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Palo Alto Networks, Inc. (PANW)

Q2 2020 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good day, everyone, welcome to the Palo Alto Networks Fiscal Second Quarter 2020 Earnings Conference. Today's call is being recorded.

At this time, I'd like to turn things over to Mr. David Niederman, Vice President of Investor Relations. Please go ahead, sir.

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 second 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 second quarter ended January 31, 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 our financial guidance and modeling points for the fiscal third quarter, full fiscal year 2020 and our next three years, our competitive position, our proposed accelerated share repurchase and the demand and market opportunity for our products and subscriptions, benefits and timing of new products and subscription offerings and trends, and 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 this call.

For a more detailed description of factors that could cause actual results to differ, please refer to our quarterly report on Form 10-Q filed with the SEC on November 26, 2019 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 GAAP 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.

And 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 attending the Morgan Stanley TMT Conference in San Francisco on March 5th.

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

Nikesh Arora

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

Thank you, David. Good afternoon, and thank you, everyone, for joining our call. I was talking to our President, Amit Singh, earlier today. He just finished a two-day review of our sales teams around the world. He was excited more than I've ever seen him excited since he started Palo Alto Networks. He was excited that we are having more strategic conversations ever around the world. And our strategy around cloud security, securing the SOC and adding capability to our firewalls is resonating with customers and we're launching more integrated capability than ever before, and our customers are responding well to our efforts.

And in the presence of all that enthusiasm, our billings are up 17% year-over-year, including strong performance from our next-generation security offerings which grew 101% in Q2. I was thinking about this earnings call. It's definitely a contrast. We are executing well on our transformation, but becoming more relevant to our customers and building a second and third leg to our security business, which is the hardest thing to do. But I do know that you all want to talk about products.

So, let's cut to the chase. Am I disappointed with what happened with our product revenues? Yes. We talked about the impact of sales incentive changes last year, which had impacted our sales team's focus on product versus Next-Generation Security. We, of course, corrected that and balanced their focus. We knew that the problem will take some time to correct as we discussed last quarter. In all fairness, we were expecting improvement this quarter, which hasn't arrived.

Product performance did (sic) [didn't] improve partly, because the sales incentive change is going to take longer than expected, and partly because we were too optimistic about some of the deals closing in the quarter. Upon deep inspection, I feel that the softness will take a little more time.

So, what are we going to do about this and what gives us comfort that performance will improve? First, we're following up with the success of our Prisma and Cortex speedboats and have created new speedboat for firewalls to drive entrepreneurial energy and momentum. The leadership for this speedboat is now in place. We've hired Andy Elder, who joined us from Riverbed and Alan Doswell, who joined us from Cisco, who will be leading this speedboat.

Secondly, we recently launched SD-WAN across our entire firewall estate. And when combined with Prisma Access, we believe this is a great SASE solution. We're still in early stages, but we have closed some deals and are seeing heightened interest from our customers and positive feedback on the vision and simplicity of our SD-WAN solution. Along with our technology partners, we have the capability to bring a full branch architecture solution and feel good about our ability to compete.

Finally, we're seeing signs and early indicators that we track across our business where we are likely to see some product growth resume in the fiscal fourth quarter. So let me revisit that in terms of what it means to our outlook going forward on product and its impact to Palo Alto Networks.

We expect product growth to improve in the second half of fiscal 2020 and turn positive in fiscal Q4. However, products will still be below our internal expectations. We expect that product will return to market growth next year in fiscal 2021. We have put cost containment measures into place to match our investment trajectory with our profitability expectations. And Kathy will give you more details around this versus our EPS forecast.

Lower product growth will, of course, impact our Firewall-as-a-Platform metric, we now expect double-digit growth this year. The management team and I have revisited our three-year guidance that we gave at Analyst Day. We're only two quarters in to that guidance. Upon deep inspection we still feel confident in our long-term outlook for fiscal 2022.

Now that we've talked about the product issue and the impact to financials, let's talk about what's working. Amit, Lee, Nir and I have seen over 100 customers this quarter. Our strategy is resonating. Organizations everywhere are undergoing a profound digital transformation. Fundamentally, reshaping the way they operate, innovate and connect with the people they serve.

These transformations are helping drive the need for Prisma and Cortex. I'd like to share a few key wins in the quarter. In fiscal Q2, a number of customer wins illustrate the power of our comprehensive approach to security, including a large US retailer who expanded the Palo Alto Network's footprint this quarter with an eight-figure deal spanning each of our three pillars including Prisma Cloud, Prisma Access and SaaS, Cortex and our Next-Generation Firewall.

This is one of our largest deals in recent times and a true cross platform buy of Prisma, Cortex and Firewall. A multinational travel management company expanded their next-generation firewalls at Prisma Access following the purchase of Demisto last fiscal quarter.

It's a great example of how one of our Next-Generation Security services opened the door with a major account for future firewall purchases. I also love this example because the client was pursuing the goal of building a network that will support a significant number of employees and also transition away from MPLS.

Our solution not only provides significant flexibility and increased visibility, we also -our customers also derive substantial savings compared to prior architectures. We got a deal with a large German automotive company who purchased Prisma Cloud Compute, formerly known as Twistlock. Prisma will be a critical pillar of the customers move to 100% cloud first architecture and shift less security model. These wins are excellent examples of our success in articulating our vision of security and being able to demonstrate our value proposition to customers.

As a final indication of our momentum, in the first half of fiscal 2020, we closed two of our top 20 largest deals in the company's history. Additionally, Prisma Cloud had another record-setting quarter and closed an eight-figure, yes, eight-figure deal with the US retailer I highlighted earlier; the largest deal in the history of Prisma Cloud.

During the quarter, we also continued to drive innovation across our products, this time with our Firewall. In December, we launched SD-WAN for Next-Generation Firewalls. Customers are currently testing this offering and feedback is positive as they appreciate our vision and the simplicity of solution. We will continue to add new firewall subscriptions in 2020, including IoT later this year.

Earlier today, we announced Cortex XSOAR, an extended Security Orchestration Automation and Response platform that natively integrates threat intelligence management. Cortex XSOAR is the significant evolution of the Demisto platform, and we believe it'll redefine the SOAR category by making threat intelligence much more actionable at scale.

In Prisma Cloud, we have launched the first version of our integrated product where SaaS customers of Prisma Cloud who are using it for workload security can seamlessly leverage the capability to deploy container security. In a short period since launch we have seen 10% of our customers take up both modules. This is exciting because we are hard at work to develop, integrate and deploy four modules over the course of this year including the integration of Aporeto.

Turning to our marketing efforts, if you will be attending RSA, you will likely notice that a fresh look and feel of the new Palo Alto Networks branding. Additionally, we have launched a standalone brand for our Firewall business,

STRATA. Over the past several months, we have launched and built two of the premier brands in cyber-security, Prisma and Cortex. When we took a step back and reviewed our position, it became clear that the firewalls needed their own brand. All three brands roll up to the Palo Alto Networks, which also sports a new updated logo.

On the people front, we are continuing to prioritize our culture and workplace environment. We're highly focused on making Palo Alto Networks a place where everyone feels inspired to do their best work. And we're extremely pleased to earn a perfect score of the Human Rights Campaign Foundation's 2020 Corporate Equality Index and also the designation of a Best Place to Work for LGBTQ Equality. We are very, very proud of this achievement.

Finally, I want to highlight our proposed accelerated share repurchase transaction, or ASR, that we announced earlier today in our earnings press release. The proposed ASR was the amount of \$1 billion and is expected to occur in our fiscal third quarter and represents the capital allocation strategy that we believe returns value to shareholders, while still allowing us with sufficient flexibility to achieve our goal. The proposed ASR is in addition to the \$1 billion repurchase authorization that we announced in February 2019. As of today, approximately \$800 million remain available for future share purchases under the February authorization.

In closing, we continue to chart new territory cyber-security with our three-platform strategies taking shape. We have a lot of work to do, but it's heartening to see our customers partnering with us in a more strategic manner. We are the largest cyber-security company providing industry-leading growth, while transforming our business to protect our customers as they go through this transition. The new data center will be the cloud, and we will be there for our customers in Prisma, a new frontier in AI and ML and Cortex was all our customers need cyber-security automation. Last, but not, definitely not the least, firewall technologies will continue [indiscernible] (00:11:18:) customers in their data centers or in the cloud and we will be there beside them with STRATA.

With that, I'll 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'd like to note that except for revenue and billings figures, all financial figures are non-GAAP and growth rates are compared to the prior-year period unless stated otherwise. As Nikesh indicated, we believe our overall business remains healthy despite our Q2 product revenue performance. In the second quarter, we continued to add new customers at a healthy clip and sales of our Next-Gen Security offerings continue to be strong.

In Q2, total revenue grew 15% to \$816.7 million. Looking at growth by geography; the Americas grew 15%; EMEA grew 12%; and APAC grew 20%. Q2 product revenue of \$246.5 million declined 9% compared to the prior year. Q2 SaaS-based subscription revenue of \$342.6 million increased 37%. Support revenue of \$227.6 million increased 20%. In total, subscription and support revenue of \$570.2 million increased 30% and accounted for a 70% share of total revenue.

Turning to billings. Q2 total billings of \$998.9 million net of acquired deferred revenue increased 17%. The dollar-weighted contract duration for new subscription and support billings in the quarter remained at approximately three years, up by approximately one-month year-over-year. For the first half of fiscal 2020, billings of \$1.9 billion increased 18% year-over-year; product billings were \$479.8 million, down 7% and accounted for 25% of total billings; subscription billings were \$868.9 million, up 34%; support billings were \$547.6 million, up 22%. Total deferred revenue at the end of Q2 was \$3.2 billion, an increase of 27% year-over-year.

In addition to adding over 2,500 new customers in the quarter, we continued to increase our wallet share with existing customers. Our top 25 customers, 24 of which made a purchase this quarter spent a minimum of \$46.2 million in lifetime value through the end of Q2 2020. This is a 30% increase over just \$35.6 million in the comparable prior year period.

Q2 gross margin was 76.4%, which was up 10 basis points compared to last year. Q2 operating margin was 17.9%, a decline of 670 basis points year-over-year and includes a headwind of approximately \$9 million of net expense associated with our recent acquisitions. We ended the second quarter with 7,643 employees.

On a GAAP basis for the second quarter, net loss increased to \$73.7 million or \$0.75 per basic and diluted share. Non-GAAP net income for the second quarter declined 18% to \$120.3 million or \$1.19 per diluted share. Our non-GAAP effective tax rate for Q2 was 22%.

Turning to cash flows and balance sheet items. We finished January with cash, cash equivalents and investments of \$3.5 billion. Q2 cash flow from operations of \$306.9 million increased by 11% year-over-year. Free cash flow was \$257.8 million, up 2% at a margin of 31.6%. Adjusted free cash flow in the quarter was \$275.6 million, representing a margin of 33.7%, excluding cash charges associated with our headquarters in Santa Clara.

Capital expenditures in the quarter were \$49.1 million, of which \$17.8 million was associated with our headquarters in Santa Clara. DSO was 57 days, an increase of seven days from the prior year period.

Turning now to guidance and modeling points. As Nikesh noted earlier, we anticipate that product revenue growth will improve in the second half of fiscal 2020, but will remain below our initial expectations. As such, we are modifying our guidance for the full fiscal year. Please note that our guidance does not reflect any potential disruptions in our global supply chain that could result from the coronavirus, which we are carefully monitoring.

For the third fiscal quarter of 2020, we expect revenue to be in the range of \$835 million to \$850 million, an increase of 15% to 17% year-over-year. We expect billings to be in the range of \$980 million to \$1 billion, an increase of 19% to 22% year-over-year. We expect Q3 2020 non-GAAP EPS to be in the range of \$0.96 to \$0.98 using approximately 99.5 million to 101.5 million shares.

For the full fiscal year, we expect revenues to be in the range of \$3.350 billion to \$3.390 billion, representing year-over-year growth of 16% to 17%. Billings to be in the range of \$4.075 billion to \$4.125 billion, representing growth of 17% to 18% year-over-year.

Next-Gen Security billings to be in the range of \$810 million to \$820 million, representing year-over-year growth of 79% to 82%. We expect fiscal 2020 non-GAAP EPS to be in the range of \$4.55 to \$4.65 using approximately 99 million to 101 million shares.

Finally, turning to free cash flow. For the full year, we expect an adjusted free cash flow margin of approximately 28%.

Before I conclude, I'd like to provide some additional modeling points. We expect our Q3 and fiscal 2020 non-GAAP effective tax rate to remain at 22%. CapEx in Q3 will be approximately \$85 million to \$90 million with approximately \$50 million related to real estate purchased to accommodate future expansion of our headquarters in Santa Clara. As a result, we are increasing our expected full-year CapEx to approximately \$220 million to \$230 million with approximately \$100 million related to our headquarters.

Finally, our adjusted free cash flow in Q3 and fiscal 2020 will exclude costs associated with the expansion of our headquarters, including the real estate purchase I just described as well as a \$50 million cash payment for litigation-related settlement.

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

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] We'll hear first today from Keith Weiss with Morgan Stanley.

Hamza Fodderwala

Research Associate, Morgan Stanley & Co. LLC

Q

Hi. This is Hamza Fodderwala in for Keith Weiss. Thank you for taking my questions. A couple ones for me. First on the product revenue side, Nikesh, is there anything else that you're seeing in terms of any unforeseen challenges within the Firewall business? Has there been any change to the competitive landscape at all? You mentioned launching SD-WAN. Obviously, there's another vendor that's had some pretty strong traction there. So, any more color would be really helpful.

Nikesh Arora

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

A

Thanks for the question. Yeah. Look, as we highlighted in the prior quarter, we made changes in our sales incentives last year to drive Prisma and Cortex because honestly, there's very few examples when I came to enterprise security of companies building a second or third product line to [ph] drive (20:27) the first product line. We spent a lot of effort as a team trying to figure out how can we build where the opportunities were, we aligned it on cloud, we aligned it on automation and machine learning and we made some significant bets both in terms of acquisitions and resources in driving Prisma and Cortex. That changed and trying to get salespeople to learn, appreciate, understand and sell these things caused them to pivot hard, because they're going to make a lot of money selling Prisma and Cortex and they did.

What they did was because they're focused on this, and there's only finite resources, they didn't go and knock on enough doors to create Firewall demand. And as you know, there's a cycle from demand to closure which has its own motion, takes its own time. And we discovered that much later in the year, while we're delighted with the success of Prisma and Cortex in Q4, we realized that we had been systematically eroding the opportunity to have a large pipeline going into Q1, which is why you saw our Q1 results. We were optimistic that we would be able to accelerate that effort and try and get deals closed sooner. But unfortunately, it was hard to fight the tape. There is a cycle, there is a motion and our customers are used to it and that's what is in front of us. Hence, we have had to revise our product efforts.

In terms of what's going on in the market, yes, SD-WAN is a trend as you see it. There are other people out there who are doing well with SD-WAN. There are SD-WAN companies out there doing well with SD-WAN. We have SD-WAN partners. Every time we go sell Prisma Access as part of our SASE solution, either we now use our own SD-WAN or customers choose other SD-WAN package. Definitely, SD-WAN is a trend. And we think as people go to the cloud, as network architectures change, MPLS starts to get pulled off of and the internet becomes a new network, we will see people leverage more SD-WAN capabilities.

So, it is an area of focus. It continues to remain an area of focus. And we're excited by the progress we've made since December in terms of getting customer interest in our solution. Other than that, honestly, I think this is an execution issue at our end. I don't see that the market is changing. So, you've got to take our medicine and got to go ahead and go execute.

Hamza Fodderwala

Research Associate, Morgan Stanley & Co. LLC

Q

Got it. And I just had one follow-up question on the Next-Gen side. On Cortex, it seems like there's been some really strong traction there. I was curious to know the announcements that you made earlier today on that product. How do you expect that to translate to further pipeline into the second half of this year? And what are some of the early trends that you're seeing there? And that's it for me.

Nikesh Arora

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

A

Yeah. So, as you know, on Cortex, we have two products. In the larger category of security, automation applying AI and machine learning, we have a product called Cortex XDR, which in the simplest form competes in the XDR category which is the next-generation of the EDR category where some of the newest sort of endpoint vendors have migrated to. And there we keep adding more data sources into our injection capability. So, XDR is doing well. Our primary customers have come mostly from Palo Alto customers who've had our firewall and some new customers who want our endpoint capabilities from the XDR perspective. And that business is doing well.

What we announced this morning was the Cortex XSOAR, which is the next evolution of what was Demisto. In the past, we sold Demisto to our customers. And the constant feedback we got was, it'll be amazing to track in terms of management will be part of this capability and we would have to go stitch it on top of our capabilities to automate and our playbooks on.

So, the Demisto team has rallied and merged threat intel management in the capability of what both Demisto and simplifying the XSOAR. [indiscernible] (00:24:05) industry analysts have been calling for this. They've been calling for this trend. So, we are first in launching that capability. But purely from a mechanical perspective, every customer who is a customer of Demisto should want an upgrade to this capability. Additionally, it should open up a larger market for us with Demisto who's with that Intel market which is we think probably the same size of the SOAR market, so very excited about it.

Hamza Fodderwala

Research Associate, Morgan Stanley & Co. LLC

Q

Thank you.

Nikesh Arora

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

A

But thank you for asking a Cortex question. I was thinking that question wouldn't come towards until the end of the call.

Operator: We'll hear next from Walter Pritchard with Citi.

Walter H. Pritchard

Analyst, Citigroup Global Markets, Inc.

Q

Hi. Thanks. Nikesh, question for you just on the – if we're thinking about this not from the sales incentive perspective and what behavior you're driving, but just from a customer demand perspective, how do you think about, I guess, we all understand I think that Firewall demand is not what it was two, three years ago. But certainly, I think we hear in the industry that customers spend on Firewall is flat or maybe slightly up. And I'm wondering as it relates to your customer base with Firewall, revenue down two quarters here now. Are customers – did they buy last year and they're holding off their purchases? Or they're holding their purchases in the future? I'm just wondering how we think about it from the buyer perspective. I think we well understand everything you've done from the sales incentive side from the sort of supply side.

Nikesh Arora

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

A

Yeah. Thanks, Walter. I think that's a good question. Look, from a buyer perspective, every customer is on a different life cycle in terms of both where their infrastructure is today and where they're trying to go tomorrow, whether they're adding more data centers or going to the cloud or trying to replace their sort of traffic coming back home and trying to build some sort of a hybrid cloud plus data center infrastructure.

So, the trend as I highlighted in the last answer is that, we are seeing SD-WAN being asked for. We are seeing buyers looking for SD-WAN solutions with security. In some cases that involves a box solution. In some cases involves a software solution. In our case, we have the opportunity now with SD-WAN from the time to deliver both. We can give you a box that gives you SD-WAN capability. We can give you Prisma Access that allows you to deploy SD-WAN into the cloud.

So from that perspective, there's definitely activity on the net – sort of re-architecting the network and trying to get more sort of evolution underway. Customers who have large data centers that go through their own refresh cycle. So, we're not seeing anything big that would give us a reason to believe that things are shifting. On the margin, our solutions given by cloud versus boxes would have caused some difference probably, but nothing we see at this point in time.

Walter H. Pritchard

Analyst, Citigroup Global Markets, Inc.

Q

Great. And then Kathy, just on the long-term goals, I know you're not revisiting those here. But as we think about the three-year CAGR you talked about, I mean can you help us understand maybe what level of firewall or product sales you were anticipating in there? And sort of I don't know, any color you can provide us around sensitivity of that overall growth number given the performance you've seen here on the product side near term?

Kathleen Ann Bonanno

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

A

Yeah, Walter, and thanks for that question. We did obviously not guide explicitly on products. But I think for the most part, the analysts were projecting less growth than we have seen historically on the product line which was appropriate and reflected in our guidance. And so, obviously that changed a little bit and we've had to adjust our guidance this quarter, but we still feel really great about the longer term view, especially given the performance of our Next-Gen Security. And we definitely think, as Nikesh mentioned, that we believe that what we have is an execution issue and that we know how to compete in Firewall sales and that we'll be able to correct the situation and improve that growth as well.

Walter H. Pritchard

Analyst, Citigroup Global Markets, Inc.

Q

Okay. Thanks for taking the questions.

Operator: And from JPMorgan, we'll move next to Sterling Auty.

Matthew Parron

Analyst, JPMorgan Securities LLC

Q

Hi, guys. This is Matt on for Sterling. Thanks for taking my question. If we're looking at product revenue, assuming that product revenue is just flat from here on out. How long do you guys think it would take to get the Next-Gen Security to parity with that revenue run rate? Thanks.

Nikesh Arora

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

A

You know what, I'm going to let Kathy answer the parity question, but I will tell you from our product revenue forecast, we've looked at the pipeline and looked at the early indicators, we think that Q3 is going to continue to be tough but we should be able to get to positive growth by Q4. And our teams are hard at work to make sure that we reverse these trends and that next year we're back to at-market or above-market growth in the Firewall space.

In terms of how long it takes for parity for NGS, I think that's a math problem. If you look at our forecast we've given you for NGS and look at our Firewall forecast, you should be able to derive that answer. I'm going to let Kathy answer that question in case.

Kathleen Ann Bonanno

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

A

And I really don't have much more to add. That was a great answer, Nikesh.

Matthew Parron

Analyst, JPMorgan Securities LLC

Q

Great, great. Thanks for that. And then just one follow-up. Geographically, it looks like there are some issues in the year. Are there any macro impacts or anything that you guys can point to geographically?

Nikesh Arora

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

A

No again, I think on a geographic basis, there is no trend thing. As you know that Europe and Asia generally have lagged the cloud trend globally, but they're slowly getting onboard. We're seeing companies in Europe also talk about hybrid cloud solutions, talk about thinking about changing network architectures. They generally lagged some of the US company in that context. So, we're seeing traction in different parts of the world of varying degrees.

So, no, I think the market is only going to get bigger on an international basis. And as Kathy said, we're all watching the coronavirus thing, you all look at the market today. I think whatever impact happens because that will happen across the industry will not be specific to any one company, but we have some – we might have less exposure compared to others but I think that will be more of a global impact around that trend.

Matthew Parron

Analyst, JPMorgan Securities LLC

Q

Great. Thanks, guys. Appreciate the color.

Operator: We'll move next to Karl Keirstead with Deutsche Bank.

Karl E. Keirstead

Analyst, Deutsche Bank Securities, Inc.

Q

Thanks, Kathy. I just wanted to make sure just given the attention on the product revenue side that I understand the outlook for the second half where you said the product revenue growth should improve. So just to be clear, the year-over-year decline you anticipate in 3Q would – there'd still be a decline but less than negative nine. So, better than negative nine I should say. And then in the fourth quarter, you think the year-over-year growth rate for product could move positive. Is that correct? I just want to be clear that you anticipate negative nine is being the floor let's say?

Kathleen Ann Bonanno

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

A

Yes. That's correct, Karl.

Karl E. Keirstead

Analyst, Deutsche Bank Securities, Inc.

Q

Okay, got it. And then maybe, Nik my other one..

Nikesh Arora

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

A

Not just [indiscernible] (00:31:16).

Karl E. Keirstead

Analyst, Deutsche Bank Securities, Inc.

Q

Okay. Thank you, Nikesh.

Kathleen Ann Bonanno

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

A

We both expect that.

Karl E. Keirstead

Analyst, Deutsche Bank Securities, Inc.

Q

Okay. Great. And just so I'm clear, the \$50 million litigation-related settlement was related to what, Kathy?

Kathleen Ann Bonanno

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

A

Yeah. We – the details of the settlement are confidential, so we won't be describing a lot in our Q or on this call, but it was related to an IP settlement which is pretty common in the industry.

Karl E. Keirstead

Analyst, Deutsche Bank Securities, Inc.

Q

Okay. Got it. Okay. Terrific. Thank you.

Operator: From Raymond James, we'll move to Michael Turits.

Michael Turits

Analyst, Raymond James & Associates, Inc.

Q

Hey, guys. Good evening. So, two competitive questions and then one on the incentives. So, can you be more specific Nikesh, about whether or not you're actually losing because you don't have any of the SD-WAN, it's just coming into play for you now? And what's going on in the market against Zscaler specifically for, let's call it cloud delivery network security competitively?

Nikesh Arora

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

A

All right. Well, let me start with the SD-WAN question, and I can try and give you some color on the network transformation architecture market. I generally prefer not to talk about other companies, because I don't understand their businesses as much as I understand ours. But on the SD-WAN front we are seeing customers require talk about SD-WAN. And remember, customers have a choice of taking best to read SD-WAN in the market which are independent players or taking that as part of an integrated firewall solution. And we've seen customers thoughtful either depending on the complexity of their needs for SD-WAN, which you're going to deploy it to across 10,000 sites, 8,000 sites you go get a specialist SD-WAN vendor, because he has a whole bunch of stuff that you want to deploy, configure and set up, which is a much more complex product that is not available in the market.

Sometimes customer's want to do a simpler architecture and just have the capability in their firewalls. And we're seeing a market for that too and that is the market we will be able to address with our evolution of our firewall capability, and we end up [indiscernible] (00:33:24) capability with the SD-WAN that we launched. So yes, we are seeing that need come in. Honestly, I've not seen many large deals in the market, where we've seen a competitive situation, where the customer says, I cannot solve this problem with the Palo Alto firewall, I'm going to go elsewhere. But clearly, other people are doing well. Now, that maybe some of the market segment issue, I haven't seen that much in the large enterprise space.

In terms of what it does to the network transformation market. Remember, let's say when I came to Palo Alto Networks, we had a product called GPCS which we deployed a lot of resources against and we worked really hard over the last 18 months. Lee and his team did a great job of launching Prisma Access and delivering it. We've had this product in the market almost only for three quarters. And in that three quarter timeframe, we have made some huge inroads with the very large customers that deployed very large deals. I highlighted some of the deals earlier in my prepared remarks and that was a large Prisma Access component with that deal.

So, a market where people weren't seeing us, we probably had more share, in a market where they did see us and we get deals, other people get less of that pie. It's one of our strongest pipelines in that space. We have a lot of expectations from that space. So, expect us to continue to be aggressive in the Southeast space, because we believe there we have one of the most comprehensive solutions. Was there a third part to your question?

Michael Turits

Analyst, Raymond James & Associates, Inc.

Q

Yeah. That was off from the cash. My follow-up is, did you make any additional incremental changes to the incentive structures as you saw that things are taking longer this quarter?

Nikesh Arora

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

A

Look, we have a very capable responsible intelligent sales team out there. And they understood the math when we did the math in the last year in terms of taking the multiples we gave them to go sell Prisma and Cortex and they did as we requested them to do. We have balanced those. We have a lot of scrutiny. We have a lot of inspections going on in the Firewall space, and our teams are responding. Honestly it takes time. Firewall cycle has a time element to it. And call it our misjudgment in the last quarter when we looked at the deals in the pipeline. We were being too optimistic that we could close a lot more of them in this quarter than we have been able to. The deals haven't gone away. They're just going to take time. And we're just trying to make sure that we are no longer setting unrealistic expectations of closing deals in our pipeline and giving a reasonable forecast both to you and setting the right expectations for our team.

Michael Turits

Analyst, Raymond James & Associates, Inc.

Q

Okay. Thanks, Nikesh.

Operator: We'll move next to Brent Thill with Jefferies.

Howard Ma

Analyst, Jefferies LLC

Q

Hi. This is Howard on for Brent. Thanks for taking the questions. Nikesh in your prepared remarks you mentioned you had gathered feedback from about 100 key customers. Could you share some – any additional details around, I guess, customer requests for either more product functionality or flexibility or even on the pricing side. So, for example, is there any demand for a subscription pricing model for on-prem firewalls?

Nikesh Arora

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

A

Yeah. Thank you for the question. Look, I'll tell you a funny story. When I did the customer tour when I started Palo Alto Networks, I got a lot of curiosity meetings because people wanted to know who's this new guy coming to cybersecurity and wanted to talk to me. And I went there and talked about firewalls and I told them about all of our subscriptions and many of them were polite and listened to me nicely and nodded their heads. But they've been buying firewalls for 15 years. And it might have been new and exciting for me. They've been buying it for a long time. And the CIOs and CISOs were interested, but this wasn't top of mind.

What has changed in the last 18 months is that we talk about cloud transformation and how the cloud transformation has to be secured with Prisma Access and Prisma Cloud. We talk about their SOC how their SOC is getting too much data and then to make sense of that data to be able to be more secure. So now we're having real conversations where they want to talk about this transformation. And slowly and steadily it's emerging that we're one of the few companies which have those products and are committing to developing them further with our customers than anybody else in the market. And I would challenge the industry to show us who else is out there talking about these topics with their customers.

So, the conversations are really, really good. They're actually meaningful. We are seeing a lot of conversation in our network transformation. We are seeing a lot of conversation with customers who want to be in multiple clouds. One year ago, they were going to a single cloud. A year later, they found they have instances of different cloud

infrastructures being used by different parts of the organization. So they want a multi-cloud security solution. So the conversations are changing in terms of what people are talking about.

In terms of what they want, I don't think you're going to see available on-prem firewalls anytime soon because there are many players in the space and customers have a motion and a way of buying these things and capitalizing them. So, yeah, if somebody wants it, I'm sure we can construct a financial solution for them that allows them to buy it that way. But honestly, we're not seeing demand for financial creativity to buy firewalls. I think there is going to be some conversations in the future about how these architectures over time need to be fungible that if I'm going to have a data center and a cloud install how do I make sure I can move things fungibly between them. And our teams are working hard at trying to understand that need and see if we need to make any forays in that direction.

Howard Ma*Analyst, Jefferies LLC*

Q

Okay. Thanks, Nikesh. That's really great color. I just had a related follow-up for Kathy. It seems like subscription billings were very strong and that's driven a lot by the Cortex XDR. And so if we were to get – product billings have performed in line with your expectations because the overall billings number was actually towards the high-end of your guidance. And despite the full-year rev guide down, the billings is actually – you guys only guided it down \$20 million, \$30 million. So if we assume product was in line with expectations, would total billings have actually – could we have seen a billings raise?

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

A

Well, I think that's a very good question and I'm going to let Kathy respond in a second, but I think this is a point I tried to highlight in my beginning of the remarks that our teams are really excited. We're delivering the billing numbers we have on tap. We're just delivering them in the wrong box as per your expectations. So, delivering them on Cortex and Prisma more aggressively than we expected and we're seeing a product mix. So, we're making it hold, which is interesting, which is a short-term financial impact, which changes our revenue and EPS in the very short term. But this is phenomenal news for the long-term. We have deferred revenues rising better than it has in the past. So, I will let Kathy add more color to that.

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

A

Yes. We've obviously been really thrilled with the strong subscription performance, not just NGS, but also our cash subscriptions are growing nicely. And we've introduced some new subscriptions, DNS and SD-WAN which is just very new. And in addition, we've introduced a Platinum support product as well. So, all of those are helping contribute to strong subscription growth, which we feel really terrific about obviously. So, look, we left our NGS full-year guidance the same. We didn't move that this time. But we are feeling really terrific about all of those numbers. And the product decline is certainly the driver of all of the change to our revenue and billings guidance.

Howard Ma*Analyst, Jefferies LLC*

Q

Okay. Thanks a lot.

Operator: Moving on to Nehal Chokshi with Maxim Group.

Nehal Sushil Chokshi

Analyst, Maxim Group LLC

Q

Yeah. Thank you. I'd like to ask about the accelerated share repurchase timing. And also, what has been the thinking on why have you only repurchased \$200 million to \$1 billion original share repurchase deployed so far?

Nikesh Arora

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

A

Yeah, thanks for the question. Look, we have a 10b5-1 plan filed, which buys stock back out of \$1 billion authorization at certain levels. And when we looked at the strength of our billings, we look at the growth trajectory of the company and our comfort in the management team and we look to the product thing. We anticipated that you would not take kindly to our product execution issue. We think this is a very good company in the long-term. So, we feel the best thing we can do for our shareholders is to return capital by buying back shares, because we think they're very, very attractive at these levels.

Kathleen Ann Bonanno

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

A

And it will take place in Q3.

Nikesh Arora

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

A

And if you look, we have \$3.5 billion of cash in our balance sheet. So, we've already outlined our M&A strategy which says we're going to be doing tuck-ins to our product strategy as opposed to try and go do any big M&A. So, from that perspective, we felt given that we generate close to \$1 billion of free cash flow every year, that gives us enough financial flexibility to be able to do this at this point in time.

Nehal Sushil Chokshi

Analyst, Maxim Group LLC

Q

Great. Thank you.

Operator: We'll hear next from Shaul Eyal with Oppenheimer.

Yi Fu Lee

Analyst, Oppenheimer & Co., Inc. (Broker)

Q

Thank you for taking my question. This is in Yi in for Shaul. Just two quick questions. First one for Nikesh. I think you talked about in the prepared remarks that there're certain key indicators tracking expecting positively on the Firewall side. Nikesh, can you help us...?

Kathleen Ann Bonanno

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

A

See, we're having a hard time hearing you. Sorry, can you speak up? We're having a hard time hearing you.

Yi Fu Lee

Analyst, Oppenheimer & Co., Inc. (Broker)

Q

Sorry, thank you for taking my question. This is Yi in for Shaul. Nikesh, I think on your prepared remarks you talked about there are some key indicators that's tracking positively on the firewall side. Can you elaborate on what are some of the metrics you're looking at?

Nikesh Arora

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

A

Yeah, look, as in any good sales organization, you have to look at your deals, you have to look at pipeline, you have to like your conversion capabilities, you have to look at the stages of deals that progress. You have to look at how many customers are evaluating your firewalls versus how many customers are up for refresh. So, we track all those metrics. And we're seeing positive indications of those metrics that our pipeline is robust.

And as I said, we are optimistic in this quarter that we've been able to close a lot more sooner than normal but we think they're going to take the normal time. But we are seeing those indicators trend up which gives us confidence about our Q3 and Q4 revival expectations from our product business. Albeit not as much as we had expected earlier, but we still believe that as somebody earlier asked this, minus 9% of trough, yes, we believe it's the trough. And we believe by Q4 we'll have – we'll be in positive territory and hopefully revive back to market plus growth next year.

Yi Fu Lee

Analyst, Oppenheimer & Co., Inc. (Broker)

Q

Thank you for that, Nikesh. And then a quick one for Kathy. On the geographic breakdown, I think you mentioned that EMEA and APAC lagged for the quarter. Any chance you could give us growth rate for the individual regions, US, EMEA and of course APAC? And maybe comment a little bit on the distribution pipeline going forward?

Kathleen Ann Bonanno

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

A

Yeah. I'm sorry. I'm really struggling to hear you, but I think you asked for our revenue growth by geography. Is that correct?

Yi Fu Lee

Analyst, Oppenheimer & Co., Inc. (Broker)

Q

Yes, that's correct, Kathy. Whether the traditional breakdown in the US and EMEA as well as APAC. If we could get some color on the year-over-year growth rate. And maybe comment a little bit on the distribution channels going forward?

Kathleen Ann Bonanno

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

A

Yes. So, our growth by theater was 15% in the Americas, EMEA's growth was 12% and APAC was 20%.

Yi Fu Lee

Analyst, Oppenheimer & Co., Inc. (Broker)

Q

Thanks, Kathy and Nikesh.

Kathleen Ann Bonanno

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

A

Thank you.

Operator: And from Guggenheim Partners, we'll move next to Taz Koujalgi.

Imtiaz Koujalgi

Analyst, Guggenheim Securities LLC

Q

Hey, guys. Thanks for taking my question. I had a question on your guidance revision. So, Kathy, if I did my math right here, you're guiding down revenues by about \$90 million for the year but your billings are being guided down by only \$35 million. So, what's the offset given that you're guiding down part revenues up doing by \$90 million? And you're not even raising your next-gen billings guide. So what is the offset for billings versus the decline in product revenues?

Kathleen Ann Bonanno

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

A

Yeah. As I mentioned in the response to the last question, we are seeing strong subscription growth. Not just in our NGS subscription, but also in our cash subscription including some of the newer subscriptions that we've launched which are contributing.

Nikesh Arora

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

A

And will launch.

Kathleen Ann Bonanno

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

A

And will launch yeah in the future.

Imtiaz Koujalgi

Analyst, Guggenheim Securities LLC

Q

Got it. And then one second question. Just to clarify, you mentioned that part revenues would be offset in 4Q, right? Because if I do the math on your full year revenue guide and then assume typical seasonality on your support and subscription revenues, it still leads to negative product growth for obviously Q3 and also Q4. So, can you just clarify Q4 be – should we expect Q4 to be positive product growth?

Kathleen Ann Bonanno

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

A

Yes, we are expecting positive growth in Q4, positive product year-over-year revenue growth.

Imtiaz Koujalgi

Analyst, Guggenheim Securities LLC

Q

Got it. Thanks, Kathy.

Kathleen Ann Bonanno

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

A

Yeah.

Operator: And Keith Bachman with Bank of Montreal has our next question.

Keith Bachman

Analyst, BMO Capital Markets Corp.

Q

Hi. Thank you very much. I have two questions I'm going to ask you currently. The first is, Palo Alto has had trouble establishing and then hitting targets. And so, while on the subscription side things have gone quite well, the performance of products has been very different. So, you're guiding to a lesser decline if you will in Q3 and then product growth in Q4. But what's the process that you think that you've either accrued upon or have more information because candidly you haven't been very effective at hitting targets. So, what's different now that gives you confidence in terms of a process or a higher discount rate so to speak on the targets that you established?

And then a corollary question is, I know you're saying this is more internal than external. But if you look at the growth rate between Fortinet product growth that are double-digit revenue growth and you're down 9%. So, it's a 20% spread on your product growth rates. It's just hard to believe that there's not competitive activities there. There are lots that are causing meaningful share loss. So, I just – one of the corollary question is, what gives you the confidence that you're not actually losing share and this is more internal and external? And that's it for me. Thank you.

Nikesh Arora

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

A

All right. Well, thank you for your questions. Yeah. Look, I think I'll repeat some of what I said. Last year, when we did our forecast, we would be delighted with some of the Next-Generation Security growth and we expected product growth to continue. And majority of that happened. But in Q4, we saw our product slowdown a bit. And we saw Next-Generation Security take up, because our teams have been focusing on generating a lot of commissions for themselves. And we look to the number in absolute. And as the prior analysts indicated, in absolute we are delivering the billings. We are still delivering industry-leading growth in cyber-security. There's no other company of our scale and size delivering the numbers that we are.

So, I know you're very focused on the product piece that's, but so are we let's focus on that. You talked about the competitive activity. I think it's unfair to look at spreads. These numbers are different. Fortinet has different revenue than we do. And absolutely, yes, there is still a spread. They operate in different segments, we operate in different segments. They've been seeing strength in SD-WAN. They've been seeing strength in the low end market where they compete in price. We've looked at the entire market. We inspect every deal, and we know every deal where we're competing with other people now. So, part of our competitive data is based on customer-by-customer understanding, who we're competing with and if they're not. So two things. One is...

Keith Bachman

Analyst, BMO Capital Markets Corp.

Q

Nikesh, just to jump in though, but in terms of the forecast you've missed the last two product forecast. Have you put a higher a bit more conservatism you think as we look out the next two quarters?

Nikesh Arora

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

A

Kathy, you want to say something?

Kathleen Ann Bonanno

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

A

Yeah. I just want to be clear that we haven't guided to product revenue. And I think if you go back and look at our history of actually when we've missed, you really don't find there are many quarters where we missed. And probably we do pretty well compared to most companies would be my guess.

Nikesh Arora

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

All right.

A

Keith Bachman

Analyst, BMO Capital Markets Corp.

Okay. I would seek before. Thank you.

Q

Operator: We'll hear now from Patrick Colville with Arete Research.

Patrick Colville

Analyst, Arete Research Services LLP

Hi, there. Thank you for taking the question. I just want to talk about SD-WAN because that was the big launch back in December last year. And just wondering if you could share any anecdotes on SD-WAN kind of early feedback. And I guess, not to flog a dead horse's product stuff. But is that a contributing factor or just any color there would be great.

Q

Nikesh Arora

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

Yeah. Look, as I mentioned, there is a lot of interest out of the market from an SD-WAN perspective, because remember there is a very large installed base of MPLS. And as people are going down the cloud journey, they are looking at the fact why do I need to bring all my traffic back home to my data center? Why can't I just send it from my branches, my remote offices, my other data centers straight to the cloud. And that is causing the SD-WAN conversation to happen. It's pretty standard now that people will replace that MPLS solution with Interac as well SD-WAN, but then they need security. So, with that as a background, since Lee is here on the call that I feel like he has to earn his keep as well. Lee, can you talk more about the SD-WAN market?

A

Lee Klarich

Chief Product Officer, Palo Alto Networks, Inc.

Sure, Nikesh. Happy to earn my keep. So, Patrick as you mentioned, SD-WAN was released in December. So, it's still very early days, but we are seeing a lot of interest, a lot of very positive reaction from customers. We have dozens of customers already that have deployed it. We – in the quarter, we had a multimillion dollar SD-WAN deployment, which gives us a lot of excitement to see the larger deals coming through as well. And I would say, even perhaps more exciting is that, while these additional deals and deployments are more of the do-it-yourself kind of variety, which is how the SD-WAN market has operated in the past, what we're hearing from our customers is that they really like our ability to combine this with Prisma Access in a more of sassy kind of variety of solution. Where we're providing the network and the networking and the security from the cloud and lighter weight branch deployments to connect to that cloud. That's the promise it's asking. We're getting a lot of very of very good feedback from customers about that is the future of how these architectures, these network transformation should happen.

A

Patrick Colville

Analyst, Arete Research Services LLP

Q

Great. And can I talk about internal segmentation? Because I do a bit of work speaking to CISOs. And one of the trends that I've been picking up of late is the ransomware, it's become increasingly prevalent threat. And the way to combat it has been increasing use of internal segmentation. So, wondering if you've seen that as well. And what kind of boxes people are buying to segment their networks internally?

Lee Klarich

Chief Product Officer, Palo Alto Networks, Inc.

A

Yeah. So, I actually separate those two things. Ransomware is a generally a solvable problem. And we have a number of ways of preventing ransomware from getting into a customer's enterprise to begin with. Segmentation can be a backstop to that, but to me segmentation is a much broader initiative that's focused more on building zero-trust architectures, designed around increasingly mobile workforce, increased number of devices, locations and devices, increasing cloud deployments, public cloud and SaaS deployments where customers as they have their enterprise architecture is transformed are looking to move to an increasingly zero trust architecture, which then leads down the path of needing to do better segmentation to have the right enforcement points in the right part of the network. We're very well suited for this because in that architecture, it's not just about a location device, it's about being able to build context-oriented policy everywhere and consistently. And we are unique, and have been unique for many years in ability to meet that requirement.

Patrick Colville

Analyst, Arete Research Services LLP

Q

Great. Thank you very much.

Operator: And from Mizuho, we'll hear from Gregg Moskowitz.

Gregg Moskowitz

Analyst, Mizuho Securities USA LLC

Q

Okay. Thank you very much, and good afternoon. So Nikesh, you mentioned earlier that product revenue would return to market growth in fiscal 2021. But as I think we all know, for many years, Palo Alto has been growing significantly above market rate. And I realize that you're taking out from the go-to-market issues. But can you shed some light on how you're thinking about your Firewall market share over a medium to longer-term basis? And then also, what do you think the Firewall market growth rate will look like over that period of time?

Nikesh Arora

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

A

Oh, I thought I had you by saying we're going to market growth or better because I didn't want to predict the firewall market growth. But that's a very good question. Thank you. Look, the reason we're not expecting to grow faster than market from a share perspective because we believe we will be taking share. We will be taking share in the software form factor. Every solution that can solve – that is sold by a box by some of our competitors, we sold by VM. We sold by a container VM. We sold by a Prisma Access delivered by the cloud solution. All these things do not classify as product revenue in the way we report. All these things end up in next-generation security.

So, this is the trap, we fall into in terms of how you recognize box sales versus software sales and the transition companies like ours have to go so. So yes, we definitely expect to be taking market share from everybody else. We think that we'll be recommending software solutions to our customers with SD-WAN with VMs for the cloud,

with container VMs s for containers. But they're not going to follow the product box. So, I believe I can sustain product growth at market levels? Yes, which means, I have a lot of new share and the market on my boxes and I will take share with software form factors because most transitions are being discussed in software form factors and not as straightforward replace the box A with box B.

Gregg Moskowitz

Analyst, Mizuho Securities USA LLC

Q

Okay. That's helpful. Thanks, Nikesh. And then just a follow-up for Kathy. Can you comment just on how discounting rates were this quarter? And related to that, was there any pushback at all from customers or from the channel on the recent appliance price increases? Thank you.

Kathleen Ann Bonanno

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

A

Sorry what were the rates you asked me about?

Gregg Moskowitz

Analyst, Mizuho Securities USA LLC

Q

Sorry, Kathy?

Kathleen Ann Bonanno

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

A

Sorry, you asked me about discount rates?

Gregg Moskowitz

Analyst, Mizuho Securities USA LLC

Q

Correct. And just if there's any pushback from customers on the recent appliance price increases?

Kathleen Ann Bonanno

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

A

Yes, we did see a small uptick in our discount rates this quarter. We feel like on the balance with the price increase that we took on product, we were still at least on par maybe a little bit better off with the price increase.

Gregg Moskowitz

Analyst, Mizuho Securities USA LLC

Q

Okay. Thank you.

Kathleen Ann Bonanno

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

A

Yeah.

Operator: Our final question today will be from Gray Powell with BTIG.

Gray Powell

Analyst, BTIG LLC

Q

Great. Thanks for marking me in. Yeah, I just had a quick one. So, how should we think about the growth rate of attached subscriptions given what's going on in the product side? And then, what do you see as the key levers to drive that component of the business going forward? Thanks.

Kathleen Ann Bonanno

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

A

Yeah. Well, our attach subscriptions have obviously performed really well in the most recent quarter along with the NGS subscription growth as I've already talked about. The reality is, we've sold a number of enterprise agreements which customers buy our subscriptions in advance and then they tend to buy more product as time goes on that's sort of part of the agreement that we strike with them. And so, we are expecting subscription growth to continue to be strong with the new subscriptions that we're adding and with continued strong attach rates. And then as we return product growth to higher levels, obviously that will help with the general attached subscriptions as well.

Gray Powell

Analyst, BTIG LLC

Q

Got it. I guess, what I was trying to get at would be with the new subscriptions coming online, should attach subscription be faster than maintenance?

Kathleen Ann Bonanno

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

A

Yes, definitely. Yeah. And we've seen that historically. Yeah, for sure.

Gray Powell

Analyst, BTIG LLC

Q

Okay. Cool. Thank you.

Kathleen Ann Bonanno

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

A

Yeah, you bet.

Operator: Anything further, Mr. Powell?

Gray Powell

Analyst, BTIG LLC

Q

I'm sorry. I'm good.

Operator: Thank you. And everyone, I'll turn the conference back to you all for closing remarks.

Nikesh Arora

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

Thank you. Before I close, I want to thank everybody again for joining us. We look forward to seeing many of you at RSA and an upcoming investor conferences. But I also would like to thank our customers, our partners and most importantly, our employees around the world who worked hard to deliver the quarter. Thank you everyone. Have a great evening.

Operator: Again that does conclude today's conference. Thank you all for joining us.

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