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Cloudflare, Inc. (NET)

Q1 2021 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Thank you for standing by and welcome to the Cloudflare Q1 2021 Earnings Conference 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]

At this time, I would like to hand the conference over to your speaker today, Jayson Noland, Head of Investor Relations. 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 2021. With me on the call, we have Matthew Prince, Co-Founder and CEO; Michelle Zatlyn, Co-Founder, President 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 and the timing 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

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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 the 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 will be virtually participating in the JPMorgan Global Technology, Media, and Communications Conference on May 25, the Cowen TMT Conference on June 1, the Bernstein Strategic Decisions Conference on June 4, the Evercore TMT Conference on June 7, and the Baird Global Consumer Technology & Services Conference on June 9.

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 outstanding quarter. In Q1, we achieved revenue of $138 million, up 51% year-over-year. Two factors drove our accelerating revenue. First, we had notable success adding new customers. Overall, our total customer count crossed 4 million in Q1. In particular, we added a record 117 large customers, those that spend more than $100,000 per year with us. Our large customer count was up 70% year-over-year. And, as expected, revenue from large customers now accounts for more than half of our total revenue.

The second factor driving our outstanding performance in the quarter was the adoption of new products by our existing customers. As we shared in February during our Investor Day, 88% of our contracted customers now use four or more Cloudflare products, up significantly from 18 months ago when we went public. Four is a significant number for us because our usage data suggests once someone is using that many products, customers consider us a core platform that is very sticky and difficult for any competitor to match. Other metrics also show our success selling new products to our existing customers.

In particular, in Q1, we achieved a dollar-based net retention rate of 123%, up 400 basis points sequentially. Since very little of our revenue is usage based, our success with this metric is driven by our success selling our broad platform to our customers. We saw a particular strength in the quarter from Cloudflare One, which unifies Cloudflare for infrastructure and Cloudflare for team solutions into a platform that we believe represents the future of enterprise networking. It's also worth noting that since we aren't dependent on usage-based billing, we see no

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indication that, as the world comes out of the effects of COVID, our ability to sell more products to customers is slowing down.

Cloudflare's engine runs on innovation, and in Q1 that engine was firing on all cylinders. Since our last earnings call, we've hosted two Innovation Weeks, Security Week and Developer Week. We announced or made generally available more than 100 products and capabilities, including Magic WAN, our modern MPLS replacement, Magic Firewall, browser isolation, data loss prevention, Super Bot Fight Mode, Cloudflare Pages, and Workers Unbound. We also entered into strategic partnerships with leading SD-WAN appliance vendors, data center operators, database vendors, observability companies, developer ecosystem support services, and even the leading graphics processor company in order to bring advanced AI to Cloudflare Workers. It's been incredible to watch our platform grow.

Our strategy with products has always been to get into the market quickly and then relentlessly improve until we are the category leader across each of the features that make up our platform. It's what we've done with products like our DDoS mitigation and web application firewall products, which industry analysts like Gartner and Forrester are increasingly recognizing as the leaders in their categories. But we're seeing the same with new products like Bot Management. We launched our advanced Bot Management feature two years ago. At the time, there were a number of companies that focused just on this one problem. We started small, with only a handful of initial early adopters, but quickly, using the incredible data from our vast platform, we iterated to deliver a product we believe is now the leader in this space. Revenue from this product has grown north of 400% compounding annually. And by the end of this year, we believe we will generate more revenue from just this product, and most of the companies focused exclusively on Bot Management.

We can build products faster and better because of the leverage we get from Cloudflare's overall platform. And today, products like Cloudflare Workers and Cloudflare Pages are following a similar path to Cloudflare advanced Bot Management. Potential [ph] categoric pillars (00:07:23) on their own, but with all the benefits for our customers of everything else our platform is capable of.

We had some terrific customer wins throughout the quarter. A Fortune 500 retailer signed a three-year, $1.2 million contract to adopt Cloudflare's platform. They preferred our well-integrated approach to performance and security over cobbling together multiple point vendors or using the Frankenstein-like solutions other companies have tried to create through M&A. They're implementing our platform and security solutions in the first phase, making extensive use of Cloudflare Workers' edge compute platform. There's room for this relationship to grow, and in phase two we expect them to add Bot Management advanced image handling and Cloudflare Pages.

A Fortune 500 financial services firm turned to us when they were under a cyberattack. Their existing hardware and telecom provision solutions couldn't mitigate the attack. They adopted our Magic Transit solution to protect their entire network and signed a three-year, $600,000 contract. They were particularly impressed with our road map and pace of innovation, wanting to go with the long-term winner in the space.

Another Fortune 500 financial services firm chose Cloudflare over legacy solutions they considered inflexible and cumbersome. They signed a three-year, $1.9 million contract. They implemented a number of our security services, including Bot Management. They also introduced Cloudflare Workers into their tool kit, which their development team is already engaged on and particularly excited about.

One of the leading SaaS e-commerce platforms chose Cloudflare to protect and secure all their customers. They liked that they could offer seamless protection and blazing-fast performance. They signed a $3.6 million, 38-

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month contract. It's worth noting that with this win a majority of the leading e-commerce platforms are now powered by Cloudflare.

A major credit reporting agency signed a four-year, $3.6 million contract. The Cloudflare One proposition resonated with them, and they adopted a broad set of our services. They're using Cloudflare to decommission a spider's web of legacy hardware boxes and upgrade to a modern cloud-based solution. Cloudflare One was a real star this quarter. We saw wins against more established competitors for our Zero Trust solutions. This included a public VoIP company that purchased 2,800 seats, a large public security company that purchased 1,800 seats, a fast-growing private security organization that adopted Cloudflare One architecture, and even an industrial drone company that is ensuring the highly sensitive data they collect is safe using Cloudflare's browser isolation technology.

As I said, we had an outstanding quarter. When a quarter goes as well as this one, the natural temptation is to wonder what could go wrong. So, I thought I'd share some of the things that I worry about.

First, I worry about security. There's been a dramatic uptick in the volume and sophistication of cyberattacks targeting our customers and our company directly. While our team security posture and awareness is world class, we are vigilant in monitoring and addressing the rise in these sophisticated attacks.

Second, I worry about our team and our culture. At Cloudflare, I believe we did an incredible job transitioning to our remote work environment. But in the months to come, as we transition to whatever is next, I worry there will be an upheaval across industries as employees reassess not just the future of work, but their future outlook.

Finally, I worry about regulatory risk. It seems that tech companies have swung from being able to do no wrong to now being able to do no right. That's a gross simplification. But it's accurate to say that the regulatory landscape on a global basis is getting far more complicated and less consistent. We've always been one to turn lemons into lemonade and our team is good at turning my concerns into products and opportunities. While we are constantly under attack, we're using those threats to productize the sort of zero trust network solutions we couldn't find from any other vendor.

While employees are likely to use the end of the pandemic as an opportunity to reassess their careers, we're doubling down on actively recruiting and hiring the best talent that previously winning consider recruiting and hiring the best talent that previously wouldn't consider changing jobs. And as the regulatory environment becomes more complex, we're using technologies like Cloudflare Workers and Durable Objects to not only meet the data residency and locality requirements we have ourselves but also solve those problems for our customers.

Back in 2010, right before Cloudflare's first board meeting and our launch, I got some advice from one of our early investors. He said, running a company is a bit like flying an airplane. You want to make sure it's well-maintained at all times and that when you're flying, you keep the wheels steady and the nose 10 degrees above the horizon. That stuck with me and we've designed Cloudflare for consistent and disciplined execution. That shows in quarters like the one we just had. And as you'll hear from Thomas, it gives us confidence as we look forward through the rest of the year.

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

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

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Thank you, Matthew, and thank you to everyone for joining us. We had a very strong start to the year. Revenue came in above the high end of our guidance benefiting from record dollar net retention and a record number of large customer additions. Total revenue for the first quarter increased 51% year-over-year to $138.1 million. The growth in revenue was driven by new local acquisition as well as expansion within our existing customer base.

From a geographic perspective, we saw continued strength in both the US and internationally. The US represented 52% of revenue and increased 61% year-over-year. EMEA represented 26% of revenue and increased 54% year-over-year. APAC represented 16% of revenue and increased 30% year-over-year. We were pleased to see revenue accelerate in the US, and we continue to ramp our go-to-market footprint outside of the US. In China specifically, we've seen some headwind to revenue as Baidu ramps down, but we are pleased to see the transition to JD track to our expectations.

Turning to our customer metrics, we had a record number of total customer additions in the first quarter adding roughly 600,000 free and paying customers. We ended the quarter with more than 4.1 million total free and paying customers representing an increase of 46% year-over-year. We exited the quarter with about 119,200 paying customers representing an increase of 34% year-over-year. We saw a notable acceleration in large customer additions in the first quarter adding 117 large customers sequentially and 389 year-over-year. We ended the quarter with 945 large customers, representing an increase of 70% year-over-year.

Our $1 million large customer cohort continues to be the fastest growing of the large customer cohort that we disclosed at our Investor Day in February. We continue to see a balanced mix of new customers and expansion customers in our large customer cohort. We saw significant expansion from our large customers, which helped to drive a record dollar-based net retention rate of 123% representing an increase of 400 basis points sequentially.

Our enterprise go-to-market efforts continue to generate significant ROI seen in the success across our customer funnel from free to large customers as well as in our strong dollar-based net retention. In addition, our customer acquisition cost is trending favorably and gives us confidence to continue to invest in our large enterprise go-to-market activities.

First quarter gross margin was 77.6%, representing a decrease of 50 basis points sequentially. Network CapEx were 15% of revenue in the first quarter. We've seen some constraints in the global electronics supply chain, but we believe we are very well-positioned to absorb those challenges and continue to expect network CapEx to be 10% to 12% of revenue for fiscal 2021.

Turning to operating expenses, first quarter operating expenses as a percentage of revenue increased to 1% sequentially and decreased 11% year-over-year to 83%. We had another strong hiring quarter with an increase of 41% year-over-year bringing our total number of employees to 1,931 at the end of the quarter. Sales and marketing expenses were $63.1 million for the quarter. Sales and marketing as a percentage of revenue was flat sequentially and decreased to 46% from 48% in the same quarter last year.

In response to the underlying strength we are seeing in the business, we plan to continue to ramp large enterprise sales capacity and expand our global footprint. Research and development expenses were $28.5 million in the quarter. R&D as a percentage of revenue increased 1% sequentially and decreased to 21% from 22% in the same quarter last year. General and administrative expenses were $23.1 million for the quarter. G&A as a percentage of revenue increased 1% sequentially and decreased to 17% from 24% in the same quarter last year. We continue to see strong operating leverage in the first quarter with operating margin improving 1,040 basis points year-over-year. Operating loss was $7.5 million compared to $14.4 million in the same period last year. Net

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loss in the quarter was $9.3 million or net loss per share of $0.03. Our effective tax rate for the first quarter was negative 16%.

Turning to the balance sheet, we ended the first quarter with $1 billion in cash, cash equivalents and available-for-sale securities. Free cash flow was negative $2.2 million or 2% of revenue compared to negative $30.6 million or 34% of revenue in the same period last year. Operating cash flow was positive $23.5 million in the first quarter or 17% of revenue, which increased $32.3 million sequentially and $37.8 million year-over-year.

We mentioned in our prior earnings call that collections were strong in January and that trend continued through the first quarter which primarily drove the sequential increase in Q1 operating cash flow. As we've mentioned previously, we expect to see some level of variability in cash flow margins due to ongoing fluctuations in working capital, the growth in our large enterprise business and seasonal factors.

Before moving to guidance for the second quarter and full year, I'd like to provide a brief update on the COVID-related impacts and associated provisions we shared last quarter. Throughout 2020, we've disclosed the percentage of revenue represented by customers in COVID-19 macro-sensitive industries such as transportation, hospitality, and retail.

This cohort represented 8% of revenue in Q1 of 2020 and 7% in the quarters thereafter, including first quarter of 2021. Customer concessions and bad debt also came in well below expectations again this quarter and therefore remain consistent with historical levels. This is the last quarter we are planning to disclose COVID-sensitive industry metrics since their performance has been consistent and encouraging.

In Q1, we saw another strong quarter of new ACV growth, solid retention and large customers making longer term commitments to Cloudflare. Remaining performance applications or RPO remained strong in the first quarter coming in at $439 million representing an increase of 14% sequentially and 88% year-over-year current RPO of 76% of total RPO.

Given the strong momentum we're seeing, we remain optimistic and confident in the continued growth of our business. As such, we are pleased to once again raise our outlook for both the quarter and full year. For the second quarter we expect revenue in the range of $145.5 million to $146.5 million representing an increase of 46% to 47% year over year.

We expect operating loss in the range of $10 million to $9 million. We expect net loss per share in the range of $0.04 to $0.03, assuming approximately 308 million common shares outstanding, and we expect an effective tax rate of negative 14%. For the full year 2021, we expect revenue in the range of $612 million to $616 million, representing an increase of 42% to 43% year over year. We expect operating loss for the full year in the range of $28 million to $24 million. We expect the net loss per share over that period in the range of $0.11 to $0.10, assuming approximately 310 million common shares outstanding. We expect an effective tax rate for 2021 of negative 21%.

In closing, it was another very strong quarter and I again want to thank our Cloudflare employees for their continued dedication and 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.

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QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] The first question is from Brent Thill of Jefferies. Please go ahead. Your line is open.

Brent Thill
Analyst, Jefferies LLC

Q

Thanks. Good afternoon. Matthew, maybe if you could talk a little bit about the go-to-market this year. Obviously, winning some great enterprise contracts and I'm curious in terms of your approach and your go-to-market if there's any anything you're changing up this year. Is it more of the same formulas that you've been executing on in the last year? Thanks.

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

A

So, Brent, thanks for the question. I think that over the course of the last year, we were very well served from our experience being able to sell without necessarily going and seeing people in person. That obviously is a skill that a lot of other companies had to learn. That's something that goes back to Cloudflare's original days.

I think what is changing is that we continue to invest in bringing in some of the best field sales that we need to service these larger and larger customers over time. And so, we have been fortunate that over the course of the last year, we've seen an incredible number of candidates that have applied, and I think we disclosed that in 2020, nearly 200,000 applicants applied to work at Cloudflare. About half of those were for sales and marketing roles. And the caliber that those people are coming from is really just extraordinary.

And so we've been continuing to invest, go to where customers are, but I think our strategy remains the same which is we invest on a very data-driven basis. We invest behind demand. We invest in a way that ensures that we have a success culture across our sales team. And that has allowed us to continue to move up market and sell more to new logos and deliver that.

I think the other thing which has really been a highlight of the last year has been how our expanding platform has allowed us to sell more to our existing customers. And so you've seen that expand where, as I said in the prepared remarks, 88% of our customers are now using four or more Cloudflare products, and we are becoming one of their critical platforms. And I think that over time, that's going to do as we still have a lot of products that we're developing and releasing on a regular basis. That's going to allow us to continue to expand with those existing customers. And I'm incredibly proud of our team's ability to get to 123% dollar-based net retention, which is all driven by our ability to sell new products.

Brent Thill
Analyst, Jefferies LLC

Q

Great. Just a quick follow-up for Thomas on the China headwind, you mentioned the transition to JD. Is that largely going to be – is it going to be effectively finished off in the second half of this year? When does that headwind abate?

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

A

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Yeah. We talked about the headwind on our last earnings call and said that it was part of our guidance. So how we look at the remainder of the year is digested in the outlook we gave. If it hadn't been for the headwind, our growth rate in Asia would have been on historical levels. And it'll return to that performance over the course of the year.

Brent Thill
Analyst, Jefferies LLC

Q

Great. Thank you.

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

Matthew Hedberg
Analyst, RBC Capital Markets LLC

Q

Hey, guys. Great, thanks for taking my questions. Congrats on the acceleration of Q1. Matthew, I want to drill into your comment about the multiproduct sales which is really interesting. I guess I'm wondering if you could refresh our memory on some of the top four products today, but I think even more interesting if we look back two, three years from now, what do you think you have today that could be in, say, a top five list for you guys?

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

A

Sure. So I think foundationally the way that we see customers is that what they want is a network that they can plug into and not have to worry about anything else. So they want a network which is fast, a network which is a reliable, and a network which is secure. And so there are a lot of different products that map to some of the legacy hardware boxes that are out there so load balancing or firewall or VPN, those sorts of things. But foundationally, what customers want is that next-generation corporate network.

And so I think we always struggle at some level answering this question, because what we think we're doing is selling that next-generation network and providing the functionality for customers that they need and where they're headed to. If you look at our products it's a little bit like a Mastermind game where we really don't care where a customer starts. A lot of times that initial interest starts with something like a security product wanting to stop a denial-of-service attack, needing to patch a particular vulnerability. But that really begins the conversation which allows us to sell more to them over time.

And so I think that when you look at our vision for Cloudflare One, which incorporates the Cloudflare for Teams products and the Cloudflare infrastructure products, that's the direction we think we're headed. And again, what it foundationally is providing is that network that you can plug into and get performance security and reliability all in one unified package. And I think that that's going to make a lot of the point cloud solutions that just do one of those things well look more like features than individual products or stand-alone companies on their own.

In terms of what I'm excited about, we saw incredible strength this last quarter in the Cloudflare One offerings and Cloudflare for Teams winning very large deals. And I think that that is only accelerating over the next period of time. I think that the features that we have in there will be something that we'll see more and more adoption of across our customers. And so that's an area that I would keep a close eye on.

And then, obviously, Cloudflare Workers which is sort of the which one of these things is not like the other. That opens obviously a whole new market for us. And I've been really impressed that in production from some of the

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largest companies in the world, they are now relying on Cloudflare Workers as one of their key technologies that their teams are using to build and maintain their applications. So this isn't vaporware. This is if you're going and checking your credit report, there's a good chance that you're actually relying on Cloudflare Workers to do that.

Matthew Hedberg
Analyst, RBC Capital Markets LLC

Q

That's fantastic. Great overview. And then I guess maybe as a follow-up to that, you guys had an announcement with NVIDIA this quarter in terms of a partnership. And I know it's probably not a revenue-generating thing here at least for the short term. But talk to us about what that does for the speed at the edge. I mean it seems like it just amplifies everything that you've done historically, but maybe talk to the importance of that partnership.

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

A

So we want to make Cloudflare Workers the most powerful development platform in the world, not the most powerful edge computing platform in the world. We want it to be the most powerful development platform in the world. And we think of ourselves as competing not with niche edge computing vendors but with the core computing vendors that are out there. And so as we talk to customers and as we look at our own needs, one of the things which is of rising importance is being able to do artificial intelligence and model mapping and do it in a way which is incredibly performant.

And so, we were looking for a partner to help us drive AI running at the edge. NVIDIA is a leader through their graphics processor units. We use their technology internally to drive a lot of our AI models for products like Bot Management and others already. And so, this is a way that we can bring that intelligence and that power to all of the developers. And I guess I think it's one of many different ways that we're going to make the Cloudflare Workers platform what we think is the preeminent computing platform for developers, whatever they're trying to do.

Matthew Hedberg
Analyst, RBC Capital Markets LLC

Q

Thanks a lot, guys.

Operator: Your next question is from Sterling Auty of JPMorgan. Please go ahead. Your line is open.

Drew E. Glaeser
Analyst, JPMorgan Chase & Co.

Q

Hey. This is Drew on for Sterling. You mentioned the success of Bot Management and mentioned that Cloudflare Workers and Pages are following a similar path. I was wondering if you could expand upon that point and the trajectory that you're seeing with those products.

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

A

Sure. So we believe that we want to get products into the market quickly and early and then use the data and use all of the customers across Cloudflare to iterate on those products and improve over time. And so what we've seen with Bot Management, what we've seen with a number of new products that we've launched is that if we get them there, if we get customer feedback then that allows us to very, very quickly make those products significantly better.

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And so I talked a little bit about Workers. Cloudflare Pages is an ability for us to really satisfy some of the needs of developers. There are a number of companies that are focused exclusively on doing what are called JAMstack development environments. That's something that we heard from Cloudflare Workers developers, the tens of thousands of developers that signed up for Cloudflare Workers every single quarter, that they were interested in. We had the technology and platform to be able to deploy that across our entire infrastructure without adding significant additional costs and that's just [ph] happening (00:32:56) for developers over time. It helps them move to our platform and makes our platform [ph] secure and secure (00:33:03).

And so that again, I think, is an embodiment of how Cloudflare thinks about product development. It's how can we take the network that we have, how can we take the customers that we have, learn from them, use the data that we generate from our network, and then provide products which are not only faster and more secure, more reliable but also just provide a greater ROI as part of the overall bundled Cloudflare experience and so that's been a real success. I think it's something that is driving more and more developers to our platform and causing them to build entire applications relying on Cloudflare Workers and the adjacent products.

Drew E. Glaeser
Analyst, JPMorgan Chase & Co.

Q

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

Operator: Your next question is from James Fish of Piper Sandler. Please go ahead. Your line is open.

James E. Fish
Analyst, Piper Sandler & Co.

Q

Hey, guys. Thanks for the questions and congrats on another great quarter. Maybe, Thomas, for you, it does seem like durations increasing again. Is that just a factor of larger customers signing up more, greater prepayments by those customers or any sales incentivization? And then, Matthew, for you, what do you see as those regulatory risks you were highlighting in your prepared remarks?

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

A

Yeah. So, our sales cycles are actually getting a little bit shorter, but our contract duration is moving out probably from 12 to 13 to 13 to 14 months and, even more importantly, if you weigh our contract duration dollar base, it's probably out 16 months. And this brings also earlier payments with all the good benefits that you saw on the capital side too. So, moving up market, being rather successful in large cohorts is driving the good results that you see.

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

A

And, Jim, I don't think there's anything unique to Cloudflare about the regulatory risk that we face. But I do think that the regulatory environment around the world is getting much more complicated. We're seeing as different countries are requiring data locality and data residency requirements, that's forcing companies to find ways to make sure that all their customer data doesn't leave India or Brazil or Germany or the sort of patchwork of regulatory environment that I think is coming down the line. That impacts us to some extent. But I don't think it impacts us anymore than any other company which is out there.

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What I do think it does because we have an awareness – and my parents will be happy that the three years I spent in law school weren't completely for waste – that that allows us to think about how we can build products to not only help ourselves meet that increasingly complicated environment but also help our customers.

And so, an example of that is something that we launched at the end of last year and brought to GA this last quarter which is Durable Objects. That allows a developer to write data into a data store and then tag that data with a particular geography saying in particular, don't ever let this data leave Germany, don't ever let this data leave India, and yet still [ph] write (00:36:25) through a single application the ability to address that. As we talk to and as we see Cloudflare Workers being adopted across some of those largest companies in the world, what's driving them to that oftentimes is that complicated regulatory environment.

And so, I think today if you look at our customer profile, it's about one in six websites according to third-party data today is using Cloudflare. That obviously means that we have a responsibility, but I think that that responsibility is something which is allowing us to build products which can help service a global audience and that's part of why you see large Fortune 500 companies adopting platforms like Cloudflare Workers.

James E. Fish
Analyst, Piper Sandler & Co.

Q

Got it. Matthew, I'm sure your parents are proud of you either way, law career or not. Just quickly supply chain shortage out there, looks like CapEx picked up a bit. I guess it seems like you guys are trying to pre-buy some of the underlying equipment and I understand you guys don't have a huge amount of capacity that's required because you're not in the media game. But how are you guys managing through those supply chain constraints?

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

A

I think we have invested a lot in delivering what we think of as almost a just-in-time infrastructure delivery service and that allows us to take advantage of times when we're able to get deals in the hardware components that we need. And it allows us to be very nimble and flexible. That was important as we got through the last 14 months where we saw unprecedented growth, and we were able to deliver and build out our network even in the face of that growth.

I'd also say that one of the things that we invested in starting back in 2015, which is starting to pay off now, is the flexibility across our platform to not be dependent on any one particular chip vendor. So we can easily migrate not only between Intel and AMD chips but also to ARM-based chips. And so right now, we have ARM-based chips in production running across our network and processing user requests in a way that's incredibly efficient. That flexibility allows us to, I think, have more options as the world is dealing with some of the shortages of chips and other semiconductors.

And I think that that engineering, that flexibility, which we've been doing for quite some time, allows us to be very nimble as we need to build out our network. But it's something we watch carefully. It's something that we're on top of. But I think that we have more nimbleness and flexibility because of the engineering work that we've done. So I think we are less exposed to it than some others in this space.

James E. Fish
Analyst, Piper Sandler & Co.

Q

Helpful. Thanks, guys.

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Operator: Your next question is from Joel Fishbein of Truist Securities. Please go ahead. Your line is open.

Joel P. Fishbein
Analyst, Truist Securities, Inc.

Q

Thanks for taking the question. Hey, Matthew, this is a follow-up to one of your earlier questions. Obviously, you guys have a huge breadth of products. I think you over 100 product capabilities now. The industry – some of the industry players are talking about turning products into, I guess, features. Can you tell me or tell us how Cloudflare is playing into that and how you guys think about that going forward?

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

A

Sure, Joel. I mean I think that that's a big part of our strategy. If you look at the companies that get to the next stage, they are taking their broad feature sets and combining it into what are effectively site licenses for large customers to deliver a broad platform that solves a large set of needs. And so as we compete with companies that just do one thing well, we're good at doing multiple things well and we're able to use the overall platform to solve not just one need but many needs and give our customers an enormous amount of flexibility as we do that. And so I think that in the past, there used to be companies focused entirely on something like DDoS mitigation. We've turned that into a feature. There used to be companies focused entirely on Web application firewall. We've turned that into a feature.

And I think that as you see us go into a lot of the Zero Trust markets, what's powerful is that when we sell against somebody who is just providing Zero Trust gateway services or Zero Trust access services, we can oftentimes win in those in those markets by not only providing a better product but then also bundling it together with other features like DDoS mitigation, WAP, DNS and other things. And so over time, that platform becomes richer and richer. And we're making sure that we have the sales sophistication as we move up the organizational chart selling multimillion-dollar deals to be selling what is essentially the entire platform to the CIO or CTO. And so I think that's going to be a big part of our story going forward. I think that that is the strategy that we're embarking on. And I think that it is a tried and true strategy over time.

And the one thing that's a little bit different about us and some others is we have been able to develop the broad set of platforms without engaging in very significant M&A over that period of time. And that has a benefit that it's not only more efficient, but it also means that our platform is very tightly integrated. And that's something that we hear over and over again as a real differentiator, where you don't have to have the sort of Frankenstein-like approach of a bunch of companies that were bought through M&A.

Joel P. Fishbein
Analyst, Truist Securities, Inc.

Q

Great. Thank you so much.

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

Keith Eric Weiss
Analyst, Morgan Stanley & Co. LLC

Q

Excellent. Thank you for taking the question, guys, and really, really nice quarter. Two questions, one I think is for Matthew. Obviously, one of the most impressive stats this quarter was the pace of new customer additions. Can you help us understand how much of that is just sort of the market getting better and people looking for these types of solutions overall, understanding the risk environment and how much is Cloudflare? Is there anything

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particular from an operational point perspective or an execution perspective that really kicked into gear for you guys that enabled those new customer adds to really turn on in the quarter? And then I have a follow-up for Thomas.

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

A

Yeah. I think that the first thing is that I think a lot of companies that, in the past, were sort of clinging to what we refer to as kind of their emu boxes – emu, the flightless bird which is a perfectly good bird but it can't fly. So there's no way it's ever going to get to the cloud. That over the last year became something, which just was untenable as people shifted to remote work. And so, a lot of the companies that in the past were somewhat reticent to shift to cloud-based services now found themselves saying we're open to this.

So, I don't think – like I actually don't think that COVID, with a particular tailwind for us over the course of last year and as we've talked about in previous calls, in a lot of ways it was a real headwind because we had to adjust to a lot of things. But I do think that it accelerated the digital transformation and it freed up a lot of companies in financial services in Europe in small businesses that sort of cloud-reticent companies in the past to say, okay, we got to take this seriously now.

And so, I think what's happening is, as people are coming back, as it's not an emergency situation anymore, IT teams are saying, okay, now we need to take that call from Cloudflare because it's time for us to get serious about making sure that we never have to go through what we went through in the spring of 2020 again. And so, I think that's what's changed in the market, and I think that that will be a positive factor for us for several years to come going forward.

I think the thing that's changed at Cloudflare is we've just done what we always do, which is we keep getting more sophisticated in our sales motion, more sophisticated in our go-to-market motion. I think we've added really great people to our team across the board from individual account managers up to the management of our sales and marketing teams, and I think that that is allowing us to better attract these customers. You can also see it just in things like industry analyst reports where Cloudflare is showing off in almost all of the categories where we compete as one of the category leaders and in the must consider list.

And so, I think that that has always been our approach. We start in one place, we work our way up, both in terms of customer size in different geographies and in different industry verticals, and you're seeing that continue to execute going through this quarter.

Keith Eric Weiss
Analyst, Morgan Stanley & Co. LLC

Q

Got it. Remarkably, that's the second time [indiscernible] (00:46:32) reference has come up in conference calls over the past two weeks; pretty remarkable though.

Hey, Thomas, a question for you, when you present the TAM you break it down into Apps services, Zero Trust services, network services. Is that a valid way to kind of think about the revenue buckets on a go-forward basis in terms of – or revenue segments on a go-forward basis, or is that just kind of market opportunity and revenue segment should be thought of separately?

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

A

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We think about the TAM differently and how we describe the TAM today, as you know, is largely driven by whole boxes were sold and some are still are sold today. So, if you want to bucket us this way it continues to be 50% falls into their security bucket and 50% falls into their reliability and performance bucket. But the bundling of the product is really describing how we assess customer needs and how we address the market. And clearly, Cloudflare One is the biggest opportunity for us from a dollar perspective how we see the market moving forward.

Keith Eric Weiss
Analyst, Morgan Stanley & Co. LLC

Q

Got it. That's helpful. Thank you, guys.

Operator: Your next question is from Alex Henderson of Needham. Please go ahead, your line is open.

Alex Henderson
Analyst, Needham & Co. LLC

Q

Great. Thank you. I appreciate the great print. Hopefully, people will realize that you really aren't a CDN and don't compete with Fastly after the print. I wanted to change the subject a little bit. One of the critical variables that I think makes your company so different from everybody else is the degree to which you are able to reach and penetrate the coding community. And you shared some statistics on that a quarter or two back, and I was hoping you could give us an update, maybe the number of coders that are currently coding on your system, the growth rate of that coding base, how many developers, anything along those lines that would help us to understand just how large and how critically important you become to the coding community.

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

A

Yeah, Alex, and thanks for the question. We have a ton of respect for Fastly and Akamai and Limelight, but we're in a very different business than they are. We are not usage based by and large, which last year actually felt kind of hard because [ph] usage is (00:49:14) going up but we weren't able to automatically build more revenue.

The good news from that though is that we also don't feel like we've got an overhang going into the back half of this or the remainder of this year. And so, I think that that just shows that it's just a very different business. I actually looked up the data and Fastly is a – we just don't see them in deals because, again, I think that they are very much going after the media space and doing media delivery, and that's something that's just very different than what we've ever intended to do. So, appreciate you recognizing the difference, but that's not to say that they don't have a great business. I think they do, it's just not one that we really compete with.

In terms of developers, we've continued to see very strong growth across the developer platform. We've seen that the rates that we had of new developer add in Q4 continued through Q1. We launched our Developer Week in Q1, which had enormous amount of success and a real engagement from the developer community. And you've seen us add products like Cloudflare Pages, which – it solved some developer's needs and really speaks to that community.

The other thing that's been amazing has been that we have really started to engage with developers where they are. We have a developer relations team, which is in a chat room on Discord, on stock exchange, on all of the different developer communities that are out there constantly commuting, hitting with developers. And if you look at how fast their workers is getting built, it's great that we've got all of the sort of Fortune 500 companies that are adding Cloudflare Workers to their stack. But it's also amazing that individual developers are able to build applications with an incredible amount of sophistication just on their own. And our goal still remains that we want

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to be the first platform that allows a developer to build a billion-dollar application by themselves. And I feel pretty confident that's going to happen.

Alex Henderson
Analyst, Needham & Co. LLC

Q

I generally think of you guys is focused on domain to domain, domain to user data in-flight protection, and performance optimization. That kind of leaves a big space of opportunity open, which I don't hear you talk too much about, which is moving backwards into the DevOps arena and participating earlier and earlier in the programming function. Can you talk a little bit about to what extent you're extending beyond data in-flight to data in development?

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

A

Yeah. I think that we – I think one of the things that's important about a company is knowing what you do and also knowing what you don't do. I think that there are places where we think that it makes more sense for us to partner with other DevOps companies. So, for instance, we announced during Developer Week an extensive partnership with Terraform platform and HashiCorp to be able to configure Cloudflare in a very programmable and developer-centric way. That's something that resonates not only with developers, but resonates with even the large Fortune 500 companies that we work with.

And so, I think that we're always looking for ways to be able to play well within the broader ecosystem, and facilitating that ecosystem we think is super important. So, I think that there may be some things that make sense for us to do. But, again, I don't think that we are under any illusion that we – we would rather be good partners to the overall DevOps space than feel like we have to own every part of it. It's similar to how I think we're a much better partner to the identity providers that are out there than wanting to build our own identity provider. We're much better partners to the endpoint security providers that are out there than ever wanting to get into that space. We do the network super well, and that's something that every developer needs. And so, we want to make sure that we're providing that in a way that works well within the broader ecosystem.

Alex Henderson
Analyst, Needham & Co. LLC

Q

That's a great answer.

[indiscernible] (00:54:05)

Alex Henderson
Analyst, Needham & Co. LLC

Q

Thanks.

Jayson Noland
Head-Investor Relations, Cloudflare, Inc.

A

Thanks, Alex. Operator, next question, please?

Operator: Your next question is from Shebly Seyrafi of FBN Securities. Please go ahead, your line is open.

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Shebly Seyrafi
Analyst, FBN Securities, Inc.

Q

Yes. Thank you very much. Can you quantify your Cloudflare for Teams offering? It was, I think, last year less than 10% of revenue. Has it crossed the 10% bogey, for example? Which products there grew perhaps more than expected? Access, for example, do you expect to come down as the world recovers from COVID, and do you expect browser isolation and DLP to ramp well this year?

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

A

Yeah. So, we are not breaking out our revenue on a product level and on a product basis. For most of last year, our Teams product was for free, so there is not a lot of revenue contribution there in last year's numbers. So, this leaves of course a bigger opportunity for this year, but we'll not give guidance moving forward on a product base. That's not how we think about the business in terms of bundling and how we are competitive in specific situation, especially against companies and competitors that only have one product, as you heard from Matthew. So, our opportunity is really in the bundling of the products here, and we are really proud with the product isolation offering that we just launched. It's an exciting product and it draws a lot of interest from our customers.

Shebly Seyrafi
Analyst, FBN Securities, Inc.

Q

Okay. And then one more, you said Bot Management was up more than 400%. That's quite impressive and it's more than any pure play out there in terms of revenue. Can you share with us what that number is for the other companies? What's the highest revenue that's out there from the pure plays?

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

A

What I said about Teams and browser isolation is also true for [ph] bot mitigation (00:56:08). We are not going to talk about our specific revenue numbers. I think what is more important is the transformation that Matthew was talking about that we're turning products, stand-alone products into features on our network. And [ph] bot mitigation (00:56:25) is one of those [ph] featurized (00:56:27) offerings where we see tremendous success based on the strengths of our platform and of the product itself.

Shebly Seyrafi
Analyst, FBN Securities, Inc.

Q

Okay. Thank you.

Operator: Your next question is from James Breen of William Blair. Please go ahead, your line is open.

James Breen
Analyst, William Blair & Co. LLC

Q

Thanks for taking the question. Just a couple, one on the sales and marketing side, around 46% of revenue this quarter, long-term model being [ph] 27%, 29% (00:56:54). Seems like you've hired a lot of people in that group. How do you think about that as we move out over the next couple of years? Is the sales [ph] getting in place now (00:57:04) [indiscernible] (00:57:05) top line, and when can then start to come down?

And then just from a business perspective, you get a lot of revenue globally. Any thoughts there on your customer base and you have multiple customers taking products at multiple locations? And then just lastly on cash, $1

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billion in cash. You're hovering around cash flow breakeven right now. What are your thoughts on that? You haven't really done any M&A. Does it seem like you need to do it to grow? Just sort of strategic thoughts on the cash balance. Thanks.

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

A

Yeah. Maybe I start there and then talk about sales and marketing, and Matthew can comment on the other question.

So, $1 billion of cash is certainly not burning a hole in our pocket. That was a transaction that we started last year during the pandemic where our outlook in the business environment was not very certain. It certainly doesn't – given us an incentive to be super aggressive on M&A activities. We always talked about how we have a natural bias towards internal development because it's just really difficult for us to find attractive targets that are [ph] integradable (00:58:21) in our software stack. So, it was supposed to make our balance sheet strong, make us opportunistic in terms of business opportunities that might show up, but it certainly is not putting any increased pressure on us to burn the money on M&A.

On the sales and marketing side, we are committed to our long-term model. But we also realize that we're in a very unique position that every dollar we currently spend on our sales and marketing is delivering superior ROI in terms of top line growth whether it's new logo acquisition or expansion of existing customers. And we always said as long as our investment gets rewarded with superior returns, we are going to continue to spend in these directions, plenty of opportunity to expand our footprint. And, more importantly, not only are the ROIs good, our customer acquisition costs are tracking also really favorable.

So, we feel good about the strategy that Matthew was talking about before following the data, following behind the demand curve that we see from a customer perspective. And as long as the ROI is right, we'll continue with that strategy.

James Breen
Analyst, William Blair & Co. LLC

Q

Great. And just on the globalization of the product, you talked about having customers taking four products. Do you have multiple customers [ph] keep going across (00:59:47) multiple regions? Could you just talk about that a bit?

Matthew Hedberg
Analyst, RBC Capital Markets LLC

A

Yeah. So, I mean, whenever we're selling to a Fortune 500 customer, they're going to be across many of our different regions. And as our sales team has gotten more sophisticated, it helps us support these more complicated sales. But Cloudflare was a global company from almost the instant that we launched, and we're adding the capacity to service customers around the world. And I think the thing that remains something that is different about us is how international where about 50% of our revenue does come from outside the United States.

We have that built in already. I think we have a brand that resonates around the rest of the world. And as we add sales capacity around the world, that helps. I also think that what people want, if you're a Fortune 500 company, is you [ph] want to be able (01:00:51) to have one company that can service you anywhere you have an office. And the fact that today we're in more than 200 cities worldwide within milliseconds of the vast majority of the world's

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population, that's an enormous advantage especially as we work with more sophisticated customers. And so, if you look at one of the largest mining companies in the world, they literally operate on every continent except Antarctica. They rely on Cloudflare's networks for a broad set of services, and that's something that having a global presence that we do is critical to winning these larger and more sophisticated customers.

James Breen
Analyst, William Blair & Co. LLC

Q

Great. Thanks.

Jayson Noland
Head-Investor Relations, Cloudflare, Inc.

A

Thanks Jim. Sheryl, can we take questions from one more analyst please?

Operator: Certainly. Your last question is from Amit Daryanani of Evercore. Please go ahead, your line is open.

Amit Daryanani
Analyst, Evercore ISI

Q

Perfect. I'm glad I made it under the line there. I have two questions. I'll ask them at the same time just to make it quicker for you all. Matthew, if I think about your TAM, it's gone from $32 billion at IPO to I think $70 billion, $80 billion today. Your penetration rate would imply it's about 0.5% to maybe 1% now. How do you manage between focusing on expanding your TAM, which is kind of what you've done so far versus perhaps penetrating your TAM further? How do you go between those two buckets? And then, Thomas, was there anything one-off on the dollar-based net retention number with a nice uplift? So, how do we think about that as we go forward? Thank you.

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

A

So, Amit, I think that from the beginning we designed Cloudflare's R&D infrastructure to be able to walk and chew gum at the same time. And so, I think it's sort of a false dichotomy if [ph] you've built (01:02:40) your R&D organization, right? So, we have 90% of our R&D organization that's really focused on how do we go deep on any of the products and features that we've launched. And they are always thinking about how do we continue to take feedback from customers whether they are current customers or prospects in order to build out the functionality across our platform, so that we can service whatever it is that they need. The power of that is that if we build reporting for one – more sophisticated reporting for one of our products, that has benefits across all our products. And that's the power of being the unified platform that we have created.

10% of our team is really dedicated to an organization we call ETI, which is the Emerging Technology and Incubations team. And their job is to invent the future. And we don't spend – they have incentives around thinking up what is the product or feature, which two years from now you guys are going to say, wow, that was a huge way that Cloudflare expanded TAM. They take lots of shots on goal. Not all of them are successful, but they are the team that came up with Cloudflare for Teams. They're the team that came up with Cloudflare Workers. And so, they are often – when we do expand the TAM dramatically, they're the team that is driving that.

And so, I think having that ability to walk, go deeper on the existing products that we have, and also chew gum, make new products that dramatically leverage the network that we have to go into new industries and into surprising other direction. I think that's how you build what is an iconic technology company over time. And that's exactly what we've set up to do and how we've designed the company from the beginning.

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

A

On DNR, unlike the third quarter of last year, we don't have any onetime items in the first quarter of this year. DNR is quite a lagging indicator. So, what you see today is really hard and focused work over the last 12 months starting to payoff and being visible in the DNR metrics. It will continue to tick up but not in a straight line. We'll see some variability over the quarters, but we still think we have room for improvement and we'll continue to go up.

Amit Daryanani
Analyst, Evercore ISI

Q

Thank you very much.

Operator: I will now turn the call over to Matthew Prince for closing remarks.

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

I just wanted to say thank you to all of the Cloudflare team for incredibly hard work. You make my, Michelle, and Thomas's job appear easy when we have quarters like this. It takes us delivering great products. It takes us servicing our customers well. And it takes everyone at Cloudflare to build the iconic technology company that we aim to become over time.

And so, I wanted to appreciate everyone on the team. Thank you for all of your hard work, and we're hard at work already on Q2. So, see you back a few months from now at the same time. And until then, I look forward to a great and strong quarter. Thank you.

Operator: This concludes today's conference call. Thank you for your participation. You may now disconnect.

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