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Cloudflare, Inc. (NET)

Q2 2021 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good day and thank you for standing by and welcome to the Cloudflare Q2 2021 Earnings Call. At this time, all participants are in a listen-only mode. After the speakers' remarks, 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. Please go ahead.

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

Thank you for joining us to discuss Cloudflare's financial results for the second 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, 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

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net loss per share, shares outstanding, non-GAAP operating expenses, free cash flow, non-GAAP effective tax rate, dollar-based net retention rate, total customers, paying customers and large customers.

These statements and other comments are not guarantees of future performance, but rather are subject to risks and uncertainties, 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 Oppenheimer Technology, Internet & Communications Conference on August 10, the KeyBanc Technology Conference on August 11, the Deutsche Bank Technology Conference on September 9, the Citi Technology Conference on September 13, the Piper Sandler Global Technology Conference on September 14, and the Jefferies Software Conference on September 15.

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

Matthew Prince

Chairman, Co-Founder & Chief Executive Officer, Cloudflare, Inc.

Thank you, Jayson. We had our strongest quarter as a public company. In Q2, we achieved revenue of $152 million, up 53% year-over-year. Our revenue growth continued to accelerate as we saw strength across all customer segments. In particular, we added a record 143 large customers, those that passed more than $100,000 per year, and ended the quarter with 1,088 large customers. 19% of the Fortune 1000 are now paying Cloudflare customers, and we continue to see particular strength across our enterprise business. Our expansion rates also improved over Q1, with dollar-based net retention reaching 124% in Q2. Even with this strong revenue and customer growth, our gross margins improved to 78%, up 120 basis points year-over-year.

If there were a theme for the quarter, it was Cloudflare winning the business of the largest and most sophisticated companies and organizations in the world. To that end, I wanted to jump right in and highlight some customer wins, starting with the world's largest IT buyer. The United States Federal Government chose Cloudflare's Zero Trust solutions in order to help secure federal agencies against the rising threat of cyberattacks.

We partnered with Accenture Federal Services and won a contract with the Department of Homeland Security to offer our protection to all civilian executive branch agencies. This was a very competitive process, where we were up against nearly every other vendor in the space. Our win highlights our Zero Trust solutions are now recognized as world-class. This is also a good example of how we're increasingly working with leading GSIs like Accenture as

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we service larger and larger organizations, and there aren't many organizations larger than the United States Government.

While we are proud of this deal and the credibility it gives us as a leader in the Zero Trust space and we believe it will ultimately be a significant contributor to revenue, we don't believe that the contribution will be meaningful in 2021. As a result, this deal, along with some other strategic deals we won in the quarter, do not show up in RPO and we have not included the impact of them in our guidance through the end of the year.

However, servicing a large customer like the United States Government, as well as other strategic deals we won in Q2, does require us to increase investments in our network. Anticipating these deals, we began making increased investments in Q1. These investments continued in Q2 and we anticipate will continue through the second half of the year. We are investing for the long term and we believe winning strategic customers proves how this strategy continues to pay off. Even with the additional investments, we still anticipate we will reach breakeven in Q1 of 2022.

While we're on the topic of profitability, I wanted to preview a conversation I anticipate having with some of you this time next year. As part of our long-term model, we have an operating margin target of 20%. When we say long term, we really mean it. We remain confident in our ability to reach that long-term target, but we are not in a rush to get there. From the point at which we reach breakeven, we intend to aggressively reinvest excess gross profit back into growth. We are nowhere close to being out of ideas for new products to build or customers to buy them. Cloudflare is optimized for innovation, and we plan to continue to launch new products, add more customers, relentlessly execute and reinvest in growth for the foreseeable future.

Security continued to be in the news and was a theme driving customer wins. A major oil and gas pipeline provider signed a $210,000 annual contract for a portion of our Cloudflare One solution. They were looking to help protect their infrastructure against the sophisticated cyberattacks they were facing. They were referred to us by a major systems integrator, and together, we help better protect their critical infrastructure. I think this is evidenced that when companies and their advisors face cybersecurity challenges, Cloudflare is increasingly one of their first phone calls.

A Fortune 500 transportation provider signed a three-year $340,000 contract for a portion of our Cloudflare One solution. This is another deal that came to us through a channel partner. We believe there's an opportunity to more than double the size of our relationship with this customer over the coming year.

A Fortune 500 industrial services provider signed a two-year $895,000 deal for a number of Cloudflare One components. This customer was targeted by a so-called Fancy Lazarus hacker group. We were able to enable our solution within four hours of our first conversation and mitigate the threat.

A Fortune 500 auto parts manufacturing company faces similar threat and turned to us to solve it. They signed a $300,000 annual deal. The CISO said the Cloudflare team was fantastic. We took this threat very seriously. Cloudflare was there for us. You can't make a car with only 99% of the parts. So, one malicious attack in the supply chain impacts everyone.

In that spirit, he referred us to another Fortune 500 manufacturing company to sign a two-year $320,000 contract. The CSO of that second firm referred us to a third Fortune 500 manufacturing firm who signed a two-year $570,000 contract. That's over $1 million of new contracts because our solutions worked and solved some of the problems that are top of mind for every technology leader right now. It increasingly feels like Cloudflare is becoming the de facto choice for enterprises and they are thinking about the future of their network security.

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A Fortune 500 borne-on-the-Web e-commerce provider expanded their use of Cloudflare. They were already using our WAF and content delivery products. Their team turned to us when they were looking for a developer-friendly Zero Trust security solution. In a competitive process with other Zero Trust vendors, we won this technically sophisticated customer's business. In the process, they also went all in on us, making us their exclusive provider of network services. This win shows how we can expand customers from using one of our products to being their complete, secure, programmable network provider. This customer's spend with us is now over $4 million annually and we expect we will grow with them.

A very large cryptocurrency exchange expanded the use of our network. As an exchange, they are obsessed with the fastest possible performance. They lean heavily on our Argo Smart Routing technology, as well as our global presence in more than 200 cities worldwide. They expanded their contract with us in the quarter and now spend over $4 million annually. It's also of note that three of the four largest cryptocurrency exchanges use Cloudflare's network to be fast and secure.

We see more and more customers building applications around Cloudflare Workers, our compute platform. A high-profile new economy delivery company signed a $1.3 million three-year deal. They use a number of our products, but increasingly are building their application using Workers in order to get fast, scalable performance. They appreciate the flexibility it provides, as they literally deliver for their geographically distributed customer base.

A financial services software provider signed a three-year $3.3 million deal for a number of our products. They're using Workers as a hyper-programmable middleware to stitch together multiple vendor solutions. They love how easy it is for developers on their team to get up and running on the platform because of the broad programming language support and rich developer tools that have been honed and battle-tested in production since Workers launched nearly four years ago.

An Asian fintech provider expanded their use of Cloudflare by $0.5 million, making their annual spend now $1.3 million. They're using workers to accelerate their development cycle and replace spend with some of the traditional hyperscale compute providers. They cited workers ease of use in global performance as key drivers of their decision to double down on Cloudflare. From old school manufacturing and in cryptocurrency from the United States government to some of the largest companies in the world I was particularly struck this quarter how Cloudflare is resonating across industry segments and geographies as the answer whenever someone is looking for the future of a secure programmable network.

Finally, I wanted to make sure you all had a chance to catch our announcement last week. We have a tradition of hosting innovation weeks where we launch new products and features. We typically host about eight of these weeks per year. Last week was our first. During the week, we highlighted Project Pangaea which provides Internet connectivity at no cost to underserved communities worldwide.

A number of initiatives to drive down Cloudflare's environmental impact and help our customers cut their carbon output. Our commitment to human rights and sustainable workforce, and our vision for a more inclusive future of work. What I really liked about these efforts is that they aren't ancillary. They are core to who we are and what we do as a company. We deeply believe in our mission of helping build a better Internet and living that everyday shows up in the continued success winning customers, and attracting and retaining the incredible team we have. Thank you to all of them for what was an outstanding quarter.

With that, I'll hand it off to Thomas to walk through the financials.

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Thomas Josef Seifert

Chief Financial Officer, Cloudflare, Inc.

Thank you, Matthew, and thank you to everyone for joining us. We continued the momentum from the first quarter and saw a new records in both dollar-based net retention and large customer additions. Our success in the first half of this year is due in part to the investments we made last year benefiting from our ability to successfully ramp product innovation and go-to-market employees in a work from anywhere world. We firmly believe that we are well-positioned to continue to deliver consistent results with disciplined execution. Total revenue for the second quarter increased 53% year-over-year to a $152.4 million. The growth in revenue was driven by another quarter of strong customer demand both in terms of 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 65% year-over-year. EMEA represented 26% of revenue and increased 53% year-over-year. APAC represented 15% of revenue and increased 23% year-over-year. We were pleased to see revenue continue to accelerate in the US this quarter while we continue to ramp our go-to-market international footprint. In China, we are pleased to see the transition of customers from Baidu to JD progressing well. In addition, network performance metrics of JD have already surpassed historical performance in China due to expanded network coverage and streamlined integration.

Turning to our customer metrics, we exited the quarter with 126,735 paying customers, representing an increase of 32% year-over-year. We saw a record number of large customer additions in the second quarter adding 143 large customers sequentially and 451 year-over-year. We ended the quarter with 1,088 large customers, representing an increase of 71% year-over-year. We saw a significant expansion from our large customers which helped to drive a record dollar-based net retention rate of 124%, representing an increase of 100 basis points sequentially.

We are encouraged to see our customer acquisition costs continue to trend favorably this quarter, giving us confidence to continue to invest in our large enterprise go-to-market activities. Second quarter gross margin was 78%, representing an increase of 40 basis points sequentially. Network CapEx represented 6% of revenue in the second quarter. We continue to expect network CapEx to be 10% to 12% of revenue for fiscal 2021.

Turning to the operating expenses, second quarter operating expenses as a percentage of revenue decreased 2% sequentially and decreased 5% year-over-year to 81%. We had another strong hiring quarter with an increase of 34% year-over-year, bringing our total number of employees to approximately 2,050 at the end of the quarter.

Sales and marketing expenses were at $68.4 million for the quarter. Sales and marketing as a percentage of revenue decreased from 1% sequentially and decreased to 45% from 48% in the same quarter last year. Research and development expenses were $30.1 million in the quarter. R&D as a percentage of revenue decreased 1% sequentially and year-over-year to 20% from 21%. General and administrative expenses were $24.4 million for the quarter, G&A as a percentage of revenue decreased 1% sequentially and year-over-year to 16% from 17%.

We continued to see strong operating leverage in the second quarter with operating margin improving 690 basis points year-over-year. Operating loss was $4 million compared to $9.5 million in the same period last year. Net loss in the quarter was $7.3 million or net loss per share of $0.02. Our effective tax rate for the second quarter was negative 26%.

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Turning to the balance sheet, we ended the second quarter with $1 billion in cash, cash equivalents, and available-for-sale securities. Free cash flow was negative $9.8 million or 6% of revenue, compared to negative $20.2 million or 20% of revenue in the same period last year. Operating cash flow was positive $7.5 million in the second quarter or 5% of revenue which decreased $16 million sequentially and increased $3.5 million year-over-year.

As we've mentioned previously, we expect to continue 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. Remaining performance obligations or RPO remains strong in the second quarter, coming in at $484 million, representing an increase of 10% sequentially and 77% year-over-year. Current RPO was 77% of total RPO. Given the strong momentum we are seeing, we remain optimistic and confident in the continued growth of our business. As such we, are pleased to once again raise our revenue outlook for both the quarter and the full year.

As Matthew mentioned previously, we saw some exciting customer wins in the second quarter that necessitate increased investment in our network and engineering staff. These wins lean heavily into the security aspect of our offering and give us a roadmap to further expand our platform and enhance strategic partnerships. Anticipating these deals, we've began making these investments in the first quarter. These investments continued in the second quarter and we anticipate will continue through the second half of the year.

Turning to guidance. For the third quarter, we expect revenue in the range of $165 million to $166 million, representing an increase of 45% year-over-year. Recall in our third quarter 2020 revenue we had a onetime benefit of $1.9 million related to a customer renewal. Without this one-time benefit, our third quarter guidance would represent an increase of 47% to 48% year-over-year. We expect operating loss in the range of $9.5 million to $8.5 million, and we expect net loss per share in the range of $0.04 to $0.03, assuming approximately $310 million common shares outstanding. We expect an effective tax rate of negative 15%.

For the full year 2021, we expect revenue in the range of $629 million to $633 million, representing an increase of 46% to 47% year-over-year. We expect operating loss for the full year in the range of $28 million to $24 million, and we expect net loss per share over that period in the range of $0.12 to $0.11, assuming approximately $309 million common shares outstanding. We expect an effective tax rate for 2021 negative to 19%.

In closing, we completed another very strong quarter. As Matthew mentioned, we also launched our first Impact Week last week. I encourage everyone to take a look at our Impact website where we centralize ESG disclosures and highlight sustainability initiatives. We also published our first greenhouse gas emission report, our first diversity report and our commitment to not only 100% renewable energy but also removing all of our historic emissions associated with powering our network by 2025. We're excited to continue to extend our sustainability efforts which not only tightly aligns with our mission but also strengthens the durability of our business and is additive to the financial welfare of Cloudflare.

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: Thank you. [Operator Instructions] Our first question coming from the line of Matt Hedberg with RBC Capital Markets. Your line is open.

Matthew Hedberg
Analyst, RBC Capital Markets LLC

Q

All right, guys. Thanks for taking my questions and congrats on a really strong quarter here. Matthew, it's clear that the large federal deal stood out to me and it's impressive because I think you've hit some additional levels of Fed ramp certification but you're still pretty early in your Fed or public sector journey. Can you talk a little bit more about I guess how extensive the public sector just in general all the way down to state and local governments could be for you guys? And how are you putting more resources behind that. It seems like you talked about GSIs but just a little bit more on that increasing opportunity?

Matthew Prince
Chairman, Co-Founder & Chief Executive Officer, Cloudflare, Inc.

A

Sure, Matt. As you mentioned, we are in the process of getting our Fed ramp certification and we anticipate that in the first half of next year we'll be fully Fed ramp certified. But we're already in the market place. Since we're going through the process and it's going very smoothly and we anticipate that that will go continue to go well. We have always had a broad set of federal customers. The FBI has been a customer for a long time, the US State Department, Library of Congress and a number of others.

And I think that's because when some of the most sophisticated organizations in the world look at – that are under constant threat, look at the solutions that are out there. They increasingly understand and have for quite some time that that we're the best solution for stopping the cyber threats that they face. And so I think that there is a significant opportunity. We are investing both in terms of partnerships with GSI like Accenture, but then also building out our own team to be able to service that.

And I think over the last 10 years we've done a terrific job of building relationships with the people that are really leading the cybersecurity efforts in the US federal government, and that's now really paying off. One of the things that's important about us and one of the reasons why this is important is Cloudflare fundamentally is a foundation on top of which a number of other companies build their products. And so as other companies are looking for companies that they can trust, these sorts of wins we see are resonating across the entire industry. And again I'm really proud of our team for the success that we've had, selling our zero trust solutions to what is literally the biggest IT buyer in the world.

Matthew Hedberg
Analyst, RBC Capital Markets LLC

Q

That's fantastic. And then, Thomas, I think the other thing 71% growth in large deals and a record ad was impressive. Can you talk about the success of bundling? I know some of your bigger customers are taking 10 or more products. But just thoughts on leveraging bundles, and I guess maybe Cloudflare One, in particular, I know it was introduced last year, but how successful is that in driving some of this momentum in large enterprise wins?

Thomas Josef Seifert
Chief Financial Officer, Cloudflare, Inc.

A

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You heard from Matthew that he picked on a couple of deals during the quarter that were Cloudflare One were in part Cloudflare One-driven. So as we might create in our evolution the product portfolio becomes broader and deeper. The bundling of in our revolution and the product portfolio becomes broader and deeper. The bundling of products and the pricing of those bundles becomes a huge opportunity for us. It's one of their more strategic important projects that we are currently running within Cloudflare, Michelle and I do, in order to get more sophistication into our approach.

If you look at companies we admire like Salesforce and Microsoft, it has been a big part of their journey going up and getting to larger accounts and larger revenue commitments per customers getting more sophisticated in the bundling effort. And the increase to 124% of dollar net retention happened primarily because we were really successful expanding large customers and especially with bundled deals. So we are making good progress but it's still a huge opportunity in front of us too.

Matthew Hedberg
Analyst, RBC Capital Markets LLC

Q

Thanks a lot, guys.

Operator: We have our next question coming from the line of Brent Thill with Jefferies. Your line is open.

Brent Thill
Analyst, Jefferies LLC

Q

Thanks. Thomas, many have asked just in the second half, the guidance is implying at pretty significant deceleration. Is there anything that we should keep in mind in terms of modeling other than the bigger comps you're coming up on?

Thomas Josef Seifert
Chief Financial Officer, Cloudflare, Inc.

A

Brent, you have to keep in mind, as I said in my remarks before, the third quarter last year was driven by a one-time customer renewal. So if you were to take this into account, the guidance is now getting up to 46% or 47% year-over-year. It's probably the strongest guidance we have given in – in our life as a public company from a growth expectation perspective but it also served us well. so far to be prudent in how we think about our future and weigh the headwinds and tailwinds that we have and this guidance is consistent with our approach over the last eight quarters taking everything into account that we know and making sure we continue to be thoughtful.

Brent Thill
Analyst, Jefferies LLC

Q

And a quick follow for Matthew. Maybe from your perspective something that maybe we all can't see that you're seeing that you're particularly surprised or proud about that maybe just didn't come through in the financials, is there one or two things that are really surfacing that are maybe surprising even you as architecting the leadership of this move?

Matthew Prince
Chairman, Co-Founder & Chief Executive Officer, Cloudflare, Inc.

A

I think I'll come back to the team that we have and the strength that we're seeing across applicants for that team. I think across the industry there are a lot of people as we come out of the other end of COVID who are thinking about what it is that they can do with their career. Everyone who gets a job at Cloudflare could work a bunch of

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other places. And yet we continue to see both retention of our current team, exceed what our expectations are, but also just the caliber and quality of people across not just our R&D organization, but in the sales and marketing organization. And I think that companies are just collections of people. and so the fact that we have at this time where people are thinking about what is it that they want to do with their career some of the best and most talented people that I've ever seen are saying if I can be part of helping build a better Internet, that's what I want to spend the next step of my career doing. And I think that that really sets us up well for just continuing to execute as we scale. So I'm really, really, really proud of our team, and I think that it's amazing that we keep raising the bar on that team.

Operator: We have our next question coming from the line of James Fish with Piper Sandler. Your line is open.

James E. Fish
Analyst, Piper Sandler & Co.

Q

Hey, guys, thanks for the questions. You guys clearly don't have enough conferences on your schedule coming up but nice quarter, guys. Wanted to start off with a question for Matthew. Really on Apple Private Relay that got announced, what can you say about the reports about this offering? It seems like traffic is already coming in across Cloudflare for this. Is that the right way to think about it? And how can a relationship like this really change the industry dynamics in your view?

Matthew Prince
Chairman, Co-Founder & Chief Executive Officer, Cloudflare, Inc.

A

So, Jim, we have a policy of not talking about any of our customers without their permission. And I'm certainly not going to speculate here on that. But I will tell three stories I got about Apple. Back in 1978, when there were two what were known as hobbyists at the time, we'd now call them developers, but Steve Jobs and Steve Wozniak had an idea to build a personal computer. They went to Venrock which is the venture capital arm of the Rockefeller family and raised their first capital.

I feel a certain kinship to that because when Cloudflare started, we went to Venrock and they were the first capital in CloudFlare and I was hanging out with Brian Roberts a few weeks ago who runs that firm, and he said that CloudFlare actually is the first company in the venture capital firm's history to now have surpassed the return that they had with Apple. So that's something that we're proud of. I think the second set which is a little bit more personal was 18 years later in 1996 I was actually in law school and I heard that Steve Jobs was actually coming back to Apple. And my dad at the time was a stockbroker. And I had worked as a ski instructor to the year before and saved up a little bit of money. And so I called him I said I think I want to buy a 1,000 shares of Apple stock. And that turned out to be a pretty good decision which largely paid for my ability to among other things go to business school a few years later where I met Michelle and we were able to start CloudFlare that.

So I've been an Apple fan boy for a long time. And it's definitely a company that we really admire. The last story which is actually 19 years after that I remember I was invited to a very small gathering of tech leaders meeting with senior government officials to talk about how technology companies can help with the fight against various law enforcement requests and terrorism. And it was pretty, pretty incredible group, was also around the same time the San Bernardino phone was in the news about whether or not Apple would unlock that. And we were definitely the smallest company there. There were 12 tech leaders and it was sort of the who's who of the big tech companies. And I remember Tim Cook in this close meeting started to talk about privacy in a way that was really clear that it came from a deep and personal place and talked about privacy as a fundamental human right. And that was long before Apple was running commercials on TV about the importance of privacy. And so I think that's something that they've at times gotten a little flack saying that's just marketing. But I think I've seen from their

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senior leadership that that's something that they deeply care about. And that's the value that we definitely share with them.

And so I've been an Apple fan boy for quite some time and hopefully that's a long enough answer, I'm not answering your question.

James E. Fish
Analyst, Piper Sandler & Co.

Q

That was a good sell side answer, honestly. But as you continue to move up market, how's the engagement and go-to-market changing? How should we think about that evolution of Cloudflare's go-to-market away – like moving away from that freemium funnel towards the more direct large enterprises over time? Thanks, guys.

Matthew Prince
Chairman, Co-Founder & Chief Executive Officer, Cloudflare, Inc.

A

Yeah, so I don't think we've ever been sort of a traditional freemium customer. We don't think of it, as from time to time, we get great customers that come in through that free funnel, but by and large that's really – that's not the purpose of that. The purpose of that is really to be able to just innovate as quickly as we can with such a broad set of customers, and that's paid off incredibly well. I think that if you fast forward 10 years from now, Cloudflare's go-to-market motion looks just like any other big enterprise company. And I think we're building that out. You heard a number of deals where we have now named accounts specific sales reps, increasingly an enterprise sales team, increasingly working with channel partners and systems integrators.

I think what's different about us is that we have used data to build out our go-to-market function in the same way that we use data across our entire company. And that's allowed us to both go into new geographies and new market customer segments and the industries had to move up in terms of servicing larger customers in a way that again we're not here to tell you that we don't need salespeople. We believe that we do. But I think what we've been able to do is use the data from our existing customers to invest behind the demand curve rather than ahead of the demand curve. And while that gets us to the same point that any enterprise sales company gets to, I think what it allows us to do is very relentlessly execute and make it much less likely that we make a misstep along the way.

Operator: We have our next question coming from the line of Shaul Eyal with Cowen. Your line is open.

Shaul Eyal
Analyst, Cowen & Co. LLC

Q

Thank you. Good afternoon, guys. Congrats on the ongoing outperformance. Matthew or Thomas, thanks for the color on paying customers and the large customer additions this quarter. But can you also provide us with an update of the total customer count? Any qualitative or even quantitative views will be appreciated? And I have a follow-up.

Matthew Prince
Chairman, Co-Founder & Chief Executive Officer, Cloudflare, Inc.

A

Thanks. Thanks, Shaul. So we're actually causing the reporting of the total customer count this quarter although we're going to bring it back. And just a reminder total customers included both free and paying customers and throughout the quarter we saw continued strength in that. The problem was that it really sort of described a different business than we're in today. It looks at active Internet properties and really only covered those products that relied on actually having like a website. And that didn't include a lot of the new products like Cloudflare One

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and another bits. And so we don't feel like that statistic was representative. So we're pausing it. We're going to bring it back. In the meantime, if you do want to continue to track something like that, there are a lot of external services that track kind of what sign up rates are. We've continued to see strength across that W3Techs, report that on a month-to-month basis. And so if that's something that you want to continue to track, that would be the place that I would look to get that. And we're looking forward to bringing our total customer count back in a way that's more accurate going forward.

Shaul Eyal
Analyst, Cowen & Co. LLC

Q

Got it. Understood. And maybe another one, Matthew or Thomas. On the topic of billings versus RPO, some investors some within the investment community are using billings as the metric to track maybe as it related to Cloudflare it could actually misconstrued how healthy the underlying trends are. Do you think RPO could be the preferred metric to track? What's the internal thinking on this topic?

Thomas Josef Seifert
Chief Financial Officer, Cloudflare, Inc.

A

Yeah, let me get started here. We think that RPO is the better indicator for the health of all of the business that is certainly the number we are focusing on. And as we said it's up 77% year-over-year in the last quarter. Current RPO that is the RPO on the balance sheet that we recognize over the next 12 months is up 60 north of 60%. Billings can be sometimes an arbitrary number just depending on how many billing cycles you run over a quarter. We think RPO is the better health metric. So I think that is the number that we at Cloudflare are focused on from how we run them in the business and how we, what KPIs we try to.

Shaul Eyal
Analyst, Cowen & Co. LLC

Q

Got It. Thank you. Understood. Good luck.

Operator: We have our next question coming from the line of Sterling Auty with JPMorgan. Your line is open.

Drew E. Glaeser
Analyst, JPMorgan Securities LLC

Q

Hey, guys. This is Drew on for Sterling. Matthew, could you expand upon your commentary surrounding the long-term investment trajectory including the timeline of that and what areas you're expecting to lean into the most?

Matthew Prince
Chairman, Co-Founder & Chief Executive Officer, Cloudflare, Inc.

A

Sure, Drew. So two areas. Obviously, we continue to invest in our sales and marketing motion. And think about how as we continue to go up market, we have the team in place to service that. And again, I think what's unique about us is that we're able to invest behind the demand, but we do believe that salespeople and we do believe that marketing matters, we will continue to invest in that because when you're servicing customers that are as large as we have, they want, they wanted to do that. And it also helps us as we want to expand those customers across our entire product set to have people who can be the advocates who can talk to them and be a part of that.

I think the second area where we continue really to invest is in our research and development efforts. Cloudflare runs on innovation and we have designed our entire business in order to be an innovation machine. And so, over the course of the year, we have a number of new products that we continue to release. I don't see that slowing

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down anytime soon. And we definitely – as what we like to do, is design the way that we think about R&D as making a number of bets in the area, iterating quickly on those bets across our broad customer base. And then, by the time something is ready for us to take it to our largest customers, it's battle-tested and something that we continue to run on. So I don't think that the formula changes, but I do think that as we get to breakeven, being able to pour resources back into that, if anything, should just accelerate the rate at which we are able to drive real innovation across the company.

Drew E. Glaeser
Analyst, JPMorgan Securities LLC

Q

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

Operator: We have our next question coming from the line of Tim Horan with Oppenheimer. Your line is open.

Timothy Horan
Analyst, Oppenheimer & Co., Inc.

Q

Thanks, guys. Just two questions. One, I think you're implying the net dollar retention can improve here. Can you talk a little bit how can you improve it still, which is pretty high number, and maybe where it can go?

And then, secondly, some of the carriers out there are partnering with some of the cloud providers. Do you think they can basically pivot to become a better competitor against you or – and/or are you seeing anyone else out there that's really pursuing a similar strategy to compete with you? Thanks.

Matthew Prince
Chairman, Co-Founder & Chief Executive Officer, Cloudflare, Inc.

A

Sure. So let me take both questions, and then Thomas may want to add to the first. So first of all, with carriers, we work and have had partnerships with carriers for quite some time. Most of the new deployments that we go into were deploying directly into the carriers' networks and we have a very symbiotic relationship with them and have been able to continue to invest in that.

We're able to see what the traffic flows are across public cloud, and we don't see that there's much resonance for some of the carrier partnerships with the public cloud yet. But it's something that we obviously are watching closely and carefully. And I think that the opportunity that we have is to continue to be a great partner to those carriers wherever they are around the world, both to deliver our services and be able to drive down our costs as we continue to build.

And I apologize. In the process of answering that, I forgot what your first question was. But can you repeat it just quickly?

Timothy Horan
Analyst, Oppenheimer & Co., Inc.

Q

Yeah, yeah. That's fine. Well, just the net dollar retention rate, how do you [indiscernible] (00:44:15) on what's really the number?

Matthew Prince
Chairman, Co-Founder & Chief Executive Officer, Cloudflare, Inc.

A

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Yeah. So again, we're – that is something that we focused on. What I love about Cloudflare is when we focus on something, we're really good at improving it. I think that it's been driven by new products. And since we don't have a usage-based model where sort of revenue can trombone up and down over time, but instead, we have a subscription model. It really requires us to sell more products, and I think that that's been a piece of it.

I think going back to what Thomas spoke about earlier as the bundling opportunity, that feels like the opportunity for us to be able to continue to improve that number over time. I will say that there might be some noise in the dollar-based net retention number, where we definitely have got – worked hard to get it above 120%, and we think that that's great. We're not satisfied with where it is. There may be from quarter-to-quarter a little bit of noise in that metric. But we do think that over time, we can continue to improve that metric.

Timothy Horan
Analyst, Oppenheimer & Co., Inc.

Q

Thank you.

Thomas Josef Seifert
Chief Financial Officer, Cloudflare, Inc.

A

One addition maybe. It's good to keep in mind that dollar net retentions are lagging indicator for us how we report it. So, it's lagging the initiatives that we drive. We also have a pay-as-you-go business. That is very important for us in terms of how we drive efficiency in the business model. But remember, we always said that is a business that is difficult to expand. So, everything you see from a DNR performance perspective happens [ph] with the drag (00:46:02) of the pay-as-you-go business and there's a lagging indicator to the initiatives we have started.

Operator: Thank you. We have our next question coming from the line of Jonathan Ruykhaver with Baird. Your line is open.

Jonathan B. Ruykhaver
Analyst, Robert W. Baird & Co., Inc.

Q

Yes. Hi. So in thinking about Workers, you've discussed in the past how it's still in the emerging tech [indiscernible] (00:46:25) price for adoption compared to revenue. I'm wondering if you can provide any insights and this might change. And in something specific here, what kind of criteria you might be looking for in evaluating, taking that to market as a more mature solution?

Matthew Prince
Chairman, Co-Founder & Chief Executive Officer, Cloudflare, Inc.

A

Yeah. Hey, Jonathan. So, I think it's a pretty mature solution. We launched it in 2017 and it is – we're seeing very, very, very large companies bet their businesses on Workers. So, I think that that – it is a large solution. I think that what we have been hesitant to do is break out what the specific revenue is because it tends to be part of the larger components of how we're selling our solution. But we continue to see strength in Workers. We see people building not random startups, but really sophisticated large companies building sophisticated, complicated applications using Workers. And so, it's – it is already taking workloads off of the traditional public clouds, and the people and that the organizations just find it magical.

So again, I think that that – even if the prices that we charge for Workers today, it is very margin accretive for us. And so, again, I think it is a competitive product. We think that being very cost effective is important when you're selling cloud products. We don't think of ourselves as competing with other niche edge computing platforms. We think of ourselves as competing with the big public cloud platforms. And so, when we think about pricing we think

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about pricing it in a way that that is competitive with those other public cloud, and even at those rates, again, it's margin accretive for us.

Jonathan B. Ruykhaver
Analyst, Robert W. Baird & Co., Inc.

Q

Right. Okay. That's helpful. And then, just as a quick follow-on, in terms of drivers of serverless, Matthew, what are the things you hit on as just the compliance use case? And can you just touch on that a bit more and if you're seeing that starting to take hold in the market yet?

Matthew Prince
Chairman, Co-Founder & Chief Executive Officer, Cloudflare, Inc.

A

Yeah. So, the first bet is the computing piece of edge computing is the easy piece. The hard piece is storage. And what I think you've seen us do is think through how to have distributed storage in a way that is still easy for developers to wrap their heads around and build, but at the same time, gives them the flexibility where they can do things like require a piece of data, never leave a particular geography.

And so, I think the regulatory environment for our customers continues to get more and more complex. We're seeing a lot of attention for the regulatory concerns which are coming out of EU. But what we hear from customers is that that's just the tip of the iceberg. And places like India and Brazil, and obviously, China and others are also putting in place requirements that require people to keep their data from users in country in that particular region. And so, I think that Workers is perfectly positioned for what is a much more complex regulatory environment. We are – today in well over 100 countries worldwide, we're on a path to being in virtually every country worldwide. And what that allows us to do is help our customers comply with these increasingly complex regulations around the world.

We talked earlier about FedRAMP. Again, that's very US-focused. We're doing similar efforts, for example, with the German equivalent and others around the world. And again, I think that sets us up very well to be able to satisfy the regulatory and compliance needs of so many large enterprises. And it's what we keep hearing as the real killer feature that distinguishes workers from any other computing platform.

Jonathan B. Ruykhaver
Analyst, Robert W. Baird & Co., Inc.

Q

Yes. That's great. Thank you.

Operator: We have our next question coming from the line of Alex Henderson with Needham. Your line is open.

Alex Henderson
Analyst, Needham & Co. LLC

Q

Thanks. Matt, I just wanted to compliment you first on the Hotel California Amazon data commentary on your blog. I thought it was really well done. I was hoping you could talk a little bit about the developer community adoption. Any change in the rates, any metrics around the size of it? Everybody focuses on the financial side of it, but I think the DevOps community integration is such a key piece. Could you talk – give us some metrics or something to qualify and quantify that, please?

Matthew Prince
Chairman, Co-Founder & Chief Executive Officer, Cloudflare, Inc.

A

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Yeah. Sure. So, more than 50,000 developers wrote their first Workers script or code this time, and that's not signed up for an account. That's actually wrote, code and deployed an application. We can – that continues to grow over time. And the retention of those developers, they don't tend to just write something and then go away. But we see them continuing to deliver more and more applications and more and more sophisticated applications as we watch what developers are building.

And so, I think when we think about the platform, I completely agree with you. Whoever has the most developers wins. We want to make a platform which, yes, satisfies the CIO and CTO and General Counsel for its regulatory compliance; yes, it's incredibly cost effective; of course, is incredibly consistent. We're already the fastest that – that are – that's out there. But then, we really need to continue to invest in making that – developing that platform's ecosystem.

One of the things that I'm excited about is while we've largely talked about big customers here, we're increasingly seeing startups that are building entire applications from scratch on the Workers platform. And that's exciting, both because it's really just a very fervent area of excitement and it's how you build communities and build ecosystems. But it also is a great way for us to be looking out at whether or not there are really great features that maybe other companies and small companies develop that might be natural, either things that we can bring into a marketplace or maybe even as potential tuck-in acquisitions that don't have the technical integration risk that there would be if they were using completely different platforms. So, I'm excited about it. If you search on Twitter, if you go on our Discord channel, you'll see the developers are excited about it, and again, it's picking up steam.

Alex Henderson
Analyst, Needham & Co. LLC

Q

Great. Thanks.

Operator: We have our next question coming from the line of Jim Breen with William Blair. Your line is open.

James Breen
Analyst, William Blair & Co. LLC

Q

Thanks for taking the questions. From time to time, you sort of update your – what you guys believe is the addressable market. Just given sort of all the new product launches, et cetera, can you just talk about how you see that moving now? And then, a little bit off of Tim Horan's question just around your existing customer base growth, any sort of metrics there on the security side in terms of your paying customers? How many products they're taking and how that's maybe changed over time? Thanks.

Matthew Prince
Chairman, Co-Founder & Chief Executive Officer, Cloudflare, Inc.

A

So I'll take the second half of that, and then – and Thomas can comment on the first half. So, we – at our last Investor Day, we updated that they – the – it's north of, I think it's 80% – Thomas, correct me if I'm wrong – of customers are using four or more of our products. And that tends to be the magic number for us in terms of really having stickiness and really differentiating ourselves in the marketplace. And typically, customers will span across both security, but then also, performance and reliability. About 50% of our revenue, 50% of sort of the initial interest that we get comes from our security product, about 25% from performance and about 25% from reliability.

But I think that that somewhat mischaracterizes what Cloudflare really is, which is a platform that allows you to have all three of those things in one unified solution. So, we continue to see that customers are taking more of our products. As we launch products, we're really building out that engine that makes it so that we can very quickly

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pour new products into our existing customer base and have them adopted. And that – again, I think that that is – it is very difficult to compete with us once we get customers to understand the power of using the broad platform that we have.

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

Yeah. I wouldn't want to disclose, I mean, your additional data, but I think the points that Matthew just made is important, relating it back to our ability to bundle as our product portfolio gets broader and broader, our ability to customize bundles for specific customer needs, and compete more effectively against point solution providers. I think this is the opportunity that rests there.

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

And I got the – I looked it up quickly. It's 88% of our contracted customers use four or more clouds and products, and 79% are five or more.

James Breen
Analyst, William Blair & Co. LLC
Q

>: Great. Thank you very much.

Operator: We have our next question coming from the line of Gregg Moskowitz with Mizuho. Your line is open.

Gregg Moskowitz
Analyst, Mizuho Securities USA LLC
Q

Okay. Thank you and good afternoon, guys. Matthew, you mentioned Zero Trust a couple of times that's driving some important wins for you this quarter. And as part of this, I was wondering if Cloudflare for Teams is starting to compete on a head-to-head basis more frequently at the enterprise level.

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

Yeah. Absolutely. I think that that – if you look at what, for example, the United States Government chose and is going to be offering to all civilian federal agencies, that was a – that's a subset of the Cloudflare for Teams product in order to make sure that government workers are not targeted by malware or don't fall for phishing scams. And so, we're really proud of that win. But there were many, many, many more wins where Cloudflare for Teams is going up against companies that only do the sort of Zero Trust types of solution, and our win rates are very strong.

I think the place where we have really excelled are – is in both ease of use and – sort of ease of use needs of deployment, which again, I think comes from the heritage that we've always really thought about how can we make things incredibly easy to use. And then, secondly, we really resonate with the developer community. And so, for the more technical buyers, they are – we win those deals up, down, left, right and sideways.

I think where we continue to invest and where we will make progress is making sure that we are top right in Gartner and Forrester and all of the other analyst briefings. But again, starting with some of these great customer wins that we have is the key in order to make – in order to be able to demonstrate that from the industry

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[indiscernible] (00:59:42). And we think we're well on path to being in the consideration set for anyone who is thinking about Zero Trust solutions.

Gregg Moskowitz
Analyst, Mizuho Securities USA LLC

Q

All right. That's really helpful. And then, just a quick follow-up on Workers, so even at its somewhat low scale today, this is a very margin accretive offering for you?

Matthew Prince
Chairman, Co-Founder & Chief Executive Officer, Cloudflare, Inc.

A

Yes. It's – it is margin accretive even at 78% gross margin.

Gregg Moskowitz
Analyst, Mizuho Securities USA LLC

Q

All right. Terrific. Thanks very much.

Operator: Thank you. There are no further questions at this time. I will now turn the call back over to the presenters for any closing comments.

Matthew Prince
Chairman, Co-Founder & Chief Executive Officer, Cloudflare, Inc.

We had an absolutely terrific quarter. Really appreciate all of our team working hard to deliver the results that we have. Looking forward to seeing many of you at the upcoming shareholder and technology conferences, and we're going to get back to work to helping build a better Internet. Thank you.

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

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