Zendesk, Inc.
Form 10-Q
May 02, 2019
Table of Contents

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)
QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended March 31, 2019
OR
TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from to
Commission File Number: 001-36456

ZENDESK, INC.
(Exact Name of Registrant as Specified in its Charter)

Delaware	26-4411091
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
1019 Market Street San Francisco, CA	94103
(Address of principal executive offices)	(Zip Code)

Registrant’s telephone number, including area code: (415) 418-7506

Securities registered pursuant to Section 12(b) of the Act

Title of each class	Trading symbol(s)	Name of each exchange on which registered
Common Stock, par value $0.01 per share	ZEN	New York Stock Exchange

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No
Indicate by check mark whether the registrant has submitted electronically every Interactive Data File required to be submitted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit such files). Yes x No
Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, a smaller reporting company, or an emerging growth company. See the definitions of “large accelerated filer,” “accelerated filer,” “smaller reporting company,” and "emerging growth company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer	x	Accelerated filer
Non-accelerated filer		Smaller reporting company

Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

Table of Contents

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).   Yes   No x

As of April 30, 2019, there were 109,564,955 shares of the registrant's common stock outstanding.

ZENDESK, INC.
TABLE OF CONTENTS

PART I — FINANCIAL INFORMATION

PART II — OTHER INFORMATION

Table of Contents

SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS

This Quarterly Report on Form 10-Q contains forward-looking statements within the meaning of federal securities laws, which statements involve substantial risks and uncertainties. Forward-looking statements generally relate to future events or our future financial or operating performance. In some cases, you can identify forward-looking statements because they contain words such as “may,” “will,” “should,” “might,” “expects,” “plans,” “anticipates,” “could,” “i “target,” “projects,” “contemplates,” “believes,” “estimates,” “predicts,” “potential,” or “continue,” or the negative of these wo other similar terms or expressions that concern our expectations, strategy, plans, or intentions. Forward-looking statements contained in this Quarterly Report on Form 10-Q include, but are not limited to, statements about:

- our future financial performance, including our revenue, cost of revenue, gross profit, operating expenses, ability to generate positive cash flow, and ability to achieve and maintain profitability;
- the sufficiency of our cash and cash equivalents and marketable securities to meet our liquidity needs;
- our ability to attract and retain customers to use our products, and our ability to optimize the pricing for such products;
- the evolution of technology affecting our products, services, and markets;
- our ability to innovate and provide a superior customer experience;
- our ability to successfully expand in our existing markets and into new markets;
- the attraction and retention of qualified employees and key personnel;
- worldwide economic conditions and their impact on information technology spending;
- our ability to effectively manage our growth and future expenses;
- our ability to introduce and market new products and to integrate such products into our infrastructure;
- our ability to maintain, protect, and enhance our intellectual property;
- our ability to comply with modified or new laws and regulations applying to our business, including privacy and data security regulations;
- our ability to securely maintain customer data;
- our ability to service the interest on our convertible notes and repay such notes, if required;
- our ability to successfully integrate people, products, technology and services following completion of acquisitions;
- our ability to maintain and enhance our brand; and
- the increased expenses and administrative workload associated with being a public company.

We caution you that the foregoing list does not contain all of the forward-looking statements made in this Quarterly Report on Form 10-Q.

You should not rely upon forward-looking statements as predictions of future events. We have based the forward-looking statements contained in this Quarterly Report on Form 10-Q primarily on our current expectations and projections about future events and trends that we believe may affect our business, financial condition, operating results, and prospects. The outcome of the events described in these forward-looking statements is subject to risks, uncertainties, and other factors described in the section titled “Risk Factors” and elsewhere in this Quarterly Report on Form 10-Q. Moreover, we operate in a very competitive and rapidly changing environment. New risks and uncertainties emerge from time to time, and it is not possible for us to predict all risks and uncertainties that could have an impact on the forward-looking statements contained in this Quarterly Report on Form 10-Q. We cannot assure you that the results, events, and circumstances reflected in the forward-looking statements will be achieved or occur, and actual results, events, or circumstances could differ materially from those described in the forward-looking statements.

The forward-looking statements made in this Quarterly Report on Form 10-Q relate only to events as of the date on which the statements are made. We undertake no obligation to update any forward-looking statements made in this Quarterly Report on Form 10-Q to reflect events or circumstances after the date of this Quarterly Report on Form 10-Q or to reflect new information or the occurrence of unanticipated events, except as required by law. We may not actually achieve the plans, intentions, or expectations disclosed in our forward-looking statements and you should not place undue reliance on our forward-looking statements. Our forward-looking statements do not reflect the potential impact of any future acquisitions, mergers, dispositions, joint ventures, or investments we may make.

4

Table of Contents

PART I — FINANCIAL INFORMATION
Item 1. Financial Statements
ZENDESK, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(In thousands, except par value and shares)

	March 31, 2019 (Unaudited)	December 31, 2018
Assets		
Current assets:		
Cash and cash equivalents	$142,418	$126,518
Marketable securities	301,941	300,213
Accounts receivable, net of allowance for doubtful accounts of $3,060 and $2,571 as of March 31, 2019 and December 31, 2018, respectively	90,465	85,280
Deferred costs	26,882	24,712
Prepaid expenses and other current assets	38,629	35,873
Total current assets	600,335	572,596
Marketable securities, noncurrent	401,079	393,671
Property and equipment, net	75,619	75,654
Deferred costs, noncurrent	28,312	26,914
Lease right-of-use assets	99,435	—
Goodwill and intangible assets, net	144,069	146,327
Other assets	23,829	22,717
Total assets	$1,372,678	$1,237,879
Liabilities and stockholders’ equity		
Current liabilities:		
Accounts payable	$29,458	$16,820
Accrued liabilities	32,722	34,097
Accrued compensation and related benefits	50,389	46,603
Deferred revenue	257,731	245,243
Lease liabilities	19,402	—
Total current liabilities	389,702	342,763
Convertible senior notes, net	464,364	458,176
Deferred revenue, noncurrent	1,865	2,719
Lease liabilities, noncurrent	94,943	—
Other liabilities	2,859	17,300
Total liabilities	953,733	820,958
Commitments and contingencies (Note 9)		
Stockholders’ equity:		
Preferred stock	—	—
Common stock	1,092	1,080
Additional paid-in capital	994,031	950,693
Accumulated other comprehensive loss	(2,330)	(5,724)
Accumulated deficit	(573,848)	(529,128)
Total stockholders’ equity	418,945	416,921
Total liabilities and stockholders’ equity	$1,372,678	$1,237,879

See Notes to Condensed Consolidated Financial Statements.

Table of Contents

ZENDESK, INC.
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(In thousands, except per share data)
(Unaudited)

	Three Months Ended March 31,	
	2019	2018
Revenue	$181,484	$129,791
Cost of revenue (1)	55,654	39,056
Gross profit	125,830	90,735
Operating expenses (1):		
Research and development	46,791	37,085
Sales and marketing	91,700	65,058
General and administrative	31,253	22,207
Total operating expenses	169,744	124,350
Operating loss	(43,914)	(33,615)
Other income (expense), net:		
Interest income	5,472	1,519
Interest expense	(6,544)	(764)
Other income, net	700	245
Total other income (expense), net	(372)	1,000
Loss before provision for (benefit from) income taxes	(44,286)	(32,615)
Provision for (benefit from) income taxes	434	(3,290)
Net loss	$(44,720)	$(29,325)
Net loss per share, basic and diluted	$(0.41)	$(0.28)
Weighted-average shares used to compute net loss per share, basic and diluted	108,630	103,692

(1) Includes share-based compensation expense as follows:

	Three Months Ended March 31,	
	2019	2018
Cost of revenue	$4,937	$3,098
Research and development	11,636	10,231
Sales and marketing	12,399	8,007
General and administrative	7,685	5,652

See Notes to Condensed Consolidated Financial Statements.

Table of Contents

ZENDESK, INC.
CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE LOSS
(In thousands)
(Unaudited)

	Three Months Ended March 31,	
	2019	2018
Net loss	$(44,720)	$(29,325)
Other comprehensive gain (loss), before tax:		
Net unrealized gain (loss) on available-for-sale investments	3,342	(636)
Foreign currency translation loss	—	(12)
Net unrealized gain (loss) on derivative instruments	1,124	(742)
Other comprehensive gain (loss), before tax	4,466	(1,390)
Tax effect	(1,072)	—
Other comprehensive gain (loss), net of tax	3,394	(1,390)
Comprehensive loss	$(41,326)	$(30,715)

See Notes to Condensed Consolidated Financial Statements.

Table of Contents

ZENDESK, INC.
CONDENSED CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY
(In thousands)
(unaudited)

	Three Months Ended March 31, 2019						Three Months Ended March 31, 2018				
	Common Stock		Additional Paid-In Capital	Accumulated Other Comprehensive Loss	Accumulated Deficit	Total Stockholders' Equity	Common Stock		Additional Paid-In Capital	Accumulated Other Comprehensive Loss	Accumu Deficit
	Shares	Amount					Shares	Amount			
Balances at beginning of period	108,037	$1,080	$950,693	$(5,724)	$(529,128)	$416,921	103,121	$1,031	$753,568	$(2,372)	$(398,0
Issuance of common stock upon exercise of stock options	376	4	8,434	—	—	8,438	454	4	6,189	—	—
Issuance of common stock for settlement of RSUs	847	8	(2,425)	—	—	(2,417)	688	7	(741)	—	—
Share-based compensation	—	—	37,329	—	—	37,329	—	—	27,487	—	—
Equity component of convertible senior notes	—	—	—	—	—	—	—	—	44,255	—	—
Other comprehensive gain (loss), net of tax	—	—	—	3,394	—	3,394	—	—	—	(1,390)	—
Net loss	—	—	—	—	(44,720)	(44,720)	—	—	—	—	(29,325
Other	—	—	—	—	—	—	—	—	(17)	—	—
Balances at end of period	109,260	$1,092	$994,031	$(2,330)	$(573,848)	$418,945	104,263	$1,042	$830,741	$(3,762)	$(427,3

See Notes to Consolidated Financial Statements.

ZENDESK, INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands)
(Unaudited)

	Three Months Ended March 31,	
	2019	2018
Cash flows from operating activities		
Net loss	$(44,720)	$(29,325)
Adjustments to reconcile net loss to net cash provided by operating activities:		
Depreciation and amortization	8,732	9,865
Share-based compensation	36,657	26,988
Amortization of deferred costs	6,918	4,510
Amortization of debt discount and issuance costs	6,188	720
Other	394	250
Changes in operating assets and liabilities:		
Accounts receivable	(6,966)	3,691
Prepaid expenses and other current assets	(3,774)	(3,364)
Deferred costs	(10,190)	(7,043)
Lease right-of-use assets	4,373	—
Other assets and liabilities	(498)	(12,027)
Accounts payable	15,655	1,052
Accrued liabilities	2,512	10,986
Accrued compensation and related benefits	(4,629)	(971)
Deferred revenue	12,149	10,910
Lease liabilities	(3,832)	—
Net cash provided by operating activities	18,969	16,242
Cash flows from investing activities		
Purchases of property and equipment	(9,258)	(6,808)
Internal-use software development costs	(1,213)	(2,344)
Purchases of marketable securities	(145,142)	(78,321)
Proceeds from maturities of marketable securities	47,265	55,263
Proceeds from sales of marketable securities	91,562	6,982
Purchase of strategic investment	(500)	—
Net cash used in investing activities	(17,286)	(25,228)
Cash flows from financing activities		
Proceeds from issuance of convertible senior notes, net of issuance costs paid of $12,937	—	562,063
Purchase of capped call related to convertible senior notes	—	(63,940)
Proceeds from exercises of employee stock options	8,437	6,193
Proceeds from employee stock purchase plan	8,415	5,096
Taxes paid related to net share settlement of share-based awards	(2,416)	(734)
Net cash provided by financing activities	14,436	508,678
Effect of exchange rate changes on cash, cash equivalents and restricted cash	33	(35)
Net increase in cash, cash equivalents and restricted cash	16,152	499,657
Cash, cash equivalents and restricted cash at beginning of period	128,876	110,888
Cash, cash equivalents and restricted cash at end of period	$145,028	$610,545

Reconciliation of cash, cash equivalents and restricted cash to condensed consolidated balance sheets

Cash and cash equivalents	$142,418	$609,229
Restricted cash included in prepaid expenses and other current assets	1,891	682
Restricted cash included in other assets	719	634
Total cash, cash equivalents and restricted cash	$145,028	$610,545
Supplemental cash flow data		
Cash paid for interest	$719	$—
Cash paid for taxes	$700	$918
Non-cash investing and financing activities		
Balance of property and equipment in accounts payable and accrued expenses	$2,411	$3,504
Property and equipment acquired through tenant improvement allowances	$349	$1,370
Share-based compensation capitalized in internal-use software development costs	$375	$850
Estimated convertible senior notes offering costs incurred but not yet paid	$—	$850
Share-based compensation capitalized in deferred costs	$297	$163

See Notes to Condensed Consolidated Financial Statements.

ZENDESK, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Note 1. Overview and Basis of Presentation

Company and Background

Zendesk was founded in Denmark in 2007 and reincorporated in Delaware in April 2009.

We are a software development company that provides software as a service, or SaaS, products that are intended to help organizations and their customers build better experiences. Our product family is built upon a modern architecture that enables us and our customers to rapidly innovate, adapt our technology in novel ways, and easily integrate with other products and applications. With our origins in customer service, we have evolved our offerings over time to a family of products and platform that work together to help organizations understand the broader customer journey, improve communications across all channels, and engage where and when it’s needed most.

References to Zendesk, the “Company,” “our,” or “we” in these notes refer to Zendesk, Inc. and its subsidiaries on a consolidated basis.

Basis of Presentation

These unaudited condensed consolidated financial statements have been prepared in accordance with United States generally accepted accounting principles, or GAAP, and applicable rules and regulations of the Securities and Exchange Commission, or SEC, regarding interim financial reporting. Certain information and note disclosures normally included in the financial statements prepared in accordance with GAAP have been condensed or omitted pursuant to such rules and regulations. Therefore, these condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements and notes included in our Annual Report on Form 10-K, for the year ended December 31, 2018, filed with the SEC on February 14, 2019. There have been no changes to our significant accounting policies described in the Annual Report on Form 10-K that have had a material impact on our condensed consolidated financial statements and related notes, except as described below.

The consolidated balance sheet as of December 31, 2018 included herein was derived from the audited financial statements as of that date. The unaudited condensed consolidated financial statements reflect all normal recurring adjustments necessary to present fairly our financial position, results of operations, comprehensive loss, stockholders' equity, and cash flows for the interim periods, but are not necessarily indicative of the results of operations to be anticipated for the full year ending December 31, 2019.

Use of Estimates

The preparation of our consolidated financial statements in conformity with GAAP requires management to make certain estimates, judgments, and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements, as well as the reported amounts of revenue and expenses during the reported periods.

Significant items subject to such estimates and assumptions include:

- the estimate of variable consideration related to revenue recognition;
- the fair value and useful lives of acquired intangible assets;
- the capitalization and useful life of capitalized costs to obtain customer contracts;
- the valuation of strategic investments;
- the useful lives of property and equipment;
- the capitalization and useful lives of internal-use software;
- the lease term and incremental borrowing rate for lease liabilities;
- the fair value of our convertible senior notes;

Table of Contents

- the fair value and expense recognition for certain share-based awards;
- the preparation of financial forecasts used in currency hedging; and
- the recognition of tax benefits.

These estimates are based on information available as of the date of the financial statements; therefore, actual results could differ from those estimates.

Concentrations of Risk

As of March 31, 2019 and December 31, 2018, no customers represented 10% or greater of our total accounts receivable balance. There were no customers that individually exceeded 10% of our revenue during the three months ended March 31, 2019 or 2018.

Recently Issued Accounting Pronouncements

In June 2016, the Financial Accounting Standards Board, or FASB, issued ASU 2016-13, regarding ASC Topic 326 "Measurement of Credit Losses on Financial Instruments," which modifies the accounting methodology for most financial instruments. The guidance establishes a new "expected loss model" that requires entities to estimate current expected credit losses on financial instruments by using all practical and relevant information. Additionally, any expected credit losses are to be reflected as allowances rather than reductions in the amortized cost of available-for-sale debt securities. This guidance is effective for annual reporting periods beginning after December 15, 2019, including interim periods within that reporting period. Early adoption is permitted. We are currently evaluating the impact of the adoption of this standard on our consolidated financial statements.

In January 2017, the FASB issued ASU 2017-04, regarding ASC Topic 350 "Simplifying the Test for Goodwill Impairment," which simplifies the required methodology to calculate an impairment charge for goodwill. The standard is effective for fiscal years beginning after December 15, 2019, however early adoption is permitted. We do not expect the adoption of this standard to have a material effect on our consolidated financial statements.

In August 2018, the FASB issued ASU 2018-13, regarding ASC Topic 820 "Fair Value Measurement," which modifies the disclosure requirements for fair value measurements for certain types of investments. The guidance is effective for annual reporting periods beginning after December 15, 2019, including interim periods within that reporting period. Early adoption is permitted. We do not expect the adoption of this standard to have a material effect on our consolidated financial statements.

Recently Adopted Accounting Pronouncements

In February 2016, the FASB issued ASU 2016-02, regarding ASC Topic 842 "Leases," including subsequent amendments. We refer to the new guidance as "ASC 842." This new guidance requires lessees to recognize most leases on their balance sheets as lease right-of-use assets with corresponding lease liabilities and eliminates certain real estate-specific provisions. The new guidance is effective for annual reporting periods beginning after December 15, 2018, including interim periods within that reporting period.

We adopted ASC 842 on January 1, 2019 and applied the following practical expedients:

- comparative periods prior to the adoption date are not adjusted to reflect the new guidance (the modified retrospective method of transition); and
- the historical determination as to the existence and classification of leases is carried forward for existing contracts as of the adoption date.

The effect of adopting ASC 842 resulted in the recognition of lease right-of-use assets and corresponding lease liabilities on our condensed consolidated balance sheets. As of March 31, 2019, the aggregate balance of lease right-of-use assets and lease liabilities was $99 million and $114 million, respectively. The standard did not affect our consolidated statement of operations or cash flows.

In August 2017, the FASB issued ASU 2017-12, regarding ASC Topic 815 "Derivatives and Hedging." This guidance simplifies various aspects of hedge accounting, including the measurement and presentation of hedge ineffectiveness and certain documentation and assessment requirements. The guidance also makes more hedging strategies eligible for hedge accounting. We adopted this standard in the first quarter of 2019. Upon adoption, we no longer recognize hedge ineffectiveness

Table of Contents

immediately in our consolidated statements of operations, but we instead recognize the entire change in the fair value of the hedge contract in other comprehensive income. The cumulative-effect adjustment to eliminate ineffectiveness was not material. The presentation and disclosures have been modified on a prospective basis, as required by the guidance.

In February 2018, the FASB issued ASU 2018-02, "Income Statement - Reporting Comprehensive Income," which provides for the reclassification of the effect of remeasuring deferred tax balances related to items within accumulated other comprehensive income to retained earnings resulting from the Tax Cuts and Jobs Act, or Tax Act. The guidance is effective for annual reporting periods beginning after December 15, 2018, including interim periods within that reporting period. We adopted this standard in the first quarter of 2019. We have elected not to reclassify the income tax effects of the Tax Act from accumulated other comprehensive income to retained earnings, therefore the adoption did not have an effect on our consolidated financial statements.

In June 2018, the FASB issued ASU 2018-07, regarding ASC Topic 718 "Compensation - Stock Compensation," which largely aligns the accounting for share-based compensation for non-employees with employees. The guidance is effective for annual reporting periods beginning after December 15, 2018, including interim periods within that reporting period. We adopted this standard in the first quarter of 2019. The adoption did not have an effect on our consolidated financial statements.

In June 2018, the FASB issued ASU 2018-08, regarding ASC Topic 958 "Not-for-Profit Entities," which clarified the guidance on how entities determine whether to account for a transfer of assets as an exchange transaction or a contribution. The guidance is effective for annual reporting periods beginning after December 15, 2018, including interim periods within that reporting period. We adopted the standard in the first quarter of 2019. The adoption did not have an effect on our consolidated financial statements.

In August 2018, the FASB issued ASU 2018-15, regarding ASC Topic 350-40 "Intangibles - Internal-Use Software," which aligns the requirements for capitalizing implementation costs incurred in a hosting arrangement that is a service contract with the requirements for capitalizing implementation costs incurred to develop or obtain internal-use software. The guidance is effective for annual reporting periods beginning after December 15, 2019, including interim periods within that reporting period. We early adopted the standard in the first quarter of 2019. The adoption did not have an effect on our consolidated financial statements.

Note 2. Business Combinations

FutureSimple Inc.

On September 10, 2018, we completed the acquisition of FutureSimple Inc., or FutureSimple, the developer of Base, a sales force automation software product. We acquired FutureSimple for purchase consideration of $81 million in cash. We incurred transaction costs of $2 million in connection with the acquisition, which were included within general and administrative expenses.

The fair value of assets acquired and liabilities assumed was based on a preliminary valuation, and our estimates and assumptions are subject to change within the measurement period. The primary areas that remain preliminary relate to the evaluation of certain tax-related items. The total purchase consideration was allocated to the assets acquired and liabilities assumed as set forth below (in thousands). During the three months ended March 31, 2019, we made certain immaterial adjustments to the preliminary purchase price allocation, which are reflected in the table below.

The excess of the purchase price over the net assets acquired was recorded as goodwill. Goodwill generated from the acquisition is primarily attributable to assembled workforce and expected growth from the expansion of the scope of and market opportunity for our products. Goodwill is not deductible for income tax purposes. Goodwill will not be amortized but instead will be tested for impairment at least annually and more frequently if certain indicators of impairment are present.

Table of Contents

Net tangible liabilities acquired	$(2,966)
Identifiable intangible assets:	
Developed technology	19,000
Customer relationships	10,400
Backlog	2,200
Goodwill	52,389
Total purchase consideration	$81,023

The developed technology, customer relationships, and backlog intangible assets were assigned useful lives of 6.5, 5.0, and 2.0 years, respectively.

In connection with the acquisition, we granted cash and share-based retention awards to certain employees of FutureSimple. The cash awards vest over a required service period and the share-based awards vest upon fulfillment of certain service and performance conditions. Each retention award will be recorded as expense based on the fulfillment of such service and performance conditions, as applicable, and is not included in the total purchase consideration.

From the date of the acquisition, the results of operations of FutureSimple have been included in and are immaterial to our consolidated financial statements. Pro forma revenue and results of operations have not been presented because the historical results of FutureSimple are not material to our consolidated financial statements in any period presented.

Note 3. Financial Instruments

Investments

The following tables present information about our financial assets measured at fair value on a recurring basis based on the three-tier fair value hierarchy (in thousands):

	Fair Value Measurement at March 31, 2019		
	Level 1	Level 2	Total
Description			
Corporate bonds	$—	$474,511	$474,511
Asset-backed securities	—	140,271	140,271
U.S. treasury securities	—	64,070	64,070
Money market funds	58,650	—	58,650
Commercial paper	—	13,977	13,977
Agency securities	—	11,339	11,339
Certificates of deposit	—	1,150	1,150
Total	$58,650	$705,318	$763,968
Included in cash and cash equivalents			$60,948
Included in marketable securities			$703,020

Table of Contents

	Fair Value Measurement at December 31, 2018		
	Level 1	Level 2	Total
Description			
Corporate bonds	$—	$460,210	$460,210
Asset-backed securities	—	127,078	127,078
U.S. treasury securities	—	58,039	58,039
Money market funds	57,758	—	57,758
Commercial paper	—	38,900	38,900
Agency securities	—	11,256	11,256
Certificates of deposit and time deposits	—	3,200	3,200
Total	$57,758	$698,683	$756,441
Included in cash and cash equivalents			$62,557
Included in marketable securities			$693,884

As of March 31, 2019 and December 31, 2018, there were no securities within Level 3 of the fair value hierarchy. There were no transfers between fair value measurement levels during the three months ended March 31, 2019. Gross unrealized gains and losses for cash equivalents and marketable securities as of March 31, 2019 and December 31, 2018 were not material. Unrealized losses for securities that have been in an unrealized loss position for more than 12 months as of March 31, 2019 and December 31, 2018 were not material.

The following table classifies our marketable securities by contractual maturity (in thousands):

	March 31, 2019	December 31, 2018
Due in one year or less	$301,941	$300,213
Due after one year and within five years	401,079	393,671
Total	$703,020	$693,884

As of March 31, 2019 and December 31, 2018, the balance of strategic investments without readily determinable fair values was $11 million and $10 million, respectively. There have been no adjustments to the carrying value of strategic investments resulting from impairments or observable price changes.

For our other financial instruments, including accounts receivable, accounts payable, and other current liabilities, the carrying amounts approximate their fair values due to the relatively short maturity of these balances.

Derivative Instruments and Hedging

Our foreign currency exposures typically arise from expenditures associated with foreign operations and sales in foreign currencies of our products. To mitigate the effect of foreign currency fluctuations on our future cash flows and earnings, we enter into foreign currency forward contracts with certain financial institutions and designate those contracts as cash flow hedges. Our foreign currency forward contracts generally have maturities of 15 months or less.

Upon the adoption of ASU 2017-12 in the first quarter of 2019, we include time value related to our cash flow hedges for effectiveness testing purposes and the entire change in the unrecognized value of our hedge contracts is recorded in accumulated other comprehensive income (loss), or AOCI. Prior to adoption, we excluded time value for effectiveness testing purposes and we recognized changes in time value immediately in other income (expense), net.

As of March 31, 2019, the balance of AOCI included an unrecognized net loss of $1 million related to the changes in the fair value of foreign currency forward contracts designated as cash flow hedges. We expect to reclassify a net loss of $1 million into earnings over the next 12 months associated with our cash flow hedges.

The following tables present information about our derivative instruments on our consolidated balance sheets (in thousands):

Table of Contents

	March 31, 2019			
	Asset Derivatives		Liability Derivatives	
Derivative Instrument	Balance Sheet Location	Fair Value (Level 2)	Balance Sheet Location	Fair Value (Level 2)
Foreign currency forward contracts	Other current assets	$1,842	Accrued liabilities	$3,726
Total		$1,842		$3,726

	December 31, 2018			
	Asset Derivatives		Liability Derivatives	
Derivative Instrument	Balance Sheet Location	Fair Value (Level 2)	Balance Sheet Location	Fair Value (Level 2)
Foreign currency forward contracts	Other current assets	$2,047	Accrued liabilities	$4,862
Total		$2,047		$4,862

Our foreign currency forward contracts had a total notional value of $232 million and $200 million as of March 31, 2019 and December 31, 2018, respectively. We have a master netting arrangement with each of our counterparties, which permit net settlement of multiple, separate derivative contracts with a single payment. We may also be required to exchange cash collateral with certain of our counterparties on a regular basis. GAAP permits companies to present the fair value of derivative instruments on a net basis according to master netting arrangements. We have elected to present our derivative instruments on a gross basis in our consolidated financial statements. We do not enter into any derivative contracts for trading or speculative purposes. As of March 31, 2019 and December 31, 2018, there was no cash collateral posted with counterparties. All derivatives have been designated as hedging instruments.

The following table presents information about our foreign currency forward contracts on our condensed consolidated statements of operations for the three months ended March 31, 2019 (in thousands):

Classification	Gain (Loss) Reclassified from AOCI into Earnings
Revenue	$ 443
Cost of revenue	(474)
Research and development	(434)
Sales and marketing	(790)
General and administrative	(276)
Total	$ (1,531)

The loss recognized in AOCI related to foreign currency forward contracts was not material for the three months ended March 31, 2019.

The gain recognized in AOCI related to foreign currency forward contracts was not material for the three months ended March 31, 2018. The gain reclassified from AOCI into earnings related to foreign currency forward contracts was $1 million for the three months ended March 31, 2018, which was included within revenue, cost of revenue and operating expenses on our consolidated statements of operations.

The cash flow effects related to foreign currency forward contracts are included within operating activities on our consolidated statements of cash flows.

Convertible Senior Notes

As of March 31, 2019, the fair value of our convertible senior notes was $838 million. The fair value was determined based on the quoted price of the convertible senior notes in an inactive market on the last trading day of the reporting period and has been classified as Level 2 in the fair value hierarchy. Based on the closing price of our common stock of $85.00 on March 31, 2019, the if-converted value of our convertible senior notes exceeded the principal amount of $575 million.

Note 4. Costs to Obtain Customer Contracts

Table of Contents

The balances of deferred costs to obtain customer contracts were $55 million and $52 million as of March 31, 2019 and December 31, 2018, respectively. Amortization expense for these deferred costs was $7 million and $5 million for the three months ended March 31, 2019 and 2018, respectively. There were no impairment losses related to these deferred costs for the periods presented.

Note 5. Property and Equipment

Property and equipment, net consists of the following (in thousands):

	March 31, 2019	December 31, 2018
Leasehold improvements	$58,119	$51,832
Capitalized internal-use software	37,489	36,444
Computer equipment and licensed software and patents	22,768	21,100
Furniture and fixtures	12,046	11,550
Construction in progress	4,564	10,538
Hosting equipment	—	34,105
Total	134,986	165,569
Less: accumulated depreciation and amortization	(59,367)	(89,915)
Property and equipment, net	$75,619	$75,654

Depreciation expense was $5 million and $6 million for the three months ended March 31, 2019 and 2018, respectively.

Amortization expense of capitalized internal-use software was $2 million for each of the three months ended March 31, 2019 and 2018. The carrying value of capitalized internal-use software at March 31, 2019 and December 31, 2018 was $19 million, including $3 million in construction in progress, for both periods.

During the first quarter of 2019, we completed the transition from our self-managed colocation data centers to third-party managed hosting services, at which time, management concluded that these assets met the criteria to be classified as held for sale. Accordingly, these assets were written down to their estimated salvage value and reclassified from property and equipment to other current assets, with $34 million and $33 million being reclassified from hosting equipment and accumulated depreciation respectively, for a net amount of $1 million.

Note 6. Leases

We lease office space under noncancelable operating leases with various expiration dates. Additionally, we are the sublessor for certain office space. All of our office leases are classified as operating leases with lease expense recognized on a straight-line basis over the lease term.

Lease right-of-use assets and liabilities are recognized at the commencement date based on the present value of lease payments over the lease term. As our leases do not provide an implicit rate, we use our incremental borrowing rate based on the information available at commencement date in determining the present value of lease payments. The lease right-of-use assets also include any lease payments made and exclude lease incentives such as tenant improvement allowances. Options to extend the lease term are included in the lease term when it is reasonably certain that we will exercise the extension option.

Our operating leases typically include non-lease components such as common-area maintenance costs. We have elected to include non-lease components with lease payments for the purpose of calculating lease right-of-use assets and liabilities, to the extent that they are fixed. Non-lease components that are not fixed are expensed as incurred as variable lease payments.

Leases with a term of one year or less are not recognized on our consolidated balance sheet; we recognize lease expense for these leases on a straight-line basis over the lease term.

The following tables present information about leases on our consolidated balance sheet (in thousands):

Table of Contents

	March 31, 2019
Assets	
Lease right-of-use assets	$ 99,435
Liabilities	
Lease liabilities	19,402
Lease liabilities, noncurrent	94,943

As of March 31, 2019, the weighted average remaining lease term was 6.2 years and the weighted average discount rate was 5.3%.

The following table presents information about leases on our consolidated statement of operations (in thousands):

	Three Months Ended March 31, 2019
Operating lease expense	$ 5,045
Short-term lease expense	874
Variable lease expense	885
Sublease income	401

The following table presents supplemental cash flow information about our leases (in thousands):

	Three Months Ended March 31, 2019
Cash paid for amounts included in the measurement of lease liabilities	$ 4,176
Operating lease assets obtained in exchange for new lease liabilities	19,550

As of March 31, 2019, remaining maturities of lease liabilities are as follows:

Remainder of 2019	$ 17,599
2020	25,880
2021	23,598
2022	22,102
2023	15,464
Thereafter	29,315
Total lease payments	133,958
Less imputed interest	19,613
Total	$ 114,345

The table above excludes future payments of $9 million related to signed leases that have not yet commenced.

Note 7. Goodwill and Acquired Intangible Assets

The changes in the carrying amount of goodwill for the three months ended March 31, 2019 are as follows (in thousands):

Balance as of December 31, 2018	$111,584
Goodwill adjustments	(64)
Balance as of March 31, 2019	$111,520

Acquired intangible assets subject to amortization consist of the following (in thousands):

	As of March 31, 2019			
	Cost	Accumulated Amortization	Net	Weighted Average Remaining Useful Life
				(In years)
Developed technology	$31,000	$ (9,492)	$21,508	5.3
Customer relationships	11,310	(1,827)	9,483	4.3
Backlog	2,200	$ (642)	1,558	1.4
	$44,510	$ (11,961)	$32,549	

	As of December 31, 2018			
	Cost	Accumulated Amortization	Net	Weighted Average Remaining Useful Life
				(In years)
Developed technology	$31,000	$ (8,151)	$22,849	5.5
Customer relationships	11,310	(1,249)	10,061	4.6
Backlog	2,200	(367)	1,833	1.7
	$44,510	$ (9,767)	$34,743	

Amortization expense of acquired intangible assets was $2 million and $1 million for the three months ended March 31, 2019 and 2018, respectively.

Estimated future amortization expense as of March 31, 2019 is as follows (in thousands):

Remainder of 2019	$6,605
2020	6,832
2021	5,490
2022	5,490
2023	4,719
Thereafter	3,413
	$32,549

Note 8. 0.25% Convertible Senior Notes and Capped Call

In March 2018, we issued $575 million aggregate principal amount of 0.25% convertible senior notes due March 15, 2023 in a private offering (the “Notes"). The Notes are unsecured obligations and bear interest at a fixed rate of 0.25% per annum, payable semi-annually in arrears on March 15 and September 15 of each year, commencing on September 15, 2018. The total net proceeds from the offering, after deducting initial purchase discounts and estimated debt issuance costs, were approximately $561 million.

Each $1,000 principal amount of the Notes will initially be convertible into 15.8554 shares of our common stock, the “Conversion Option,” which is equivalent to an initial conversion price of approximately $63.07 per share, subject to adjustment upon the occurrence of specified events. The Notes will be convertible at the option of the holders at any time prior to the close of business on the business day immediately preceding December 15, 2022, only under the following circumstances: (1) during any calendar quarter commencing after the calendar quarter ending on June 30, 2018 (and only during such calendar quarter), if the last reported sale price of our common stock for at least 20 trading days (whether or not consecutive) during a period of 30 consecutive trading days ending on the last trading day of the immediately preceding calendar quarter is greater than or equal to 130% of the conversion price on each applicable trading day; (2) during the five business day period after any five consecutive trading day period, the “Measurement Period,” in which the trading price per $1,000 principal amount of notes for each trading day of the Measurement Period was less than 98% of the product of the last reported sale price of our common stock and the conversion rate on each such trading day; or (3) upon the occurrence of specified corporate events (as set forth in the indenture). On or after December 15, 2022 until the close of business on the second scheduled trading day immediately preceding the maturity date, holders may convert their Notes at any time, regardless

Table of Contents

of the foregoing circumstances. Upon conversion, we will pay or deliver, as the case may be, cash, shares of our common stock or a combination of cash and shares of our common stock, at our election. If certain specified fundamental changes occur (as set forth in the indenture governing the Notes) prior to the maturity date, holders of the Notes may require us to repurchase for cash all or any portion of their notes at a repurchase price equal to 100% of the principal amount of the Notes to be repurchased, plus accrued and unpaid interest to, but excluding, the fundamental change repurchase date. In addition, if specific corporate events occur prior to the applicable maturity date, we will increase the conversion rate for a holder who elects to convert their notes in connection with such a corporate event in certain circumstances. It is our current intent and policy to settle conversions through combination settlement with a specified dollar amount of $1,000 per $1,000 principal amount of Notes. During the three months ended March 31, 2019, the conditions allowing holders of the Notes to convert have not been met. The Notes are therefore not convertible during the three months ended March 31, 2019 and are classified as long-term debt.

In accounting for the transaction, the Notes were separated into liability and equity components. The carrying amount of the liability component was calculated by measuring the fair value of a similar debt instrument that does not have an associated conversion feature. The carrying amount of the equity component representing the Conversion Option was $125 million and was determined by deducting the fair value of the liability component from the par value of the Notes. The equity component was recorded in additional paid-in capital and is not remeasured as long as it continues to meet the conditions for equity classification. The excess of the principal amount of the liability component over its carrying amount, the "Debt Discount," is amortized to interest expense over the contractual term of the Notes at an effective interest rate of 5.26%.

In accounting for the debt issuance costs of $14 million related to the Notes, we allocated the total amount incurred to the liability and equity components of the Notes based on their relative values. Issuance costs attributable to the liability component were $11 million and are amortized to interest expense using the effective interest method over the contractual term of the Notes. Issuance costs attributable to the equity component were netted with the equity component in additional paid-in capital.

The net carrying amount of the liability component of the Notes is as follows (in thousands):

	March 31, 2019	December 31, 2018
Principal	$575,000	$575,000
Unamortized Debt Discount	(101,743)	(107,494)
Unamortized issuance costs	(8,893)	(9,330)
Net carrying amount	$464,364	$458,176

The net carrying amount of the equity component of the Notes is as follows (in thousands):

	March 31, 2019	December 31, 2018
Debt Discount for Conversion Option	$124,976	$124,976
Issuance costs	(2,948)	(2,948)
Net carrying amount	$122,028	$122,028

Interest expense related to the Notes is as follows (in thousands):

	Three Months Ended March 31,

	2019	2018
Contractual interest expense	$356	$44
Amortization of Debt Discount	5,751	671
Amortization of issuance costs	437	49
Total interest expense	$6,544	$764

In connection with the pricing of the Notes, we entered into privately negotiated capped call transactions with certain counterparties, the “Capped Calls.” The Capped Calls each have an initial strike price of approximately $63.07 per share, subject to certain adjustments, which correspond to the initial conversion price of the Notes. The Capped Calls have initial cap prices of $95.20 per share, subject to certain adjustments. The Capped Calls cover, subject to anti-dilution adjustments,

Table of Contents

approximately 9.1 million shares of our common stock. Conditions that cause adjustments to the initial strike price of the Capped Calls mirror conditions that result in corresponding adjustments for the Notes. The Capped Calls are generally intended to reduce or offset the potential dilution to our common stock upon any conversion of the Notes with such reduction or offset, as the case may be, subject to a cap based on the cap price. For accounting purposes, the Capped Calls are separate transactions, and not part of the terms of the Notes. As these transactions meet certain accounting criteria, the Capped Calls are recorded in stockholders' equity and are not accounted for as derivatives. The cost of $64 million incurred in connection with the Capped Calls was recorded as a reduction to additional paid-in capital.

The net impact to our stockholders' equity, included in additional paid-in capital, of the above components of the Notes is as follows (in thousands):

Conversion Option	$124,976
Purchase of Capped Calls	(63,940)
Issuance costs	(2,948)
Net deferred tax liability	(13,784)
Total	$44,304

Note 9. Commitments and Contingencies

Commitments

As of March 31, 2019, there were no material changes in our commitments under contractual obligations, as disclosed in our audited consolidated financial statements for the year ended December 31, 2018.

Litigation and Loss Contingencies

We accrue estimates for resolution of legal and other contingencies when losses are probable and estimable. From time to time, we may become a party to litigation and subject to claims that arise in the ordinary course of business, including intellectual property claims, labor and employment claims, threatened claims, breach of contract claims, tax, and other matters. We currently have no material pending litigation.

We are not currently aware of any litigation matters or loss contingencies that would be expected to have a material adverse effect on our business, consolidated balance sheets, results of operations, comprehensive loss, or cash flows.

Indemnifications

In the ordinary course of business, we enter into contractual arrangements under which we agree to provide indemnification of varying scope and terms to customers, business partners, and other parties with respect to certain matters, including, but not limited to, losses arising out of the breach of such agreements, intellectual property infringement claims made by third parties, and other liabilities relating to or arising from our products or our acts or omissions. In these circumstances, payment may be conditional on the other party making a claim pursuant to the procedures specified in the particular contract. Further, our obligations under these agreements may be limited in terms of time and/or amount, and in some instances, we may have recourse against third parties for certain payments. In addition, we have indemnification agreements with our directors and executive officers that require us, among other things, to indemnify them against certain liabilities that may arise by reason of their status or service as directors or officers. The terms of such obligations may vary. To date, we have not incurred any material costs, and we have not accrued any liabilities in our consolidated financial statements, as a result of these obligations.

Certain of our product offerings include service-level agreements warranting defined levels of uptime reliability and performance, which permit those customers to receive credits for future services in the event that we fail to meet those levels. To date, we have not accrued for any significant liabilities in our consolidated financial statements as a result of these service-level agreements.

Note 10. Common Stock and Stockholders’ Equity

Common Stock

Table of Contents

As of March 31, 2019 and December 31, 2018, there were 400 million shares of common stock authorized for issuance with a par value of $0.01 per share and 109.3 million and 108.0 million shares were issued and outstanding, respectively.

Preferred Stock

As of each of March 31, 2019 and December 31, 2018, there were 10 million shares of preferred stock authorized for issuance with a par value of $0.01 per share and no shares of preferred stock were issued or outstanding.

Employee Equity Plans

Employee Stock Purchase Plan

Under our Employee Stock Purchase Plan, or ESPP, eligible employees are granted options to purchase shares of our common stock through payroll deductions. The ESPP provides for 18-month offering periods, which include three six-month purchase periods. At the end of each purchase period, employees are able to purchase shares at 85% of the lower of the fair market value of our common stock at the beginning of an offering period or the fair market value of our common stock at the end of the purchase period. No shares of common stock were purchased under the ESPP during the three months ended March 31, 2019. Pursuant to the terms of the ESPP, the number of shares reserved under the ESPP increased by 1.1 million shares on January 1, 2019. As of March 31, 2019, 5.0 million shares of common stock were available for issuance under the ESPP.

Stock Option and Grant Plans

Our board of directors adopted the 2009 Stock Option and Grant Plan, or the 2009 Plan, in July 2009. The 2009 Plan was terminated in connection with our initial public offering in May 2014, and accordingly, no shares are available for issuance under this plan. The 2009 Plan continues to govern outstanding awards granted thereunder.

Our 2014 Stock Option and Incentive Plan, or the 2014 Plan, serves as the successor to our 2009 Plan. Pursuant to the terms of the 2014 Plan, the number of shares reserved for issuance under the 2014 Plan increased by 5.4 million shares on January 1, 2019. As of March 31, 2019, we had 12.1 million shares of common stock available for future grants under the 2014 Plan.

On May 6, 2016, the compensation committee of our board of directors granted equity awards representing 1.2 million shares of common stock. These awards were granted outside of the 2014 Plan pursuant to an exemption provided for “employment inducement awards” within the meaning of Section 303A.08 of the New York Stock Exchange Listed Company Manual and accordingly did not require approval from our stockholders.

A summary of our share-based award activity for the three months ended March 31, 2019 is as follows (in thousands, except per share information):

Table of Contents

	Options Outstanding					RSUs Outstanding		
	Shares Available for Grant	Number of Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term	Aggregate Intrinsic Value	Outstanding RSUs	Weighted Average Grant Date Fair Value	Aggregate Intrinsic Value
				(In years)				
Outstanding — January 1, 2019	8,232	5,938	$ 20.85	6.58	$ 222,959	6,611	$ 37.77	$ 385,891
Increase in authorized shares	5,402							
Stock options granted	(336)	336	73.27					
RSUs granted	(1,522)					1,522	64.88	
Stock options exercised		(376)	22.43					
RSUs vested						(847)	33.95	
Stock options forfeited or canceled	26	(26)	28.98					
RSUs forfeited or canceled	251					(251)	37.73	
RSUs forfeited or canceled and unavailable for grant						(7)	23.44	
Outstanding — March 31, 2019	12,053	5,872	$ 23.71	6.53	$ 360,015	7,028	$ 44.11	$ 597,191

The restricted stock units, or RSUs, forfeited or canceled and unavailable for grant relate to our employment inducement awards. The aggregate intrinsic value for options outstanding represents the difference between the closing market price of our common stock on the last trading day of the reporting period and the exercise price of outstanding, in-the-money options.

The total intrinsic value of stock options exercised during three months ended March 31, 2019 and 2018 was $21 million and $13 million, respectively. The intrinsic value for options exercised represents the difference between the exercise price and the market value on the date of exercise. The weighted-average grant date fair value of stock options granted during the three months ended March 31, 2019 and 2018 was $28.65 and $16.38, respectively.

The total fair value of RSUs vested during the three months ended March 31, 2019 and 2018 was $63 million and $30 million, respectively. The fair value of RSUs vested represents market value on the vesting date. The weighted-average grant date fair value of RSUs granted during the three months ended March 31, 2019 and 2018 was $64.88, and $36.90, respectively.

As of March 31, 2019, we had a total of $330 million in future expense related to our stock options and RSUs to be recognized over a weighted average period of 2.9 years.

Performance Restricted Stock Units

During the three months ended September 30, 2018, the compensation committee of our board of directors granted performance-based restricted stock units, or PRSUs, representing 0.2 million shares of common stock, the substantial majority of which were granted in connection with the acquisition of FutureSimple. The PRSUs vest in four semi-annual tranches through March 2021. The PRSUs include a service condition and a performance condition related to the attainment of semi-annual performance targets approved and communicated in advance of each performance period. During the three months ended March 31, 2019, we recorded $1 million of share-based compensation expense related to the PRSUs and no PRSUs were vested. The total future expense related to the PRSUs will be based on the fair value of the underlying shares on the grant date for each performance tranche.

Table of Contents

Note 11. Deferred Revenue and Performance Obligations

During the three months ended March 31, 2019 and 2018, $118 million and $86 million of revenue was recognized that was included in the deferred revenue balances at the beginning of each period, respectively.

The aggregate balance of remaining performance obligations as of March 31, 2019 was $441 million. We expect to recognize $346 million of the balance as revenue in the next 12 months and the remainder thereafter. The aggregate balance of remaining performance obligations represents contracted revenue that has not yet been recognized and does not include contract amounts which are cancelable by the customer and amounts associated with optional renewal periods.

Note 12. Net Loss Per Share

Basic net loss per share is computed by dividing net loss by the weighted-average number of shares of common stock outstanding during the period. Diluted net loss per share is computed by giving effect to all potential shares of common stock, including those related to outstanding share-based awards and our convertible senior notes, to the extent dilutive. Basic and diluted net loss per share were the same for each period presented as the inclusion of all potential common stock outstanding would have been anti-dilutive.

The following table presents the calculation of basic and diluted net loss per share for the periods presented (in thousands, except per share data):

	Three Months Ended March 31,	
	2019	2018
Net loss	$(44,720)	$(29,325)
Weighted-average shares used to compute basic and diluted net loss per share	108,630	103,692
Net loss per share, basic and diluted	$(0.41)	$(0.28)

The anti-dilutive securities excluded from the shares used to calculate diluted net loss per share are as follows (in thousands):

	As of March 31,	
	2019	2018
Shares subject to outstanding common stock options and employee stock purchase plan	6,167	6,646
Restricted stock units	7,028	7,768
Shares related to convertible senior notes	1,283	—
	14,478	14,414

The shares related to convertible senior notes calculated in the table above are calculated based on the average market price of our common stock for the three months ended March 31, 2019.

We expect to settle the principal amount of the convertible senior notes in cash and therefore use the treasury stock method for calculating any potential dilutive effect of the conversion spread on diluted net income per share, if applicable. The conversion spread has a dilutive impact on diluted net income per share when the average market price of our common stock for a given reporting period exceeds the initial conversion price of $63.07 per share for the convertible senior notes. Based on the initial conversion price, potential dilution related to the convertible senior notes is approximately 9.1 million shares. The convertible senior notes are not convertible as of March 31, 2019.

Note 13. Income Taxes

We reported immaterial income tax expense in the three months ended March 31, 2019. We reported a benefit from income taxes of $3 million in the three months ended March 31, 2018, primarily due to the recognition of an income tax benefit of $4 million related to taxable temporary differences of the convertible senior notes and the capped call.

The effective tax rate for each period differs from the statutory rate primarily as a result of not recognizing a deferred tax asset for U.S. losses due to having a full valuation allowance against U.S. deferred tax assets.

Table of Contents

Note 14. Geographic Information

Our chief operating decision maker reviews the financial information presented on a consolidated basis for purposes of allocating resources and evaluating our financial performance. Accordingly, we have determined that we operate in a single reporting segment.

Revenue

The following table presents our revenue by geographic area, as determined based on the billing address of our customers (in thousands):

	Three Months Ended March 31,	
	2019	2018
United States	$94,901	$68,354
EMEA	52,075	37,872
APAC	19,476	13,996
Other	15,032	9,569
Total	$181,484	$129,791

Long-Lived Assets

The following table presents our long-lived assets by geographic area (in thousands):

	As of March 31, 2019	As of December 31, 2018
United States	$77,242	$ 32,351
EMEA:		
Republic of Ireland	46,293	14,698
Other EMEA	3,544	2,450
Total EMEA	49,837	17,148
APAC:		
Singapore	20,486	1,117
Other APAC	8,151	5,772
APAC	28,637	6,889
Total	$155,716	$ 56,388

The carrying values of capitalized internal-use software and intangible assets are excluded from the balance of long-lived assets presented in the table above.

Table of Contents

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

The following discussion and analysis of our financial condition and results of operations should be read in conjunction with our condensed consolidated financial statements and related notes appearing elsewhere in this Quarterly Report on Form 10-Q and in our Annual Report on Form 10-K for the year ended December 31, 2018, filed with the SEC on February 14, 2019. As discussed in the section titled "Special Note Regarding Forward-Looking Statements," the following discussion and analysis contains forward-looking statements that involve risks and uncertainties, as well as assumptions that, if they never materialize or prove incorrect, could cause our results to differ materially from those expressed or implied by such forward-looking statements. Factors that could cause or contribute to such differences include, but are not limited to, those identified below, and those discussed in the section titled "Risk Factors" included under Part II, Item 1A below.

Overview

We are a software development company that provides SaaS products that are intended to help organizations and their customers build better experiences. Our product family is built upon a modern architecture that enables us and our customers to rapidly innovate, adapt our technology in novel ways, and easily integrate with other products and applications. With our origins in customer service, we have evolved our offerings over time to a family of products and a platform that work together to help organizations understand the broader customer journey, improve communications across all channels, and engage where and when it's needed most.

We believe in developing products that serve organizations of all sizes and across all industries. The flagship product in our family, Zendesk Support, provides organizations with the ability to track, prioritize, and solve customer support tickets across multiple channels, bringing customer information and interactions into one place. Our other widely available products integrate with Support and include Zendesk Chat, Zendesk Talk, Zendesk Guide, and Zendesk Connect. Chat is live chat software that provides a fast and responsive way for organizations to connect with their customers. Talk is cloud-based call center software that facilitates personal and productive phone support conversations between organizations and their customers. Guide is a self-service destination that organizations can use to provide articles, interactive forums, and a community that help an organization's customers help themselves. Connect enables customer service teams to send automated and timely messages based on a customer's past actions and preferences. Additionally, we offer Zendesk Suite, an omnichannel offering which provides Support, Chat, Talk, and Guide together for a single price, Zendesk Sell, sales force automation software that complements our mission in delivering products that provide a better customer experience, and Zendesk Sunshine, a customer relationship management platform which enables organizations to connect and integrate customer data generated through the Zendesk product family.

We offer a range of subscription account plans for our products that vary in price based on functionality, type, and the amount of product support we offer. We also offer a range of additional features that customers can purchase and add to their subscriptions.

For the three months ended March 31, 2019 and 2018, our revenue was $181 million and $130 million, respectively, representing a 40% growth rate. For the three months ended March 31, 2019 and 2018, we derived $87 million, or 48%, and $61 million, or 47%, respectively, of our revenue from customers located outside of the United States. We expect that the rate of growth in our revenue will decline as our business scales, even if our revenue continues to grow in absolute terms. For the three months ended March 31, 2019 and 2018, we generated net losses of $45 million and $29 million, respectively.

The growth of our business and our future success depend on many factors, including our ability to continue to innovate, further develop our unified omnichannel offering geared towards the entire customer experience, build brand recognition and a scalable product for larger enterprises, maintain our leadership in the small and medium-sized business market, add new customers, generate additional revenue from our existing customer base, and increase our global customer footprint. While these areas represent significant opportunities for us, we also face significant risks and challenges that we must successfully address in order to sustain the growth of our business and improve our operating results. We anticipate that we will continue to expand our operations and headcount in the near term. The expected expenditures that we anticipate will be necessary to manage our anticipated growth, including personnel costs, expenditures relating to hosting capabilities, leasehold improvements, and related fixed assets, will make it more difficult for us to achieve profitability in the near term. Many of these investments will occur in advance of us experiencing any direct benefit and will make it difficult to determine if we are allocating our resources efficiently.

Table of Contents

We have focused on rapidly growing our business and plan to continue to invest for long-term growth. We expect to continue to develop our hosting capabilities primarily through expenditures for third-party managed hosting services. The amount and timing of these expenditures will vary based on our estimates of projected growth and planned use of hosting resources. Over time, we anticipate that we will continue to gain economies of scale by efficiently utilizing our hosting and personnel resources to support the growth in our number of customers. In addition, we expect to incur amortization expense associated with acquired intangible assets and capitalized internal-use software. As a result, we expect our gross margin to improve in the long-term, although our gross margin may decrease in the near-term and may vary from period to period as our revenue fluctuates and as a result of the timing and amount of such costs.

We expect our operating expenses to continue to increase in absolute dollars in future periods. We have invested, and expect to continue to invest, in our software development efforts to broaden the functionality of our existing products, to further integrate these products and services, and to introduce new products. We plan to continue to expand our sales and marketing organizations, particularly in connection with our efforts to expand our customer base. We also expect to continue to incur additional general and administrative costs in order to support the growth of our business and the infrastructure required to comply with our obligations as a public company.

Key Business Metrics

We review a number of operating metrics, including the following key metrics, to evaluate our business, measure our performance, identify trends affecting our business, formulate business plans, and make strategic decisions.

Number of Paid Customer Accounts. We believe that our ability to increase our number of paid accounts using our products is an indicator of our market penetration, the growth of our business, and our potential future business opportunities. We define the number of paid customer accounts as the sum of the number of accounts on Zendesk Support, exclusive of our legacy Starter plan, free trials, or other free services, the number of accounts on Chat, exclusive of free trials or other free services, and the number of accounts on all of our other products, exclusive of free trials and other free services, each as of the end of the period and as identified by a unique account identifier. In the quarter ended June 30, 2018, we began to offer an omnichannel subscription, which provides access to multiple products through a single paid customer account, Zendesk Suite. The number of Suite paid customer accounts are included in the number of accounts on products other than Support and Chat, and are not included in the number of paid customer accounts using Support or Chat. Existing customers may also expand their utilization of our products by adding new accounts and a single consolidated organization or customer may have multiple accounts across each of our products to service separate subsidiaries, divisions, or work processes. Each of these accounts is also treated as a separate paid customer account. Other than paid accounts for Zendesk Connect, an increase in the number of paid customer accounts generally correlates to an increase in the number of authorized agents licensed to use our products, which directly affects our revenue and results of operations. We view growth in this metric as a measure of our success in converting new sales opportunities. We had approximately 145,600 paid customer accounts as of March 31, 2019, including approximately 75,600 paid customer accounts on Support, approximately 45,300 paid customer accounts on Chat, and approximately 24,700 paid customer accounts on our other products. As the total number of paid customer accounts increases, we expect the rate of growth in the number of paid customer accounts to decline.

Dollar-Based Net Expansion Rate. Our ability to generate revenue is dependent upon our ability to maintain our relationships with our customers and to increase their utilization of our products. We believe we can achieve this by focusing on delivering value and functionality that retains our existing customers, expands the number of authorized agents associated with an existing paid customer account, and results in upgrades to higher-priced subscription plans and the purchase of additional products. Maintaining customer relationships allows us to sustain and increase revenue to the extent customers maintain or increase the number of authorized agents licensed to use our products. We assess our performance in this area by measuring our dollar-based net expansion rate. Our dollar-based net expansion rate provides a measurement of our ability to increase revenue across our existing customer base through expansion of authorized agents associated with paid customer accounts, upgrades in subscription plans, and the purchase of additional products as offset by churn, contraction in authorized agents associated with paid customer accounts, and downgrades in subscription plans. We do not currently incorporate operating metrics associated with our legacy analytics product, our legacy Outbound product, our Sell product, our legacy Starter plan, free trials, or other free services into our measurement of dollar-based net expansion rate.

Our dollar-based net expansion rate is based upon our annual recurring revenue for a set of paid customer accounts on our products. Annual recurring revenue is determined by multiplying monthly recurring revenue by 12. Monthly recurring revenue for a paid customer account is a legal and contractual determination made by assessing the contractual terms of each paid customer account, as of the date of determination, as to the revenue we expect to generate in the next monthly period for that paid customer account, assuming no changes to the subscription and without taking into account any usage above the subscription base, if any, that may be applicable to such subscription. Monthly recurring revenue is not determined by reference to historical revenue, deferred revenue, or any other United States generally accepted accounting principles, or GAAP, financial measure over any period. It is forward-looking and contractually derived as of the date of determination.

We calculate our dollar-based net expansion rate by dividing our retained revenue net of contraction and churn by our base revenue. We define our base revenue as the aggregate annual recurring revenue across our products from paid customer accounts as of the date one year prior to the date of calculation. We define our retained revenue net of contraction and churn as the aggregate annual recurring revenue across our products from the same customer base included in our measure of base revenue at the end of the annual period being measured. Our dollar-based net expansion rate is also adjusted to eliminate the effect of certain activities that we identify involving consolidation of customer accounts, or the split of a single paid customer account into multiple paid customer accounts. In addition, our dollar-based net expansion rate is adjusted to include paid customer accounts in the customer base used to determine retained revenue net of contraction and churn that share common corporate information with customers in the customer base that is used to determine our base revenue. Giving effect to this consolidation results in our dollar-based net expansion rate being calculated across approximately 102,200 customers, as compared to the approximately 145,600 total paid customer accounts as of March 31, 2019. To the extent that we can determine that the underlying customers do not share common corporate information, we do not aggregate paid customer accounts associated with reseller and other similar channel arrangements for the purposes of determining our dollar-based net expansion rate. While not material, we believe the failure to account for these activities would otherwise skew our dollar-based net expansion metrics associated with customers that maintain multiple paid customer accounts across their products, and paid customer accounts associated with reseller and other similar channel arrangements.

Our dollar-based net expansion rate was 118% as of March 31, 2019. We expect that, among other factors, our continued focus on adding larger paid customer accounts at the time of addition and the growth in our revenue will result in an overall decline in our dollar-based net expansion rate over time as our aggregate annual recurring revenue grows.

Components of Results of Operations

Revenue

We derive substantially all of our revenue from subscription services, which are comprised of subscription fees from customer accounts on Support and, to a lesser extent, Chat, Talk, Guide, Explore, Sell, and Connect. Each subscription may have multiple authorized users, and we refer to each user as an “agent.” The number of agents ranges from one to thousands for various customer accounts. Our pricing is generally established on a per agent basis. We offer a range of subscription account plans for our products that vary in price based on functionality, type, and, for Support and Chat, the amount of product support we offer. We also offer a range of additional features that customers can purchase and add to their subscriptions. Certain arrangements provide for incremental fees above a fixed maximum number of monthly agents during the subscription term. We sell subscription services under contractual agreements that vary in length, ranging between one month and multiple years, with the majority of subscriptions having a term of either one month or one year.

Subscription fees are generally non-refundable regardless of the actual use of the service. Subscription revenue is typically affected by the number of customer accounts, number of agents, and the type of plan purchased by our customers, and is recognized ratably over the term of the arrangement beginning on the date that our services are made available to our customers. Subscription services purchased online are typically paid for via a credit card on the date of purchase while subscription services purchased through our internal sales organization are generally billed with monthly, quarterly, or annual payment frequencies. Due to our mixed contract lengths and billing frequencies, the annualized value of the arrangements we enter into with our customers may not be fully reflected in deferred revenue at any single point in time. Accordingly, we do not believe that the change in deferred revenue for any period provides sufficient context to accurately predict our future revenue for a given period of time. Additionally, because of the mix of contract lengths, customer purchasing patterns, and renewal patterns for our products, we similarly do not believe that the amount of unsatisfied performance obligations, or any backlog calculated therefrom, measured as of any particular determination date, or period-over-period changes in such amounts, provides sufficient context to accurately predict our future revenue for any future period, and we caution you not to rely on such amounts for that purpose.

We also derive revenue from implementation and training services, for which we recognize revenue based on proportional performance, and Talk usage, for which we recognize revenue based on usage.

Cost of Revenue, Gross Margin, and Operating Expenses

Table of Contents

Cost of Revenue. Cost of revenue consists primarily of personnel costs (including salaries, share-based compensation, and benefits) for employees associated with our infrastructure, product support, and professional service organizations, and expenses for hosting capabilities, primarily for third-party managed hosting services and costs associated with our self-managed colocation data centers. Cost of revenue also includes third-party license fees, payment processing fees, amortization expense associated with capitalized internal-use software, amortization expense associated with acquired intangible assets, and allocated shared costs. We allocate shared costs such as facilities, information technology, and security costs to all departments based on headcount. As such, allocated shared costs are reflected in cost of revenue and each operating expense category.

We utilize third-party managed hosting facilities located in North America, Europe, Asia and Australia to host our services, support our infrastructure, and support certain research and development functions. In the first quarter of 2019, we completed transitioning support of our customers from our self-managed colocation data centers to third-party managed hosting services.

We intend to continue to invest additional resources in our infrastructure, product support, and professional service organizations, organically and through acquisitions. We expect that recent and future business acquisitions will result in increased amortization expense of intangible assets such as acquired technology. As we continue to invest in technology innovation, we expect to continue to incur capitalized internal-use software costs and related amortization. We expect these investments in technology to not only expand the capabilities of our products but also to increase the efficiency of how we deliver these services, enabling us to improve our gross margin over time, although our gross margin may decrease in the near-term and may vary from period to period as our revenue fluctuates and as a result of the timing and amount of these investments. To the extent that we continue to rely on third-party technology to provide certain functionality within our products or for certain subscription plans or integrations, we expect third-party license fees for technology that is incorporated in such products and subscription plans to remain significant over time.

Gross Margin. Gross margin is gross profit expressed as a percentage of revenue. Our gross margin may fluctuate from period to period as our revenue fluctuates and as a result of the timing and amount of usage of third-party managed hosting resources, investments to expand our product support and professional services teams, investments in additional personnel, increased share-based compensation expense, as well as the amortization of certain acquired intangible assets, costs associated with capitalized internal-use software, and third-party license fees.

Research and Development. Research and development expenses consist primarily of personnel costs (including salaries, share-based compensation, and benefits) for employees associated with our research and development organization and allocated shared costs.

We focus our research and development efforts on the continued development of our products, including the development and deployment of new features and functionality and enhancements to our software architecture and integration across our products. We expect that, in the future, research and development expenses will increase in absolute dollars. However, we expect our research and development expenses to decrease modestly as a percentage of our revenue in the long-term, although this may fluctuate from period to period depending on fluctuations in revenue and the timing and the extent of our research and development expenses.

Sales and Marketing. Sales and marketing expenses consist of personnel costs (including salaries, share-based compensation, sales commissions, and benefits) for employees associated with our sales and marketing organizations, costs of marketing activities, and allocated shared costs. Marketing activities include both online and offline marketing initiatives, including digital advertising such as search engine, paid social, e-mail and product marketing, content marketing, user events, conferences, corporate communications, web marketing and optimization, and outbound list generation. Sales commissions are considered incremental costs of obtaining customer contracts and are capitalized and amortized on a straight-line basis over the anticipated period of benefit, which we have determined to be three years.

We focus our sales and marketing efforts on generating awareness of our products, establishing and promoting our brand, and cultivating a community of successful and vocal customers. We plan to continue investing in sales and marketing by increasing the number of sales employees, developing our marketing teams, building brand awareness, and sponsoring additional marketing events, which we believe will enable us to add new customers and increase penetration within our existing customer base. Because we do not have a long history of undertaking or growing many of these activities, we cannot predict whether, or to what extent, our revenue will increase as we invest in these strategies. We expect our sales and marketing expenses to continue to increase in absolute dollars and continue to be our largest operating expense category for the foreseeable future. Our sales and marketing expenses as a percentage of our revenue over time may fluctuate from period to period depending on fluctuations in revenue and the timing and extent of our sales and marketing expenses.

Table of Contents

General and Administrative. General and administrative expenses consist primarily of personnel costs (including salaries, share-based compensation, and benefits) for our executive, finance, legal, human resources, and other administrative employees. In addition, general and administrative expenses include fees for third-party professional services, including legal, accounting, and tax related services, other corporate expenses, and allocated shared costs. We expect to incur incremental costs associated with supporting the growth of our business, both in terms of size and geographic expansion, and the infrastructure required to be a public company. Such costs include increases in our finance, legal, and human resources personnel, additional legal, accounting, tax, and compliance-related services fees, insurance costs, and costs of executing significant transactions, including business acquisitions, and other costs associated with being a public company. As a result, we expect our general and administrative expenses to continue to increase in absolute dollars for the foreseeable future. However, we expect our general and administrative expenses to decrease modestly as a percentage of our revenue in the long-term, although this may fluctuate from period to period depending on fluctuations in revenue and the timing and extent of our general and administrative expenses.

Other Income (Expense), Net

Other income (expense), net consists primarily of interest income from marketable securities, foreign currency gains and losses, and interest expense from our convertible senior notes. Interest expense includes amortization of the debt discount, amortization of issuance costs, and contractual interest expense.

Provision for (Benefit from) Income Taxes

Provision for (benefit from) income taxes consists of federal and state income taxes in the United States, income taxes in certain foreign jurisdictions, and a non-cash benefit in 2018 related to the issuance of our convertible senior notes.

Results of Operations

The following tables set forth our results of operations for the periods presented in dollars and as a percentage of our revenue:

	Three Months Ended March 31,	
	2019	2018
Revenue	$181,484	$129,791
Cost of revenue (1)	55,654	39,056
Gross profit	125,830	90,735
Operating expenses (1):		
Research and development	46,791	37,085
Sales and marketing	91,700	65,058
General and administrative	31,253	22,207
Total operating expenses	169,744	124,350