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Palo Alto Networks, Inc. (PANW)

Q3 2020 Earnings Call

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MANAGEMENT DISCUSSION SECTION

[Video Presentation] (00:00-01:00)

Operator: Hello. Welcome to the Q3 Fiscal Year 2020 Earnings Call for Palo Alto Networks. This call is being recorded and will be accessible on the Palo Alto Networks Investor Relations website.

Now, I'd like to turn it over to David Niederman, Vice President of Investor Relations.

David Niederman
Vice President-Investor Relations, Palo Alto Networks, Inc.

Good afternoon, and thank you for joining us on today's conference call to discuss Palo Alto Networks fiscal third quarter 2020 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 Nikesh Arora, our Chairman and Chief Executive Officer; Kathy Bonanno, our Chief Financial Officer; and Lee Klarich, our Chief Product Officer.

This afternoon, we issued a press release announcing our results for the fiscal third quarter ended April 30, 2020. 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 the duration and impacts of COVID-19 on our business, our customers, the enterprise and cybersecurity industry and global economic conditions, our financial guidance and modeling points for the fiscal fourth quarter and full fiscal year 2020, our competitive position and the demand and market opportunity for our products and subscriptions, benefits and timing of new products, features and subscription offerings, revenue, ARR and various billings, run rates, as well as trends in certain financial results and operating metrics.

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. You should not rely on them as representing our views in the future, and we undertake no obligation to update these statements after the 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 February 25, 2020 and our earnings release posted a few minutes ago on our website and filed with the SEC on Form 8-K.

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.

Finally, once we have completed our formal remarks, we will be posting them to our Investor Relations website under the Quarterly Results section. We'd also like to inform you that we will be virtually presenting at the Baird Global Consumer, Technology & Services Conference; the Bank of America Global Technology Conference; the Piper Sandler P.S. It's Friday session on SASE versus SD-WAN; and the Morgan Stanley Zero Trust Architectures' Virtual Thematic Conference.

And with that, I will turn the call over to Nikesh.

Nikesh Arora

Chairman & Chief Executive Officer, Palo Alto Networks, Inc.

Thank you, David. Good afternoon. Thank you to everyone joining our first video earnings call. I appreciate you being patient as we experiment with a Zoom earnings call.

Before I comment on our results, I'd like to thank our employees, our partners, suppliers for the tremendous dedication and commitment they've shown over the last three months. I couldn't be prouder of our teams who worked tirelessly to ensure the security needs of our customers were met in this uncertain environment. It is important to note, our last month of this quarter saw a majority of the world under lockdown, and to be able to deliver these results in these times is a testament to the strength of our teams and our partner ecosystem.

As a company, we responded quickly. We have made the transition to a nearly 100% remote workforce without a hitch. Focused on the well-being of our employees, we moved to work from home in early March, ahead of local ordinances.

As a global team whose mission is enabling our customers to work securely no matter where they are, we were well-equipped with the tools, technologies and security to work safely from home. Our teams have been hard at work in recent months, helping our customers adjust to entire organisations working from home. This change has prompted companies to rethink how they manage data and applications no longer protected by hardened corporate network perimeters. As always, Palo Alto Networks has served as a trusted partner to our customers. Our teams rallied to help customers secure remote workers and provide expanded infrastructure security quickly, encompassing thousands of workers across multiple locations.

We have over 1,500 customers just in the past six weeks using our free trials for remote secure access, which we enabled in the middle of March. The feedback we have received from customers has been gratifying, and we look forward to the opportunity to continue to serve them potentially across even more areas of our platform.

Additionally, we have offered extended payment terms and financing options to some of our customers that have been financially impacted by COVID-19. In the same vein, we launched Palo Alto Networks Financial Services LLC or, as we will call it, PANFS, a financing company within Palo Alto Networks created to offer flexible financial solutions through our products and services, supporting enterprise customers looking for large multi-year engagements. We closed our first-ever financing transaction at the end of the quarter with a large multinational customer, providing the customer with flexible payment terms.

Given the current environment and the fundamental changes that are occurring around us, I feel it's important to articulate our view of the path forward. I have elaborated those views and how we are preparing ourselves as a company in a Letter to our Stockholders, which we published today and is available in our Investor Relations website.

Let me touch on a few highlights over here. We expect this pandemic shock to last 12 to 18 months before our customers return to a new normal. And we expect the enterprise and cybersecurity industry will have a bumpy ride over the next three to nine months as strategies for reopening the economy start to emerge, some likely to be more successful than the others.

Given our outlook over the next 12 to 18 months, we're announcing FLEXWORK, a new way of working for Palo Alto Networks. With FLEXWORK, a few essential employees will be encouraged to come into our office, while others will choose how many days they wish to spend in our offices. For employees choosing to work in the office, we will ensure social distancing and all local safety regulations are followed. The health and safety of our employees is our top priority.

Let's focus on industry trends. These changes in consumer behavior will impact industry, and we will see winners and losers. We believe the largest companies with strong balance sheets are poised to become even larger. In all the industries, those companies supporting a mobile and cloud-based consumer workforce will surely benefit. We will certainly see new businesses emerge, which we have not yet envisioned.

To ensure their future success, we expect businesses to accelerate their technology investments. A recent survey by Fortune Magazine showed that three-fourths of Fortune 500 CEOs believe the crisis will force their companies to accelerate their technological transformation. Businesses that have relied upon physical presence will focus on automation and technology transitions. The cloud transformation should accelerate, and remote work infrastructures will become more robust and necessary across most organizations. As a consequence, networking architecture will need to change to support the transformation to the cloud.

Let's talk about the outlook for cybersecurity. The accelerated move to the cloud is attracting the attention of cybercriminals. Data breaches in cloud-delivered services will accelerate as many InfoSec and DevOps organizations, in their rush to the cloud, have not yet brought their cloud security posture to the level of their traditional data centers. This will drive the need for increased cloud security investment, especially in technologies that secure multi-cloud and hybrid cloud environments.

Moving away from relying primarily on physical offices and physical data centers to emphasizing remote work and the cloud will also prompt the redesign of wide area networks. This provides an opportunity to finally realize a long-held vision of networking and network security coming together, as detailed recently by Gartner in their new SASE or Secure Access Service Edge framework.

The infrastructure changes that are needed to provide effective cybersecurity in this new reality provide an opportunity for organizations to significantly reduce the numbers of point product solutions and vendors by moving to platforms; implement consistent security across the entire infrastructure, physical, virtual and cloud-delivered, as well as across network, endpoint and cloud; moving security from physical to software-as-a-service; securing the cloud with a single platform; and automating their security operations.

As the largest enterprise security company in the world, our security proposition, offering more integrated and automated solutions to secure data regardless of where it is, should position us well for the transformation we anticipate. Our goal is to leverage our advantage and come through this unprecedented event even stronger and more resilient than before.

Let's turn to our Q3 2020 results. As I think about our results in the context of this pandemic, I'm extremely pleased with our performance. Fiscal Q3 was the second highest quarter in the company's history with billings of $1.02 billion, an increase of 24% year-over-year. Given that half the quarter was impacted by the COVID-19-related shutdowns, this result is even more exciting.

I'd like to share a few key deals in the quarter that illustrate the power of our comprehensive approach to security, as well as the strength in our installed base. A Fortune 10 company demonstrated their commitment to Palo Alto Networks by expanding with an eight-figure deal in a multi-year enterprise support agreement. We're also working with this customer on an extensive proof of concept for cloud security.

We continue to solidify our role as a strategic security partner of this U.S. retailer that we highlighted in fiscal Q1 and Q2. This quarter, we won another seven-figure deal as a part of their continuous large-scale transformation project where they purchased enterprise agreements for VM-Series, additional Cortex XSOAR licenses, again validating their selection of XSOAR for the security operations center.

We won a seven-figure deal with a major New York healthcare provider who expanded with Palo Alto Networks by purchasing Prisma Access, VM-Series, Prisma Cloud, Cortex Data Lake, and adding new line cards to existing next-generation firewall chassis.

Let's now look at the three pillars of our security offerings, starting with Strata. We made good progress on the product challenges that we faced in the first six months of our fiscal year. We now believe those challenges are behind us. We saw an improvement in our Firewall as a Platform billings, which grew 13% year-over-year. We expect our Firewall as a Platform growth to exceed the growth of the market, which we believe is 6% to 8%. So, we're delighted with a return to above-industry average growth.

A good example of our success in Strata this quarter was a seven-figure deal we won that brought together three different ministries of a European government agency to migrate both the state network and the education network to Palo Alto Networks' next-generation firewalls.

In this COVID-19 environment, we saw some of our customers enable remote access by turning on our GlobalProtect solution, an attached subscription to firewall. In this quarter, we added more than 1,000 customers to our remote work GlobalProtect subscription. As an example of this solution, a leading clinical research hospital was able to scale their environment to provide remote access securely for their entire user community within 48 hours. The robustness and simplicity of the solution enabled them to make this transition quickly and, even more importantly, seamlessly.

We continue to innovate in this category. Coming in mid-June, we will launch new features and functionality for our firewall operating system, including some industry-first features that will further differentiate us from the competition, including artificial intelligence, machine learning and a new subscription around IoT.

Moving now to Prisma. As you saw in the commercial that we played at the top of this call, we're helping all types of organizations quickly scale and secure remote workers, in some cases in a matter of weeks or days. Prisma Access, which provides cloud-delivered security for remote workers, had a record quarter in terms of billings, number of deals closed, and custom evals. In the last few months, Prisma Access effortlessly scaled over three times the aggregate capacity, helping our global enterprise customers enable their remote workforces overnight. As an example, a large oil and gas company went from a 25,000 remote user base to 80,000 users working remotely very quickly, again made possible by Prisma Access.

In April, we completed the acquisition of CloudGenix, a strategic decision to provide the industry's most comprehensive SASE platform. SASE, the convergence of network and security capabilities in the cloud delivered as a service. Before our acquisition of CloudGenix, they were a technology partner of Palo Networks. CloudGenix integrated with Prisma Access will prove to be a valuable solution for our customers. After listening to our combined customer installed base, we believe that bringing the two platforms together is the right approach to deliver the best possible end-to-end SASE solution.

We will further enhance our SASE platform by integrating the CloudGenix SD-WAN product with Prisma Access, expediting the intelligent onboarding of remote branches, remote retail stores, and providing a seamless end-to-end solution to our customers. This combination will accelerate the enterprise shift towards the SASE model.

We believe in giving our customers choices, so we will continue to enhance both the existing CloudGenix SD-WAN product, as well as our own next-generation firewall-based SD-WAN product that we launched in late 2019. Our two-pronged strategy for SD-WAN will provide our customers with the flexibility to implement SD-WAN on-premise or in the cloud with a thin branch where security is delivered from the cloud or heavy branch where security is in the branch. Therefore, we will be able to support whichever SD-WAN architecture our customers believe is right for them.

We've begun the first phase of integration, which focuses on simplification of the user experience. We expect to deliver a fully integrated solution towards the end of this calendar year. The acquisition positions Prisma Access as the best-in-class SASE offering, extending its ability to address network and security transformation requirements.

We expect the combined billings for Prisma Access and CloudGenix to total approximately $300 million over the next 12 months. Not to be outdone, Prisma Cloud had another record-setting quarter and exceeded their plan. We have now acquired more than 1,500 Prisma Cloud customers, representing 10% of the Global 2000 and 43% of the Fortune 100. In this quarter alone, we won Prisma Cloud deals with two of the Fortune 10, two of the top 10 US telcos, and two of the top 10 global CPG companies.

Our most recent release of Prisma Cloud extends security across the DevOps lifecycle and the cloud native stack. As enterprises continue to embrace modern tools for software development, we offer capabilities to protect their applications, data and infrastructure. Gartner recognizes our vision as cloud workload protection platforms and cloud security posture management converge, highlighting Prisma Cloud four times in a recent report than the most of any vendor. We will continue to innovate and add functionality to Prisma Cloud, including the micro-segmentation capabilities we acquired with Aporeto; and application security, data security and IM security soon to follow.

And finally, Cortex. As our company made the transition to remote workforce, we also transitioned our Security Operations Center or SOC to remote model. We leveraged Cortex XSOAR for automation, case management and real-time collaboration, allowing us to run our security operations remotely without sacrificing the level of security. Enabling the remote workforce has never been more important, and we've been hearing from our existing XSOAR customers that their transition to remote SOC has been seamless.

As an example, a remote – a European bank deployed Cortex XSOAR in December to automate routine SecOps tasks in order to focus on higher-level alerts. When the pandemic began affecting the region, they leveraged Cortex XSOAR to automate more advanced functions, including escalations from their fraud prevention systems to ensure the remote teams, executives and analysts have the information needed to respond and combat critical fraud alerts.

In terms of Cortex XDR, we continue to gain industry recognition. The independent security testing group, MITRE, conducted a second round evaluation recently, and we are proud to announce that no vendor, no vendor achieved higher attack technique coverage than Cortex XDR. We have come a long way in a year with Cortex XDR. A little more than a year ago, we launched the industry's first holistic detection response platform spanning endpoint networking cloud. Gartner has now included XDR as one of the top cybersecurity trends of 2020.

Six months ago, we engineered our endpoint security offering, Traps, and merged it with the Cortex XDR offering, creating a unified customer experience from endpoint security through extended detection and response. We have now successfully upgraded all Traps customers to Cortex XDR, continuing to offer them the strong prevention capabilities they've come to expect, managed from unified Cortex XDR console for a superior user experience.

As a part of our ongoing efforts around comprehensive security, today we are proud to announce the upcoming GA of our Managed Threat Hunting service. Through this service, our customers will not only have the most powerful and comprehensive detection and response platform in the industry, but they will also have the supervision of some of the best threat hunters from our Unit 42 research team hunting down threats using the customer's XDR platform to provide additional peace of mind.

I'm excited. We have made great progress in these new areas of our business, collectively referred to as Next-Generation Security or NGS. And a year-and-a-half ago, these collective offerings made up approximately 7% of our total billings. Today, our NGS billings are on track to end the year at over $800 million, representing approximately 20% of total billings. Additionally, the NGS ARR, or annual recurring revenue, was approximately $550 million in Q3 2020.

While we're pleased with our Q3 performance, the final quarter of this fiscal year will likely be a truer test of how this crisis will impact our business. The tailwinds we experienced in Q3 2020 should continue to some degree in Q4, but it remains to be seen how sustainable these benefits will be. In many industries, budgets have been cut, spending has slowed. It's difficult to imagine a scenario where many of our customers are facing severe financial impact to not have that trickle down in some way, shape or form into IT spending, including security spending, as important as it is.

We did see a few deals in the quarter pushed out, and we monitor them closely. But as you know, the environment is going to evolve on a daily basis. Kathy will speak to our fourth quarter guidance in a moment. But considering the environment, we're very pleased to raise our full year fiscal 2020 guidance, driven both by our outperformance this quarter and our anticipated strong performance in upcoming Q4. Regarding the three-year guidance we shared during our Analyst Day this past September, we feel it prudent to withdraw that outlook and revisit the subject when the longer-term impact of this crisis is more clear.

In summary, we quickly executed the transition to working from home, doing the right thing for employees. We are seeing new business related to remote working. And with CloudGenix, we feel we are well-positioned to be an industry leader in Prisma SASE. Our cloud security strategy is working with validation from a number of the world's largest customers. With the upcoming IoT launch, we expect to see continued momentum for our security services. We expect an accelerated transition to the cloud to be a net benefit to our business, but we do expect a bumpy ride over the next few quarters as the economies and business seek to recover from the COVID-19 crisis. We have, however, prepared ourselves in a financially prudent manner. We are cautiously optimistic, and continue to invest wisely. Our goal continues to be to come out of this stronger and cement our position as the global cybersecurity leader.

Once again, I want to extend thanks to our partners and employees for their hard work and dedication, and to our customers who are placing their trust in us. We will get through this, as a company, as a nation, and globally. We have the opportunity to improve ourselves and strengthen our bonds through hard work and compassion. I'm honored to have the opportunity to lead the amazing people at Palo Alto Networks.

With that, I will turn the call over to Kathy.

Kathleen Ann Bonanno

Chief Financial Officer & Executive Vice President, Palo Alto Networks, Inc.

Thank you, Nikesh.

Before I start, I want to echo Nikesh's sentiments, and thank our employees, partners and suppliers for their dedication and the incredible work done to support our customers during this global pandemic. A special call-out to our operations team for managing through the global supply chain challenges associated with COVID-19. Our team and our manufacturing partner, Flex, did a terrific job working with our suppliers around the globe to ensure that we could meet the security needs of our customers during this time.

Moving on to our results, I'd like to note that, except for revenue and billings, all financial figures are non-GAAP and growth rates are compared to the prior year periods unless stated otherwise. As Nikesh indicated, we had a great third quarter even in the wake of COVID-19. In the third quarter, we continued to add new customers at a healthy clip, we saw improvement in our product revenue, and our next-gen security sales continued to be strong.

In Q3, total revenue grew 20% to $869.4 million. Looking at growth by geography, the Americas grew 19%, EMEA grew 24% and APAC grew 15%. Q3 product revenue of $280.9 million increased 1% compared to the prior year. Q3 SaaS-based subscription revenue of $354.3 million increased 37%. Support revenue of $234.2 million increased 24%. In total, subscription and support revenue of $588.5 million increased 31% and accounted for 68% of total revenue.

Turning to billings. Q3 total billings of $1.015 billion, net of acquired deferred revenue, increased 24%. The dollar-weighted contract duration for new subscription and support billings in the quarter remained at approximately three years, flat year-over-year. At the margin, we are seeing certain customers sign up for annual billing terms, given the dynamics of the COVID environment. Total deferred revenue at the end of Q3 was $3.4 billion, an increase of 28% year-over-year.

In addition to adding to approximately 2,500 new customers in the quarter, we continued to increase our wallet share with existing customers. Our top 25 customers, all of which made a purchase this quarter, spent a minimum of $47.1 million in lifetime value through the end of fiscal Q3 2020, a 21% increase over the $38.7 million in the comparable prior year period.

Q3 gross margin was 75.2%, which was down 130 basis points compared to last year. Q3 operating margin was 16.4%, a decline of 450 basis points year-over-year and includes a headwind of approximately $3 million of net expense associated with our recent acquisitions. We ended the third quarter with 8,049 employees.

On a GAAP basis for the third quarter, net loss increased to $74.8 million, or $0.77 per basic and diluted share. Non-GAAP net income for the third quarter declined 12% to $114.6 million, or $1.17 per diluted share. Our non-GAAP effective tax rate for Q3 was 22%.

Turning to cash flows and balance sheet items. We finished April with cash, cash equivalents and investments of $2.2 billion. Q3 cash flow from operations of $169.9 million declined by 43% year-over-year. Free cash flow was $83.6 million, down 70% at a margin of 9.6%. Adjusted free cash flow in the quarter was $187.4 million, representing a margin of 21.6% and excludes cash charges associated with our headquarters in Santa Clara, in particular $51.7 million related to real estate purchase to accommodate future expansion and $50 million associated with a litigation-related settlement. Capital expenditures in the quarter were $86.3 million, of which $51.7 million was associated with the real estate purchase mentioned earlier. DSO was 63 days, an increase of 12 days from the prior year period.

Turning now to guidance and modeling points. For the fourth fiscal quarter of 2020, based upon our current deal pipeline and assuming a similar economic environment to Q3 and no further supply chain interruptions, we expect billings to be in the range of $1.190 billion to $1.210 billion, an increase of 13% to 14% year-over-year. We expect revenue to be in the range of $915 million to $925 million, an increase of 14% to 15% year-over-year. We expect Q4 2020 non-GAAP EPS to be in the range of $1.37 to $1.40, which incorporates approximately $8 million of net expenses, or $0.06 per share, related to the CloudGenix acquisition, using 96 million to 98 million shares.

For the full fiscal year 2020, we are raising our guidance. We expect billings to be in the range of $4.102 billion to $4.122 billion, an increase of 18% year-over-year. We expect revenue to be in the range of $3.373 billion to $3.383 billion, an increase of 16% to 17% year-over-year. We expect non-GAAP EPS to be in the range of $4.78 to $4.81, using approximately 98 million to 100 million shares.

Regarding free cash flow, for the full year we expect an adjusted free cash flow margin of approximately 27% to 28%, which incorporates the impact of the CloudGenix acquisition and those deals expected to close via Palo Alto Networks Financial Services. Our adjusted free cash flow for fiscal 2020 will exclude costs of $146 million associated with the free cash flow adjustments I mentioned earlier.

Before I conclude, I'd like to provide some additional modeling points. We expect our Q4 non-GAAP effective tax rate to remain at 22%. CapEx in Q4 will be approximately $25 million to $35 million. We continue to expect our next-gen security billings to be in the range of $810 million to $820 million for the full fiscal year 2020.

With that, I'd like to open the call for questions. Operator, please poll for questions.

QUESTION AND ANSWER SECTION

Operator: Our first question is from Keith Weiss with Morgan Stanley.

Keith Eric Weiss
Analyst, Morgan Stanley & Co. LLC

Q

Excellent. Thank you, guys. I hope everyone is well on your side of the fence. Nikesh, I was thinking give us a little bit more color into – both in terms of the results that you guys saw in Q3, which were ahead of our expectation, I think ahead of most people's expectations. Can you help us parse out what of that came from better execution on your side of the equation? You had talked about a lot of initiatives that you guys put into place to get sort of the sales force more focused on selling firewalls, building up that pipeline. So, how much of that was kind of better execution? How much came from perhaps a pull forward of spending or crisis spending, if you will, of people setting themselves up for work from home environments?

And then secondarily, can you give us a little bit of a sense of what you've been seeing so far in May? You talked about a difficult macro ahead. Have the positive trends – how well have the positive trends you saw in Q3, how well has that actually sustained into May thus far?

Nikesh Arora
Chairman & Chief Executive Officer, Palo Alto Networks, Inc.

A

Thanks, Keith. Thanks for the question. Look, I think it's fair to say as the pandemic hit, we saw a spurt of activity in the first few weeks where customers wanted to rush and create more capacity to be able to support their remote workers. So, people asking for more firewalls or chassis cards to expand capacity, people doing our GlobalProtect trials to see if they can fill in the remote work capability by using our free option that we've offered because we want to support our customers. Some people accelerated their Prisma Access trials into full purchase orders because they wanted to get it deployed quickly and we put in teams to go deploy it. So, definitely, there was an early surge in the first few weeks.

I'd say, on the margin in the quarter, there were puts and takes. There were things that got slowed down because customers are not in the office. The federal government can't have half their people go in. So, all those things cause puts and takes. So, I'd say the puts and takes probably gave us a slight bump, but not a substantial bump in the last quarter. And to be fair, I think some of these trends are going to be here to stay. I suspect that most companies want to maintain the remote secure access capabilities coming out of the pandemic.

We announced today a policy called FLEXWORK. We're allowing our employees to come into work as many times a week as they want when things open. We're not dictating everybody has to come to the office, which means we have to maintain our remote secure capacity across our entire employee base because now they will split their time between our office as well as their homes. And I think that's going to be true for many companies. If you see the last week, multiple companies have announced that they don't expect all their employees to come back to work. So, I think that extra remote secure capacity has to be created. I don't think every company has actually scaled up to that. I think that's going to be a sustainable trend for the next three, four quarters. So, I don't think that's a one-time spurt that's going to be systemic in the industry. I think the cloud transformations are real. I think those are getting accelerated. I think it's just going to be the puts and takes in terms of people who can get business done in the next three months or not versus people who are accelerating their spending.

Keith Eric Weiss
Analyst, Morgan Stanley & Co. LLC

Q

Got it. Excellent. And then the trends that you've seen so far in May?

Nikesh Arora
Chairman & Chief Executive Officer, Palo Alto Networks, Inc.

A

We have no reason to believe so far, as what we've seen in May, that our guidance is not achievable. Otherwise, we would not have guided. So, I think that's the best answer I can give you.

Keith Eric Weiss
Analyst, Morgan Stanley & Co. LLC

Q

Okay. Thank you very much.

Operator: Our next question is from Walter Pritchard with Citigroup.

Walter H. Pritchard
Analyst, Citigroup Global Markets, Inc.

Q

Hi. Thanks. And thanks for doing the call this way. Two questions. Just first on – Kathy, you mentioned the financing program. Could you just walk us through, is there any difference in how we see sales through that program hit the financial statements? And maybe some sense as to how widespread the uptake was on using that and what you expect over time.

Kathleen Ann Bonanno
Chief Financial Officer & Executive Vice President, Palo Alto Networks, Inc.

A

Sure, Walter. The Palo Alto Networks Financial Services arm that we've – the entity that we created this quarter is designed to allow us to offer some financial flexibility to our customers for larger deals, particularly in this time when so many of our customers have been financially impacted. The goal for us is to help smooth the deal process and accelerate the timing of deals getting to closure, offering some assistance to our customers, and then, of course, ultimately hopefully improving our margins by getting into the deal economics early enough to understand when they need financing. And so, we do hope that this will be a win-win for both our customers and for us. The entity is very small. We've done one deal. We're not expecting this to be a significant portion of our billings. It should, in fact, be pretty immaterial, and therefore the entity itself will not be broken out and the results will be combined in total on the financials.

Walter H. Pritchard
Analyst, Citigroup Global Markets, Inc.

Q

Great. And then just on hiring, I think you talked about on the call that you did with Cloudgenix that you were slowing your hiring to some degree, and you've taken away the long-term guidance. So, maybe it'd be helpful, which is prudent it seems, but it would be helpful to understand how you're thinking about spending through this environment, if you do see some incremental weakness on the top line. Do you expect to continue to be cautious on OpEx? Or do you think you'll spend through to just drive the investments you had planned on before?

Nikesh Arora
Chairman & Chief Executive Officer, Palo Alto Networks, Inc.

A

So, Walter, let me take that one. We announced, as soon as we got out of the gate of the pandemic, that we were not going to have any COVID-related layoffs, because very important for our employee base to feel secure and comfortable during these times as people are having to work from home. We have been pretty ahead of the curve in making sure we had enough resources to cover our base on revenue and support our sales team. We have ample resources, both in acquisition and in our hiring processes, to make sure that our product teams have enough runway to go build products.

I think it's – as we've – it's only been two months. As we power through the pandemic, as we start seeing signs of economic recovery, you will see us continue to ramp up hiring again. At this point in time, we've just been prudent, and we're hiring very, very critical roles, which we believe are needed to continue to keep momentum on our projects, both on the go-to-market side as well as our product side. So, we're not anticipating any impact of our slowing down of hiring in our ability to produce results. We're just being cautious in these times to make sure we align that with how the market evolves. So, yeah.

Walter H. Pritchard
Analyst, Citigroup Global Markets, Inc.

Q

Great. Thank you.

Nikesh Arora
Chairman & Chief Executive Officer, Palo Alto Networks, Inc.

A

In terms of – the other part is your expense question. Look, I think people have realized the expense categories that have shifted when nobody travels, you don't have any face-to-face conferences, you don't have people in the office, a lot of certain spending goes away, you have to shift that spend to provide capability for employees. So, as we announced this morning, our FLEXWORK program, we increased allowance for employees to be able to make their homes more comfortable so that they can actually work more effectively and productively from home.

And there's a longer note, which is in our blog post, you can go and take a look at it. But we expect when we come back out of this pandemic, the way people work is going to change. We've introduced this concept of FLEXWORK where people, we think, will, in the long-term, work partly from home and partly from the office, which will eventually require us to rethink our workplaces.

I've seen other companies offer people to move out of the state or the city. I've seen other companies say, don't come back to work ever again. We don't think it's going to be as extreme, but we do believe there'll be a shift in the way we think about employees, we think about travel, we think about meetings, and that is going to create a different cost structure.

Walter H. Pritchard
Analyst, Citigroup Global Markets, Inc.

Q

Great. Thank you.

Operator: Our next question is from Sterling Auty with JPMorgan.

Sterling Auty
Analyst, JPMorgan Securities LLC

Q

Thanks. Hi, guys. And I echo. I like this format a lot. So, I guess my question is, you mentioned the next six to nine months are going to be a bumpy ride for cybersecurity. I'm just wondering how that's going to manifest itself in your product revenue versus the rest of the subscription revenue.

Nikesh Arora
Chairman & Chief Executive Officer, Palo Alto Networks, Inc.

A

Sterling, I think it's fair to say we're all very focused on how our Q3 happened and how we plan our Q4, and we're all sort of digging deep to understand what this means over the following 12 months. We have visibility into Q4. We obviously have some visibility in Q1, as we progress through Q4. We haven't really put our heads down in terms of what this actually translates into, which we will talk about more at the end of Q4.

All I'm talking about the bumpy ride is the macroeconomic environment is not coming back as most people expect. We were experimenting one day in the office, and it feels weird, and then having to wear a mask as you walk around, having to rub my hands six times in an hour, [ph] now I've got (39:07) the softest hands I've ever had. And all these things are going to take time for us to adapt to, as our employees, as they're cautious about coming back to work. I think that's going to have ripple-through impact to our customers and our capabilities. The good news is I think the worst is over. I think now we're slowly building back to an economic recovery, which means our customers are more relaxed and are more interested to see how they create these technological transformations that need to happen in their business. So, I feel that that's going to happen. All I'm saying is, it may not fall neatly into quarters as life used to fall neatly into quarters. That's kind of the only way – takeaway from my comment.

Sterling Auty
Analyst, JPMorgan Securities LLC

Q

That makes sense. And then one follow-up. How does SD-WAN demand get impacted positively or negatively from increased work from home?

Nikesh Arora
Chairman & Chief Executive Officer, Palo Alto Networks, Inc.

A

I think it's going to be huge. But since Lee Klarich is here, and I feel like he has to answer a question, and this is the perfect question for me to give my friend, Lee.

Lee Klarich
Chief Product Officer, Palo Alto Networks, Inc.

A

Thank you, Nikesh. Look, I think we're not only seeing greater work from home, but we're seeing greater work from remote locations, branch offices, even retail environments will come back. And as that happens, in conjunction with a accelerated shift of applications to the cloud, SD-WAN becomes increasingly important. So, it will obviously play out over time, but I believe that we're going to see an acceleration of these network transformation projects as a result of the shift to cloud, as a result of working from home, and SD-WAN in a cloud-delivered format will be central in that.

Sterling Auty
Analyst, JPMorgan Securities LLC

Q

Great. Thank you.

Operator: Our next question is from Fatima Boolani with UBS.

Fatima Boolani

Analyst, UBS Securities LLC

Q

Thank you for taking the questions. I hope you guys are doing okay. I appreciate this format as well. Maybe just to start, as I think about the adoption levels in the portfolio of NGS solutions, that seems to be seeing a continued healthy takeup. So, I'm wondering if you can kind of talk through the concept of ELAs or EAAs and to what extent this type of transaction structuring is becoming more frequent in your sales engagements. And then I have a follow-up for Kathy.

Nikesh Arora

Chairman & Chief Executive Officer, Palo Alto Networks, Inc.

A

Yeah. I think it's – Fatima, thank you for the question. I don't think we have seen much, we have changed much in our EAA and ELA activity. I think what's primarily happened is that we've seen a healthy balance between new logos and existing customers buying into some of these products. Like Prisma Cloud has opened up a whole new set of customers to us who are more cloud-centric, cloud transformation-focused, maybe cloud-only companies. And getting to 1,500 customers in any business from a standing start over 18 to 24 months is amazing for us. So, we're very excited about the progress our sales teams have made on the Prisma Cloud side. Take Cortex XDR, it used to be a product called Traps, again, getting to top of the charts, great execution by our product and sales teams to get us to be leading contender against some of the industry leaders.

So, I think what's happened over the last 18 to 24 months, our concerted efforts around both go-to-market, as well as product, have let us to really target the market, focus on acquiring customers. We have established these speed boats 2 years ago or 18 months ago when I came in, and the whole purpose was to go accelerate and not get bogged down by a lot of cross-collaborative efforts until we establish clear propositions, clear leadership. So, probably in the next phase, we'll worry more about putting stuff together.

Having said that, there are some customers who bought everything from us, the retailer we mentioned; has, over time, established our platform across every category within the infrastructure because they believe the integration across our platforms and products is key. So, I'd say this is less driven by EAA, ELA activities; more driven by product excellence and go-to-market excellence in those categories. And as time evolves, as we get more robust and as we start cross-selling more and more into our existing customer base, hopefully that becomes an accelerator for EAAs and ELAs in the future.

Fatima Boolani

Analyst, UBS Securities LLC

Q

That makes sense. I appreciate that. And Kathy, for you, just with the conversation around FLEXWORK and potentially some structural changes with respect to the 8,000 employees at Palo Alto and how they work, can you talk a little bit about the implications for CapEx here? I mean, there's been a huge effort to build out the headquarter footprint. So, to what extent does that change or is reevaluated? And that's it for me. Thank you.

Kathleen Ann Bonanno

Chief Financial Officer & Executive Vice President, Palo Alto Networks, Inc.

A

Hi, Fatima. Thanks for the question. Yeah. Obviously, the CapEx investments that we've made around headquarters were made in a pre-COVID environment, and we're going to have to wait and see how long this work from home phenomenon lasts and to the extent with which our employees choose to work from home. We made a land purchase, which we talked about on the call. And that purchase, we've not yet started to develop. However, our plans were to start developing that somewhat quickly. In this current environment, that will probably be pushed out a bit. But ultimately, the land here is very valuable, the real estate here is very tight typically, and so we still think that that's going to present us with a good opportunity in the future.

Fatima Boolani
Analyst, UBS Securities LLC

Q

Sounds good. Thank you, and nice to see you guys.

Operator: Our next question is from Brian Essex with Goldman Sachs.

Brian Essex
Analyst, Goldman Sachs & Co. LLC

Q

Hi. Thank you. Good afternoon, and thank you for taking the question. I guess, Nikesh, I want to dig into product revenue, if I could. Maybe, could you give us a little bit of color in terms of how much visibility you had into improvement of sales force productivity given the adjustment and incentives that you had? And maybe how much was from expansion with existing customers versus new logo wins? And how durable do you think the growth there will be?

Nikesh Arora
Chairman & Chief Executive Officer, Palo Alto Networks, Inc.

A

Thanks, Brian. Thanks for the question. As you know, the conversation last quarter was around our product revenues. And we had offered our insight that we had seen a slowing down of customer evaluation, customer evals and POCs, and there was a discussion on execution of our sales team. And we're in the high single negative digits in product growth last quarter. So, our team really rallied. Our team is really focused on the product issue, built tremendous execution. So, I'm very proud of what they've been able to achieve going into Q3, especially as you see people having to work from home, get deals done from home, customers are home, getting through their purchasing departments, and being able to target a number, and meet and beat the number, is not trivial in such environment, not to mention the incredible amount of supply chain effort it takes.

I know many companies have slipped on supply chain this quarter, and our supply chain team did a phenomenal job working with our sales and go-to-market team. So, I think the execution has been spectacular. I do believe there's probably a few 100 basis points of tailwind, as Keith asked in the beginning, from that. So, maybe without COVID, we'd be in 1 or 2 percentage points lower, but there are some companies in our industry whose entire growth is that number in the COVID environment.

So, I think the teams do a great job. And don't forget, the reason I actually – I understand product is important because it's instant gratification, it falls to revenue and EPS. But going back, Firewall as a Platform, 13% growth, industry growing to 6% to 8%. We once again started taking share from people. Because remember, I can sell a firewall with GlobalProtect to a customer or I can sell Prisma Access delivered to the cloud.

Now, the beauty of Prisma Access, the customer calls and says, I want to go from 25,000 to 80,000 remote secure workers now. I don't have to do anything. I just have to increase capacity, reconfigure things from remotely, and allow them the capacity.

On firewalls, I got to ship a firewall. They're going to deploy the firewall, they're going to enhance the subscription, so it's a lot higher friction in physical box firewall sales for remote secure access than it is to provide a cloud delivered firewall to our customers. So, whilst I understand it's very important for financial modeling how much revenue and cash flow Palo Alto drops in the same year from a firewall, my team and I really look at the

Firewall as a Platform number, and watching that get back to double-digit high industry growth is more gratifying than just seeing the product number go up. So, once again, kudos to the team out there. I'm just delighted the way they stepped up to the challenge.

Brian Essex
Analyst, Goldman Sachs & Co. LLC

Q

Great. Thank you for that. Maybe, Kathy, to follow up. Thank you for the ARR commentary, by the way that's very helpful. Maybe if I could ask, I get a lot of question from investors around how to think about balancing the core clients-based business with the growth in next-gen. How should we think about how you manage those two businesses? One is the installed base in the core business, still growing. It's generating, obviously a lot of cash flow. We can see that in maintenance revenue. And then two, is next-gen generating cash flow or profitability? Is one funding the other? Or is it self-funding? Like, how could we – if we kind of split those businesses and think about those and the strategy to grow and leverage your installed base and cash flow to grow those businesses, what's the best way to frame that out?

Kathleen Ann Bonanno
Chief Financial Officer & Executive Vice President, Palo Alto Networks, Inc.

A

Yeah. It's a good question, Brian. And obviously, we're very focused on driving the newer products in our portfolio. Lots of times you see companies who make acquisitions or try to develop internally, and you just don't ever see the kind of momentum that you saw with their original core product. And so, we're really pleased, and Nikesh has done a great job building out these speedboats and driving the discipline and focus around allowing us to build out those businesses so that they can be successful.

Initially, they take investment, like all new businesses. And so, it is kind of a company now with a multi-product strategy. We have a core product that's been very successful for us, that we continue to innovate in, and we're adding new subscriptions. You've seen us add recently three, a fourth is to come soon, and still more to follow. So, we're still investing in the core. We're still releasing a lot of new great technology there.

But additionally, as Nikesh mentioned, we have lots of different options now for firewalls. We have the cloud-delivered firewall, we have a cloud version of the firewall, so – a software version of the firewall, so we can serve a much different breadth of product offerings to our customers today. And so, really, you're just going to have to think about the lifecycle of the different stages of growth that our portfolio is in, which is why we've separated out next-gen security to give you some markers and show you that we are making progress in this group as a whole, that is our newest set of offerings that, granted, is less mature, therefore the margin profile is not as strong. But over time, we're definitely committed to profitability and improving overall operating margin performance, as we've said in the past.

Brian Essex
Analyst, Goldman Sachs & Co. LLC

Q

Fair enough. Thank you.

Operator: And with consideration for time, our final question is from Jonathan Ho with William Blair.

Jonathan Ho
Analyst, William Blair & Co. LLC

Q

Thank you. Can you hear me okay? Hi.

Operator: Yes, we can hear you.

Jonathan Ho

Analyst, William Blair & Co. LLC

Q

Fantastic. Can you talk a little bit about maybe what you're seeing with the trends around SASE and firewall as a service, and maybe the trajectory that you're seeing in terms of a shift away from the more traditional infrastructures over the cloud?

Nikesh Arora

Chairman & Chief Executive Officer, Palo Alto Networks, Inc.

A

Yeah, Jonathan. Thank you for the question. And as Lee mentioned, we are seeing customers evaluate the remote secure access posture even more aggressively now, of course, because of COVID. I think that's been an accelerator. I think people want capacity for all their employees to be able to do this remotely. Given the choice of adding more hardware into their data centers or infrastructure they prefer the software solution, we can offer both.

We see a predilection for people to go after the software use case more than the hardware use case, unless they already have a lot of firewalls in there. I think, as we see the cloud transformation accelerate, people will realize that they don't need to bring all their traffic back to the data center and incur MPLS costs. So, that will drive more and more of an SD-WAN use case. And I think if you look at what's happened in the last even six months, Gartner coined the term, if you go search for SASE on Google, their extension and you'll find every vendor now has converted their offering to SASE. SASE requires you to have an SD-WAN capability and security capability in one UI, one cloud-managed capability.

So, we think this is the new trend. We think this trend is going to be around for the next few years as customers kind of re-architect their network infrastructures. So, I think there's going to be a solid tailwind in that category. In terms of trajectory, it really depends on customers' ability to execute in this environment whether or not they're not in the office.

Operator: And that concludes the Q&A portion of our call. Thank you for all of your questions. I'm going to turn it back to Nikesh for closing remarks.

Nikesh Arora

Chairman & Chief Executive Officer, Palo Alto Networks, Inc.

As I close, I actually want to thank every one of you for joining us today. And thank you, everyone, for your encouraging comments to do this again in a Zoom format. Although, Kathy and I had a big debate about this, and somehow we feel we have radio voices as opposed to video voices, so we'll figure it out. But sorry, jokes apart, thank you again for joining us.

I do once again want to call out our employees across the company, across different functions, our sales teams for working on the execution to get us out of the challenges we had in the past quarter, our supply chain teams, our product teams, our go-to-market teams, our IT teams. There's not a single person of Palo Alto Networks who has not put their heart and soul for the last few months in really getting us through this quarter while we settle into a new normal. So, I want to say thank you from the bottom of my heart.

My heart also goes out for the people who are impacted by the pandemic, and I hope they stay safe and healthy. I want to thank our customers, our partners, everyone around the world. So, I think the hard work and dedication that I've seen in these times gives me hope that we will come out stronger from this pandemic. And I look forward to seeing you guys in the next earnings call. Thank you.

Operator: This concludes the Palo Alto Networks earnings call. Thank you.