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Palo Alto Networks, Inc. (PANW)

Q4 2018 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good day, everyone, and welcome to the Palo Alto Networks' Fiscal Fourth Quarter and Fiscal Year 2018 Earnings Conference Call. Today's conference is being recorded.

At this time, I would like to turn the conference over to Ms. Amber Ossman, Director-Investor Relations. Please, go ahead.

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Amber Ossman
Director-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 fourth quarter and fiscal year 2018 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; Mark Anderson, our President; and Lee Klarich, our Chief Product Officer.

This afternoon, we issued a press release announcing our results for the fiscal fourth quarter ended July 31, 2018. 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 first quarter 2019; our competitive position and the demand and market opportunity for our products and subscriptions; benefits and timing of new products and subscription offerings. These forward-looking statements involve a number of risks and uncertainties, some of which are beyond our control, which could cause actual results to differ materially from those anticipated by these statements. These forward-looking statements apply as of today and you should not rely on them as representing our views in the future. And we undertake no obligation to update these statements after this call.

For a more detailed description of factors that could cause actual results to differ, please refer to our quarterly report on Form 10-Q filed with the SEC on June 5, 2018 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've 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've completed our formal remarks, we will be posting them to our Investor Relations website under Quarterly Results.

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

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

Thank you, Amber, and thank you everyone for joining us this afternoon for our fiscal fourth quarter and fiscal year 2018 results. I've spent the last 90 days talking to over 100 people in the industry, experts, customers,

partners and our peers. It's been a lot of fun learning and drinking from the cybersecurity fire hose. I've also spent some time reading what all of you've been wondering about, and I realize you're all very curious to understand what the future holds for Palo Alto Networks and how we're likely to perform under new leadership.

So, before Kathy takes you through our strong Q4 results, which I think are a testament to the company's great marketing opportunity and execution – market opportunity, I want to share five key observations and messages with you to give you a little more insight into what to expect from me going forward.

First, I think the security market is large and continues to grow. The security market size estimates are close to about $100 billion in 2018, and expected to grow at a CAGR of about 9% over the next five years. Despite being the leader in cybersecurity, we're still a small percentage of the market and we have aspirations to be larger.

Continued spending on security is being driven by a few notable technology trends. One, consumers and employees are walking around with very powerful computing devices, which are constantly connected using increasing bandwidth. This is forcing a large scale upgrade in IT infrastructure globally; two, the transition to the cloud is gathering steam. Every customer I've talked to is working on a version of a cloud strategy and migrating either some or all of their business to SaaS and PaaS; three, there's a broad understanding of the value of data and the need for good usable data as a basis for applying AI and machine learning in the future.

The increased complexity of managing these changing IT environments is creating significant challenges for enterprise security practitioners. We believe that the benefits organizations seek, as they make these transitions, cannot be fully realized unless security solutions transform with them.

Digital transformation requires security transformation, which gives me a lot of confidence in the continued growth in security spending. This leads me to my second observation and that is, with the need for security transformation so apparent, we are well positioned to continue to succeed as Palo Alto Networks.

Our strength lies in our platform approach to security, which emphasizes best-in-class security with automation and integration to simplify security management. The company started with network security, where the next generation firewall changed the industry. Network security remains extremely important to enterprises, and we continue to innovate and take share in this space.

In the past 15 months, we've introduced updated versions of almost every next-generation firewall we offer and have delivered new models which allow us to solve additional use cases for our customers. Our cloud delivered subscriptions are natively integrated into our firewalls and offer best-in-class network security protection, as well as eliminate the need for our customers to deploy multiple point product solutions. As digital transformation accelerated and as mobility and cloud computing has grown, our innovation has kept pace.

We're also doing well in the nascent cloud security space. This is one area where I personally feel we could do a lot better. Our customers are facing new challenges. And as we see the market embrace hybrid cloud and multi-cloud strategies, customers are asking for solutions that can integrate with their existing infrastructure.

With over 54,000 customers worldwide, we have a ringside seat to understand the challenges of both traditional network security as well as the evolving needs of our customers in the cloud security space. Today with over 6,000 customers using our VM-Series Aperture, Evident and GlobalProtect Cloud Service offerings, we have made great inroads into cloud security.

In the endpoint market, which is extremely competitive and also in transition, I believe we're on the right path with Traps and Secdo. With Traps, we now serve over 3,000 customers and protect over 5 million endpoints. With our recent acquisition of Secdo, we will add important EDR capabilities, which will enable us to compete even more aggressively.

My third observation is that I believe that our bet on the Application Framework is the right one, and I'm pleased to report that it's progressing well. Coming from the outside, I had no bias one way or the other. After spending a good deal of time talking with customers about the Application Framework, three things came across loud and clear.

One, customers are looking for greater integration. They continue to be concerned with the fragmentation of solutions in the market. As new attack vectors are exploited by cyber criminals, the response for many has been to add more point products and solutions. The results, however, have been challenging from a management and policy perspective. And management of the overall security environment has become too cumbersome to be effective.

Two, customers are looking for simplification in deployment. With a multitude of users and endpoints and a sprawling infrastructure to manage, customers are concerned with the time to deploy security solutions across the enterprise. The longer it takes to deploy, the more exposed they feel.

Three, the bad actors are more and more in the cutting edge of technology. And customers are concerned with the level of sophistication both in their use of large scale computing resources and approach to data.

The Application Framework is an attempt to resolve all of these and prepare for a world which is data rich. The Application Framework will provide simple yet flexible integration, fast speed of deployment and innovative security applications offering big data analytics and machine learning to stay ahead of the bad guys and solve the most challenging cybersecurity threats. In August, the Application Framework became generally available to third-party apps, and we expect the first of those applications to be offered to customers in the near future.

In R&D, the teams, led by Lee Klarich who's on the call, are attacking all of these challenges for our customers with tremendous innovation. Lee's organization now includes more focused leadership across each of our product areas. The goal of this change is to launch product speedboats to help us innovate faster. I'm also delighted to say that Nir Zuk and Rajiv, our Co-Founders, have both reengaged are in entrepreneurial mode helping to accelerate our development engine and ensure we stay ahead of the evolving threat landscape.

Onto my fourth observation. I've recently read a number of analyst notes and I understand that my attitude towards M&A is a topic of interest. While we all know we have cash in our balance sheet, which in the tech sector seems to be the norm. We don't intend to spend it in a non-judicious manner. Not only as a shareholder, but also as an investor, my interests are very aligned with yours to create long-term shareholder value. I understand that we cannot create value either by expensive acquisitions or without bringing significant value and execution to any acquisitions we make. Any activities in this area are going to be guided by aspirations to solve our customers' problems and bring value to our customers and shareholders.

Which leads me to my fifth and final message I'd like to leave you with today, and that is our intend to run the business for the long-term. Being a student of Warren Buffett, I'm going to be focused on generating long-term value, balancing investment in the business which will allow us to grow and succeed with the need to provide returns to our shareholders.

And while I appreciate the value of guidance for analysts and investors, I'm all about creating long-term value for our shareholders and not just managing for the next six to nine months. Therefore, you will notice a shift in our approach this year as we provide guidance for only one quarter. But rest assured, I'm here for one reason and one reason only that is to build the best cybersecurity company in the world.

In summary, I'm delighted to be here and believe that we have a significant opportunity ahead of us as long as we continue to grow fast, innovate and most importantly provide industry-leading security for our customers around the globe.

With that, I'll turn the call over to Kathy.

Kathy 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, 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 strong finish to our fiscal year. We continued to see healthy security spending and strong demand across our platform. With the addition of over 3,000 new customers during the quarter, we are privileged to now serve over 54,000 customers. We also continue to increase our wallet share with existing customers. Our top 25 customers, all of which made a purchase this quarter, spent a minimum of $31.7 million in lifetime value, a 45% increase over the $21.9 million spend in the same period a year ago.

In the fourth quarter, total revenue grew 29% to $658.1 million. For the fiscal year, we reported total revenue of $2.3 billion, a 29% increase year-over-year. By geography, Q4 revenue grew 24% in the Americas, 43% in EMEA and 43% in APAC. Q4 product revenue of $267.6 million grew 26% compared to the prior year.

Q4 SaaS-based subscription revenue of $214.5 million increased 38%. Support revenue of $176 million increased 25%. In total, subscription and support revenue of $390.5 million increased 32% year-over-year and accounted for 59% of total revenue.

Q4 total billings of $868.1 million increased 29% year-over-year. The dollar-weighted contract duration for new subscription and support billings in the quarter was approximately three years consistent with what we have seen in prior periods. For fiscal 2018, total billings were $2.9 billion, up 25% year-over-year. Product billings were $871.5 million, an increase of 23% year-over-year and represented 30% of total billings. Support billings were $856.2 million, up 20% and represented 30% of total billings. And subscription billings were $1.13 billion, an increase of 31% year-over-year and represented 40% of total billings.

We continue to drive a mix shift towards greater subscription services, as we provide more of our offerings from the cloud. In addition to strong attached services revenue during the quarter, the momentum of our non-attached subscriptions continued. Our VM-Series, Traps, AutoFocus, Aperture, Magnifier, GlobalProtect Cloud Service, Logging Service and Evident offerings exited the fiscal year with run-rate billings of approximately $274 million growing over 68% year-over-year.

Total deferred revenue at the end of Q4 was $2.4 billion, an increase of 33%. The recently announced acquisitions were not material for revenue and billings in the quarter.

Q4 gross margin was 76.2%, a decline of 110 basis points compared to last year due to continued pressure from new product introductions. Q4 operating expenses were $349.9 million or 53.2% of revenue, which represents a

40-basis-point improvement year-over-year. Q4 operating margin was 23%, a reduction of 70 basis points year-over-year and includes approximately $13.4 million of operating expense related to acquisitions.

For the full fiscal year 2018, operating margin was 20.8%, an increase of 70 basis points year-over-year compared to FY 2017 operating margin of 20.1%. Included in the 70-basis-point increase is approximately 140 basis points of organic operating margin expansion, which adjusts for acquisition related revenue and expenses.

We ended the fourth quarter with 5,348 employees. Non-GAAP net income for the fourth quarter grew 46% to $125 million, or $1.28 per diluted share. For the full fiscal year 2018, non-GAAP net income grew 51% year-over-year to $381.4 million or $3.99 per diluted share.

On a GAAP basis for the fourth quarter, net loss declined 94% to $2.3 million or $0.02 per basic and diluted share. For the full fiscal year 2018, GAAP net loss declined 32% year-over-year to $147.9 million or $1.61 per basic and diluted share.

Turning to cash flow and balance sheet items. We finished July with cash, cash equivalents and investments of $4 billion. This includes net cash of approximately $1.5 billion raised through the July 2018 offering of convertible senior notes due in 2023.

Q4 cash flow from operations of $277.9 million increased 16%. Free cash flow was $252.5 million, up 33% at a margin of 38.4%. These numbers include approximately $12.4 million of operating cash outflow related to our recent acquisitions. Capital expenditures in the quarter were $25.4 million. DSO was 57 days, a decline of 13 days from the prior-year period.

Turning now to guidance and modeling points. In addition to the usual reminder that this guidance includes the type of forward-looking information that Amber referred to earlier, there are two important notes for guidance this quarter.

First, we intend to revert to quarterly revenue and EPS guidance only, which was our practice prior to fiscal 2017. Second, we will adopt ASC 606 during Q1 fiscal 2019, and our guidance reflects the change in accounting rules.

In our fiscal 2018 10-K and our Q4 2018 supplemental financial information, we will provide an overview of ASC 606 adjustments associated with select financial metrics. The impact on revenue and operating income is expected to be immaterial in Q1 2019.

For fiscal Q1 2019, we expect revenue to be in the range of $625 million to $635 million on an ASC 606 basis, an increase of 25% to 27% year-over-year. We expect first quarter non-GAAP EPS to be in the range of $1.04 to $1.06, also under ASC 606, using approximately 98 million to 100 million shares.

Before I conclude, I'd like to provide some additional modeling points. Our non-GAAP EPS guidance includes expense of $10 million to $15 million associated with our recent acquisitions. We expect our non-GAAP effective tax rate to remain at 22%. And CapEx in Q1 2019 will be approximately $35 million.

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

QUESTION AND ANSWER SECTION

Operator: Certainly. [Operator Instructions] Our first question will come from Phil Winslow with Wells Fargo.

Philip Winslow
Analyst, Wells Fargo Securities LLC

Q

Hey. Thanks guys, and congrats on a great quarter. You saw another strong quarter of new customer additions, but you also highlighted just continued upsell and just penetration inside of your existing customers. So, my questions is, as you look forward to Q1 and over the coming quarters here, how you think about the balance between that new customer addition, the land there, but also kind of further gaining wallet share inside of existing customers? How do you kind of think about this coming fiscal year versus what we saw over this last year? Thanks.

Mark Anderson
President, Palo Alto Networks, Inc.

A

Yeah. Hey, Phil, its Mark Anderson here. I think we're going to see more of the same. I think we have strong motions with partners and sales teams around the world with a really good coverage model focusing on growing their existing customers and expanding into new customers. I think the wind is probably never been more behind our sales than it is right now just in terms of our brand in the market and the reputation for driving better security outcomes. We've got, I think, a team that's focused on doing both of these work streams as part of their day-to-day job.

Philip Winslow
Analyst, Wells Fargo Securities LLC

Q

Got it. Eventually a follow up for Nikesh. The App Framework going live here. Obviously, it's just kicking off here. But what are the milestones or KPIs that you're looking at to show the adoption of that? Is it customer go lives? Is it partner go lives? How do you think about the milestones that you're looking at that we should keep track of to?

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

A

Hey, thanks for your question. I think when I talk to customers as I mentioned, the challenge seems to be a lot of point solutions in the industry. And from my perspective, the App Framework is definitely the long-term direction both for us and for the industry. The way we're trying to think about it internally is to make sure that we get our big products to start working together much better. So, I expect us to start seeing more and more integration between our firewall products and our endpoint products like sort of in the [ph] XDR (21:22) world as we acquired Secdo and we're busy working hard to make these things go live together.

At the same time, obviously, we want the Application Framework to be useful for other third-parties. So, the more third-party players we can get to adopt our model, the more we can get our products to work together and more we can provide customers the opportunity to be able to see how to look at their threats, how to look at their security posture across multiple parts of their infrastructure, to us that is a win.

Mark Anderson
President, Palo Alto Networks, Inc.

A

And if I can just add on top of that, Nikesh. I think we both feel when we talk to customers about it, that they love the notion, they love the concept, they love the idea of being able to distill innovation into much more consumable form factors. And I think more importantly, prospects that we're talking to, we talk about the Application Framework as a future state for them. And it gives them real sort of strong belief that picking Palo Alto Networks as their future provider is the right way to go.

Philip Winslow
Analyst, Wells Fargo Securities LLC

Q

Great. Thanks, guys.

Mark Anderson
President, Palo Alto Networks, Inc.

A

Yeah. Thank you.

Operator: Thank you. Our next question will come from Matt Hedberg with RBC Capital Markets.

Matthew George Hedberg
Analyst, RBC Capital Markets LLC

Q

Hey, guys. Thanks for taking my questions. Congrats on the results as well. The product refresh seems to be moving along nicely. And clearly, Kathy, you called out strong growth in SaaS and emerging products. I'm curious though, if you could drill down a little bit more on pricing both within the core firewall and also some of the newer products that are seeing quite a bit of growth as well?

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

A

Sure. Yeah. Thanks, Matt. We're definitely very excited about the opportunity that refresh presents to us. Obviously, it's important opportunity for us and we're definitely very focused on capturing that opportunity. But as we've already discussed, most of the opportunity for us comes from attracting new customers, winning new customers and expanding within our existing base. And we've seen very consistent pricing throughout our history. Our deal size tends to remain in the sort of mid five figures. And we're not really seeing a change to that. What we focus primarily on is expanding the lifetime value. And we've seen very nice continued expansion of lifetime value over time with our customers.

Matthew George Hedberg
Analyst, RBC Capital Markets LLC

Q

That's great. And then, we continue to hear good things from Traps. You called out good growth, good customer addition there. I'm curious though now that with Secdo in the fold here, how do you look at that antivirus opportunity adding EDR capabilities? And maybe how do you think about the competitive landscape in that market? Thanks.

Lee Klarich
Chief Product Officer & Executive Vice President, Palo Alto Networks, Inc.

A

Yeah. Thanks. This is Lee Klarich here. So, we're very pleased with the progress we made with Traps. We're very prevention focused in how we approach the endpoint security market. There was a lot of opportunity there for us to take advantage of. With the acquisition of Secdo, it gave us an opportunity to expand that footprint toward EDR. And as we've looked at that and we've made progress on it, our views have of course expanded to thinking

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about not just what we can do for endpoint data, but what we can do with data collector across the entire platform. And the ability to do that is in large part enabled by physician execution we're doing in Application Framework that brings these different components together, brings the data together in one place enables us to build applications to take advantage of that.

Operator: Thank you. We'll move to our next caller, Pierre Ferragu with New Street Research. Please go ahead, sir.

Pierre C. Ferragu
Global Team Head, New Street Research LLP (US)

Q

Hey. Thanks for taking my questions. Nikesh, you mentioned your objective is to become the best cybersecurity company in the world, which is very exciting. And I was wondering, could you tell us a bit more about that? Like five years from now, what does Palo Alto Network look like? Is that like a product company selling its own cybersecurity technology and appliances, and products almost, an enabler, helping develop their own products?

And then I'd love to hear your thoughts about what you see in the early buildup of your developer community. So, who's typically very excited about the opportunity to develop on your platform today typically? And also, I'm really curious to hear whether you meet the new excitement, also some sort of resistance from people who might have to choose between collaborating with you or competing with you.

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

A

Hey, thank you for your question. I want to remind you that this is day 90 on the job for me and my cybersecurity knowledge is only restricted to my ability to read everything in cybersecurity, meet industry players and constantly pepper Lee, Nir and Rajiv and the team with questions. So, having said that, that's a good question, where do we see the company five years from now? It's kind of very fascinating. As I go talking to customers, they're obviously trying to protect things that they can as quickly and easily as they can.

And if you think about the bad actors, they're busy trying to attack the most vulnerable part of the infrastructure, which is the easiest thing they can crack. What's important is, they're getting more and more sort of best of breed in terms of user computing, use of data, use of technology and we need to be able to match them and do better than them in terms of our ability to understand data and be able to deploy large amounts of computing against it. So, 5 to 10 years from now, I think this is going to become a data game and an AI game and ML game, it'll be impossible for human beings to be able to protect companies or large enterprise infrastructures because the whole world is going to the cloud. And there's tons and tons of data being created every day.

So, if you believe that, then to be able to apply good AI and I know it's very important to get [ph] right data in (27:30), garbage in, garbage out. Good stuff in, you're more likely to get a good outcome. So, I think part of what Lee and Nir and the team they've been working on is to make sure that we've produced good data from the products we have. So, a lot of the acquisitions that Palo Alto Networks has made have been very strategic in their ability to collect the right data. And that allows us to create the version of the Logging Service and the Application Framework that we're aspiring to create. So, you can expect us to keep trying to put good data into our Logging Service, keep trying to encourage both our internal teams and partners to write applications against that Logging Service, so it's no longer a point solution that endpoint solves for endpoints and firewall solves for firewalls and cloud security solves for cloud security.

You see a threat ones anywhere and you have the ability to figure out what to do with it across all parts of infrastructure. So that's what we like to be, is be able to look at threats across any sort of ingress point into infrastructure any user and be able to give you a solution that fixes that at the other end.

Now, over time, you want AI and MLs to do this and it's a journey from getting there from where we are. But given all the products we have in place all the ingredients we have in place, I'm personally very excited that we have the skill set and the capability and the people and the resources to get there.

Pierre C. Ferragu
Global Team Head, New Street Research LLP (US)

Q

Thanks, guys. It's very clear. Thank you very much.

Operator: Thank you. Our next question will come from Jonathan Ho with William Blair. Please, go ahead.

Jonathan F. Ho
Analyst, William Blair & Co. LLC

Q

Hi. I just wanted to, I guess, start with you, Nikesh. Now that you've had some time in seat as the CEO, what do you see – in particular, you mentioned that in cloud security, you saw maybe some room for improvement. But what do you maybe see as the gaps or the opportunities just given your time so far?

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

A

Look, I think it's fair to say that Palo Alto Networks has grown at an amazing pace. And as we grow at an amazing pace, there are things that you could have done better as we were growing. So, part of the opportunities collectively as a management team to sit down and say, look, what have we been ignoring, what can we collectively put our efforts behind, where can we improve our execution and how do we compare with other players in the industry? What is our strategic vision? Where should we go from here?

So, I think, generally, that's what me and the team have been doing for the last 90 days. And the team has been very collaborative and open to rethinking certain things. Having said that, as I mentioned both in my due diligence before I got to Palo Alto Networks and in my last 90 days, there are no major obstacles to being able to achieve the vision that I laid out. And we have a collective opportunity as management to continue to hone our execution, continue to stay focused. And as I mentioned in my prepared remarks that, one of the best things we've done in the last 90 days is sit down with Lee and the product team and say, look, to win in this space we have to be a product company first, which is how we got here in the first place. So, let's make sure that our product teams are aligned towards the opportunities. And we are being very honest with ourselves in terms of how do we get scale and how do we win these areas. And we've taken the step towards streamlining our teams and getting more focused.

And now the plan is to put more wood behind those arrows and be able to compete effectively in all those places. So, sort of like work as an entrepreneurial empowered team in each of our product areas to go ahead and solve the problem for our customers, at the same time keep the integrated fabric of our aspiration to have a common set of data coming from all of our products, so we can actually solve the larger problem as we get smarter about applying AI and ML to those opportunities.

Jonathan F. Ho
Analyst, William Blair & Co. LLC

Q

Got it. And then just as a quick follow up, what's been the initial, I guess, partner response with the Application Framework? Can you maybe talk a little bit about what's exciting for them and some of the integrations that you're performing with those third-parties?

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

A

Look, I think there's two ways to look at it. I think from a customer perspective, there is a resounding sort of yes, we would love something like that, on a philosophical and principle level, where they'd like to see the data sort of being commingled and be able to work together across our product. Obviously, they like to see more data [ph] compared to (31:37) ours and part of that opportunity is to understand what is good data, and over time how that gets into the same place. I think from a partner perspective, our partners, the first 30 beta partners that we have, are happy that they can get access to the data and start building their apps on top of it as opposed to having again to solve point by point with our product on an individualized basis. But I think this is a journey in both ends, both on the partner side and the customer side of getting more and more good stuff to the center. Mark, do you want to add something?

Mark Anderson
President, Palo Alto Networks, Inc.

A

Yeah. Just, with regards to channel partners, Jonathan, I think the value proposition for them is quite compelling. I think most of them tend to focus on four or five different vendors and apply the training necessary to enable their people to be a trusted advisers for those four, five different companies. We now give them the opportunity to partner with many partners, so that we're doing the integration work with the Application Framework and abstracting the complexity, how to provisioning that innovation. So, it's really compelling proposition for them. Most partners that I've talked to are busy looking at how they can build an application themselves, how they can take advantage of the Application Framework to deepen their ties with their customers.

Operator: Thank you. [Operator Instructions] We'll take our next called Andrew Nowinski with Piper Jaffray. Please go ahead, sir.

Andrew James Nowinski
Analyst, Piper Jaffray & Co.

Q

Great. Thank you, and congrats on the strong quarter. So, as it pertains to expanding within your installed base, we're hearing that enterprises are increasingly leveraging micro segmentation in the networks creating these separate enclaves of data. Is that one of the drivers of your new appliance growth or your product growth within your installed base?

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

A

This notion of sort of Zero Trust architectures is not a new concept. And internal segmentation and micro segmentation, these are all use cases that have been around for actually for many years and have been something that we've been very strong in for many years as well. And so, while the new appliances with higher performance and higher capacity certainly are a very good fit for this use case, it's part of a go-to-market motion that is not new to us and something we're very good at.

Andrew James Nowinski
Analyst, Piper Jaffray & Co.

Q

Okay. And then the growth of your SaaS-based revenue continues to outpace the rest of your portfolio. Should we expect the three-year average contract duration to start going down? Or are those deals also coming in at a three-year average?

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

A

Yes, Kathy. We've seen pretty consistent contract lengths or durations, as I mentioned during my remarks. We haven't really seen any change in that just because, and we've been adding more and more of our revenue base from subscriptions as more and more of our new offerings tend to be in subscription format. And so, we're getting customers to commit to us on average for about a three-year duration, which has been pretty consistent over time.

Mark Anderson
President, Palo Alto Networks, Inc.

A

Thanks, Andy.

Operator: Thank you. Our next question will come from Michael Turits with Raymond James. Please go ahead.

Michael Turits
Analyst, Raymond James & Associates, Inc.

Q

Hey, guys. Good evening. Two questions of both somewhat high level. And I think both for Lee and Nikesh. First, both of you guys alluded to doing more with data, and specifically around the Application Framework and the Logging Service. Does this shift what kind of native apps you might build around the App Framework and Logging Service? Is it moving you more towards SIM or towards what other types of applications might we be aiming?

Lee Klarich
Chief Product Officer & Executive Vice President, Palo Alto Networks, Inc.

A

Hi, Michael. The first application for the Application Framework actually was Magnifier, which does user behavioral analytics and that's a very sort of telling example of the kinds of applications that we can build with the right data, brought to the right place in a centralized fashion. And it's basically a way of applying machine learning to a very challenging kind of security capability that in the past often was very difficult to use because it was heavily people-oriented. And shifting that toward machine learning and automation is the kind of example for the applications that we're going to be focused on.

Now, when you do bring data to a central location, there's obviously a whole bunch of other options that present themselves, whether it has to do with threat intelligence, analytics, data visualization, automation, et cetera. And some of those will be things that we will take on ourselves and a lot of those will be things that third-parties are able to build applications with.

Michael Turits
Analyst, Raymond James & Associates, Inc.

Q

And my follow-up question has to deal with cloud. And there are lots of different ways to approach cloud. One is thinking what you put in the cloud and then what you deliver from the cloud. So, it's that latter that I'm interested in. And Nikesh and Lee, do you think that there is a need to do more on the GP and the GlobalProtect direction of actually delivering from the cloud because that's an area we've had less of a presence?

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

A

Well, I'll give you my learnings of 90 days and Lee can jump in with more. I think the whole cloud space is a huge opportunity. And I think it's still early because people are just beginning to move their workloads and mass to the cloud and trying to understand what their sort of internal operating infrastructure looks like. As that becomes to get more robust, they're going understand the need for having the same features and tools that they've had with their traditional infrastructure. I think there are a lot of tools which need to be created, which don't exist and which are not going to come from your native cloud providers. So, they're going to be looking for third-party like us or others to provide those capability. I think that's why I said, there's an area we could do a lot better in. So, we are focusing our speedboats towards that area and you'll hear more from us in upcoming quarters about progress in those areas.

But clearly as you identified, GlobalProtect, as we believe, is a unique product, which has a lot of use cases. And our opportunity and challenges to be able to hone each of those use cases and really go aggressively in those categories and the different use cases to drive and make sure customers understand the benefit and value of that product. Lee, if you want to add.

Lee Klarich
Chief Product Officer & Executive Vice President, Palo Alto Networks, Inc.

A

Yeah. Look, if you think about what it takes to properly secure an enterprise and particularly mobile users, remote networks, branch offices, et cetera, our view and philosophy is, you need to secure all applications, all traffic, all locations, all users with very consistent and sophisticated security capabilities. And we think we're very uniquely positioned with GlobalProtect and GlobalProtect Cloud Service to be able to do that.

Operator: Thank you. Our next question will come from Fatima Boolani with UBS. Please go ahead.

Fatima Boolani
Analyst, UBS Securities LLC

Q

Good afternoon. Thank you for taking the question. Nikesh, in your prepared remarks, you talked about getting Lee sort of more defined product related leadership. So, maybe a question is for you, Lee. Just what specific areas in terms of the priority sequence you're focusing on within your product organization because you have a lot of irons in the fire. And I just love to understand, sort of, you're focused on from an R&D perspective. And I've a follow-up for Kathy if I may.

Lee Klarich
Chief Product Officer & Executive Vice President, Palo Alto Networks, Inc.

A

Yeah, absolutely. So, just to clarify what Nikesh said in his prepared remarks, what I've done within my organization is, create focus across the different product areas with leaders that have the sort of empowerment, the entrepreneurship, the ability to make decisions quickly and drive the product strategies and innovation. And that's about me creating the structure within the team. What that then creates for me is the ability to then focus on the areas that we view as being the highest opportunity in the future, cloud, Application Framework, et cetera.

Fatima Boolani
Analyst, UBS Securities LLC

Q

That's really helpful. And Kathy, for you. Just at high level, can you give us any sense or a complexion of the product revenue trajectory as we think about next year or this year rather? And appreciate that the attached

subscriptions are an important part of the story. I just wanted to get a better sense of how you're thinking about that for next year? Thank you.

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

A

Yeah, absolutely. We saw really nice product growth this year and this quarter as well. So, we're really pleased with the product trajectory. The new products that we've introduced are being very well accepted in the marketplace. And we're having a lot of success selling those new product offerings. So, we're really excited about them in the marketplace. Obviously, we haven't guided to product revenue in the future. And all I can really tell you about that is, we feel good about our position in the market. And we've seen and expect to see continued good performance of our products in the market.

Fatima Boolani
Analyst, UBS Securities LLC

Q

Thank you.

Operator: Thank you. We'll move next to Ken Talanian with Evercore ISI. Please go ahead.

Kenneth Talanian
Analyst, Evercore ISI

Q

Hi. Thanks for taking the question. As we look into next year, I was wondering if you could rank order the primary drivers of billings growth. And then, among those, where do you see the greatest potential for variability?

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

A

Sure. In terms of billings growth, I would say the same thing that we've been talking about for some time. Our primary driver of growth continues to be expansion within our existing customer base and trying to drive that lifetime value higher. And we've had a lot of success with that as you know, and that has worked out very well for us and continues to be the primary driver.

We're also seeing nice new customer acquisitions which is very important for us as well. And those two movements really dwarf any other opportunity that we have. We've talked about refresh in the past. That's a very important opportunity for us. So, when we think about the magnitude and the numbers, it really comes primarily from expansion and the new customer acquisition.

Kenneth Talanian
Analyst, Evercore ISI

Q

Okay, great. And Nikesh, as you think about the importance of data going forward, what types of changes to Palo Alto, as an organization and from a technological standpoint, are needed to really position it for success?

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

A

I think part of what as you saw some of the changes we already made I talked about, one is, Lee has really focused the team because what we want to understand is, clearly how each of his product areas can go out and become big for us and win for us. We felt that we needed to put more sort of directed effort in the Application

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Framework and Nir himself has decided to jump in. And he's leading the Application Framework team to keep moving them in line with our strategy and move them faster.

So, one is clearly speed. I think second is, giving all those product leaders, go-to-market partners who are basically focused with them to become more entrepreneurial and grow faster. So, part of what we're trying to do is that this is an industry which has a lot of vendors, a lot of players and industry is moving really fast. And we're trying to figure out how we can leverage the benefits of being a large player in this space and being cybersecurity leader, at the same time not give up the ability to move fast, move quickly, try fail, try again, execute. So, we're trying to keep the entrepreneurial spirit reinvigorated and trying to make this company which actually gives balance to those two things, which is both an opportunity and our challenge going forward.

Kenneth Talanian
Analyst, Evercore ISI

Q

Great. Thanks very much.

Operator: Thank you. Our next question will come from Keith Weiss from Morgan Stanley. Please go ahead.

Keith Eric Weiss
Analyst, Morgan Stanley & Co. LLC

Q

Excellent. Thank you guys for taking the question, and a very nice quarter. Maybe to play devil's advocate a little bit to see your thoughts on the subject. I mean, you guys have $4 billion of cash on the balance sheet now and you took out sort of more of a credit facility. So, it definitely seems like you're building up a war chest. And you're talking about customers need to consolidate and integrate solutions and buy from fewer vendors, which makes a ton of strategic sense. And I've heard it from CISOs for quite some time.

But it also seems like CISOs say that they want consolidation and they want to buy from fewer vendors, but in reality they keep buying point products. They keep sort of doing the same thing that they have been doing of buying sort of best-of-breed point solutions. What do you think is going to change that in the marketplace? Like, what do you think is going to make consolidation the right answer that you guys could effectively consolidate multiple products and get customers actually buy a broader swath of the products over time?

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

A

Look, I'd like to make a very clear point here. You should not hear the word consolidation from us. You will hear the word integration from Palo Alto Networks, but never the word consolidation. And the distinction I make and I've made internally and for you is that product consolidation means that being able to buy from the same person. We're not interested in that. We're interested in solving the multiple problems for the same customers ourselves. That actually is a bigger effort, requires a lot more thinking, a lot more work on our part to make two things work together. That's why you see – when we got Secdo, we started selling Secdo in addition to selling our firewalls.

We basically took the product team inside, we're reintegrating them into our architecture. We're trying to make it work with our stuff so that when the customer comes in, okay, I'd just check another box and get more capability across multiple pieces of infrastructure. The customer definitely wants that and they will buy it if you can actually prove that they don't have to learn two different policy systems, two different [ph] management pains (45:58), two different ways of managing threat vectors. They want the ability to manage across their threat landscape from fewer tools, and they want it to be as good as the other product they could have bought. So, they want both. They want best of breed and they also want integration.

So, you're right. So, these are the buying point solutions because somebody comes and tells this is best-of-breed, they go buy their best-of-breed. Nobody wants to be caught with a breach, say, oh my God, I bought something that was easier to buy than one that was better. So, they definitely want best-of-breed, but they also wanted to work together because they know when they have 140 vendors across the enterprise, they can't sleep well at night.

Keith Eric Weiss
Analyst, Morgan Stanley & Co. LLC

Q

Excellent. That makes a ton of sense. And perhaps a follow-up for Kathy. Product gross margins have been sort of way down by sort of the new product introductions. But this quarter, we saw sequential improvement. And it looks like it's starting to turn up a little bit. How should we think about product gross margins, where they are today versus where they've been historically and the ability for them to sort of inch back up towards those historical levels?

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

A

Sure. Yeah. We're really comfortable with where our gross margins are right now. We've been operating within a gross margin range that we've talked about for some time now, 75% to 78%. And what the current gross margins reflect is the fact that we've introduced a lot of new products. And when we introduce new products, they tend to be lower margin. And we expect those to increase over time. So the fact that we're selling a lot of new products, we're very excited about, we would expect that those margins will improve over time, but we're always looking at a range of margins within the various products that we sell. And obviously, we haven't provided guidance for gross margins into the future, but we're comfortable with where we are now given the fact that we've got so many new products in our mix right now. And we're also continuing to invest not on the products side, on the services side in the Application Framework and Logging Service, et cetera, which is also impacting our overall gross margins.

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

A

Thanks, Keith.

Operator: Thank you. We'll move now to Gregg Moskowitz with Cowen and Company. Please go ahead.

Gregg Moskowitz
Analyst, Cowen and Company

Q

Okay. Thank you very much. I have a follow up to one of Michael's questions on the Application Framework, and this is probably for Lee. How are you thinking about the timetable of being able to take customer data from physical and virtual firewalls and endpoint and bring that into the data lake and use ML to run correlations against it? Any color on where the solution is today from a technical perspective and more importantly where you think you could be in a year or two would be helpful.

Lee Klarich
Chief Product Officer & Executive Vice President, Palo Alto Networks, Inc.

A

Absolutely. Good question. So, first of all, we're doing a lot of what you just said. We are taking data from much of the platform into the Logging Service and being able to deploy machine learning to that with the Magnifier

application. And we're very pleased with the progress we've continued to make on that. And in the prepared remarks, we talked about just last week releasing the production-ready APIs that will enable third-party applications to be delivered most likely later this month. So that's where we're at and we continue to make a lot of progress.

From a future state perspective, and I think we've painted this vision many times over. We envision collecting more and more data from more and more customers and applying more and more of our own and third-party applications against that. And the response that we've seen from customers has been tremendous. They buy into the vision. They understand how it solves important problems that they've been facing in very unique ways that others are not able to do.

Gregg Moskowitz
Analyst, Cowen and Company

Q

Okay. Terrific. And then just a follow up for Kathy, if I could. You mentioned that the Q1 will have $10 million to $15 million of expenses from recent M&A. Are you able to give us a sense of approximately how long into fiscal 2019 we should expect you to incur elevated investment levels from Evident and Secdo?

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

A

Yeah, we're not really providing any guidance beyond Q1 at this point.

Gregg Moskowitz
Analyst, Cowen and Company

Q

Okay. Thank you very much.

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

A

Thank you.

Lee Klarich
Chief Product Officer & Executive Vice President, Palo Alto Networks, Inc.

A

Thanks, Gregg.

Operator: Thank you. We'll now move to John DiFucci with Jefferies. Please go ahead.

John DiFucci
Analyst, Jefferies LLC

Q

Thank you. My first question is, I think, it's for Lee, and maybe Mark from a feel perspective. We all know that Palo Alto Networks provides a broad platform of security offerings that are more or less integrated. And the Application Framework enables the integration data, okay, from these different security solutions and vendors. But Nikesh noted that customers are really looking for an even greater integration. What about the next level of integration which sometimes called orchestration across other vendors established products that are even complementary to your offerings? Is that something that you can even do? Or does a truly neutral vendor need to fill that role? I want to get a head of it.

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

A

You can hear us all laughing, there's a reason.

Lee Klarich
Chief Product Officer & Executive Vice President, Palo Alto Networks, Inc.

A

Yeah. That's an interesting question. When I think about automation, I think about it from a number of different ways. And actually I believe that the most valuable automation is the automation that nobody even sees. And if the automation that we're able to do natively within the platform that where things just happen and the customers just benefit from it.

So, when you asked a question about orchestration, like, yeah, it's a necessary component. But often orchestration is used to make up for a lack of integration. And so, yes, we will enable it. We have partners to do it. They do important things, but we're going to always be looking to see in terms of the unique value that we can provide, how do we more natively automate things in the back end and actually reduce the necessity to have external orchestration.

John DiFucci
Analyst, Jefferies LLC

Q

Okay. Okay. And it sounds, because I do have a second question. So, maybe it is a big topic, we can talk further on that at some point, Lee. But my second question is really I think for Nikesh and Kathy. We certainly understand your desire to manage the business for the long-term. But why does that goal coincide with the discontinuation of annual guidance? Because I mean, you're going to end up having a wide disparity of expectations out there which is fine, but I'm not sure that's great.

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

A

Yeah. So, look, I really view this as more of a returning to our practice prior to fiscal 2017 when we had always provided quarterly revenue and EPS guidance. And in fiscal 2017, we felt the need to provide additional metrics than more longer term guidance given that we undertook a sales restructuring during that year, but we are beyond that. We're very comfortable with your ability to model. We're very comfortable with our ability to execute. And so, we feel like returning to that prior practice is appropriate at this time.

John DiFucci
Analyst, Jefferies LLC

Q

Well, thanks for that vote of confidence, Kathy. Nice job.

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

A

We want you to have the same confidence enough that we have in you.

John DiFucci
Analyst, Jefferies LLC

Q

Okay, great. Well, nice job. Thank you.

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

A

Thanks, John.

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

A

Thanks.

Operator: Thank you. We'll move now to Walter Pritchard with Citi. Please go ahead.

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

Q

Hi, thanks. First question for Nikesh. On the cloud side a lot have been talked about here, but one thing I think is a question out there is, do the public cloud providers enable the third-party vendors at this point to really provide the solutions customers need? Or do you need more access to APIs and network protocols and so forth to be able to insert yourself in the right position and I'm curious your thoughts on that.

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

A

Look, I personally have very encouraging discussions with the leaders of all the public cloud providers out there over the last 90 days and the CEOs of their companies. So, clearly, they understand that there is the shared responsibility between the customer and them. They don't want to take the entire onus of security onto themselves. At the same time, to somebody's earlier question, in that case nobody wants one vendor to provide the solution and most solutions that customers are deploying are multi-cloud or hybrid clouds. In this case, they want a third-party to provide that capability. Yes, we do need some access to certain parts of the APIs, et cetera. We have to figure out the container stuff with them. So, there's stuff that we need to do, and I'll let Lee answer that because that's past my 90-day expectation of understanding, but Lee can jump in.

Lee Klarich
Chief Product Officer & Executive Vice President, Palo Alto Networks, Inc.

A

Yeah. I mean, there's a lot that they already do and work closely with engineering to engineering to enable the things that we need to secure our joint customers in the cloud. Now, we're also constantly working with them to expand and further enable that tight integration, which makes it easier for our customers to consume and leverage our security capabilities within these environments.

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

Q

Got it. And then just for Kathy. I think on the product side, the thing that's a bit of a challenge here is I think your original guidance, you ended up about 17 percentage points ahead of your original product guidance for fiscal 2018 in reported results. And I guess would love to hear from your perspective, how much of what drove that substantial upside in fiscal 2018 are sustainable trends you see going forward versus factors that may have been refreshed or one-time or forecasting it was challenging. Just trying to understand you had such big upside, I think it's hard for all of us to think about even where your product revenue might land next year given that?

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

A

Yeah. I think that the important thing to note is that the biggest opportunities for us continue to be motions that we have executed on year after year after year. So, continuing to expand within our existing base and continuing to attract and win new customers. And that remains the vast driver of our growth. And I would just say perhaps, when we look at our product performance, we introduced new products during the last 15 months that have been very well received in the market, which is allowing us to solve new use cases, win new customers and definitely keep nice win rates against our competition. So, we don't feel like these are one-time benefits to our company. And refresh is certainly an important opportunity, but I've mentioned before the real opportunity comes from continued expansion and winning new customers.

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

A

Yeah. And Walter, if I can just underline that. I mean, our customers are working with our sales teams and our partners to solve really important business problems for them and that inevitably leads them to buying into our Security Operating Platform motion, which provides consistent security controls wherever they put their data and their applications and infrastructure employees. So, I think buying into that that architecture is a really, really big difference between what we do and what everybody else does. And I think that's why we're enjoying such tailwinds relative to the market.

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

Q

Great, thanks.

Operator: Thank you everyone. That will conclude our question-and-answer session for today. I would like to turn the conference back over to Mr. Arora for any additional or closing remarks.

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

Hey, everyone, thank you very much for joining us for our earnings call, my maiden earnings call at Palo Alto Networks. In closing, I'd like to thank all the employees at the company, our customers and our partners for the amazing work they've done so far. This is really the beginning for us and for me, and I'm excited to see what's in store for us in the future. Thanks again for your time.

Operator: Again that will conclude today's conference. Thank you all for participating. You may now disconnect.