07-Nov-2019

Cloudflare, Inc. (NET)

Q3 2019 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Ladies and gentlemen, thank you for standing by and welcome to Cloudflare Q3 2019 Earnings Conference Call. At this time, all participants are in a listen-only mode. After the speaker's presentation, there will be a question-and-answer session. [Operator Instructions]

I would now like to hand the conference over to your speaker today, Jayson Noland, Head of Investor Relations. Thank you. Please go ahead.

Jayson Noland

Head of Investor Relations, Cloudflare, Inc.

Thank you for joining us to discuss Cloudflare's financial results for the third quarter of 2019. With me on the call are Matthew Prince, Co-Founder and CEO; Michelle Zatlyn, Co-Founder and COO; and Thomas Seifert, CFO.

By now, everyone should have access to our earnings announcement. This announcement may also be found on our Investor Relations website. In addition, we have also posted to our website supplemental financial and key business metrics information.

Let me remind you that we'll be making forward-looking statements during today's discussion, including but not limited to the company's anticipated future revenue, financial and operating performance, non-GAAP gross margin, non-GAAP net loss from operations, and net loss per share, shares outstanding, operating expenses, free cash flow, non-GAAP effective tax rate, dollar-based net retention rate, paying customers, and large customers.

These statements and other comments are not guarantees of future performance, but rather are subject to risk and uncertainty, some of which are beyond our control. Our actual results may differ significantly from those projected or suggested in any forward-looking statements. These forward-looking statements apply as of today and you should not rely on them as representing our views in the future. We undertake no obligation to update these statements after our call.

For a more complete discussion of the risks and uncertainties that could impact our future operating results and financial condition, please see our filings with the Securities and Exchange Commission as well as in today's earnings release. Unless otherwise noted, all numbers we talk about today other than revenue will be on an adjusted non-GAAP basis. All current and prior period financials discussed are reflected under ASC 606. Please refer to our earnings release on our Investor Relations website for a reconciliation of GAAP to non-GAAP financial measures. For historical periods, the GAAP to non-GAAP reconciliations can be found in the supplemental financial information referenced a few moments ago.

We would also like to inform you that we will be participating in the Jefferies' Cybersecurity Conference in San Francisco on November 12, the RBC Global Technology Conference in New York City on November 20, and the Wells Fargo TMT Summit on December 3 in Las Vegas.

Now, I'd like to turn the call over to Matthew.

Matthew Prince

Co-Founder, Chair of the Board of Directors & Chief Executive Officer, Cloudflare, Inc.

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Thank you, Jayson, and thanks to all of you on the phone for what is Cloudflare's first quarterly earnings call as a public company. While this is our first earnings call since our IPO, it's actually far from Cloudflare's first earnings call. I believe this is technically our 13th earnings call. Since July of 2016, we've held practice earnings calls every quarter, scripted, recorded, complete with Q&A, guidance, and a press release we wrote, but never actually put on the wire. So while we admittedly have some butterflies as we step onto this larger stage, the process of getting ready for this call has felt unsurprising and predictable, which is exactly how we aim to run Cloudflare's business.

We had a great quarter. Our Q3 revenue finished at $74 million, growing 48% year-on-year. Importantly, nearly all of our revenue is subscription based, which provides predictability as we think about head count investment and capital outlay. We also posted a gross profit margin of 79%. We believe our continued gross margin strength is evidence of the underlying efficiency of our network and the broad set of services delivered across our unified platform.

I'm joined today on the phone by Michelle, Thomas, and Jayson, but I wanted to take a second to acknowledge and thank all of the employees at Cloudflare, they are designing, engineering, marketing, selling, and running the products that allow us to drive our business. We couldn't do this without the entire team supporting us.

For many of the investors and analysts dialed in, we've gotten to know you over the years, but some of you may be new to Cloudflare story. To that end, in case you're not familiar, I wanted to take some extra time to walk through who we are and what we do.

Cloudflare launched in 2010 with a mission to help build a better Internet. At the time, we saw the paradigm shift IT teams around the world we're going through as they moved from on-premise hardware and software that they bought, to services in the cloud that they rented. As we watched packaged software turn into SaaS applications, and physical servers migrate to instances in the public cloud, it became clear that it was only a matter of time before the same happened to network appliances. Firewalls, network optimizers, load balancers, and the myriad of other hardware appliances that previously provided security, performance and reliability would inevitably turn into cloud services. To be the provider that could meet the IT's security, performance, and reliability needs in the cloud, replacing all the band-aid network hardware boxes of the past, we needed to build our own efficient global network. And we've done that.

Today, our network spans 194 cities in more than 90 countries worldwide. Our network is within less than 100 milliseconds of 99% of the developed world's Internet-connected population. And as we continue to expand our network, we are able to drive down our operating costs, increase the performance of our service globally, and make our products better for all of our customers. Importantly, we designed our network with a new type of software architecture we refer to as serverless. Practically, that means that every server in our network can deliver every Cloudflare product and service. Our engineers can develop new features and solutions quickly and efficiently without having to worry about waiting for new custom hardware to be deployed and without having to manage or think about VMs or containers.

To give you some sense of the developer efficiency our serverless platform allows, we rolled out 122 new features in Q3 alone. And that doesn't count all the lines of code our users have deployed directly into our network themselves with Workers, our edge computing platform.

Our strategy is to get to market quickly with early adopters, gather feedback from those first customers, and then iterate quickly to move up market, serving larger and larger enterprises over time. That's why it's powerful that we have a broad set of total customers, more than 2 million across our free and paying segments, which provide a test bed to build great products and meet the needs of the largest enterprises.

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Today, we count more than 10% of the Fortune 1000 as paying customers and last quarter, our large customer count, those customers that spend more than $100,000 per year with us, increased 71% year-on-year to 475.

I'm thankful to all our customers who entrust us with their business. I wanted to walk through a handful of customer wins for the quarter, to give you a sense of how we're both winning new logos and expanding our relationship with our existing customers.

Let's start in Europe. In Q3, we signed up a new customer that is a large European Stock Exchange. Digital transformation was a top priority for them and they were looking to move more of their operations to the cloud and away from on-premise hardware. Like many companies going through this transition, the challenge they faced was that they weren't all in one world or another. Cloudflare provided a perfect solution to help them ensure they have a consistent control plane across both their on-premise and cloud applications.

As is common, they didn't come to us for just one use case, but sought the power of Cloudflare's platform and a number of our security and performance products. I was particularly pleased to see them adopt two of our newer products, Workers and Access. With Workers, they were able to deploy custom, sophisticated code directly into our network to route requests between their new public cloud deployments and their legacy on-premise infrastructure. This enabled a new digital currency application they launched. In addition, they used Cloudflare Access to replace their hardware VPN and allow them to manage who had access their applications in a scalable, efficient way.

Continuing on the theme of digital transformation, we worked with a Fortune 500 industrial company with close ties to the financial services industry. A division within the company had signed up for one of Cloudflare's pay-as-you-go services by coming to our website and entering a credit card. Our systems flagged our sales team that this was a large potential prospect. We approached them to see if Cloudflare's network could better serve them. The one use case for a particular client of theirs quickly led to an opportunity to help protect and secure many of their financial services clients. We signed a three-year deal with an annual contract value over $300,000, and we expect that we'll be able to expand the relationship as we introduce them to more products on Cloudflare's platform.

Expansion is a critical part of our strategy, and once a customer adopts any part of Cloudflare's platform, it is usually as easy as a single click in a dashboard to enable more products and grow the value of the relationship. Two great examples from Q3. First is a large industrial distributor in the automotive space. They had been a customer of our core security and performance products for about a year. They came to us originally because they wanted a single control plane across all their digital properties. In Q3, we were able to expand their use across more of their portfolio. This more than doubled their annual spend with us. Powerfully, they were able to leverage Workers, our edge computing platform, to solve some custom traffic routing issues they didn't have a good solution for before. As customers adopt more of our products and especially, as they write custom code on our Workers platform, it deepens their relationship with us and increases the stickiness of our platform.

We saw another great expansion deal with a large, European pharmaceutical company. They had been using Cloudflare to protect and accelerate their Internet properties. Large, European, and pharmaceutical is another way of saying that this is a customer that will put you through your regulatory and compliance paces. And they did when they first became a customer back in Q4 of 2018. But now that we've demonstrated the Cloudflare platform can meet their requirements, they were eager to see what else we could do for them. In particular, their corporate VPN was a point of pain, they, like nearly every other company we talked with, hated their on-premise VPN solution.

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In Q3 they adopted Access, signing a deal with us to purchase 25,000 seats for their employees, partners, and contractors around the world. This allows them to manage access to their applications through a consistent user interface while leveraging the global Cloudflare network to ensure fast, secure performance around the globe. I think this is a great example of how winning the trust of a customer in one area of our platform allows us to expand and sell more solutions across Cloudflare's entire platform. I'm especially excited about Access and think you'll be hearing more and more about it on future calls.

Finally, I wanted to tell you about a free customer our entire team is incredibly proud of. As we were flying back to San Francisco in the middle of our IPO roadshow, I got an email from our team. They'd been contacted by Wikipedia about whether they could onboard with Cloudflare. Wikipedia was facing a massive cyberattack targeting their entire network infrastructure and they didn't know who else could help. Wikipedia is the sixth largest website on the Internet and a very sophisticated technical operation.

Even with the help of many partners, Wikipedia was unable to stop the attack they were facing. We immediately agreed to donate services. Michelle, Thomas, Jayson, and I watched from the plane's spotty Wi-Fi as over the course of a few hours, our team worked with theirs to get Wikipedia fully onboarded onto our Magic Transit service which protects not just their website, but their entire network infrastructure. We stopped the attack and Wikipedia came back online worldwide.

I'm proud of this story for several reasons. First, Wikipedia represents the best of the Internet and that we were able to ensure that it remained accessible, directly fulfills our mission of helping build a better Internet. Second, that we could react quickly and solve this customer's problem in a matter of hours from first contact to the attack fully mitigated speaks to the power and flexibility of our service. Finally, it illustrates the efficiency of our network. We could donate services to the sixth largest website in the world and know that because we built such an efficient network, it would build incredible goodwill and brand equity without having a measurably negative impact on our financials.

That seems like an appropriate segue to turn it over to Thomas, who will walk through our financial results for the third quarter. Thomas, take it away.

Thomas J. Seifert

Chief Financial Officer, Cloudflare, Inc.

Thanks, Matthew, and thanks again, everyone, for joining us. I'll start by providing a brief overview of our financial model and then, I'll go through our third quarter results before moving on to our guidance for the fourth quarter and full-year 2019.

We provide cloud-based network services through a highly efficient global cloud platform. We generate nearly 100% of our revenue from subscriptions across two different go-to market motions. Our pay-as-you-go customers typically pay with their credit card on a monthly basis. Our contracted customers, which consist of customers that sign up for our enterprise plan, have contracts that range from one to three years, and they're typically billed on a monthly basis. We recognize revenue ratably over the life of the contract.

Now, onto the details. Total revenue for the quarter was $73.9 million, representing an increase of 48% over the same period last year. Top line growth was driven by strong customer demand, both in terms of new customer acquisition and growth within the installed base.

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We exceeded 77,000 paid customers, up 26% year-over-year, and reflecting a net add of roughly 2,200 customers over the quarter. We now have 475 customers with more than $100,000 of an annualized billings, representing 71% year-over-year growth and a net add of 67 of these large customers over the quarter.

Our investment in enterprise go-to market is in the beginning stages, but we are encouraged by the continued progress that we are making.

Our Q3 dollar-based net retention rate was at 111%. Dollar-based net retention measures our ability to retain and expand revenue from existing customers in the prior-year period. Our measurement is net of contraction, net of churn, and excludes the benefit of free customers that upgrade to a paid subscription. We continue to see solid customer retention with the opportunity to try to improve the expansion in the medium-to-long-term. As we add more products and functionality to our platform, we see opportunities to drive upsell as customers seek to consolidate to a single platform to meet all of their network requirements.

In terms of revenue by geography, the US represented 51% of revenue; EMEA was 24% of revenue; and Asia-Pacific was 19% of revenue. In Q3, our contract with Baidu was extended through the end of 2020. We are proud of the relationship we have built with this strategic partner through the years.

Network efficiency is a key strength of our business model. We utilize off-the-shelf hardware and a single homogeneous software stack allowing every server to run every Cloudflare service across our platform. Third quarter gross margin was 78.9%, which represents an increase of 80 basis points sequentially and 92 basis points year-over-year. We will continue to drive high-quality revenue and use gross margin upside to invest back into the business. We are maintaining our long-term gross margin target of 75% to 77%.

Turning to operating expenses. We remain focused on improving the leverage in our business while balancing our investments for growth. Our total operating expenses grew 7% sequentially and 50% year-over-year to $76.5 million. Sales and marketing expenses were $40.7 million for the quarter, representing 55% of total revenue. Sales and marketing expense increased 14% sequentially and 68% year-over-year. While we expect to realize leverage in sales and marketing over the long term, we continue to add sales capacity to drive growth and capture the large TAM in front of us. These investments include key initiatives such as expanding our global footprint and supporting our increasingly successful efforts to move up market. Our sales productivity per fully ramped rep continues to remain high, which gives us additional confidence to continue to invest.

R&D expense was $20.1 million in the quarter, representing 27% of total revenue. R&D expense increased 9% sequentially and 40% year-over-year. The growth in R&D expense is largely due to our continued investment in engineering head count to enhance the functionality of our global cloud platform. We expect to see long-term leverage in R&D as we expand our Lisbon office over the coming years.

G&A expense was $15.8 million for the quarter, representing 21% of total revenue and 27% growth year-over-year. The growth in G&A includes investments of head count, infrastructure, and other expenses that we have made to prepare for being a public company. Our operating loss in the quarter was $18.1 million, representing an operating margin of negative 25%. Operating margin expanded sequentially this quarter, up over 300 basis points, driven by a combination of a higher gross margin and improved operating leverage within R&D and G&A.

Net loss in the quarter was $18.5 million, a net loss per share of $0.16, using 118.1 million common shares outstanding. Our non-GAAP effective tax rate for this quarter was negative 2%. Free cash flow was negative $33.6 million in Q3 compared to a negative $22.1 million last year. Free cash flow margin was negative 45%. We ended the quarter with a total head count of about 1,200 employees, growing 50% year-over-year.

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Lastly, turning to the balance sheet, we ended the third quarter with $645 million in cash, cash equivalents, and marketable securities. We raised $565 million, net of fees and expenses, in our initial public offering that priced on September 12 of this year.

Now moving onto guidance. As a reminder, except for revenue, these numbers are all non-GAAP, which excludes stock-based compensation expenses, amortization of acquired intangible assets and for net loss per share, it excludes a provision for income taxes. For the fourth quarter, we expect revenue in the range of $78.5 million to $79.5 million. We expect non-GAAP operating loss in the range of negative $21 million to negative $22 million. We expect non-GAAP net loss per share in the range of negative $0.06 to negative $0.07, assuming approximately 295 million common shares outstanding. And we expect the non-GAAP effective tax rate of negative 2.1%.

For the full year 2019, we expect revenue in the range of $281.5 million to $282.5 million. Non-GAAP operating loss in the range of negative $74 million to negative $75 million. Non-GAAP loss per share in the range of negative $0.49 to negative $0.50, assuming approximately 146 million common shares outstanding and a non-GAAP effective tax rate of negative 2%.

In closing, we had strong execution during our first quarter as a public company and I would like to thank the entire Cloudflare team for their hard work. We remain excited about the opportunity in front of us.

With that, I'd like to open it up for questions. Operator, please poll for questions.

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] We'll pause for just a moment to compile the Q&A roster. Your first question comes from Sterling Auty from JPMorgan. Your line is open. Please go ahead.

Sterling Auty
Analyst, JPMorgan Securities LLC

Q

Yeah, thanks. Hi, guys. So looking at the traction that you're having in terms of revenue per customer, you've had three straight quarters of acceleration. So in other words, the amount that customers are paying are growing at an accelerating rate. And what I'm curious about is, how much of that is coming from expansion, sales into existing customers, versus just naturally moving up market and landing with larger deals right off the bat?

Matthew Prince
Co-Founder, Chair of the Board of Directors & Chief Executive Officer, Cloudflare, Inc.

A

Sterling, thanks for the question. I think that it's a combination of both of those things. I think when we think about our business, we think about the business as one single funnel and it's sort of like the Mr. Rogers' line that, everything grows together because we are one piece. And so I think we've had success both landing new customers and you can see that in our large customer growth. But we also are able to expand those existing customers both by increasing the number of products that we sell them, and we see that our product team is really delivering incredible new products that we're able to sell to them and expand that way. And then also expanding their overall use. And so I think that we see growth on both of those. And I think that, that's the part of the strength of our overall business.

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Sterling Auty
Analyst, JPMorgan Securities LLC

Q

Great. One follow up, Matthew. Looking at Workers, you'd given some examples of what's going on there, but from a high level, how should we think about what is the prototypical application that's perfectly suited for Workers rather than a traditional cloud implementation?

Matthew Prince
Co-Founder, Chair of the Board of Directors & Chief Executive Officer, Cloudflare, Inc.

A

So Workers is our edge-computing platform and what's really powerful about Workers is that our customers can write in the languages that they already know, code and then deploy it to inside of our network. And I think that the Workers' tasks fall into sort of two broad buckets. The first is that we see that customers are able to fully program and customize all of our existing features in order to meet their specific needs. And that's powerful because if, for example, our firewall doesn't do something that they need, that they can take that, adjust it, and really program that functionality. And I think that's the simpler use case and the use case that we're seeing from a majority of the Workers adopting customers today.

The second bucket though, and I think the bucket that is the long-term exciting bucket is that there are customers that are able to build functionality that just wouldn't have been possible before. And so, I'd look at a customer that is doing like an AB test platform where they don't want to deploy a lot of JavaScript that would run on a client and they can't actually deploy this in some centralized cloud location because they need performance. Workers in that case provides the perfect environment for you to get the speed of being close to where the client is while having the resources of a fully functioned server and the ability to deliver across that. So, we continue to see use cases across that, and we're proud of the fact that more than 20% of our new enterprise customers have Workers attached to their order. And so, it's driving real use and the applications that are being built with it are getting more and more sophisticated over time.

Sterling Auty
Analyst, JPMorgan Securities LLC

Q

Got it. Thank you.

Operator: Your next question comes from Heather Bellini from Goldman Sachs. Your line is open. Please go ahead.

Heather Bellini
Analyst, Goldman Sachs & Co. LLC

Q

Great. Thank you. Matthew, I just wanted to follow up a little bit on what you were just talking about with the large customers with over $100,000 in billings. Noticing that, I think it was the largest number of net adds in this category that you guys have had since you've been disclosing the data. So a little bit just more if you can some color on what you were just talking about. I'm wondering, how often is it that customers might be landing as that large of a size. Like, are you seeing the lands actually get bigger at this point, or is it people are kind of hanging out around the net maybe at $80,000 or $90,000 in billings and then they just have an expansion and they get over? I'm just trying to get a sense for how we think about the split of those customers as they're breaching that $100,000 billings mark. And then I just had a follow-up.

Matthew Prince
Co-Founder, Chair of the Board of Directors & Chief Executive Officer, Cloudflare, Inc.

A

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Yeah. So I think that the reality is that both of those things are true. We are seeing many more customers that are landing in the – starting in the six- and seven-figure range. And I think that our team has, our sales and go-to-market functions are maturing that there's a real opportunity to see that as an initial customer. But again, the power of our business is the fact that we think of the business as one continuous funnel. And so there's also an opportunity to take a customer from below that large customer account and move that up. So I think we're seeing success in both of those areas, and I'm really proud of our entire sales and marketing team driving more and more business to larger and larger enterprise customers.

Heather Bellini
Analyst, Goldman Sachs & Co. LLC

Q

Okay. Great. And then one just quick follow-up if you don't mind. Just wondering when these customers are starting with, the lands are getting – are starting at a larger level, what are the – what's the product portfolio that they're typically starting out with?

Matthew Prince
Co-Founder, Chair of the Board of Directors & Chief Executive Officer, Cloudflare, Inc.

A

Yeah. I think that – yeah. So I think that it really depends on what the customer is looking for. About 50% of the products that people are landing with are those security products that we have. And then about 50% of the performance and reliability products that are there. So if you're a financial institution, I think that your bias is going to be landing towards the security products first. If you're someone who is more concerned about a marketing or a media site that might be something that lands with more of the performance and reliability piece. But what we've seen successfully is that as we land with that one customer because it is one unified platform where every one of our applications is delivered across the same network, what that's allowing us to do is very easily expand. And when we see customers that say, I need to just rethink how I'm thinking about my network services and I need a network like Cloudflare, we win those customers all the time and those are some of our favorite customers.

Heather Bellini
Analyst, Goldman Sachs & Co. LLC

Q

Thank you very much.

Operator: Our next question comes from Keith Weiss from Morgan Stanley. Please go ahead. Your line is open.

Keith Eric Weiss
Analyst, Morgan Stanley & Co. LLC

Q

Excellent. Thank you for taking the question and very nice first quarter out of the gate. I want to begin sort of the customer side of the equation and continue on this kind of line of questioning. Very impressive, another very impressive quarter and kind of large customer adds. But on the flip side of the equation sort of the overall customer base growth building that addition that like 2,200 in line with what we saw last quarter, but definitely down from the rate that we saw last year. So I just want to make sure that I understand this correctly in terms of when we think about the investment into – more into the enterprise business and more into the enterprise distribution motion, is this at the expense to some extent as sort of the run rate kind of smaller business or does it too go, sort of, to Simpatico and that sort of, lower new customers as it just – can more of like a scaling issue?

Thomas J. Seifert
Chief Financial Officer, Cloudflare, Inc.

A

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Yeah. Let me get started Keith, and then Matthew will follow up. I think it's really important for us to reiterate that we manage our business across the complete funnel of how customers come to us. And you have to look at that number in the context of the larger number. So our total web properties that we protect are up from 20 million to 22.2 million quarter-over-quarter. Our free and paid customers are up from 2 million to 2.3 million customers. And the large customer count is up.

So we will see from time-to-time, noise in some segments. But of our, customer portfolio, but overall, it's really important to us how we manage the momentum across the complete funnel. And that was particularly strong this quarter again. And as we get pulled-up market or our customer engagements become larger, and the momentum on the large customer count itself, as I said before, has been very encouraging. The team has done an outstanding job across the three geos in order to achieve that. But we are not the de-prioritizing one go-to market versus the other. It's really important to us to keep the momentum across all the funnels we serve.

Matthew Prince
Co-Founder, Chair of the Board of Directors & Chief Executive Officer, Cloudflare, Inc.
A

I think that's exactly right. I don't have anything to add, but happy to take any follow ups, Keith.

Keith Eric Weiss
Analyst, Morgan Stanley & Co. LLC
Q

Got it. Actually, the follow up was on the gross margin side of the equation. Nice teens in terms of the overall gross margins. I was hoping to maybe get some color on where those are stemming from and sort of how much more is there to go in that regard of – should we expect to see further gross margin improvements across the platform?

Thomas J. Seifert
Chief Financial Officer, Cloudflare, Inc.
A

Yeah. It was really important for us to reiterate our guidance that we, over the long term, that we want to stay in the 75% to 77%, so – and that we are – we will continue to use gross margin as a strategic weapon really to introduce new products and accelerate growth wherever possible. There was less need of that this quarter. And in addition to that, the infrastructure team has done an outstanding job managing productivity across the network and that really led to that nice performance. But we will continue with our statement that we use. This is a strategic weapon to reinvest in our business.

Matthew Prince
Co-Founder, Chair of the Board of Directors & Chief Executive Officer, Cloudflare, Inc.
A

Yeah. The only thing I would add is that this really does speak to the power of having a single integrated platform. And so, as we are able to continue to build out our network, we think that by being able to deliver the full range of Cloudflare's products across that, that gives us advantages over other companies that might just be trying to do one product or one solution across the network. And so, we – I think that what – just to reemphasize what Thomas said, that the gross margin success that we've had makes us just a more fearsome competitor in all of the markets that we're competing in.

Operator: Your next question comes from Phil Winslow from Wells Fargo. Your line is open. Please go ahead.

Philip Winslow
Analyst, Wells Fargo Securities LLC
Q

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Hey. Thanks guys for taking my question. Congrats on a great first quarter out of box. And Matthew, I just wanted to focus on some of the newer services. Obviously, you already highlighted Cloudflare Workers which obviously it adds up here. But what are some of the newer services that you've seen – sort of particularly traction, I know that, that sort of surprise you with the upside so far this year?

Matthew Prince
Co-Founder, Chair of the Board of Directors & Chief Executive Officer, Cloudflare, Inc.

A

Yeah. I think there are two services that I'd highlight in addition to Workers. The first is our Access product, which is our zero trust product. If you think about Cloudflare, you can kind of divide our business into two halves. One half is the products that protect infrastructure and those have been more of our traditional products, but we're increasingly focusing on products that protect teams. And Access was our first case with that. And we've just seen – every single IT team that we talk to has – what they have in common is they hate their VPN. It's a pain to manage. It slows things down. And Access is a real solution to that. And we're seeing real customer traction.

And what's powerful about that is we're seeing that customer traction from a lot of customers that were already Cloudflare customers. So it's both an expansion opportunity. And from new customers, when we come in with Access, they're also often saying, wow, we'd love to also replace our firewall or some of our other solutions as well. So we see a real symbiotic relationship there. And there were – we told the story during the prepared remarks about the customer that added 25,000 Access seats. We're seeing wins like that increasing, and it's an incredibly exciting opportunity for us and I think something that you'll hear a lot more about.

The second product which is newer in the market, but has real traction is a product that we call Magic Transit. And we also snicker a little when we say the term because we couldn't come up with a better name for it because every time we would turn it on for a customer, they'd say, wow, that's like magic. And so we finally just said that that was the case. This is a product that falls in our classic infrastructure protection set of products, and it's what we deployed in order to protect Wikipedia. And what's powerful about that is it extends the value of Cloudflare's network beyond just APIs and Web phasing infrastructure to total infrastructure of companies where they can say that their entire infrastructure sits behind our network. We're seeing early wins in these cases. These tend to be larger customers and they tend to be larger deals. And so, that's a product that I'm watching very carefully and our team is extremely excited about.

Philip Winslow
Analyst, Wells Fargo Securities LLC

Q

Great. Thanks. Well, my team and I are also WARP users. So maybe next quarter, that will be highlighted.

Matthew Prince
Co-Founder, Chair of the Board of Directors & Chief Executive Officer, Cloudflare, Inc.

A

Yeah. Well, and WARPs, I think if you think about what WARP is, WARP is the largest test bed for a consumer VPN that could hopefully someday make corporate VPNs not suck. And I think that's an exciting – I'm glad that you're using it, and we'd – in the not too distant future, love to talk with more of the Well's team about how we can help make your VPN not suck.

Philip Winslow
Analyst, Wells Fargo Securities LLC

Q

I'd appreciate that. Thanks, guys.

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Operator: Your next question is from Matt Hedberg from RBC Capital Markets. Your line is open. Please go ahead.

Matthew Hedberg
Analyst, RBC Capital Markets LLC

Q

Hey guys. Thanks a lot. Thanks for taking my questions. Matthew, I think roughly today about half your revenues from security, the balance from performance and reliability, obviously there was a lot of innovations across your entire portfolio of products, but thinking longer term, I'm sort of curious what that mix might look like. I mean do you think it tilts even more towards security over time, just – maybe just in high level thoughts.

Matthew Prince
Co-Founder, Chair of the Board of Directors & Chief Executive Officer, Cloudflare, Inc.

A

I think – we're really good at building security products that solve incredibly hard problems and we have the data across the vast set of customers that we offer to be able to continue to deliver high quality security products. And that's I think a real differentiator for our business. But I think – if you think long-term, what we're seeing with the most innovative organizations that we work with, is that increasingly the IT functions and the security functions are on a path towards re-converging. And that the reason why those two functions split apart in the past was at some level because the security products were so complicated and so different to manage.

What I think is powerful about Cloudflare is that we focused on ease of use from the very beginning. And that means that you do not have to trade-off between performance and security. And so, I sort of think of security as being table stakes. And it's something that people are going to come to Cloudflare for and that we will continue to be able to drive a lot of our revenue from. But that over time what customers really want is a better Internet and a better network to be able to support it and that's what we're building Cloudflare to be able to deliver.

Matthew Hedberg
Analyst, RBC Capital Markets LLC

Q

Got it. It makes a lot of sense. And then just to circle back on Access, we hear a lot of good things about it from the market. I'm curious when you sell that into account, is that generally a greenfield sale? Is it replacing anything? I mean, I know you've mentioned firewalls. Just sort of wondering about like VPN – sort of like just what is the competitive dynamic for that product look like, I guess?

Matthew Prince
Co-Founder, Chair of the Board of Directors & Chief Executive Officer, Cloudflare, Inc.

A

I think usually we're replacing hardware, which is being retired from what would be a more traditional firewall. And Access today doesn't necessarily solve every need that a enterprise has to completely replace their firewall. But that is the direction that that product's road map is headed in. And it's how we think about it and we think about how – there's a lot of on-premise firewalls that are out there. Nobody loves them. And we think there's an opportunity for us to not only make our – the buyers of our products happy, but then make all of their constituent team members happy as well not having to wait to try marrying the traffic through a legacy firewall.

Operator: Your next question comes from Brent Thill from Jefferies. Your line is open. Please go ahead.

Brent Thill
Analyst, Jefferies LLC

Q

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Good afternoon. Given the ongoing success, I'm curious if you could just help us understand the go-to-market strategy over the next year and how you're thinking about reshaping direct sales rep investments? And maybe from a partnership perspective, any real partners helping benefit you in the field? Thank you.

Matthew Prince
Co-Founder, Chair of the Board of Directors & Chief Executive Officer, Cloudflare, Inc.
A

Thanks, Brent. I think that we have continued to execute in what has been Cloudflare's go-to-market strategy for some time, which is we move up market over time. So, we've begun building out our field sales efforts around the world, hiring seasoned leaders to run those efforts in markets like New York, London, Munich, Sydney, Australia. Those are places where we see that effort continuing to expand.

We're working with great partners that help bring us to market in various areas. So, IBM has been a terrific partner to us for a little over two years now, and we're excited to continue those relationships. But I would say that our efforts around partnerships is an opportunity where we will continue to invest We hired [ph] Matt Harrell (00:41:14) who had run G Suite partnerships out of Google for the last number of years. He's come on board and we are investing in that area and think that especially for some of these new products like Access and Magic Transit, like there might be some new opportunities for partners and that's something that I think you'll see us develop over the course of 2020.

Thomas J. Seifert
Chief Financial Officer, Cloudflare, Inc.
A

And let me make one more point in that direction. But it's really important to reiterate that for us to manage our go-to-market across all funnels continues to be important. We build out our international footprint. We are getting ready to support the larger and in terms of ACV bigger customer structure. But we also need to make sure that we keep the go-to-market model efficient and that means keeping the small and medium sized customers as well as the pay-as-you-go customers in mind from a from a go-to-market perspective. So, we are not going to disregard one and overemphasis one go-to-market over the other.

Brent Thill
Analyst, Jefferies LLC
Q

Thank you.

Operator: Our next question is from Pat Walravens from JMP Securities. Your line is open. Please go ahead.

Pat Walravens
Analyst, JMP Securities LLC
Q

Oh, great. Thank you and congratulations on the IPO, the first quarter, and the first public call.

Matthew Prince
Co-Founder, Chair of the Board of Directors & Chief Executive Officer, Cloudflare, Inc.
A

Thanks, Pat.

Pat Walravens
Analyst, JMP Securities LLC
Q

So, Thomas, one for you to start. So, yeah. Net dollar expansion was sort of flat sequentially at 111%. Can you talk a little bit...

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Thomas J. Seifert
Chief Financial Officer, Cloudflare, Inc.

A

Yeah.

Pat Walravens
Analyst, JMP Securities LLC

Q

...just since – since this is the first time people heard it. What are the puts and takes on that number and where should we expect it to go over time?

Thomas J. Seifert
Chief Financial Officer, Cloudflare, Inc.

A

Yeah. Yeah. Let me give you some color. I think the first important remark is for us, dollar net retention is a very clean number. So, it's net of contraction, it's net of churn, and it also excludes the benefit of free customers that upgrades. So it's – it's a very transparent number and the 111% I think is a good achievement. For us DNR is also a lagging indicator. Our business started with plans in the pay-as-you-go and we move ourselves up market. So the – all the older customer cohorts, the good news is they're still with us, they're more difficult to expand and the opportunity to expand now comes as we are getting pulled up market, the customers become larger. And if we were to zoom in on those DNR numbers for larger customers, they would look significantly higher.

So this number is going to move up over time. It will be small progress, but consistent and steady progress since we have the older customer cohorts with us. And as I said, it's a lagging indicator of our performance but the number will go up.

Pat Walravens
Analyst, JMP Securities LLC

Q

Okay great. And then Matthew one for you. Just $600 million in cash is going to cause some people to wonder. What's your philosophy around M&A and what sorts of things might you be looking for going forward?

Matthew Prince
Co-Founder, Chair of the Board of Directors & Chief Executive Officer, Cloudflare, Inc.

A

Yeah. I think, Pat, as Michelle and I wrote in the Founders letter in the S1, I think our general bias is toward organic growth of our products internally. And I think the thing that we have learned looking at other people in the industry is that if you relied too much on M&A, you can lose some of the advantages of a consistent unified platform. But I think there are a couple of areas that are really interesting for M&A for us. So the first is that as we see interesting companies start to build functionality on our Workers platform that, that naturally is the place where we might find some exciting opportunities to be able to take functions that third parties build and integrate them into our core platform, and the integration from that is much easier than if we were to having to integrate two completely disparate networks.

The second is, that I think that there are areas that are potentially adjacent to where we are, where there might be opportunities for us. But we will be disciplined. As we think about that, I think where we are again biased against – just because we have the capital to be able to make acquisitions heading in that direction and I think that we want to continue to be good stewards of the capital that we've been entrusted with. And if we make that, it should be clear that those were best that are accretive to the opportunity we have ahead of us.

Operator: Our next question comes from Alex Henderson from Needham. Your line is open, please go ahead.

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Alex Henderson
Analyst, Needham & Co. LLC

Q

Thank you very much. I'm tempted to bring up 1.1.1.1, but I'll instead focus on Magic Transit, if I could. So, this obviously is a very disruptive technology and I think it's one of the more interesting ones in your portfolio, but it also looks like it still needs to be filled out. Can you talk a little bit about some of the enhancements you expect and what the timing of some of those enhancements are, things like policy management and log management, things of that sort, that would fill out Magic Transit and how the – what kind of response you're getting from customers on it?

Matthew Prince
Co-Founder, Chair of the Board of Directors & Chief Executive Officer, Cloudflare, Inc.

A

Yeah. The thing that has been consistent Alex across our business I think has been that we like to get products out quickly and get people using them quickly. And then, learn from those places where they're might be gaps and move up market in order to address those gaps.

And so I think the places that you pointed out are areas that we're actively thinking about and are in our roadmap. What's been powerful about Magic Transit though, is that since it relies on the same infrastructure that was already in place, that then allows us to tap into some of the policy management and log management that we have for our more traditional products. And so, every time we improve any one of these products, it makes the overall Cloudflare portfolio more and more enterprise-ready.

What's – I think then somewhat surprising to our team has been that even though there are still places where that product in the Magic Transit case can improve the architecture and the performance and the ability to stop what are just crippling attacks to legacy solutions has been enough that we're – even as we still have work to complete the product in some of the areas you mentioned, we're already getting a lot more traction than I think we anticipated with that. So my instructions to that team is just continue to run because it's a really magical product.

Alex Henderson
Analyst, Needham & Co. LLC

Q

Super. And one business model question if I could. So 68% growth in the sales and marketing line year-over-year. Obviously, you're over the head of our forecast and I think, looks like you're really stepping up to the plate on investing to drive for penetration. Can you talk a little bit about the mix of that between how much of it is your geographic, how much of it's associated with new sales hires, what the productivity time for those hires to kick in, or some of the granular stuff that helps us understand how that investment is being deployed? Thanks.

Thomas J. Seifert
Chief Financial Officer, Cloudflare, Inc.

A

Yeah.

Matthew Prince
Co-Founder, Chair of the Board of Directors & Chief Executive Officer, Cloudflare, Inc.

A

Go. We're stepping on each other already. So, go ahead, Thomas.

Thomas J. Seifert
Chief Financial Officer, Cloudflare, Inc.

A

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I think I'll start it and then Matthew jumps in. In terms of head count and geographies, it's pretty even spread across the geographies we serve, so we are continuing to build out our global footprint. And that takes investment. It's also in terms of sales versus marketing, pretty evenly spread between marketing and sales head count. And in terms of productivity numbers, that's one of the KPIs we really monitor carefully is that while we ramp up, that we do not lose productivity and that our sales rep productivity has been consistently on a very high level and we've been able to maintain that performance despite the head count increase. But today, we talk about three months for a rep to get from start to – three to six months to get to full productivity.

Matthew Prince
Co-Founder, Chair of the Board of Directors & Chief Executive Officer, Cloudflare, Inc.
A

Yeah. And I think that what I would add is we definitely pulled in some of our investment in sales and marketing, and we have the confidence to do that, first, for what Thomas said by the fact that as we're growing that team, we monitor the productivity of ramped reps very carefully and that has held very, very steady over time and that's given us the confidence to continue to invest. The second is just traction with new products where products like Access and Magic Transit, we're seeing that success that reps are having in the field and those are – and that's giving us the confidence.

The third is, that we've had real success moving up the market with larger customers and you can see that from the 71% year-over-year growth and the 16% quarter-over-quarter growth of large customers. and then the fourth, which has been – it's harder to sort of measure, but what has been really helpful to us is we added Mark Anderson last quarter to our board.

Mark's been someone that we've admired for a really long time, built the sales teams at F5 and Palo Alto Networks, and he's really been somebody who's helped us think through as we think about our sales investment, when is the right time to step on the gas and when isn't. And I think that all of the measures that we looked at and consulted with, it became clear that this was the right time for us to step on the gas on sales and marketing.

Operator: Our next question comes from Amit Daryanani from Evercore. Your line is open. Please go ahead.

Amit Daryanani
Analyst, Evercore Group LLC
Q

Perfect. Thanks a lot, guys. I guess two from me as well. First off, when I look at the midpoint of the revenue guide that you guys have, I think it implies the year-over-year revenue growth of about low 40s, 42%, 43% versus the 47%, 48% trend line you've had for essentially the rest of – the early part of 2019 in Q3. I'm just wondering what are the reasons for the deceleration, here or have you already learned to become conservative given the fact you've been doing these calls for the last few years?

Thomas J. Seifert
Chief Financial Officer, Cloudflare, Inc.
A

Well, we want to be predictable and we want to be prudent about how we talk about our business and I think that is what you also see reflected in the guidance. And over there, that we practiced over the last couple of quarters certainly helped us get to a prudent approach of how we think and communicate our business.

Amit Daryanani
Analyst, Evercore Group LLC
Q

Fair enough. And then, I was hoping you could elaborate. I know you talked a little bit about the serverless offering initially, but I was hoping you could just talk about how big of an opportunity, do you think either from a

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dollar basis or the new customers that you can go after as – with this offering. And then how does that differentiate your Cloudflare serverless offering versus something like AWS' Lambda, I guess?

Matthew Prince
Co-Founder, Chair of the Board of Directors & Chief Executive Officer, Cloudflare, Inc.
A

Yeah. I think that we're all in early days in the serverless world, and what we're seeing primarily from our Workers platform today is that it is a differentiator that helps us win customers across our broader portfolio. And it's also the platform that we built for ourselves first so that we can develop products like Magic Transit and Access and get those out in the market as quickly as we have.

I think architecturally we've made some decisions that have allowed us to deliver our Workers platform more efficiently and from a end customer's perspective, in a much more cost effective way than what AWS Lambda does. And that's largely because Lambda is still running within containers and have significant overhead which is on top of it. So, I don't think we fully understand the scale and scope of what that serverless offering is going to be.

And when we were putting together the S1, for instance, and we were forecasting what our total addressable market was, we didn't include serverless in that at all. I think we're still in early innings. I think we've built the right architecture to be able to be extremely competitive over the long term. And I think we're excited that we already have the adoption rate that we do.

Jayson Noland
Head of Investor Relations, Cloudflare, Inc.
A

And, Christina, can we take questions from two more analysts, please?

Operator: Absolutely. Our next question comes from Joel Fishbein from SunTrust. Your line is open. Please go ahead.

Joel P. Fishbein
Analyst, SunTrust Robinson Humphrey, Inc.
Q

Good afternoon, everybody. Matthew, I had one, just to follow up with you. On a large European stock exchange win that you had, could you just talk about the ROI that you were able to deliver with that opportunity?

Matthew Prince
Co-Founder, Chair of the Board of Directors & Chief Executive Officer, Cloudflare, Inc.
A

Yeah. I think in that case, the ROI was replacing a lot of the on-premise infrastructure that they had in place. And so I don't have the specific numbers for them in front of me, but it was a very significant win for them. It allowed them both to retire a significant amount of the legacy infrastructure that they were using to manage their existing hardware spend. But equally importantly, it provided a path for them to go from an on-premise deployment where they were spending a significant amount to run and maintain their own servers to shifting to a much more agile cloud deployment. And they could do that without having to completely shut down one or turn up the other.

So Cloudflare, in that case, provides a very good on-ramp for companies that are going through a digital transformation and that the savings that they're going to be able to achieve over the long term with a much more flexible and agile cloud infrastructure were that path that allows them to make that migration. And it's – and they saw that as a huge win.

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Joel P. Fishbein
Analyst, SunTrust Robinson Humphrey, Inc.
Q

Thank you. And, Thomas, just a quick follow up with you. Last quarter I guess you were seeing around a 20% plus attach rate to Workers for new customers. Is that still the case or is that accelerating?

Thomas J. Seifert
Chief Financial Officer, Cloudflare, Inc.
A

It's still about 20%. Matthew, correct me if I'm wrong.

Matthew Prince
Co-Founder, Chair of the Board of Directors & Chief Executive Officer, Cloudflare, Inc.
A

That's right.

Thomas J. Seifert
Chief Financial Officer, Cloudflare, Inc.
A

That is where it has held steady at that number over Q3.

Joel P. Fishbein
Analyst, SunTrust Robinson Humphrey, Inc.
Q

Okay. All right, great. Thank you so much.

Thomas J. Seifert
Chief Financial Officer, Cloudflare, Inc.
A

Most welcome.

Operator: And our last question comes from Shaul Eyal from Oppenheimer. Your line is open. Please go ahead.

Shaul Eyal
Analyst, Oppenheimer & Co., Inc.
Q

Thank you so much. Congrats on the first quarter as a public...

Matthew Prince
Co-Founder, Chair of the Board of Directors & Chief Executive Officer, Cloudflare, Inc.
A

Shaul, I think we lost you there.

Jayson Noland
Head of Investor Relations, Cloudflare, Inc.
A

And Christina, then we might have to go to the next analyst.

Operator: Certainly. We can go to Edward Parker from BTIG. Your line is open, please go ahead.

Edward Parker
Analyst, BTIG LLC
Q

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Hey, guys. Just one question from me. I wanted to ask about your large enterprise business. Obviously the customer count growth is impressive and you're making a lot of good progress in the enterprise. But I guess when you speak to large customers that want to adopt Cloudflare but haven't yet for whatever reason. I guess what are like the top one or two asks they have? And I guess what I'm asking are their capabilities that you think you need to build out in order to capture more mission critical workloads or is it is the products where you think you needed and it's just more a function of maturing your go-to-market organization and evangelizing your message?

Matthew Prince
Co-Founder, Chair of the Board of Directors & Chief Executive Officer, Cloudflare, Inc.

A

Yeah. I think that our strategy has always been to move up market relentlessly over time. And I think some of that is exactly building our go-to-market function and we've started to invest in specific field reps that have relationships with those large customers that we are targeting and a lot of this is just the awareness of Cloudflare, and I think that that's something that we continue to invest in. There are places in our product where customers give us feedback that we – they need one particular feature or another, and I think our product team is very good at prioritizing those requests. We just had our Connect event to a sold out house in New York. We were actually over overcapacity for the entire event. So a number of the people from the Cloudflare team volunteered to actually leave the room for the event to make room for the additional customers and the enthusiasm across that was – it was incredibly high.

And so, I think that there are always things that were going to be continuing to improve, make our products better, increase our awareness. But we're in a really great spot, and I think that's driving what you're seeing in terms of large customer growth. 71% year-over-year is something that I'm really proud of and our team is really proud of, and we're, as Michelle and I like to say, we're just getting started.

Edward Parker
Analyst, BTIG LLC

Q

Right. Thank you.

Operator: There are no further questions at this time. I'll turn the call back over to Matthew Prince for closing remarks.

Matthew Prince
Co-Founder, Chair of the Board of Directors & Chief Executive Officer, Cloudflare, Inc.

I appreciate everyone dialing in. Thank you to the entire Cloudflare team for helping us to continue on a great path and close a terrific quarter, and look forward to hearing from you either at the – some of the events that we're speaking at, the industry events and analyst events over the next few months or next quarter. And thanks for everyone tuning in.

Operator: Ladies and gentlemen, this does conclude the Cloudflare Q3 2019 earnings conference call. Thank you for participating. You may now disconnect.

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