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Cloudflare, Inc. (NET)

Q1 2020 Earnings Call

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CORPORATE PARTICIPANTS

Jayson Noland
Head-Investor Relations, Cloudflare, Inc.

Matthew Prince
Chairman & Chief Executive Officer, Cloudflare, Inc.

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

OTHER PARTICIPANTS

Sterling Auty
Analyst, JPMorgan Securities LLC

Philip Winslow
Analyst, Wells Fargo Securities LLC

Matthew Hedberg
Analyst, RBC Capital Markets LLC

Shaul Eyal
Analyst, Oppenheimer & Co., Inc.

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

Keith Eric Weiss
Analyst, Morgan Stanley & Co. LLC

MANAGEMENT DISCUSSION SECTION

Operator: Ladies and gentlemen, thank you for standing by and welcome to the Cloudflare Q1 2020 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, sir.

Jayson Noland

Head-Investor Relations, Cloudflare, Inc.

Thank you for joining us to discuss Cloudflare's financial results for the first quarter 2020. With me on the call, we have 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 as well as our supplemental financial information may be found on our Investor Relations website. As a reminder, we'll be making forward-looking statements during today's discussion, including, but not limited to, the impact of the COVID-19 pandemic on our and our customers, vendors and partners' operations and future financial performance, anticipated product launches in the time and market potential of those products, the company's anticipated future revenue, financial performance, operating performance, non-GAAP gross margin, non-GAAP net loss from operations, non-GAAP net loss per share, shares outstanding, non-GAAP operating expenses, free cash flow, non-GAAP effective tax rate, dollar-based net retention rate, free and paying customers and large customers.

These statements and other comments are not guarantees of future performance, but rather are subject to risks and uncertainty, some of which are beyond our control, including, but not limited to, the extent and duration of the

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impact of the COVID-19 pandemic and adverse conditions in the general, domestic and global economic markets. Our actual results may differ significantly from those projected or suggested in any forward-looking statements.

These forward 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 this 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 press 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. You may find a reconciliation of GAAP to non-GAAP financial measures in our earnings release on our Investor Relations website. For historical periods, the GAAP to non-GAAP reconciliation can be found in the supplemental financial information referenced a few moments ago.

We would also like to inform you that we will be virtually participating in the JPMorgan Global Tech, Media & Communications Conference on May 12 through the 14 and the Baird Consumer Tech & Services Conference on June 2 through the 4.

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

Matthew Prince

Chairman & Chief Executive Officer, Cloudflare, Inc.

Thank you, Jayson. Let me start by saying what feels almost awkward to say given the circumstances. We had a very strong quarter. Our Q1 revenue finished at $91 million, up 48% year-on-year. We posted a gross margin of 78%, showing the continued efficiency of our platform, and we made substantial progress on our path towards profitability, realizing over 1,000 basis points of operating leverage improvement year-on-year. That's the easy part.

As I said in our first earnings call as a public company, we've been practicing mock earnings calls for years to the point that they already feel like business as usual. However, as I sat down to write up these remarks, I have to confess I struggled because what we're all living through is definitely not business as usual. So, in many ways, this isn't going to be a usual earnings call, settle in, buckle up. I wanted to take a bit more time to walk through four areas I've been focused on: Our team, our platform, our business and our customers. And in particular, I wanted to give you more of a sense of what we're seeing not just in the last quarter but focusing on March and April as the world reacted to COVID-19.

First, our team, we are very fortunate that the first customer of all of Cloudflare's products is Cloudflare ourselves. We are digital natives and we're able to use our products like Cloudflare for Teams to transition to productive and secure remote work. Our network operation center, security operation center and technical support center are all continued to be fully, securely and reliably staffed 24/7.

But it's not just about technology. It's also an inspiring mission that empowers a team. Cloudflare's mission is to help build a better Internet. Had this been a banking or agricultural crisis, we would likely have felt as powerless as many of our friends and colleagues at other companies do right now. But this was a crisis that caused us all worldwide to lean on the Internet more than ever before. Undoubtedly, the superheroes of this crisis are the medical professionals and scientists taking care of the sick and searching for a cure to this disease. But the faithful sidekick, the Ant-Man to Captain Marvel has been the Internet. And as one of the guardians of the

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Internet, I'm proud of how our team has risen to the occasion to support our customers, new and old, as they deal with unprecedented challenges.

I wanted to take this opportunity to thank all our teams. You are working incredibly hard to ensure the Internet continues to function while the world has needed it more than ever before. I'm proud of how well you've all kept up our level of productivity and excellence, and, most importantly, honored to see you support each other as well as our millions of customers as we live through these challenging times together. Companies are really just collections of people, and this crisis has reaffirmed to me we have a great team.

Second, our platform. The growth in Internet traffic has been unprecedented. Across our platform, we saw as much growth in traffic in 12 weeks as we have seen in the previous 12 months. The flexibility of our platform where every server in every city can run every Cloudflare service has allowed us to continue to spread load and serve all our customers. Stress does make systems better, and our engineering team has used this time as a way to make our platform more efficient.

For instance, our firewall team released a series of improvements that save 40% of the processing time of every request. That means we are doing full deep packet inspection and threat analysis in a fraction of a millisecond at our tremendous scale. It also means that our network has actually gotten faster during this crisis while at the same time requiring less hardware. We expect these and many more innovations will pay dividends to us for years to come.

One of the concerns we had early in the crisis was our supply chain. Cloudflare sources the hardware that powers our network through multiple ODM partners. These partners as well as the many component manufacturers that they rely on for parts are largely based in Asia where the virus first hit. Beginning in early January in light of the at-the-time unnamed virus, our infrastructure team thoroughly analyzed our supply chain identifying potential bottlenecks. We moved up some purchases of key components we thought may become constrained. This proved prescient.

Thus far, we've been able to continue to receive the equipment we needed without meaningful delay in order to expand our network during this time of unprecedented demand, and the demand has been unprecedented. We've seen Internet traffic use nearly double through March and April versus the beginning of the year. While global traffic is still increasing, regionally we're seeing network traffic plateau. Different categories of traffic have grown more than others. Demand for educational and kids content, arts and crafts, and parenting content have all more than doubled. On the other hand, traffic to sites about sports scores, travel and real estate has declined. The scalability and flexibility of our unified platform, with its ability to serve our diverse customer base and distribute load globally has served us very well.

Third, our business. I've given you the Q1 highlights, but let me zoom into March and April and give you more granularity in what we're seeing. Beginning in March, we saw a modest uptick in the length of our average sales cycle. That added a few days to our closing deals. However, our average sales cycle still remains well under a quarter and even with the modest uptick is shorter than it was just 12 months ago.

Our sales in March were strong, finishing ahead of our plan. What was surprising to us was how much of March's business closed in the last week of the quarter. Our ability to close new business has continued without a break through April. And to-date, we are tracking well to our plan for new business this quarter. Our read is that much of the world took a bit of a pause for a few weeks in mid-March while companies figured out their remote procurement processes. But, once those were figured out, deals for critical services like those Cloudflare provides our customers got done.

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One more view into what the data are showing. We track our sales pipeline closely. While many things may still impact win rates, we are encouraged that we added more new pipeline in February than in January, more in March than in February, and more in April than in March. I'm proud of our team and while the demand is there, we have no intention of slowing down.

Part of the key to our success comes back to our short sales cycle and our ability to sell services without sending account or professional service teams on premise. Businesses, large and small, have an acute need for a fast, reliable, secure network now more than ever. They come to us every hour of every day and we can have them up and running as quickly as a few hours or minute compared to our competitors' weeks or months. And because of our short sales cycle, we can adapt quickly. As we came to understand that certain industries were going to be particularly impacted by the current crisis, we shifted our sales resources to thriving verticals, so our teams could still make their quarter.

One surprise for the quarter was our pay-as-you-go business. This segment is for customers who sign up with a credit card on month-to-month agreements and without talking to anyone on our sales team. Today, it's a small portion of our revenue but it's our roots where we started over nine years ago, and so it's still very important to us. We were concerned this segment may be more impacted because of its exposure to small businesses and individual developers.

To our surprise, last quarter it had its strongest year-over-year growth in the years and it continued to show strong growth in April. That won't make a big difference to our bottom line because it's a relatively small portion of our overall revenue. But I'm proud we're still there to serve the small businesses, startups, and individual developers who need a service like Cloudflare now more than ever. Businesses of all sizes and shapes are moving online to survive and we are helping them. That's the good news. But it's not all rosy. We are seeing an uptick in requests for concessions. Thomas will give you more details, but I wanted to tell you how we're thinking about those requests.

Based on our analysis of the customer base and the industries that are most impacted, we believe the vast majority of our customers will get through this. Some, however, may need short-term help. We're using the strength of our balance sheet to help these customers in their time of need, build goodwill, and at the same time, working out beneficial terms to deepen our relationship over the long term.

We are fortunate that because of the breadths of our product offering is delivered across our unified platform, we're often able to cost effectively bundle services together and help our customers replace legacy vendors, especially now helping customers save money and simplify their operation leads to a particularly compelling ROI.

Our competition with their narrower set of offerings does not have this luxury. While some hardware vendors may have had a temporary bump this quarter as CIO scramble to make sure they had enough firewall or VPN capacity, we believe that is short lived. Those same CIOs are e-mailing me saying we never want to go through something like this again. There's a cartoon circulating that asks, who led the digital transformation at your company, CEO, CTO or COVID-19?

History may well record this crisis as the last gasp for on-premise network hardware. Similarly, there are a number of cloud providers that only offer limited point solutions. Our platform strategy has positioned us well for this current moment and we are aggressively leveraging it to take market share. We are seeing a number of new prospects engaged in conversation with us to find ways of saving money by leveraging our robust more cost-effective platform.

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To that end, as we said before, we will continue to use our gross margin as a weapon to gain share. As an example of that, in March, we made the call to make Cloudflare for Teams, which we just launched in January, free for any business until September 1. Cloudflare for Teams solve an acute need as companies shifted to a 100% remote work, and their existing firewall and VPN hardware solutions couldn't keep up.

In the last two months, we've on boarded over 1,000 companies onto Cloudflare for Teams. Since we made it free, right now, they're all costs and no revenue. But we're proud of being there for businesses in their time of need. And what we've learned in the last nine years of running Cloudflare is that once you're part of someone's infrastructure, you've inherently built trust and that builds opportunity.

In other words, while we feel very fortunate with our results in the short term, we remain relentlessly focused on the long term; however, make no mistake. There will be headwinds in the short term. We are part of the broader economy and as businesses struggle and go out of business, we will lose some customers. But, long term, we believe we are well positioned to be one of the few networks that will help run a large portion of the Internet.

So, lastly, I wanted to talk about some of our customer wins for the quarter. We had some incredible wins like a credit reporting service that signed a three-year deal worth $800,000 per year, a major gaming platform with a deal worth over $1 million per year, a reinsurance provider who will pay us $750,000 over three years to protect their network, and a US government agency using a broad set of our platforms features to secure nuclear research for over $150,000 per year.

So, let me focus on some customers that are uniquely relevant to this moment. One of the largest telemedicine providers in the United States turn to Cloudflare as the crisis set in. They had to shift the majority of their physicians from clinics where they had legacy on-premise security hardware to their homes where obviously they did not.

As a highly regulated industry, security of patient information is critical. They onboarded their physicians onto Cloudflare for Teams so they could keep serving patients. Here's what their CIO said about the experience, "I wish we had done this years ago after seeing how easy it was. Beautiful. This is perfect". I mean, on so many levels. I love that.

A company many of us are relying on to deliver food to our homes while we shelter-in-place signed a deal for over $600,000 per year in January. In March, their demand was up so much they increased their deal by more than $500,000 per year. One of their goals was to ensure that they could decrease their dependency on Amazon Web Services. They found Cloudflare was not only faster and more robust, but also significantly more cost-effective. And they're using Cloudflare Workers, our edge computing platform to solve a handful of development challenges they couldn't through any other platform.

Beyond the customers who paid us, we're also proud of the customers doing critical work. We could support through our Project Galileo initiative. Last quarter, we helped ensure fast, reliable, secure access for projects like covidnearyou.org, a project created by Harvard epidemiologists and software developers to track COVID-19 hotspots.

maskaherony.com, which facilitated donation of more than 27,000 masks to medical professionals in New York City. samaritans.org which is providing emotional support resources and suicide prevention for the millions of lonely people impacted by this crisis. beatcovid19now.org, developed by a team of Australian public health and IT researchers to track and make sense of COVID-19 symptoms and many, many, many more.

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It is inspiring to our whole team that we're able to lend our technology and expertise to help the true superheroes behind these organizations. Finally, this is a hard time no doubt and there will be headwinds even for a business like ours, but it's also replete with opportunities. My message to our team has been clear. Iconic companies are born out of crisis. They take these opportunities to do two things, focus and invest. So, we are focusing on the products and innovation that lead to the highest returns and we are investing in building trust, hiring the greatest people, and establishing ourselves for the long-term. There are a small number of companies that will power the future of the Internet. We feel very fortunate, very privileged, and very lucky to be one of the Internet's guardians during this crisis and I'm confident that will serve us well as we strive to build an iconic company over the long-term.

With that, I'll hand it off to Thomas. Thomas, take it away.

Thomas J. Seifert

Chief Financial Officer, Cloudflare, Inc.

Thank you, Matthew, and thanks again to everyone for joining us. We continued the momentum from 2019 and delivered a strong first quarter exceeding the high-end of our revenue guidance. We believe this reflects the critical role Cloudflare plays in helping customers transform and digitize their business model.

Today, I plan to review our first quarter results, discuss the impact of COVID-19, provide guidance for the second quarter, and update guidance for the full year 2020.

Turning to our results. Total revenue for the first quarter grew 48% year-over-year to $91.3 million. The growth in revenue was driven by strong customer demand both in terms of new logo acquisition as well as expansion within our existing customer base.

As Matthew mentioned, we saw significant strength with our pay-as-you-go business. Our pay-as-you-go customers are not committed to a contract, but rather are on a month-to-month subscription plan and predominantly composed of small and medium-sized businesses. We believe the strength in this cohort during a global pandemic speaks to the value of Cloudflare's network and the durability of our business model. To provide some additional transparency, our pay-as-you-go customers represent the strong majority of our paying customer base. Our contract customers represent the strong majority of our revenue base.

From a geographic perspective, the US represented 48% of revenue and increased 44% year-over-year. Our international business represented 52% of revenue and increased 52% year-over-year. International growth was driven primarily by Europe which increased 58% year-over-year. We started making incremental field sales investments in Europe last year behind the traction in our pay-as-you-go business. We are pleased to see those investments start to take hold specifically in France, Germany and the UK.

As a reminder, beginning this quarter, we shifted to revenue-based KPIs and away from billings as the basis for our KPIs. We believe this move to revenue-based KPIs better aligns with our peer group, our publicly disclosed financials and our business model as we continue to scale. We provided eight quarters of revenue-based historicals for comparison purposes, which can be referenced in this quarter's supplemental financial information document on our Investor Relation website.

We added approximately 250,000 total customers during the quarter to exit the quarter at roughly 2.8 million total free and paying customers, representing an increase of 40% year-over-year. We also added over 5,000 paying customers in the first quarter, bringing the total number of paying customers to over 89,000.

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We remain focused on expansion within existing customers and growing our large enterprise customer base and ended the quarter with 556 paying customers, with greater than $100,000 in annualized revenue, which is up 65% year-over-year.

Our first quarter dollar-based net retention rate was 117%, which decreased 2% sequentially and 1% year-over-year. The slight decline was largely driven by higher churn in the Asia Pacific region. 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.

First quarter gross margin was 78.3%, down 40 basis points sequentially and up 150 basis points year-over-year. Network efficiency continues to be a defining strength of our business model, allowing us to absorb significantly higher rates of traffic and offer a critical solution like Cloudflare for Teams to new customers at no charge through September 1.

As we said previously, we'll use our gross margin advantage as a strategic weapon when opportunities present themselves. During this crisis, we are focused on doing the right thing for our customers today and for our business in the long-term. Therefore, in second quarter we expect to see gross margin closer to our long-term target of 75% to 77%.

Turning to operating expenses. We remain focused on improving the leverage in our business while balancing investments for growth. Total operating expenses were $85.9 million for the first quarter, up 2% sequentially and 35% year-over-year. While we increased our head count by 43% year-over-year, bringing our total number of employees to 1,368 at the end of the quarter, we saw a delay in hiring and onboarding which we expect to catch-up in the current quarter.

First quarter operating expenses as a percentage of revenue decreased 6% sequentially and 9% year-over-year to 94%. Sales and marketing expenses were $43.4 million for the quarter, representing a decrease of 1% sequentially and an increase of 42% year-over-year. The sequential decrease was largely due to a swift reduction in travel, discretionary and marketing spend in response to the COVID-19 pandemic. Sales and marketing expenses as a percentage of revenue decreased to 48% from 49% in the first quarter last year and from 52% last quarter.

Research and development expenses were $20.5 million in the quarter, representing a decrease of 7% sequentially and an increase of 19% year-over-year. R&D as a percentage of revenue decreased to 22% from 28% in Q1 last year and from 26% last quarter.

General and administrative expenses were $22 million for the quarter, representing an increase of 18% sequentially and 40% year-over-year. The sequential and year-over-year increase was primarily driven by increased head count and an increase in bad debt expense, primarily due to COVID-19 impact of $1.2 million. G&A as a percentage of revenue was 24%, representing an increase of 2% sequentially and a decrease of 1% year-over-year.

We continue to see operating leverage in the business as operating margin improved over 1,000 basis points year-over-year and 600 basis points sequentially. Operating loss was $14.4 million in the first quarter compared to $16.1 million in the same period last year. Net loss in the quarter was $12.3 million or net loss per share of $0.04.

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Our effective tax rate for Q1 was negative 8%. We ended the first quarter with $588 million in cash, cash equivalents and available-for-sale securities.

Q1 free cash flow was negative $30.6 million or 34% of revenue compared to a negative $22.1 million or 36% of revenue in the same period last year. As we've mentioned previously, we expect to see continued variability in cash flow margins due to ongoing fluctuations in working capital and the growth in our enterprise business.

Before moving to guidance for the second quarter and the full year, I would like to begin with our expectations for COVID-19 related impacts and the associated provisions we factored into guidance. We performed rigorous analysis to understand both the risks and opportunities in the current environment. We've factored into our outlook the challenges our customers have been facing, our views of current and prior trends and the customer behavior we have seen in our existing customers and pipeline.

We saw a notable bifurcation across our customer base emerge during the quarter with significant acceleration among certain customers, for example, sales cycles that would have taken a quarter or two being compressed into days given an urgent need, as well as some pullback from other customers who are highly affected by COVID-related challenges, particularly, those in macro-sensitive industries such as transportation, hospitality, and retail. However, only approximately 8% of our business is associated with the highly-affected transportation, hospitality, and retail industries.

During the quarter, we observed an increase in our sales cycle which was extended by five days and expect similar sales dynamics to continue and potentially worsen leading to longer lead-time deal closures. We also began to see an uptick in customer contract modification requests, which peaked in March at 133 customer requests with a notable slowdown in April.

Despite the recent slowdown, our guidance assumes these requests will continue and reflects a headwind of roughly $2 million in the second quarter. We are committed to helping our customers through those (sic) [these] challenging times and providing them with increased payment flexibility, often in exchange for extended contract duration. We're fortunate that our strong margin profile and balance sheet enables us to provide support to our customers in need, which we also believe will benefit our shareholders and community over the long-term.

Despite these headwinds, we remain uniquely positioned as a mission-critical, security and Internet performance partner for our customers. We have a large and diverse customer base, landing customers of all sizes across every industry and all geographies with no customer contributing more than 5% of revenue.

In first quarter, we met or exceeded our new customer ACV and customer renewal targets and our DSOs trended flat to down through the quarter. We also think it's important to point out that April has trended as planned from a net new ACV and renewals perspective. Since March, we've seen organic inbound leads double and our customer pipeline has reached its highest levels on a weekly basis.

Turning to our guidance for the second quarter, we expect revenue in the range of $93.5 million to $94.5 million, representing an increase of 39% to 40% year-over-year. We expect operating loss in the range of $20 million to $19 million. The sequential increase is primarily due to anticipated hiring and onboarding catch-up from Q1 and COVID-related provisions. We expect net loss per share in the range of $0.06 to $0.05 assuming approximately 299 million common shares outstanding, and we expect an effective tax rate of negative 1.7%.

In light of the rigorous analysis performed, we are pleased to reaffirm our 2020 guidance for revenue, operating loss and net loss per share despite the uncertainty in the global environment. As such, for the full year 2020, we

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expect revenue in the range of $389 million to $393 million, representing an increase of 36% to 37% year-over-year.

As a reminder, we have a predictable subscription business with strong visibility into near-term revenue. We expect operating loss in the range of $65 million to $61 million. We expect net loss per share in the range of $0.21 to $0.19, assuming approximately 301 million common shares outstanding. And we expect an effective tax rate of negative 4%.

In weighing both the headwinds and tailwinds of the current environment, we continue to remain optimistic about the demand for our offerings and our long-term opportunity. While the full impact of the macro economy from COVID-19 is still unfolding, we continue to closely monitor the business environment and we believe our guidance is appropriately prudent.

In closing, as we navigate through these uncertain times, we feel very privileged to be a mission-critical pillar of our customers' operations and fortunate to be there for them when they need us most. We'd like to thank the Cloudflare employees for their continued dedication and resiliency in delivering exceptional service to our customers, partners, and communities.

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

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] Your first question comes from the line of Sterling Auty from JPMorgan. Your line is open.

Sterling Auty
Analyst, JPMorgan Securities LLC

Q

Yeah. Thanks. Hi, guys. Listen, I know there's a ton of things that you had to get through, but one item that wasn't mentioned was you signed another noticeable partnership agreement in China during the quarter. Just wonder if you can give us some sense of what that can mean to your growth in the region moving forward?

Matthew Prince
Chairman & Chief Executive Officer, Cloudflare, Inc.

A

Yeah. Thanks, Sterling, for the question. We have been operating in China now for five years in partnership with Baidu. And I think what I've learned in China is that, the Chinese tech community even though it's a very big country is a very tight-knit part of – very tight-knit community. And I think that what we really did over the last five years is prove ourselves as a good partner. And so, beginning at the end of 2019, we were approached by a number of different Chinese Internet companies. We wanted to diversify the number of partners that we had in China. And we were in the fortunate position to be able to choose who we thought would be a great partner going forward. And JD Cloud really fit that bill incredibly well. And so, we signed an agreement with them. It's going to take us a little bit of time for us to get that online, but I'm incredibly excited about it. We're adding 50 new cities per year to a total of 150 PoPs across China that will augment the existing network that we have with Baidu.

And I think that there's a real opportunity here for us to extend what we think is very unique about Cloudflare, which is we are one global network that spans the entire world and allow our global customers to manage their traffic both inside and outside of Cloudflare through a single-user interface. So, while I'm excited about this, I think

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it decreases the – some of the risk that we had on China in terms of being dependent on one provider there. And I think there's a substantial amount of opportunity that this provides as the world recovers from what we're going through right now.

Sterling Auty
Analyst, JPMorgan Securities LLC

Q

Makes a lot of sense. And then, Thomas, one follow-up for you. Thank you for the information on the exposed industries like travel. You made the comments on the pay-as-you-go program. But a question I get a lot from investors is, how should we think about your business as you stratify it between exposure to SMB versus mid-market versus enterprise? How would you kind of characterize the business that way?

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

A

I think we pointed out early that we really manage our go-to-market across the broadness of the funnel we have. So there's not really a focus that shifts from small to medium to big. It's really important for the efficiency of our business model and I think this current crisis shows how important that is to manage the across this broadness of the funnel.

We were surprised how resilient our pay-as-you-go business is and as Matthew mentioned in his part of the script, it was the strongest part as – it had the highest growth for years in the segment and shows you how important it is for us to deliver those services to small and medium sized companies and also developers.

So, it's really important that we continue to convey the message of managing across the broadness of this funnel. That is what keeps our cost of customer acquisition low. This keeps our go-to-market model efficient. And you heard it in my script, we saw significant strength in Europe in their first quarter following the investment with incremental field sales investments we made at the end of last year and that was based on the strength of our local pay-as-you-go business. So, it continues to provide us the data we need in order to invest behind the demand.

Sterling Auty
Analyst, JPMorgan Securities LLC

Q

Understood. Thank you so much.

Operator: Your next question comes from the line of Phil Winslow from Wells Fargo. Your line is open.

Philip Winslow
Analyst, Wells Fargo Securities LLC

Q

Hey, guys. Thanks, guys for taking my question. Glad to hear that you all are well and hope the same is true for your family and your broader team. Matthew, obviously, you commented on just the sheer amount of volume that's going across the Internet and your network as well and whether it be video work from home, et cetera. Wondering if you can talk about just – you have this huge menu of solutions. [ph] Has there been (00:38:04) any of that standout you're seeing incremental interest whether it be your load balancing, Argo, obviously, you mentioned Teams? Is there anything you'd highlight there based on sort of the environment that we're seeing right now?

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Matthew Prince
Chairman & Chief Executive Officer, Cloudflare, Inc.

A

I mean, I think the thing that has been the real standout for this time has been Cloudflare for Teams. We couldn't have, in some ways, gotten more fortunate to have announced that in January. That was a product that it was new for us, it's something that there wasn't a lot of awareness in the market for. As a result, it made it actually a very easy decision for us to say as we were seeing businesses struggle, for us to say, let's make that product free through September 1.

And the response was really overwhelming. We signed up over 1,000 businesses to be using Cloudflare for Teams. And what was really inspiring for me is that our – we wanted to make sure that our main sales team was focused on closing the quarter and onboarding customers on to products that would generate revenue. And we saw strong demand across our entire product base. And so, we had people on Thomas' finance team, on our customer support team, on our engineering team, on our product team, all raising their hands around the world saying, we'll volunteer to do 30-minute onboarding sessions with over 1,000 businesses.

And so, I think that has raised the awareness of that product very substantially. And I think that will pay us dividends for a long time to come. I think in terms of the product that generated revenue, if you think about what Cloudflare is fundamentally, we're what the future of a network should look like and that network should be resilient. It should be secure. It should be reliable. And so, what we saw was that as more and more of the world shifted to relying on the Internet in order to keep their businesses online, in order to continue do their work, a modern network is what they needed.

And so, that meant that load balancing, firewall, security, all of the different functions came together. And I think that, what this crisis really illustrated was, it really isn't about one product or another. Customers are looking for a suite where they can sort of say, hey, I don't have expertise here. I want you guys to have this. And that's why they're turning to Cloudflare and I think our platform strategy really has shown over Q1.

Philip Winslow
Analyst, Wells Fargo Securities LLC

Q

Great. Thanks, guys.

Operator: Your next question comes from the line of Heather Bellini from Goldman Sachs. Your line is open.

Q

Hi. This is [ph] Caroline (00:41:22) on for Heather. Thank you, again, for taking my question. I hope you and your families are doing well. I wanted to dive a little bit deeper into the net expansion rate. Just given your diversified customer base, I'm curious, how have the retention rates been trending within your – the small mid-size as well as enterprise customer base? And then, specifically the weakness in Asia Pac, was that driven by the SMB customers or was there some changes in churn within the larger enterprise customers?

Matthew Prince
Chairman & Chief Executive Officer, Cloudflare, Inc.

A

Yeah. Thanks for the question. So, starting with SMB customers globally, I think that, looking at our pay-as-you-go business, that is a rough approximate for our SMB customers. And, I think the thing that we were I think, pleasantly surprised by was that, globally, that segment actually had its strongest growth that we've seen in any

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period of time. When we had seen customers in that segment, who have gone from paying customers and churn, what we're not seeing is them switching to another solution.

We're seeing some instances where companies are going out of business. But, again, this is a very small portion of our overall business. Even the pay-as-you-go segment is a relatively small portion. But what we're more seeing is that they might just need some relief on their bill. And so, the number one thing that competes for our sort of pay-as-you-go subscription business is the free version of Cloudflare's product. And so, we're not losing them on our platform, but we're seeing them what they are struggling downgrading.

That said, the expansion in the pay-as-you-go business both through new customers as well as our existing customers upgrading to become a paying customers is the strongest that we've seen in Q1 as we've seen in several years in the past. And I think that was a very pleasant surprise. And I think what that speaks to is, even small businesses are looking for ways to continue to operate and that means more and more of them are turning to the Internet. And that has actually been a tailwind for us.

In terms of Asia, I think that we had just some churn from some customers that again were impacted by various factors of what was going on in Asia. Again, though, I think there's nothing systemic to that. And in those cases, I think that we see that as a region that we're excited about going forward. So, it definitely was not an exposure to the SMB market which was – which is what drove the weakness in Asia.

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

A

Yeah. Let me give you some additional...

Q

That's a very helpful color. Yeah.

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

A

Let me give you some additional color, because I think it's very important that the first time we show a revenue-based DNR number. The 117%, that is what you would expect from good performance in our peer group. But like them, you will see a lot – a higher level of volatility in this measurement because larger customers don't expand their business in a perfectly linear manner. And so, that's why you will see some volatility there. This quarter, if you heard from Matthew from a revenue perspective, not so much from a billing and ACV perspective, but also a bit more backend loaded as everybody paused towards the end of March and had to figure out our new procurement processes would look like. That is certainly a reflection in there. And the churn in Asia is not really a regional topic. It's much more a vertical topic where we saw a couple of customers churn off that had a higher exposure to the verticals that are highly impacted.

Q

Got it. That's a very helpful color. And I guess my follow-up really is, Matthew, how do you see the competitive landscape evolving post the crisis? I mean, are you currently seeing more conversations about replacements of the legacy on-premise vendors?

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Matthew Prince
Chairman & Chief Executive Officer, Cloudflare, Inc.

A

For sure we're bearing that. There were CIOs that we've been talking to for a long time. And they're sort of like, yeah, I don't know about the cloud and sort of still figuring out what my strategy is going to be. I think that the current crisis has just accelerated everyone's move toward the cloud. We're seeing more and more people turning that direction. And again, I think that we're already starting to have that as a tailwind for us.

And I think that will continue for quite some time to go. There are a lot of Cisco boxes out there that need to be replaced. And I think that we've got a very full product suite to be able to do that. What we are not seeing is a lot of, again, competition that's pulling away our businesses. We see a very strong growth both with our existing customers and our ability to land new customers.

And again, I think where we're trying to be very prudent in terms of understanding the risk is that, I don't think any of us know actually how long this is going to go on, how much it's going to impact the overall business climate. But I think inevitably as we come out, the world is going to look different and it's going to be a world where more and more customers are excited to use a solution like Cloudflare.

Q

Great. Thank you again.

Operator: Your next question comes from the line of Matt Hedberg from RBC Capital Markets. Your line is open.

Matthew Hedberg
Analyst, RBC Capital Markets LLC

Q

Oh, great, guys. Thanks for taking my questions. Matthew, you obviously have a lot of products that can aid work-from-home trends and you've talked about them tonight. Just wondering from a high level, can you talk more broadly about your exposure to this particular use case and how you expect to continue to invest and also benefit from this long-term trend that obviously is changing the way, I think all of us think about work?

Matthew Prince
Chairman & Chief Executive Officer, Cloudflare, Inc.

A

Well, I think if – first of all, this is a terrible crisis and there are – we all have friends who have been impacted and are not able to work right now because their jobs do require them to go in, restaurant workers and nail salons and hair – people who cut hair. But I think that – what I think we're, as a society overall fortunate about is that this didn't happen 10 years ago. And over the course of the last 10 years, we at Cloudflare and lots of other companies have built out cloud solutions that can continue to allow people to work. And I've been – we – Cloudflare has traditionally been very much a work-from-office culture ourselves. And I was nervous when we switched almost overnight to globally being a work-from-home culture.

And what I've seen is incredibly encouraging that our productivity is incredibly high. We're getting work done. We're closing deal. And it feels like we've not missed the beat. And I think that that's an illustration of what the business of the future looks like, which is how can we think about what are the best aspects of remote work and what are the best aspects of working from offices. And I think a lot of the reason why we were able to do what we did was that we had the IT system in place to be able to support that and a lot of those were products that we built for ourselves.

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And so, I think having a reliable network, which is fundamentally what it is that Cloudflare provides, one that is performance, one that doesn't fail, one that is secure no matter why, that is a foundational aspect of any work-from-home strategy. And then – and so that is our business.

And then, on top of that, the fact that we've got Cloudflare for Teams, which today is not responsible for a lot of revenue, but going ahead, there a lot of interest based on what it is. I think that a solution like that is going to be a part of every company going forward when they make sure that they have the flexibility if ever in the future 100% of their workforce has to work from home because of another outbreak or more likely, because, going forward, I think that we're all going to realize that the future of work is going to be a mix of office and home.

And I think we've got a big opportunity to play a role in that not just by providing that foundational, secure, reliable performance network but then to provide additional solutions on top of that, that can make working from home fast, secure, and productive.

Matthew Hedberg
Analyst, RBC Capital Markets LLC

Q

That's great. And then maybe as a follow-up, obviously, you have a unique perspective on China that's expanding now. I'm curious if you can talk about what you're seeing there when people go back to work. How trends of China opening up might potentially impact and think about how the rest of the world is going to react to opening up?

Matthew Prince
Chairman & Chief Executive Officer, Cloudflare, Inc.

A

We have an office in Beijing and so we were very acutely aware of this crisis. I think maybe earlier than some other companies that might not have exposure to that region. Our team outside of China was quick to support our team inside of China. We shifted to an entirely remote work posture there. And then what's been interesting is I think it has – while they led the way in sheltering in place and adjusting in that way, they're now also leading the way in transitioning back out.

And so we have reopened our office in Beijing. We have designated that team in terms of a yellow team and a red team which split it up, so that we don't have everyone in the office every day. We're practicing what are appropriate measures. And we're watching as the Chinese economy and not just our team but teams around the country are coming back online.

And I think that that's part of – China is an enormous market and whatever the current concerns are around the virus or the current concerns around trade tension, over the long term, I think there's almost no way that we don't find ways to reengage with that country. And what I am proud of is that we are the one network that global companies that want to be able to operate inside of China and outside of China, whether they are Chinese based or they are based in the United States or anywhere else, we help facilitate that movement a bit.

And then I think especially with the deal that we did with JD, they are really the on-the-grounds' logistics experts and I think that that creates an incredible opportunity for companies that are outside of China to work with us to be able to market through the Cloudflare network and then work with JD as a partner to actually get their goods in the hands of Chinese customers. And I think that you've got to invest in things like network infrastructure well ahead of when this comes back, but all of the signals that we're seeing are that, that this is going to come back and is obviously going to be a real source of economic growth for the world going forward.

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Matthew Hedberg
Analyst, RBC Capital Markets LLC

Q

Thank you.

Operator: Your next question comes from the line of Shaul Eyal from Oppenheimer. Your line is open.

Shaul Eyal
Analyst, Oppenheimer & Co., Inc.

Q

Thank you. Good afternoon, guys. Congrats on the quarterly results. Matthew or Thomas, I know that typically you do not provide the RPO metric especially on the call but any color from a quantitative, maybe even from a qualitative perspective. That will be highly appreciated. Then I have a follow-up.

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

A

Yeah. Normally, we don't talk about RPO but I think given the economic backdrop, it's relative to ask for some more transparency. RPO for us is well over 50% for the remaining fiscal year 2020 guidance, so backlog and deferred revenue. You have to keep in mind that this is primarily our contract business, so the second large contributor then would be the renewal base in our contract business and especially in our pay-as-you-go business which you heard from Matthew was specifically exceptionally strong in the first quarter. So, if you add those two together, you're probably already at 70% or slightly above. And then new ACV is literally the smallest contributor, and that's why we confidently can say based on 100% subscription business that the visibility we have into our, especially near-term revenue, is pretty solid.

Shaul Eyal
Analyst, Oppenheimer & Co., Inc.

Q

Understood. Thank you for that color. And also, when we think about those new 1,000 team businesses that joined during the quarter, if we conflate this number into subscribers, what could that be like? Is that 1 million, 2 million, 3 million? Whatever color you can share with us will be greatly appreciated. And also, if I can kind of stick another one. What would you think the renewal rate as we start thinking about 2021 of those 1,000 team businesses once they convert? What this renewal rate might look like down the road? Thank you for that.

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

A

So, Shaul...

Shaul Eyal
Analyst, Oppenheimer & Co., Inc.

Q

Go ahead. Go ahead, Thomas.

[indiscernible] (00:57:29)

Matthew Prince
Chairman & Chief Executive Officer, Cloudflare, Inc.

A

Okay. We're coordinating in our independent sheltering in place. So, we're still mastering it. Yeah. What I'll say is we're not – we don't know what that 1,000 businesses is going to turn into exactly. I am optimistic. As I said in my

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remarks that once you're part of somebody's infrastructure, that builds a relationship and builds trust, and that will build business for us. But I think we're trying to be very conservative because we don't know exactly what that will turn into. And so, I think that we're not forecasting revenue based on that right now. And I think we will know a lot more when we get to September.

Shaul Eyal
Analyst, Oppenheimer & Co., Inc.

Q

Thanks.

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

A

Yeah. Let me just underline that we've been very conservative in our assumptions, how much revenue we will derive from this business for the remainder of the year. But in general, our gross-dollar retention is in the 90s across all paying customers.

Shaul Eyal
Analyst, Oppenheimer & Co., Inc.

Q

Thank you for that, Thomas. Matthew, good luck.

Matthew Prince
Chairman & Chief Executive Officer, Cloudflare, Inc.

A

Thank you.

Operator: Your next question comes from the line of Joel Fishbein from SunTrust. Your line is open.

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

Q

Thank you and great execution this quarter. Matthew, I'm sorry you had – I had one for you on the – Thomas, I mean on the – you gave us a lot of very good metrics on your guidance. I wanted to ask you what kind of testing did you do to look at what – how the downside risk was? Obviously, you have most of your businesses subscription and you talked about the strong pipeline but I'd love to hear that, and I have one quick follow-up for you as well.

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

A

Yeah. Let me like start at here. I think we really – we did not want to just assume that an automatic recovery would happen in the second quarter. So, we really wanted to especially test the downside risk and then we – and the impact – the uncertainty around COVID-19 might have. So, we built probabilistic models and we used Monte Carlo simulation to understand especially our exposure to verticals and industries that suffered in the 2000 and then in 2008 crisis. So, we modeled against those default rates. We looked at customer size. We looked at conversion rates. So – and run, I don't know, millions of [indiscernible] (01:00:20) around it really to – and understand, to test the downside, not wanting to assume just an automatic recovery in the second half.

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

Q

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Okay. And I guess as a follow-up, I guess the antithesis of that is it will track ahead of plan. And so, the – and it sounds like the trends are that things likely tracking a little bit better than that as far as I can, as I guess what the message that we're supposed to have now.

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

I think there is a lot of uncertainty in front of us. We wanted to be appropriately prudent in how we think about the remainder of the year. We have more visibility in the near term and I think that is reflected in the guidance for the second quarter, and there's more uncertainty in the second half. And then there, especially there we wanted to understand the downside and I think that this is prudent in a situation like this. And, yeah, this is prudent guidance for the remainder of the year.

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

All right. And then last one for me is a real quick one. On the DSOs, they were flat actually which is good. So, you're – customers are actually paying. I'm assuming that you're going to expect DSOs to track up as we move forward on extended payment terms.

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

We have been conservative in our modeling. We have not seen any uptick in April either.

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

Okay. Thank you. That was great.

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

Operator, can we take one more question please?

Operator: Well, certainly. Your final question comes from the line of Keith Weiss from Morgan Stanley. Your line is open.

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

Excellent. Thank you guys for squeezing me in. Matthew, one for you and one for Thomas. The opportunity that you're describing around really catalyzing the shift towards security into cloud-based environment. How do you weigh the fact that a lot of people just had to double down on their common vendors just because it was a crisis mode they had to pull forward firewall spending with that incumbency versus the ability to get these guys to move on a going forward basis?

Matthew Prince
Chairman & Chief Executive Officer, Cloudflare, Inc.
A

I think it's worth probing that. I will say that I have been spending a lot of my time talking to CIOs of very large Fortune 50 institutions, and that hasn't been what our concern that any of them have brought up. I think that they have made decisions to band-aid their way through the current crisis. But I think that it's become very clear,

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having lived through it that again what I hear over and over again is I never want to live through something like this again.

And so, the inbound interest that we're getting for our solution especially from large customers is substantial. And while I think that that is a – that's worth continuing to test and continuing to refine, it has not been a concern which has been brought up on a single call that we've talked to.

My hunch is that in every board room, you're hearing people who really witnessed the pain and the loss of productivity that relying on on-premise hardware imposed on them. And they're saying we need a different architecture. And right now, I think they're going to tolerate being able to switch over. I think we have the additional benefit that because we're a subscription business, it doesn't have nearly the cash outlay that you have to have for trying to double down on hardware.

Keith Eric Weiss

Analyst, Morgan Stanley & Co. LLC

Q

Got it. Got it. That makes a lot of sense. And Thomas for you, one of the numbers, pretty much across the board, numbers came in ahead of guidance and ahead of expectations. One number that came in a little bit below expectations was free cash flow. You talked about some accelerated hardware purchases. There's also a lot of load on the overall network. Any one-time items or anything in particular weighing on free cash flow in Q1 that we should keep in mind when we're modeling the rest of the year?

Thomas J. Seifert

Chief Financial Officer, Cloudflare, Inc.

A

No. I think we are going to stay over the year with the guidance we gave. This is really trying to manage through the crisis. We also were able to save some costs by paying certain things earlier. So, over the year there, I think the guidance is good, and as Matthew said, we did – the infrastructure team did an extraordinary good job making sure that early in the year in January already making sure our supply chain is protected. And that weighted heavily on our cash flow in the first quarter. But that should balance out for the remainder of the year. We are well on track.

Keith Eric Weiss

Analyst, Morgan Stanley & Co. LLC

Q

Excellent. Thank you very much, guys.

Operator: That concludes question and answers. I turn it back to the presenters for final comments.

Matthew Prince

Chairman & Chief Executive Officer, Cloudflare, Inc.

Thank you, everyone, for tuning in. We – I want to just to say again how proud I am of the entire Cloudflare team. We're working under extraordinary conditions and I'm proud of the fact that you're all helping make the Internet function. Thanks to all of the analysts who tuned in and to all of our shareholders. I hope everyone is safe and healthy and washing your hands often. And we'll talk to you again next quarter.

Operator: That concludes today's conference call. You may now disconnect.

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