mix around that, which all comes out in the wash on billings growth and total revenue growth over time, which is where we're very focused on as part of the total platform.

Walter H Pritchard - *Citigroup Inc, Research Division - MD and U.S. Software Analyst*

Any comment on attached revenue this quarter? Just any run rate or anything to help us understand sort of traction collectively in that part of the subscription business.

Mark D. McLaughlin - *Palo Alto Networks, Inc. - Chairman and CEO*

Sure, yes. We talk about the attached business on a semiannual basis, but we said last quarter's about 2 points on the attached side. It went up.

Steffan C. Tomlinson - *Palo Alto Networks, Inc. - CFO and EVP*

And then on the unattached business, it was very good. We had -- we referenced in our prepared remarks the number of new customers. So that's an indication as well of the traction that we're getting.

Operator

And ladies and gentlemen, our final question today comes from Keith Weiss with Morgan Stanley.

Keith Weiss - *Morgan Stanley, Research Division - Equity Analyst*

One of the things that I want to just kind of drill down into is -- or better understand is the dynamic on how you're able to like keep adding customers so well. You had a really good like new customer add in the quarter despite the fact that you're going through a sales reorg. And one, like how does that dynamic sustain? Like how do you guys sustain new customer adds so well while you're going through the sales reorg? And then on the flip side of the equation, while new customer adds look to be up pretty nicely on a year-on-year business, product revenue was basically like flat on a year-on-year basis. Should we take away that sort of where the weakness resides is more in terms of sort of expanding existing customers more so than getting new customers in the door?

Mark D. McLaughlin - *Palo Alto Networks, Inc. - Chairman and CEO*

That's a great question, Keith. Well, a couple of thoughts in that. The first was -- I think in reverse, as we said last quarter, when you look at our business, it's going to come from new customer acquisition and expansion of existing customers. And about 2/3 of our business today is driven by expansion opportunities with customers who's already acquired. So of course, we want to continue to have high rates of customer acquisition. I'll come to that in just a second. We're very happy to see high rates of customer acquisition. Then the trick is to expand the business inside of this. Where we had some issues, and we're working through them with the reorg stuff, was looking at the lifetime value expansion when you look at the segments of the market. So when we look at the highest end segment of the market, which is the Global 2000 and the biggest customers, wallet share lifetime value expansion has done very nicely there and continues to do very nicely there despite some of the issues that we've talked about before. It's really about getting the lifetime value expansion where we want it to be and where we had it historically below that segment of the market. And that's where a lot of the reorg and alignment issues were, and that's where we're really focused on -- we're focused on fixing. And just from a new customer acquisition perspective, we're getting new customers not only from our direct team. As well, we're also getting customer acquisition through the channel, our channel is strong and growing over time. So we're going to continue to get more customers from them. That's why I love the fact that we just had our second highest customer acquisition order history. I think we could do better, right. The better we get from a go-to-market perspective, we should be able to continue to acquire even more customers than that and we look forward to being able to do that.

Keith Weiss - *Morgan Stanley, Research Division - Equity Analyst*

Got it. And if I could sneak in a follow-up. So while 1% product revenue growth was better than what we had anticipated, it's still under-growing the marketplace. But I'm assuming if those dynamics around sort of the new customer acquisition, being able to continue to get the customers in the door that give you guys the confidence that you're not kind of losing share, if you will, that, that opportunity remains. It's just more of like untapped within these existing customers versus kind of net losing opportunity.

Steffan C. Tomlinson - *Palo Alto Networks, Inc. - CFO and EVP*

Keith, yes, just on the year-over-year growth rate, were clearly coming off of with very high, tough comparable. We grew product revenue last year at 33% year-over-year. If you look at the dollar amount of product revenue that gets done in a particular quarter, as Mark mentioned earlier, we're taking more than our fair share. And there are some vendors that don't even give out product revenue, and so like we're shadowboxing with them a little bit. But we are doing very well in the market. And the new products that we have that we've just introduced, the rate of new customer acquisition, we feel like there are crosscurrents that we talked about around sales reorganization. But we are laser-focused on increasing the growth prospects of the company.

Mark D. McLaughlin - *Palo Alto Networks, Inc. - Chairman and CEO*

Yes. And that, of course, includes product revenue as well. So...

Operator

Ladies and gentlemen, that does conclude our question-and-answer session for today. Mr. McLaughlin, I'd like to turn the call back over to you for any closing remarks.

Mark D. McLaughlin - *Palo Alto Networks, Inc. - Chairman and CEO*

Thanks, operator. Appreciate it. And before I close, I want to thank the Palo Alto Networks team for their dedication and our customers and partners for the opportunity to work with them. We hope to see everyone at Ignite in just a couple weeks. Thanks for being on the call today. Bye-bye.

Operator

Ladies and gentlemen, this does conclude today's conference. We appreciate your participation.
