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Cloudflare, Inc. (NET)

Q3 2020 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Ladies and gentlemen, thank you for standing by and welcome to the Cloudflare Q3 2020 Earnings Call. At this time, all participants are in a listen-only mode. After the speakers' presentation, there will be a question-and-answer session. [Operator Instructions] Please be advised that today's conference is being recorded. [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-Investor Relations, Cloudflare, Inc.

Thank you for joining us to discuss Cloudflare's financial results for the third 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 in 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 and the time and market potential of those products; the company's anticipated future revenue, financial performance, operating performance, non-GAAP gross margin,

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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 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-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 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, a 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'll be virtually participating in the RBC TIMT Conference on November 18, the Wells Fargo TMT Summit on December 1, the Credit Suisse Annual Technology Conference on December 3, the Morgan Stanley Future of Application Development Conference on December 9 and the Jefferies CyberSecurity Conference on December 10.

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

Matthew Prince

Chairman & Chief Executive Officer, Cloudflare, Inc.

Thank you, Jayson. We had an exceptional quarter. In Q3, we crossed a number of significant milestones. First, we blew through $100 million in quarterly revenue, achieving $114 million, up 54% year-over-year. We crossed 100,000 paying customers, ending the quarter with just shy of 101,000. For large customers, in the quarter, we added nearly 100, 99 precisely, and now have 736 spending more than $100,000 per year with us. These large customers accounted for 47% of our total revenue in Q3, and we anticipate they will make up more than half of our revenue going forward.

One goal we had at the beginning of 2020 was to win our first $10 million customer on an annual run rate basis. We're proud that we achieved that this quarter. That customer, a Fortune 500 software company, started with us in 2016, because one of their engineering leaders had used the free version of our service on his personal site. He loved the experience and brought us to work, initially signing a $60,000 per year contract. It's grown quite a bit since then. Today, this customer has tightly integrated our network and customized our products deep into their stack. It's been a terrific partnership and we expect we will continue to grow alongside them.

We've had great success with our go-to-market efforts and especially signing large enterprise customers. About half of our new revenue in the quarter came from new logos and about half from expanding relationship with our existing customers. Even as we continue to sign a record number of large enterprise customers, we remain very happy with the diversity of our customer mix. None of our customers account for more than 5% of revenue and our top 20 customers remain well under 20% of total revenue.

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While we're incredibly proud of our financial results and the strength of our business, I wanted to talk about something else we're also really proud of. Our team watched the United States election this week carefully, as I'm sure many of you did as well. While there is still some uncertainty around the ultimate outcome and there have been and will be stories around who voted and how those votes were counted, one story we worried about a lot going into the election that didn't materialize was the impact of cyberattacks. We played some role in that.

In 2016, that wasn't the case. Four years ago, at Cloudflare, we watched with deep concern as attackers were able to use various techniques to subvert parts of the election infrastructure and undermine confidence in its results. We decided shortly after it was our duty to provide our technology and expertise to ensure cyberattacks don't disrupt fair election. We launched the Athenian Project, which provides our enterprise-class service for free to any state or local government elections officials.

We also partnered with a non-partisan civil society organization defending digital campaigns to work with the Federal Election Commission, so we could provide our services at no cost to national campaigns without violating campaign contribution laws. This year, more than half of US states participated in the Athenian Project. That includes so-called red, blue and purple states. More than half of the battleground states used Cloudflare in order to protect services like voter registration, poll location, precinct reporting and official results.

We worked both presidential campaigns and many of the federal candidates for Congress. We were able to fend off cyberattacks and found no instances in which they impacted the ability of citizens to learn about candidates or to vote. That's a big step-up from 2016. While democracy can be messy, inherently it depends on a process you can trust. We're proud of the small role we played in defending the democratic process.

Switching to the other topic that continues to be top-of-mind for all of us, November will be the 9th month most of the world has been impacted by COVID-19. While it's not in our nature to take victory laps, I wanted to pause to recognize our team and their ability to execute during these difficult times. Early in 2020, we began to see challenges sourcing equipment for our network as the virus hit our Asia-based suppliers. Then, in late March, traffic across our network spiked as the world shifted to working from home. In two weeks, we saw more than 50% growth in traffic, more than we had forecast for 12 months.

At the same time, our team had to adjust to working remotely. Product managers and engineers had to figure out how to develop innovative new products without gathering around a physical whiteboard. Our go-to-market teams had to adjust to selling to customers without ever meeting them in person, and we had to learn how to continue to hire and onboard great new members of our team without them ever stepping into an office. It would have been easy for a misstep in any of these areas to cause our business to stall, but our team has executed and our business has thrived.

We've been able to continue to build out our network to meet the unprecedented demand for our services while staying within our CapEx budget. Even though we charge almost exclusively on a fixed subscription basis, we were able to meet our gross margin target, hitting 77% in Q3 without surprising our customers with burgeoning bills. And we've exceeded our ambitious revenue goals, actually accelerating growth while continuing to sign up larger and larger enterprise customers.

We were prudent at the beginning of the pandemic, reserving for potential customer allowances and bad debt, and we've worked with a subset of our customers who have struggled during the pandemic to ensure they always had a reliable network they can afford, knowing that being accommodating today would buy us loyalty over the long-term. We've been fortunate that when our customers sort vendors, we've been sorted into the bucket of

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differentiated must-have services. As a result, we've not seen pricing pressure and we had zero concessions and less bad debt than we'd forecast.

We've also been able to hire great people. In Q2, we've received more than 40,000 applications and extended offers to a mere 0.6%. In Q3, we had over 60,000 and extended offers to only 0.4%. An investor last quarter asked why that was an important statistic for us to mention. Companies are just collections of people, and we believe whatever company is able to attract and retain the best people will win. That we can organically attract so many great candidates means we can save money by not having to hire third-party recruiters.

We can source candidates from less expensive geographies in order to achieve operational leverage while still adding head count to realize our ambitious plans and we're more likely to have a diverse team with different outlooks who will come up with solutions to problems that no one had dreamed of before. While COVID has created challenges for our team, it has also made our mission of helping build a better Internet resonate with team members and customers more than ever before.

The world has never needed a better Internet more than it has over the last nine months, and our team wakes up excited every day to deliver exactly that for our customers. In the last four months, we've been on a tear releasing a ton of incredible new products. We announced more than one product per day around Cloudflare Workers, our serverless computing platform, during the week of July 26. We celebrated our birthday during the week of September 27 with a series of products that are less about directly generating revenue and more about doing the right thing for the Internet.

And more recently, we fleshed out our vision for Cloudflare for Teams with a new architecture called Cloudflare One over the week of October 11, which we dubbed Zero Trust Week. Each week leverage one of our superpowers, engineering and marketing, and they result in significant spikes in organic inbound interest from potential customers. In fact, during Zero Trust Week, organic inbound leads more than doubled off their already elevated level. Stay tuned. We have one more Cloudflare Week before the end of the year focused on privacy and compliance.

I wanted to drill into two products I know there's a lot of interest in, Cloudflare for Teams and Workers. First, Teams. We launched Cloudflare for Teams in January and it happened to be in exactly the right place at exactly the right time as the world shifted to remote work and needed a scalable cloud-based VPN and firewall replacement. Seeing how many businesses were struggling with the shift to remote work, we made the call to make Teams free through September 1. We had thousands of companies, ranging from small businesses to Fortune 500 corporations take us up on our offer.

Over the course of Q3, we began conversations with all of them to transition from the free offer to becoming paying customers. We are happy with how that went. 75% of customers transitioned from free to paid accounts that included some great new logos like JetBlue Travel Products, OneTrust and Delivery Hero. For some customers who are still particularly hard hit by COVID, we've allowed them to continue with the free offering until they can get their feet back under them. Teams is a very high margin product for us. So, this doesn't cost us much.

And as I said before, we've always found that doing the right thing by our customers pays back in spades over the long-term. Because the converted accounts transition came late in the quarter and because Teams' seat-based pricing tends to be even more land small and then expand than some of our other products, these new converted customers did not result in material additional revenue in Q3. However, the other benefit for running this program is how much it accelerated our learning curve.

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We had positioned Teams as nearly all our competitors have with an access management product we called Cloudflare Access and an Internet gateway product we called Cloudflare Gateway. What we learned since March is that customers wanted a more holistic solution. If you adopt a zero trust networking model, you need an access and gateway component, but you inherently then are exposing more of your infrastructure to the Internet. So, you often need products like our web application firewall and DDoS mitigation.

We also learned that by leveraging products like Argo Smart Routing and Magic Transit, we can provide a much higher quality of service unmatched by traditional zero trust vendors and delivering on the real promise of SD-WAN. These conversations with customers over the last nine months helped us realize there's an opportunity to package our services with the addition of intrusion detection, next-generation firewall and data loss protection, which we announced during Zero Trust Week, into a comprehensive solution that we believe can help define the future of the corporate network. We've dubbed this Cloudflare One and we believe it's the suite that is unmatched in the market.

Turning to Cloudflare Workers, it's incredibly exciting to see how the platform is taking off. In Q3, more than 27,000 developers wrote and deployed their first Cloudflare Worker. That's up from 15,000 a year ago. History proves with new computing platforms the more developers they have, the more quickly they improve and the more likely they are to win. Looking at GitHub and other sources of data on developer engagement, we believe more developers write and deploy real applications and code on Cloudflare Workers every month than every other edge computing platform combined.

So, what are they building? One of the most viewed publications during the 2020 elections used Cloudflare Workers to power their elections news platform and ensure it scaled during the unprecedented spike in traffic last Tuesday as well as Wednesday and today. A popular health foods company uses Workers to power their online ordering system. An online marketing firm working with major brands uses Workers to customize content on a per-visitor basis. A publicly traded electronics testing firm uses Workers to bridge their on-premise and cloud-based infrastructure.

An innovative start-up is using Workers to power an online crypto scavenger hunt. And one of the largest online learning platforms uses Workers to deliver their customized content during this time of skyrocketing demand. It's great to see more use cases every quarter, but I think we're just scratching the surface. Most use cases today have focused on performance. Over time, I expect those use cases will pale in comparison to what is a much bigger opportunity, helping customers manage the challenge of the compliance.

As governments around the world increasingly insist on data localization and data residency, sending all your users' data back to AWS East for processing will become unacceptable. What our largest, most sophisticated, most compliant-sensitive customers are looking to Workers for is as a way to manage this increasingly complex regulatory environment. That's why during Cloudflare's Birthday Week, our announcement of Durable Objects may have been one of the most important edge computing developments you may have missed.

Durable Objects allows developers to define a data structure and store it safely on our network, close to users that need to access it in order to ensure performance and consistency. It also allows developers to define where that data can move across our network and where it's not, such as this user's data may never leave the EU or this user's data may never leave Brazil. Given Cloudflare's network spans more than 200 cities in more than 100 countries worldwide, Durable Objects provides fine-grained control over where data is stored and processed.

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That functionality is critical for the increasingly complex compliance challenges that face every global company today. In other words, the future of edge computing will be defined as much by intelligent edge storage as it is by computing. And while others are still working to launch their edge computing platforms, we have products like Durable Objects in market that are defining that future today.

Before I hand it off to Thomas, I wanted to close by talking about three more Fortune 500 large enterprise customers whose business we won in Q3. A Fortune 500 industrial manufacturing company came to us to consolidate multiple vendors and products into a single unified platform. They replaced discrete network optimization, load balancing and bot management vendors with Cloudflare in order to, in the CISO's words, have a single pane of glass to understand and control what's happening on their network. They signed a $1.4 million annual contract in Q3.

A Fortune 500 food and beverage company came to us following a security audit. They replaced their legacy network optimization service with Cloudflare. They use most of Cloudflare's core services including Workers. They were looking to save money over their previous vendor and were able to cut their spend in half while still being a very attractive customer for us. They signed a $0.5 million annual contract with us in Q3.

Finally, a Fortune 500 pharmaceutical company adopted the Cloudflare One architecture to protect their employees and global network. They were able to onboard 47,000 employees and contractors and more than 130 applications on to Cloudflare One. They were particularly impressed with the comprehensive solution as well as its ease of use. They called out how much our solution reduced their internal IT support ticket load. They signed a $1.5 million annual contract in Q3. Sometimes we hit on all cylinders. We had one of those quarters. I want to take a second to thank the whole Cloudflare team who are working hard to make Thomas and my job easy.

With that, I'll turn it over to Thomas.

Thomas J. Seifert

Chief Financial Officer, Cloudflare, Inc.

Thank you, Matthew, and thanks again to everyone for joining us. As Matthew mentioned, we delivered another outstanding quarter where we exceeded the high-end of our guidance and with that top line beat carrying through to a strong operating margin and another quarter of positive operating cash flow generation. Total revenue for the third quarter grew 54% year-over-year to $114.2 million. The growth in revenue was driven by new logo acquisition, as well as expansion within our existing customer base.

Included in our Q3 revenues is a one-time catch-up of $1.9 million related to a customer renewal. Excluding this non-recurring revenue, our year-over-year revenue growth would have been 52%. From a geographic perspective, we saw strong performance domestically and internationally with particular strength in the US and EMEA, both increasing 58% year-over-year. The US represented 52% of revenue, while our international business represented 48% of revenue and increased 51% year-over-year.

Turning to our customer metrics, we exited the quarter with more than 3.2 million total free and paying customers, representing an increase of 40% year-over-year. In Q3, we achieved an exciting milestone of over 100,000 paying customers, adding roughly 4,800 sequentially. We also had another record quarter of large customer additions, which we define as paying customers with greater than $100,000 in annualized revenue, adding roughly 100 large customers sequentially and 285 large customers year-over-year.

We ended the quarter with 736 large customers, representing an increase of 63% year-over-year, with particular strength in North America. We've shown 60%-plus year-over-year large customer growth every quarter since the

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first quarter of 2018 with large customers now approaching almost half of our total revenue. Similar to our disclosure last quarter, roughly half of the 736 large customers has been on the platform for less than one year and the other half for more than one year.

Our third quarter dollar-based net retention was 116%, which increased 100 basis points sequentially and decreased 500 basis points year-over-year. We saw acceleration in top line revenue growth this quarter driven by both existing customers as well as new customers who have been on the platform for less than a year. Overall expansion from large enterprise customers was again strong this quarter with 6 of our top 10 deals in terms of new ACV coming from existing accounts.

We expect DNR to trend flat to up going forward with Teams as the potential tailwind for expansion opportunities. Third quarter gross margin was 77.3%, representing an increase of 50 basis points sequentially and a decrease of 160 basis points year-over-year, which is in line with the expectations we shared last quarter and our long-term target of 75% to 77%.

Turning to operating expenses, we remain focused on building a long-term business with sustainable growth while improving the operating leverage in our business. Third quarter operating expenses as a percentage of revenue decreased 5% sequentially and 22% year-over-year to 81%. We had another strong hiring quarter, increasing our head count by 42% year-over-year and bringing our total number of employees to 1,697 in the end of the quarter. Sales and marketing expenses were $51.2 million for the quarter, representing an increase of 8% sequentially and 26% year-over-year. Sales and marketing as a percentage of revenue decreased to 45% from 48% last quarter and 55% in the same quarter last year.

Research and development expenses were $23.5 million in the quarter, representing an increase of 11% sequentially and 17% year-over-year. R&D as a percentage of revenue remained flat sequentially and decreased to 21% from 27% in the same quarter last year. General and administrative expenses were $18 million for the quarter, representing an increase of 3% sequentially and 14% year-over-year. G&A as a percentage of revenue was 16%, representing a decrease of 2% sequentially and 6% year-over-year.

Scaling our business efficiently remains a top priority and we continued to see acceleration in operating leverage in the third quarter with operating margins improving over 2,000 basis points year-over-year and 550 basis points sequentially. Operating loss was $4.5 million compared to $18.1 million in the same period last year. We've been hiring aggressively and expect to continue to invest behind the success we see in top line revenue. Net loss in the quarter was $5.7 million or net loss per share of $0.02. Our effective tax rate for Q3 was negative 22%.

Turning to the balance sheet, we ended the third quarter with $1.1 billion in cash, cash equivalents and available-for-sale securities. Free cash flow was negative $17.9 million or 16% of revenue compared to negative $33.6 million or 45% of revenue in the same period last year. Operating cash flow was positive $2 million in the third quarter or 1.7% of revenue, which decreased $2 million sequentially and increased $19.8 million year-over-year.

Q3 operating cash flow was helped by an increase in cash profitability while offset by our annual D&O insurance payment as well as changes in working capital. Our DSOs trended down slightly quarter-over-quarter and remained well within the historical range. Q3 network CapEx was 11% of revenue and we expect it to trend down as a percent of revenue in the fourth quarter.

Before moving to guidance for the fourth quarter and full-year, I would like to provide another update on the COVID-related impacts and associated provisions we shared last quarter. You may recall, on our first quarter earnings call, we disclosed that customers highly affected by COVID-related challenges, particularly those in

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macro-sensitive industries such as transportation, hospitality and retail, represented 8% of our business. In Q2 and Q3, this cohort was 7% of total revenue. We are pleased to see these customers facing COVID-related challenges turn to us, as Cloudflare plays a critical role for them as they accelerate their digital transformation plans.

We also disclosed last quarter that we saw customer concessions come in well below the $2 million headwind we anticipated, trending down during the quarter to historical levels. This trend remained consistent in the third quarter with both concessions and bad debt coming in below expectations. We were pleased to observe another strong quarter of new ACV growth, increasing average customer spend and high sales productivity. In Q3, we observed an acceleration in remaining performance obligations or RPO, which was $342 million, representing an increase of 25% sequentially and 81% year-over-year. A multi-year partnership agreement of $15 million contributed to the growth in RPO this quarter. So, it's not expected to materially contribute to revenue until 2021.

Excluding this large partnership agreement, we saw 73% year-over-year RPO growth. Again, we had a great quarter. Our results demonstrate the resiliency and differentiation of our business model, which emphasizes customer diversity with no customer representing more than 5% of revenue, strong visibility and predictability with the vast majority of our revenue billed upfront on a subscription basis, and multiple vectors of growth fueled by the massive scale and efficiency of our global cloud network.

Given the momentum we are seeing, durability of our model and our differentiation from competitors, we remain confident in the continued growth of our business, and as such, are pleased to raise guidance for both the quarter and full-year. For the fourth quarter, we expect revenue in the range of $117.5 million to $118.5 million, representing an increase of 40% to 41% year-over-year. We expect operating loss in the range of $10 million to $9 million, and we expect net loss per share in the range of $0.04 to $0.03, assuming approximately 304 million common shares outstanding. We expect an effective tax rate of negative 13%.

For the full-year 2020, we expect revenue in the range of $422.5 million to $423.5 million, representing an increase of 47% to 48% year-over-year. We expect operating loss for the full-year in the range of $38 million to $37 million. We expect net loss per share over that period in the range of $0.13 to $0.12, assuming approximately 300 million common shares outstanding. We expect an effective tax rate for 2020 of negative 12.4%.

We'd also like to inform you that we will be hosting a Virtual Investor Day on February 12, 2021, where we look forward to providing a deep dive into our products and our platform. In addition, we will also be providing an update on our financial progress and targets for fiscal 2021. In closing, I again want to thank our employees for delivering these great results and for their continued dedication to our customers and global community.

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

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QUESTION AND ANSWER SECTION

Operator: Certainly. [Operator Instructions] Your first question comes from Phil Winslow with Wells Fargo. Your line is open.

Philip Winslow
Analyst, Wells Fargo Securities LLC

Q

Hey. Thanks guys for taking my question and congratulations on really just a great quarter, and thank you for all the work that you do in securing our elections. Now, a lot of numbers are really impressive this quarter, but large deals and really their contribution to revenue jumped out to us. Now, in the past, your team has talked about how four products was really often the tipping point to customers that lead to higher net expansion rates and lower churn. Can you give us some more color in terms of the drivers of existing, but even newer customers that you mentioned consolidating more functions on the Cloudflare driving these larger deals? And then, I just have one follow-up to that.

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

A

Yeah, Phil. Thanks for the question. I think that our traditional products that are kind of the tips of the spear continue to be the case. So, we saw a large number of companies that were coming under cyberattack in Q3 that would turn to us. Originally, those have been our DDoS mitigation products. Increasingly, we're putting entire networks behind us using our Magic Transit product, and that has been extremely well-received. I think the new addition to that, which is really driving more and more initial interest, is people coming to us for what we call our Cloudflare for Teams products. So, that's our access and gateway products.

That – pardon the pun, but that has turned into a gateway for us to get more large customers onboard. And I think the thing that has surprised us over the course of the last nine months, as we really have been talking with those initial customers and getting feedback, is how much Cloudflare's products that existed before the Teams products really actually dovetail nicely with the rest of the Teams products. And so, we're seeing a lot of times where someone will come to us for say Cloudflare Access and Gateway, but then realize that they need the Web application firewall, DDoS mitigation, and that's really been a differentiator for us versus a lot of the other zero trust vendors that are in the market.

Philip Winslow
Analyst, Wells Fargo Securities LLC

Q

Great. It actually leads me to my follow-up because – in terms of just more services being available. As you mentioned, Cloudflare launched Cloudflare One in October. It's really a culmination of a couple of years' worth of individual component releases. Can you touch on just the early feedback you're getting from customers on projects and how, in particular, you're positioning Cloudflare One versus competitors in the secure access service edge market that maybe have [indiscernible] (00:31:59) networking and so on?

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

A

Yeah. I think that we've always seen the vision for Cloudflare as building the future of the enterprise network. It's why, when we picked ticker symbol, we didn't pick [indiscernible] (00:32:16), we picked NET, because we think that we are the future of the network. And the individual products are really coming together, and we allow

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companies to adopt just the portions that make sense for them. But what we realized is that the kaleidoscope of all of our different products and the picture that they form together really is a compelling value proposition. And I think what differentiates us then is, first of all, the ease of use across all of those different products. Secondly, the unified control plane, where you're not having to go to a number of different vendors. And finally, that it can be significantly cost-effective, and that last piece has been a big driver as CIOs and CTOs are looking to consolidate vendors, looking to simply their deployment and looking to solve some of the budgeting problems they have. And we were there to help them with those issues.

Philip Winslow
Analyst, Wells Fargo Securities LLC

Q

Great. Thanks, guys, and congrats again.

Operator: Your next question comes from Sterling Auty with JPMorgan. Your line is open.

Sterling Auty
Analyst, JPMorgan Securities LLC

Q

Yes. Thanks. Hi, guys. Matthew, I guess I would shift the focus over to Workers and ask whether you've seen any change in terms of the percentage of new customers coming in that are taking Workers and what kind of penetration into the existing base you're starting to see with the platform.

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

A

Yeah. So, we're tracking very carefully the developer engagement of Workers as a whole. And the fact that we had 27,000 developers, that's not people who created accounts, but that's actually written code and deployed it across our network. So, they really have some skin in the game. And that's been a real involvement. Across our customers, as we sign, the percentage that adopt Workers are holding pretty steady. Around 20% of new customers coming onboard on a contracted basis are adopting the Workers platform. As we've talked about before, we think that there is really kind of a short, medium and long-term opportunity for Workers.

The short-term opportunity is it makes all of our existing products the most programmable and configurable version in the market. So, the most programmable firewall, the most programmable zero trust solution, the most programmable load balancer. That's what Workers really delivers and that's where the bulk of the sort of new customers are coming from. The medium-term solution is that it is a platform that allows our own team to innovate as quickly as we have. So, all of Cloudflare for Teams was built using the Workers platform, and we really think that the best development platform, the first best customer of those platforms is the company that builds them themselves, and that's the rule that we're following.

And the long-term opportunity, which frankly as I see that more and more sophisticated applications are being written, and we gave a number of examples on the call, but what I'm really excited about is how the sort of large financial institution, healthcare organization, consumer applications that are existing on a global basis that those companies with really sophisticated compute needs are increasingly seeing Workers as a platform they can do something with that they really can't do on any other platform. So, we've been really happy with it. Again, I think it's going to be sort of a short, medium and long-term opportunity, but the long-term keeps getting closer and closer every day.

Sterling Auty
Analyst, JPMorgan Securities LLC

Q

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That makes a lot of sense. Thank you.

Operator: Your next question comes from the line of Brent Thill with Jefferies. Your line is open.

Brent Thill
Analyst, Jefferies LLC

Q

Good afternoon. Matthew, on the $10 million transaction, I'm curious if you could just provide a little more high-level color on what's happening there, how much opportunity is left and anything else you can give to fill in a great transaction for you guys. And then for Thomas, just a couple of questions on the guide. Good acceleration this quarter, but you're obviously guiding to a decel in Q4. I realize you have a tougher comp in Q4 from last year. But anything to keep in mind given the deceleration Q3 to Q4 in terms of the year-over-year just to put it in perspective? Thank you.

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

A

I'm glad you asked me the easy questions and Thomas the hard questions. So, thank you for that. So, the $10 million customer has been, as I mentioned, a customer with us since 2016. I think the thing that we see over and over again is that not only organizations, but individuals that fall in love with us for our pay-as-you-go and even our free products often will then bring us to work. And that has allowed to very quickly build a very loyal fan base in almost every IT organization in the world and it really differentiates us.

That customer is using us for a number of our web performance as well as our security products. They tend to be our older products, the products around DDoS mitigation, WAF and others. They are increasingly looking at adopting other products across their platform, including bot management and maybe even our Cloudflare for Teams product. So, I think that we have been able to grow with them. We have become a key part of their network. We are able to continue – there are a number of different ways we can continue to expand the relationship with that customer. And I think that this is – while this is the first of our $10 million customers, they're – we think that with anyone who's a Fortune 500 company, there is an opportunity for us to have a similar level of penetration.

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

A

Coming back to guidance, I think there a couple of points to make. First of all, we are pleased that we're able to raise our guidance again both for the quarter as well as for the year. And a couple of things are coming together. The [ph] Teams (00:38:31) growth rate for the third quarter was 52%. When we look at Q4, it was a really difficult compare growing 51% year-over-year in the fourth quarter of last year. And we are still in the middle of the COVID crisis with maybe a second wave hitting. So, there is also uncertainty in the market on how this is going to affect macro factors. So, I think what you see is a prudent guidance that shows confidence in the business model, keeps the tough compare in mind, and let's not forget this gets us to a growth rate for the year of 47% to 48%.

Brent Thill
Analyst, Jefferies LLC

Q

Thank you.

Operator: Your next question comes from James Fish with Piper Sandler. Your line is open.

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James E. Fish
Analyst, Piper Sandler & Co.

Hey, guys. Thanks for the question. Great quarter. One question we're getting is, as you guys look to move up-market and really get into some of these like Fortune 500 customers, how do you guys feel about the need for additional sales capacity and more direct reps? We traditionally know Cloudflare for being able to just go direct via the website for example or kind of the low-touch model. So, I guess how do feel about your sales capacity and need for additional support?

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

A

Yeah. Appreciate the question. So, the – I think that we have a very diversified go-to-market strategy. We are able to sign people up on a – on come in, put in your credit card. But as we've said in previous calls and has continued to be the case in Q3, that is a smaller and smaller percentage of our revenue and today is well under 20% of revenue. Now, I think it has – as we've written about in our Founders' Letter and the S-1 and the updated Founders' Letter that we wrote before, being able to serve everyone and being able to build relationships with those individuals and those developers that can sign up for their own account, even though it doesn't account for a substantial portion of our revenue, it has driven a lot of marketing benefits and it gives us a really strong relationship and a really developer love, which helps us when we're trying to win those large customers.

In terms of sales capacity, we have a – we continue to move up-market. We support customers. We don't believe that you can do what we do without having a sales team. And so, we have a – we started with an inside sales team early on in Cloudflare's history. We now increasingly have a direct sales team with experienced sales leaders that have come from other enterprise companies that have really been able to thrive over time. And I think one of the people who's been very helpful on this is Mark Anderson on our board, who obviously came from a number of great enterprise sales organizations. That's what has allowed us to continue to scale. So, we have great sales capacity. We've been hiring. One of the things that's been amazing is that during this time when a lot of people have pulled back hiring, we've actually stepped on the gas. And the caliber of the team as a whole and in particular the caliber of the team that we're being able to attract in our field sales organization really, I think, is – you're going to look back and say, wow, there was an incredible opportunity that they had during this particular time and they took advantage of it.

James E. Fish
Analyst, Piper Sandler & Co.

Q

Got it. That's helpful. And then, Matthew, a lot of product announcements over the last few months with things like browser isolation and we go down the list. But what's next? Where do you see the Cloudflare platform as next [indiscernible] (00:42:21) handling? Could we see something on identity for example?

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

A

I think that our thought on identity has been that we really think partnering is the right place. Companies have largely made their bets on what their identity management companies are going to be. And so, we're working with great companies like Okta, Ping Identity, Microsoft, in order to integrate their existing identity solutions. One of the things though that we think is powerful and that we're hearing from customers is that they often tend not to have one identity provider. They might have their contractors using one provider and their internal employees using another, and that could either be just because of the complexity of running a business, it could be because of M&A activity.

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But what's powerful about the Cloudflare for Teams product and especially our access and gateway product is that they can really rationalize the complexity of those various identity providers and say, you can mix and match Okta plus Microsoft Active Directory plus what might be a more consumer-facing identity provider for contractors like a LinkedIn or a GitHub and use one control plane provided by Cloudflare in order to deliver that. So, I think that that's been – that's an area I think it's unlikely that we will go into directly. I think it's an area we're much more likely to partner in. But I think it is a way that we can help simplify that complex set-up that a number of people have.

James E. Fish
Analyst, Piper Sandler & Co.

Q

Got it. Congrats again.

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

A

Thanks.

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

Matthew Hedberg
Analyst, RBC Capital Markets LLC

Q

Hey, guys. Thanks for taking my questions. I'll offer my congrats as well. I wanted to ask about Cloudflare One again. It certainly strikes us as a good opportunity not only in your [ph] enterprise, but also sort of the mid-size (00:44:19) opportunities of the market. But I guess in particularly the enterprise is what really interests me and it was great to hear you call out the pharmaceutical company. When you think about this platform, I was wondering if you can give us more color on how it's priced, be it a bundle or a la carte. And what sort of ROI does the customer like that pharmaceutical company see when they standardize on Cloudflare One?

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

A

Yeah. So, Matt, I appreciate it. We're really excited about Cloudflare One, and I think it is an emerging area for us. So, when we published a few weeks ago what was effectively the schematic for what we think of as the enterprise of the future, it really resonated with the market and a number of people reached out to it. But it was conversations with customers that got us there. We had traditionally thought of kind of Cloudflare for Teams and a lot of our other infrastructure products as being separate. But in retrospect, it's kind of one of those forehead-slapping moments where you realize that these things go together like graham crackers and Hershey's Chocolate and the marshmallow together create just an incredible thing which is better than the sum of its parts. It's a s'more. And that's just incredible opportunity for us to build something which really resonates with customers.

Right now, we price the various components of Cloudflare One individually. But one of the things that we think we are investigating is whether we can take what is effectively an architecture and turn it into a SKU. And in that case, what we're investigating is, is there a way that we can bundle together a number of Cloudflare's products and sell them on a just a per-seat basis. And we think that that's really attractive on both ends of the market. On the low-end of the market, that allows us to get more of our features into start-ups early stage companies and really have them have the best possible architecture from early in their history. For larger companies, what we're seeing is that there's an opportunity for us both to help them rationalize the number of different vendors, and then hopefully, also allow us to grow with them. And so, I think it's a space to continue to watch. I don't think we know

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exactly how that's going to come together. But we do think that it is a real opportunity to both simplify the deployment of our customers and help them have a very significant ROI with their deployments.

Matthew Hedberg
Analyst, RBC Capital Markets LLC

Q

That's great. It makes a lot of sense. And then, sort of the other big product, and it's been asked a couple of times, but when we think about Workers, how do you think about the size of that market? I know it's a tough question. But when we think about alternatives there, when it comes to the speed of the Cloudflare network, it is quite unique. How do you think about just ultimately – I know it's small today, but what is the monetization? What is the TAM opportunity there longer term?

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

A

We've really resist – when we put together any TAM forecast or anything else, we've resisted kind of calling out what that is, because I think it's tough to say. I – and this is – maybe this is a little bit heretical. But I actually think that if the only advantage of Workers is it's a little bit faster, that the TAM is actually not that big. And while I understand that there's a lot of excitement around edge computing and Gartner will throw out a really large number, if you actually talk to developers, their priority is – making something a little bit faster is sort of the last in their sort of hierarchy of needs, whereas they have other things around ease of use, more affordability and reliability.

The opportunity that I think is the biggest one, which I mentioned in the prepared remarks, is really around how can we help companies with what is an increasingly regulatory compliant situation. So, if you imagine in the future that what the folks at TikTok are living through, what Facebook is increasingly facing in Europe, that that comes to every business that is operating on a global basis, where the data for their customers is required to be kept in-market and processed in-market, then there really isn't another platform on the market that can provide that solution without cobbling together a bunch of things. And if in the future, you've got 100 different laws in 100 different countries, then you need a network to span the 100 different countries. And I think that that's the real opportunity for Workers. It's early there. But when we look at our largest, most sophisticated customers, that's where they are saying, this is the real opportunity, this is where we want you to invest, and that's why our team is investing in that area.

Matthew Hedberg
Analyst, RBC Capital Markets LLC

Q

Super-exciting. Thanks, guys.

Operator: Your next question comes from Keith Weiss with Morgan Stanley. Your line is open.

Keith Eric Weiss
Analyst, Morgan Stanley & Co. LLC

Q

Excellent. Thank you guys for taking the question and a really nice quarter. You guys really blew it out of the water in this quarter. I kind of wanted to ask about that. You talked about really good conversion on the free Teams customers. But that didn't add a lot to revenues, because they converted pretty late in the quarter. So, two questions on that. If it wasn't the – like the Teams conversion driving all the upside, can you help us out with what it was, like anything you can point to and what drove that upside? And then part two, what do those Teams contracts look like when you are converting? 75% is a huge conversion rate. And are these guys signing on for a longer term contract or is it just a small part of their business today and you expect it to grow over time?

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

A

Yeah. Keith, so let me take those in order. So, from the upside perspective, I think because of the nature of our business, where we're a subscription business, the seeds of a lot of this got planted early in the quarter and late in last quarter. And we just had a very strong growth across all of our various components of our business. I will say that as we tried to emphasize in the prepared remarks, the large customer segment, those customers that are over $100,000 and also those customers that are over $1 million, we're seeing more adoption from those customers. We're also seeing that we're getting more expansion from those large customers, and sometimes that expansion is actually coming so fast that it's happening within the year. And so, it isn't yet reflected in our dollar-based net retention number.

Keith Eric Weiss
Analyst, Morgan Stanley & Co. LLC

Q

Okay.

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

A

So, I think that, as I said, we hit on all cylinders here. I'm really proud of the team. I think they did an incredible job delivering the quarter that we had and it really was a team effort, and I don't think it was any one thing, but it was a combination of many different factors working out very well. On the Teams side, I think that those are typically annual contracts. We are, in some cases, signing longer term contracts, but they are typically annual contracts. We think that since this is a newer product, us having a little bit of flexibility to revisit pricing makes sense and gives customers flexibility as well. And then, it's a real – it depends on various organizations.

So, some organizations are having very broad adoption across their entire team, someone like a Delivery Hero, that was a substantial adoption across their entire platform. Others are small businesses where they might adopt it across the entire platform, but there aren't all that many seats. But because we've made the product so easy to use, we can service that into the market and we really don't have any competition in that part of the market. And then, we sometimes see individual teams. But what we've learned is that oftentimes when somebody adopts Teams within an individual team that that then spreads in an organization very well. And so, we think it's actually the Teams product has a very – is a real tailwind for our dollar-based net retention and that it gives a very natural expansion motion over time for us, which is – we think is really exciting.

Keith Eric Weiss
Analyst, Morgan Stanley & Co. LLC

Q

Excellent. That's super helpful. Thank you, guys.

Operator: Your next question comes from James Breen with William Blair. Your line is open.

James Breen
Analyst, William Blair & Co. LLC

Q

Great. Thanks for taking the question. Just with respect to the new sales and some of the new customers, any particular products that you seem to be leading the pack in terms of the initial sale? And then of the customers, how broad is their take rate in terms of the products you offer? And I guess just lastly geographically, any real focus, US, international, et cetera? Thanks.

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

A

Sure. So, I can start with those and then Thomas can add a little bit more color. So, I think our goal is to continuously be releasing new products, so that the take rate on any given customer, even if they had adopted everything that we had yesterday, is – we'll have new stuff for them tomorrow. And I think if you're not following our blog already, just the rate of innovation, the rate that the team has been able to continue to adapt and deliver products is really outstanding, and we're seeing that that is one of the many components that is driving our continued ability to grow and scale.

It's really different on different customers in terms of what the take rate for the products are. But we do naturally see products that fit together fairly well. So, the Teams products fit very well with our DDoS and our web application firewall product. We're seeing a lot of interest over the last two quarters in our Magic Transit product. That tends to be a great – again tip of the sphere product for us to come in with. But once somebody's entire network is behind us, that then allows us to approach them and talk about Teams and some of the other products as well. So, the journey into Cloudflare can come in many different directions. But we're really happy with our – again our ability to continue to innovate, continue to add to the platform, and see the adoption of these new products by our existing customers.

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

A

From a new ACV perspective, a particularly strong quarter in North America. From a revenue production perspective, strong in both North America and Europe, up 58% year-over-year, and strong across all verticals. No vertical really that stood out. A very even performance across industrial, healthcare and other verticals.

James Breen
Analyst, William Blair & Co. LLC

Q

Great. Thank you.

Operator: Your next question comes from Gray Powell with BTIG. Your line is open.

Gray Powell
Analyst, BTIG LLC

Q

Okay, great. Thank you very much for working me in, and congratulations on the quarter. So, I know you guys had a few questions on Teams and Access, and maybe I'll just throw in one more. How should we think about the typical uplift to an enterprise customer's ARR when they go all-in on Cloudflare Access?

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

A

Sure. So, Access is priced on a per seat basis and there are various tiers of that pricing. And so, the dimensions will be how many employees do they have on their organization and then what tier of that service are they adopting. And so, that could be as low as a few dollars per seat. It could be as high as tens of dollars per seat. And it depends on exactly what their deployment is. But we are now seeing six-plus-figure deals that are just in the Cloudflare for Teams – just for Cloudflare for Teams. And again, it's – we think it has a natural expansion on two directions, both when customers grow and then also when we convince those customers to adopt a higher tier – a higher per-seat tier.

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Gray Powell
Analyst, BTIG LLC

Q

Got it, okay. And then, I know you disclosed the numbers earlier this year. But did you have any like updated stats on the total number of customers that had a free version of Teams before Q3? And then, I know you said 75% converted in the quarter. So, I'm just trying to figure out the raw number of customers that actually converted. And then, can you give us any sense as to like how big those customers are, [ph] are they skewed more (00:57:26) small, mid or large enterprise?

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

A

Yeah. So, it was a couple thousand customers took us up on the free Teams offer. I don't – just to be 100% clear, we have also extended a free offer for small organizations and small teams, which we plan to continue indefinitely. And we think that that's a really great gateway to get start-ups and smaller organizations on to the platform. So, I think you were asking about the free offer that we made back in March. But there is this other free offer that we'll continue to extend over the long-term. In terms of the people that took us up on the free offer, it really was across the board. We mentioned a handful of what are relatively large organizations that are part of this. There were much larger organizations as well that came in through that funnel. I would say the majority – the majority would reflect what is sort of a typical distribution of sizes of companies. So, we would have a lot of small businesses that are in that mix, but then a handful of Fortune 500 and very large customers as well.

Gray Powell
Analyst, BTIG LLC

Q

Got it. That's helpful. Thank you very much.

Jayson Noland
Head-Investor Relations, Cloudflare, Inc.

A

Marianna, can we take questions from one last analyst, please?

Operator: Certainly. Your last question comes from the line of Amit Daryanani with Evercore. Your line is open.

Amit Daryanani
Analyst, Evercore Group LLC

Q

Perfect. I'm glad I was able to squeeze in. I guess two for me. First one, I know we've talked about Cloudflare One a fair amount. But I was wondering if you could perhaps address the thoughts on two fronts. One, the traction you're seeing, [ph] is it skewed to (00:59:10) more enterprise or SMB? And do they both like it for the same reason or different reasons? And then secondly, in the instances where you're winning, where you're getting deployed, what exactly are you replacing or what other entity that you're replacing in the infrastructure there?

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

A

Sure. So, I think that actually somewhat opposite how we went to market with a lot of Cloudflare's other products. We're actually seeing for Cloudflare One and the products that make up Cloudflare One more interest in the larger enterprise segment first and then we're trying to pull that down to small businesses. We don't see really any competition in the self-service, pay-as-you-go segment. And so, we think that that's an area that we can really help define what the standard is and that that will be a fertile ground. But if we look at the people that – organizations that are adopting Cloudflare One, if you look at the leads that were generated from that interest in it,

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it really has been the much larger end of the customer set, both in terms of new logos coming to us, as well as the people that we've been able to approach and upsell on as existing customers.

In terms of who we replaced, I think that fundamentally the zero trust network architecture is a just different way of doing networking. In the past, the way that you would construct a corporate network is you would build a castle, built a moat around that castle and you put all your secret inside the castle, you make all your employees come to work in the castle, and then anyone that was – that had to live outside the castle would cross over a drawbridge. Those drawbridges are VPNs. The moat is a firewall, that next-generation firewall types of companies, intrusion detection companies, data loss protection companies. Typically, they were the folks that sold boxes that define that moat or allowed access to those drawbridges to get across that.

As people are adopting a zero trust model, they need a different approach to it. And so, what we see often is people will – maybe will leave some of that in place, but then they will migrate more and more applications to this new approach. And over time, the budget dollars that that new approach is coming from comes from those budget dollars that you would otherwise be buying that VPN, that firewall, that next-generation firewall, the intrusion detection system, the data loss prevention system. With Cloudflare One – that's really the Teams piece. With Cloudflare One, we extend also, making sure that we have sort of a web application firewall component and a DDoS mitigation component as well. And so, that could either be boxes that people buy, or in some cases, it could be services provided by either the telecom or other companies that are sort of point cloud solutions. Does that – Amit, does that answer your question?

Amit Daryanani
Analyst, Evercore Group LLC

Q

That is really helpful. And thank you very much, and obviously, I appreciate the change of pace with some great hold music prior to the call. So, thanks for that.

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

A

Well, that was – so, that was a really talented musician, a guy name Jonah Cuddy, and he was accompanied by Bebe Stockwell. Jonah is a freshman at the Berklee College of Music. I met him in part because he's a proud Cloudflare shareholder, and we're excited to have him as a shareholder. And we've always really admired [ph] Shopify (01:03:02). They've been a great customer of ours for a long time. They've done this with Canadian bands, and so it was great to convince the conference call folks to allow us to do it. So, thanks for asking about it.

Operator: There are no further questions at this time. I will now turn the call back over to the presenters.

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

Thanks, everyone. And again, I really wanted to thank the Cloudflare team. It's been a really tough last couple of week as we've been on pins and needles, making sure that the US election went as smoothly as possible. I'm proud to have played a small part in ensuring that that was the case and really proud of our entire team for making that happen. So, thank you and we'll see you back here next quarter.

Operator: Ladies and gentlemen, this concludes today's conference call. Thank you for participating. You may now disconnect.

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