

03-Aug-2023

# Cloudflare, Inc. (NET)

Q2 2023 Earnings Call

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## MANAGEMENT DISCUSSION SECTION

[Abrupt Start]

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### Philip Winslow

*Vice President-Strategic Finance, Treasury & Investor Relations, Cloudflare, Inc.*

Thanks for joining us today to discuss Cloudflare's financial results for the second quarter of 2023. 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 will be making forward-looking statements during today's discussion, including but not limited to our customers, vendors and partners, operations and future financial performance, our anticipated product launches and timing and market potential of those products, our anticipated future financial and operating performance, and our expectations regarding future macroeconomic conditions.

These statements and other comments are not guarantees of future performance and are subject to risks and uncertainties, much of which is beyond our control. Our actual results may differ significantly from those projected or suggested in any of our 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 SEC 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. You may find a reconciliation of GAAP to non-GAAP financial measures that are included 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 participating in the Stifel's Tech Executive Summit on August 29th and the Goldman Sachs Communacopia and Technology Conference on September 6.

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

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### Matthew Prince

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

Thank you, Phil. We had a strong quarter in spite of continued macroeconomic uncertainty. In Q2, we achieved revenue of \$308.5 million, up 32% year over year. We added 196 new large customers, those that pay us more than \$100,000 per year; and now have 2,352 large customers, up 34% year-over-year.

Our focus on go-to-market improvement is already paying off. After we saw sales cycles increase 20% in Q1, discipline around deals had them return to levels closer to what we saw last year. While our customers and

prospects continue to be very careful around their IT spend, our improved execution led to a record quarter in new ACV booking.

My sense talking to customers is that while the macro environment is still challenging, it is stabilized. And for the first time in several quarters, sentiment among IT buyers does not appear to be getting worse.

Our dollar-based net retention ticked down to 115%, down 2% quarter-over-quarter. Dollar-based net retention is a lagging indicator, so will be slower [indiscernible] (00:03:13) to go-to-market improvement we're seeing. It's also important to note that we did not see any new competitive pressure or churn throughout the quarter. Instead, the lower dollar-based net retention is due to slower expansion from some of our existing customers. We expect that our focus on go-to-market operational excellence will improve this metric over time.

Our gross margins held stable at 77.7%, still above our long-term target of 75% to 77%, and in line with 77.8% last quarter. We delivered an operating profit of \$20.3 million, our fourth consecutive quarter with a record operating profit. We also meaningfully outperformed on free cash flow, generating \$20 million during the quarter, which represents a free cash flow margin of 6.5%. I'm proud that our team has proven we can not only execute in good times, but also be disciplined and deliver operational improvement while we're in more challenging times.

We continue to see very strong pipeline growth. Q2 is another record for new pipeline generation. As we discussed last quarter, we made significant changes in our sales team to proactively address underperformance. That went very well both qualitatively and quantitatively. Our top performers are invigorated. We saw a marked improvement in the average account executive productivity.

At the same time, we've implemented robust onboarding, enablement and training programs. Combined with the record number of applicants we're seeing for sales roles, this makes for the right formula to build a world class sales organization.

And our team is armed with great products to sell. Last quarter alone, Forrester recognized Area 1, our email security product, as a leader. IDC recognized us as the leader for two reports in Zero Trust and Network Edge Security-as-a-Service. And we were the only new vendor recognized by Gartner for Secure Service Edge. Our developer platform, Cloudflare Workers, continues its explosive growth. We reached 10 million active Workers applications in Q2, up 250% since December and 490% year-over-year.

R2 continues to grow and now stores over 13 petabytes of customer data, up 85% quarter-over-quarter. We have 44,000 distinct paying customers with R2 subscriptions. And brand name customers are beginning to adopt it as their primary object storage solution. That seems like a good segue into some other customer wins in the quarter.

One of the fastest-growing generative AI companies expanded their relationship with Cloudflare, signing a one-year \$1.7 million contract less than a year after first starting to use our platform. Like many AI companies in the space, this customer relies on a multi-cloud architecture for training and processing requests. R2 lets them unlock the best prices and performance across multiple cloud providers. In their words, "We see Cloudflare as a strategic, foundational glue across all our services. Cloudflare continues to be our best strategic partner of all partners". That's great to hear from many customers, but it's especially fun coming from a company that's doing such cutting edge work.

These days feel like membership in the CEO club is predicated on saying AI as many times as possible in your earnings call script. I have to confess, I still find it a bit awkward. When we first pitched Cloudflare to venture capitalists back in 2010. At one point, I described it as "The first AI-powered security company for the cloud". The

eye-rolls around the table were so intense that I'm still a bit scarred. But, more than a decade later, here we are. And by our estimates, Cloudflare is the most commonly used cloud provider across the leading AI startups.

They're using R2 to help arbitrage the lowest GPU cost to train their models. They're using our security tools themselves powered by AI, or what our team would prefer to call machine learning, to protect their own AI systems. And increasingly, they're using the edge of our network to perform inference. We are continuing to invest in this area and believe that we are uniquely positioned to win the inference market, which we believe will be substantially larger than the training market.

In Q2, we hosted our Developer Week, highlighting 10 major announcements and features to extend Cloudflare Workers as the preeminent developer platform for the leading AI companies. Q3 will feature our annual birthday week and we have a lot more in store to provide the picks and shovels to enable AI companies to build the future.

Beyond AI, Cloudflare's Zero Trust solutions were another big winner in Q2. A Fortune 500 technology services company expanded their relationship with Cloudflare, signing a three-year \$7.2 million contract for 25,000 Zero Trust seats. That brought their annual spend with us to over \$5 million. They first became a customer in Q3 last year using our application security product. Six months into the deployment, one of their senior executives said "Cloudflare is like magic" and brought us into an ongoing competitive zero trust proof of concept. Cloudflare's Access and Gateway products were chosen over first generation zero trust competitors due to our rate of innovation and ability to consolidate all their security onto a single pane of glass.

One of the largest online recruiting platforms expanded their relationship with Cloudflare, signing a 25-month, \$2.4 million contract, and bringing their annual spend over \$5 million. With more than 90% of their employees remote, they were looking for a comprehensive zero trust solution and evaluated us against every leading vendor in the market. They decided to go all in on Cloudflare with 15,000 seats for Access, Gateway, CASB, Data Loss Prevention, Browser Isolation and Area 1 email security. I'm especially proud of how quickly we were able to onboard them, less than a month to fully replace their first generation zero trust vendor. That's awesome.

An Australian technology company expanded their relationship with Cloudflare, signing a one-year, \$2.2 million contract, bringing their total spend with us to over \$5 million. This customer started out on our pay-as-you-go plan in 2016. This quarter they signed a Zero Trust deal to protect their expanding workforce. They're also broadening their use of Cloudflare's developer platform with both R2 and Durable Object.

Sticking down under, a leading Australian healthcare provider expanded their relationship with us, signing a three-year, \$2.8 million contract. We are replacing their hodgepodge of first generation zero trust vendors with 12,000 seats of Access, Gateway, Browser Isolation, CASB, Data Loss Protection and Area 1 email security. This is another example of a customer looking to consolidate vendors and choosing Cloudflare for their holistic network security solution.

Here's another cool one. A Fortune 500 social network expanded their relationship with Cloudflare, signing a three-year, \$2.4 million contract. They initially became a customer a year ago, building on top of workers and using our global network to authenticate the security of one of their messaging products. They approached us again, looking to add increased privacy onto another product with our Privacy Gateway solution.

They view Cloudflare as a leader in privacy based on our co-development of the oblivious [ph] HCV (00:10:44) standard. And they admire us as one of the only other companies that truly understands scale. As privacy is increasingly top of mind, we believe there will be more and more of these sort of strategically beneficial relationships.

I think I've only said AI 11 times so far, putting me way behind [ph] Satya (00:11:02). So let me end with one more AI customer win. Another generative AI company expanded their relationship with us, signing a three-year, \$1.3 million contract. It came to us for our developer platform, signing up as a pay-as-you-go customer. Because their developers loved us, they approached us about a security need and signed a deal to use our application security and Zero Trust products. They're only a 100 seats. But they're growing like crazy and building Cloudflare deep into their whole stack.

Whether you're a Fortune 500 industrial company that used us for application security and are now hiring AI developers to use our Workers platform to drive innovation across your business or you're a 100-person AI startup that started using our developer platform and then realized you can get the same security as the biggest Fortune 500 companies, that's what's really unique about Cloudflare. We've built the cloud that connects the world securely, reliably and efficiently.

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

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## Thomas Josef Seifert

*Chief Financial Officer, Cloudflare, Inc.*

Thank you, Matthew. And thank you to everyone for joining us. During the second quarter, I'm pleased to share that we've seen improvements in terms of the impact from the external challenges that we highlighted last quarter.

Specifically, [ph] while still (00:12:20) somewhat elevated from historical levels, sales cycles shortened in part due to the implementation of more efficient processes and tactics. Our pipeline close rates have also shown improvement as we continue to refine our go-to-market strategies and operations. Furthermore, we observed a notable uptick in collections in our accounts receivable, which we believe reflects a rebound in customer confidence and financial stability.

We also continue to maintain our strong commitment to being fiscally responsible and act as good stewards of investors' capital. We delivered our fourth consecutive quarter of record operating profit. We also prudently allocated capital with a focus on maximizing shareholder value by taking action to retire our 2025 convertible notes during the second quarter.

Turning to revenue, total revenue for the second quarter increased 32% year-over-year to \$308.5 million. From a geographic perspective, the US represented 53% of revenue and increased 30% year-over-year. EMEA represented 27% of revenue and increased 38% year-over-year. APAC represented 13% of revenue and increased 23% year-over-year. We were pleased to see notable performance in the EMEA and APAC regions with both achieving record new ACV bookings in the second quarter. The strength in APAC was primarily driven by large customer deals and we are seeing security become an even higher priority in EMEA given the geopolitical situation in the region.

Turning to our customer metrics. In the second quarter, we had 174,129 paying customers representing an increase of 15% year-over-year. We ended the quarter with 2,352 large customers, representing an increase of 34% year-over-year, and an addition of 196 large customers in the quarter. In fact, we added a record number of customers spending more than \$500,000 on an annualized basis with Cloudflare, and the second quarter was also one of our highest quarterly additions of customers spending more than \$1 million annually, including our largest Zero Trust contract to-date.

Our dollar-based net retention rate was 115% during the second quarter, representing a decrease of 200 basis points sequentially. Importantly, renewal rates in the second quarter were consistent with the quarterly average in 2022, which was an all-time high for the company. Instead, similar to the last two quarters, the decline in DNR was again primarily driven by slower expansion in our larger customer cohort.

We calculate DNR by comparing the analyzed revenue from paying customers four quarters prior to the annualized revenue from the same set of customers in the most recent quarter. As a result, this will be a lagging indicator of Cloudflare's underlying business trends. Based on our visibility, we believe the deceleration in DNR is nearing a bottom.

Moving to gross margin. Second quarter gross margin was 77.7%, representing a decrease of 10 basis points sequentially and a decrease of 120 basis points year-over-year. Network CapEx represented 11% of revenue in the second quarter. For fiscal 2023, we now expect network CapEx to be 10% to 12% of revenue, underscoring the scalability and efficiency of our network even as we onboard new workloads, including AI.

Turning to the operating expenses. Second quarter operating expenses as a percentage of revenue remained consistent sequentially and decreased by 8% year-over-year to 71%. Our total number of employees increased 11% year-over-year, bringing our total head count to 3,389 at the end of the quarter.

During the second quarter, we addressed consistently low performing sales capacity with a focus on upgrading our customer facing talents to improve growth, increase productivity and drive long-term success. We will continue to pace hiring for the year based on market conditions and remain committed to raising the bar on new hire additions given talent opportunities available in the market.

Sales and marketing expenses were \$125.4 million for the quarter. Sales and marketing as a percentage of revenue decreased by 1% sequentially and decreased to 41% from 44% in the same quarter last year. Research and development expenses were \$53 million in the quarter. R&D as a percentage of revenue decreased by 1% sequentially and decreased to 17% from 20% in the same quarter last year. G&A expenses were \$41 million for the quarter. G&A as a percentage of revenue increased 1% sequentially and decreased to 13% from 15% in the same quarter last year.

Operating income was \$20.3 million compared to an operating loss of \$891,000 in the same period last year. Second quarter operating margin was 6.6% an increase of 700 basis points year-over-year. These results highlight our continued focus on becoming more efficient and more productive, not just during the currently uncertain macroeconomic backdrop, but also because operational efficiencies are long-term competitive advantage.

Turning to net income and the balance sheet. Our net income in the quarter was \$33.7 million or a dilutive net income per share of \$0.10. We ended the second quarter with \$1.6 billion in cash, cash equivalents and available for sale securities. Free cash flow was \$20 million in the second quarter or 6% of revenue compared to negative \$4.4 million or 2% of revenue in the same period last year. Remaining performance obligations or RPO came in at \$1 billion, representing an increase of 8% sequentially and 36% year-over-year. Current RPO was 75% of total RPO.

Before moving to guidance for the third quarter and full year, I would like to begin with our expectations and the progressions we have factored into this outlook. Despite being encouraged by the forward progress we delivered during the second quarter in terms of shortening sales cycles and improving growth rates, mixed macroeconomic data points serve as a reminder that we are operating in a business environment that, though showing signs of

stabilization, continues to be challenging to predict. As a result, we remain prudent and cautious in our outlook for the second half of the year and we are fully committed to continuing to adapt our tactics and strategies in response to these external variables.

Now turning to guidance. For the third quarter, we expect revenue in the range of \$330 million to \$331 million, representing an increase of 30% year-over-year. We expect operating income in the range of \$20 million to \$21 million. And we expect diluted net income per share of \$0.10, assuming approximately 347 million shares outstanding. We expect an effective tax rate of 11%.

For the full year 2023, we expect revenue in the range of \$1.283 billion to \$1.287 billion, representing an increase of 32% year-over-year. We expect operating income for the full year in the range of \$81 million to \$85 million. And we expect diluted net income per share over that period to be \$0.37, assuming approximately 345 million shares outstanding. We expect an effective tax rate of 9% for 2023.

After having achieved positive free cash flow in the second half of last year and, again, during both the first and second quarters of this year, we anticipate generating significant free cash flow for the full year 2023. For modeling purposes, we continue to expect free cash flow to trend upward on an ongoing basis, but anticipate variability in our free cash flow generation quarter to quarter.

In closing, our team remains committed to driving operational excellence, ensuring long-term growth and delivering significant shareholder value. I'd like to thank our employees for their continued dedication to our mission, customers and partners. And to our shareholders, we greatly value your continued support.

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

## QUESTION AND ANSWER SECTION

**Operator:** Thank you. [Operator Instructions] And we will take our first question from Shaul Eyal with TD Cowen. Your line is open.

**Shaul Eyal**  
*Analyst, TD Cowen*

Q

Thank you. Good afternoon, guys. Congrats on the results and the outlook. Matthew, can you talk about some of your displacement activity this quarter? And maybe my second part of the question will be, do you see AI as accelerating your displacements and win rates? Thank you.

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

A

Yes, Shaul. I really appreciate the question. And we've had a lot of noise on the line from the operator, so hopefully I believe we can get things muted. Apologies for that.

So I think that when we look at displacement, it really is across three different parts of our business. So the first area is our traditional application security business. And in that space, we continue to displace a number of traditional hardware vendors, the people who are providing web application firewalls, load balancers, funding various services that people had in those areas. We also see point cloud solutions that are doing just one of those

things getting displaced by us where we can very much pick up a significant amount of their business. And that that's been the case for quite some time.

And the second part of our business which is our Zero Trust business. The first is sort of the front door to your business. The second is kind of the backdoor of your business. The Zero Trust business is about protecting employees and data. In that case, we're more and more going head-to-head with the other first generation zero trust providers. So the de-scalers, Palo Alto Networks, Cisco Umbrella of the world. And again, we really like our win rates in this space.

And in a number of the examples that I cited, we were specifically either in competitive solutions there or, in some cases, where we were actually doing take-outs, people who had made bets on the first generation of zero trust providers and wanted to upgrade to us for better ROI, a much better user experience, much faster, more performant network. And I think that that's one of the areas that I'm the most excited about.

The third area is really our Workers business, which is our developer platform. And in that space, it really depends on what's going on. Increasingly, we're doing take-outs from object store where people are moving data off of more traditional object stores onto R2, which is our object store. But a lot of times we're also just moving individual applications or individual functions to us. And so it's not a complete displacement. Oftentimes, people will use us alongside a more traditional hyperscale public cloud. But we can see that working together.

In the AI space, in particular, I think that, again, it's such a new space that I don't know that we're displacing people as much as we're just helping AI companies get what they need. And the two big areas around that are first around training, where GPU scarcity is significant and the cost with the traditional hyperscale public clouds are moving data to wherever there's cheap GPU capacity or even available GPU capacity makes it cost prohibitive. And so, R2, because we don't charge for egress, had been just a real boon for a lot of AI companies to be able to adopt wherever they can find the cheapest GPU at any moment in time. And that, again, has been an area where a lot of that growth has come from.

And then, increasingly, we think that the inference market is really going to be fought between two areas. One is going to be on your device itself. If you have a driverless car, you don't want when a ball is bouncing down the street and the kid is chasing after it, for that decision on whether or not to put on the brakes to have to go out to the network. Now you want that to live in the car itself. And so a lot of inference and [ph] models to be (00:26:19) run on devices.

But we think if they're not a run on devices, if they have – if they're too large, if they need too much capacity from either a GPU or memory or network access space, in those cases, it's going to make sense to run it in the network itself. And in that sense, Cloudflare is uniquely positioned to win in that inference market for those models that make sense not to run on the device themselves the more complicated model that makes sense to run in – out at the edge of the network, and that's exactly what we're starting to see from more and more of these really innovative AI startups.

**Shaul Eyal**  
*Analyst, TD Cowen*



Got it. Thank you so much. Good job.

**Operator:** And we will take our next question from Matt Hedberg with RBC Capital Markets. Your line is open.

**Matthew Hedberg**

*Analyst, RBC Capital Markets LLC*

Q

Great. Thanks for taking my question, guys. Thomas, I had a question for you. Obviously, good results this quarter and there was a lot of optimism. In your portion of the prepared remarks, you talked about sort of like better win rates, shorter deal cycles, et cetera. When I look, though, at sort of the sequential growth for Q3, Q4, it's a bit higher than what we saw in the first half. I just – what are some of those main factors that are giving you sort of increased optimism for the second half? And does guidance assume that macro stay constant or maybe even improve a little bit?

**Thomas Josef Seifert**

*Chief Financial Officer, Cloudflare, Inc.*

A

Well, thank you, Matt. We saw the first data points that, what you called, made me feel a bit more optimistic. We still think we need to apply a good portion of [ph] cautions (00:27:56) to our outlook. One data point doesn't really make a trend. At this point, we do not assume that the macroeconomic environment is improving significantly. We still see significant mixed macroeconomic data points that we factored into our guidance and then, therefore, [indiscernible] (00:28:20) prudent and cautious, not over-interpreting just on one data point.

**Matthew Hedberg**

*Analyst, RBC Capital Markets LLC*

Q

Got it. That's helpful. Maybe just a quick follow-up. Sort of double clicking on the strength that you saw this quarter. There was a lot of conversations about shorter sales cycles, better win rates. Have you noticed any quantifiable benefit from your new CRO, Marc, as he's come on board and maybe improved sort of the sales focus?

**Thomas Josef Seifert**

*Chief Financial Officer, Cloudflare, Inc.*

A

We are making good progress, both in terms of restructuring our team, in terms of adapting our tactics and strategy, so we move up market. But you have to remember that bringing on key new people takes ramp time, a little bit shorter in the midmarket, a little bit longer in the enterprise segment. We have not seen most of those improvements yet and we do not expect to see them over the course of the remainder of this year. So we are making really good progress. But we have been cautious in terms of what we've factored in, in the guidance we've given for the second half.

**Matthew Hedberg**

*Analyst, RBC Capital Markets LLC*

Q

Thanks, guys.

**Operator:** And we will take our next question from Trevor Walsh with JMP Securities. Your line is open.

**Trevor J. Walsh**

*Analyst, JMP Securities LLC*

Q

Great. Thanks, team, for taking my question. Maybe, Matthew, just for you first. A lot of the comments around AI seems to focus more around the developer piece and Workers specifically, which you kind of have as part of your act three. Does that become more something accelerated into more of an act two for that part of the platform? Can you just maybe talk a little bit about kind of the changes of the game from that perspective?

## Matthew Prince

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

A

Sure. Thanks, Trevor. I think that the order of the acts is pretty – I would still say act one is application security, act two is Zero Trust, and act three is Workers. But I would say that we have been very pleasantly surprised at how quickly the Workers platform is taking off, but we are not at this time optimizing that platform for how can we bring as many dollars out of it as possible.

We think that studying developer platforms across history, what we've seen is what you really need is adoption. And so what I'm encouraged by is that every single day when new companies are starting, when new trends take off [indiscernible] (00:31:01) that people are turning to this. And I think – I don't think that this is a flash in the pan. This isn't a polyester kind of new wardrobe that is going to look good for a little while, but quickly fade. This is something that's real and we're seeing that more and more companies, more and more experienced developers are turning to the Workers platform in order to be able to deliver something that they can't get from the traditional hyperscale public cloud.

And so, I think that any great work of fiction or otherwise, some of the excitement often comes in the later chapters. And so I don't want to diminish it by saying that it's act three, and I think there's a huge opportunity there. But I also don't want to lose the fact that we had many customers this year really dive into our act two products and we're making incredible gains in that space as well. So I think we've got a really exciting second and third act.

## Trevor J. Walsh

*Analyst, JMP Securities LLC*

Q

Awesome. Thanks, Matthew. Appreciate the color. Maybe just a quick follow-up for Thomas. Of the 196 large customers that you added in the quarter, could you maybe provide a little bit of color around are those current customers crossing into that threshold or is there a preponderance or like an even split of new customers kind of just landing of that size? Can you just give us a maybe a general sense of kind of where that pool of customers is coming from?

## Thomas Josef Seifert

*Chief Financial Officer, Cloudflare, Inc.*

A

In the past it was pretty even, 50/50 between new customer sign-on on the defender expansion. I would say, in the last quarter specifically, we had probably a larger share of new customers signing up right beyond the \$1 million range. So it shifted slightly away from expansion into a new logo sign-on.

## Trevor J. Walsh

*Analyst, JMP Securities LLC*

Q

Awesome. Great. Thanks again for taking the questions.

**Operator:** And we will take our next question from Jonathan Ho with William Blair. Your line is open.

## John Weidemoyer

*Analyst, William Blair & Co. LLC*

Q

Good afternoon. This is John Weidemoyer for Jonathan. Thanks for taking our question. I'd like to get some clarification, if I could, on – and better understand. Your net retention rate, if I understood you correctly, you had indicated in your prepared remarks that the retention rate is a lagging indicator that should benefit from your go-

to-market and sales replacement initiatives and such. But then I believe you also said that was impacted by the largest customer cohorts.

I wouldn't expect large customers to be quite as impacted. I wouldn't think that there's large customers would be impacted so much by your sales or go-to-market, because their existing customers or most – a lot of them would be. Could you help me understand how that would impact retention rate and what kind of some of the moving parts are there?

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**Thomas Josef Seifert**

*Chief Financial Officer, Cloudflare, Inc.*

A

All right. Just to make sure the expansion rate stayed high. Expansion in large customer cohort was a little bit lagging. That is what we already saw in the prior quarter. It's also one of the reasons for my previous answer that the large customer growth was pretty much coming more biased towards new logos than it was coming from expansion.

Expansion, as I said in my prepared remarks, it was a lagging indicator because it's pretty much a look back to the four prior quarters. That is what you compare to [ph] new sign-on (00:34:55). So, any movement we see in an existing quarter will take time to show up in DNR. We think we are seeing broadening of the DNR development. So we are quite hopeful we'll move that upwards to where – and beyond where we came from. But because we're so conservative in how we measure DNR, it's an all-in across all customer cohorts, it's very much a lagging indicator. So it will take a while before all the improvement that we are initiating in getting expansion going again will show up in DNR.

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**John Weidemoyer**

*Analyst, William Blair & Co. LLC*

Q

Okay. Thank you. And if I could just ask for – you mentioned that some of these initiatives you wouldn't expect to see the new sales folks and whatnot being fully productive through the end of the year. That makes sense. Can you talk about your progress on the implementation of the sales processes, kind of when – where you might think you're like halfway done, fully done, at what point in time, and have you identified further process improvements since our last talk a quarter ago? Thank you.

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**Matthew Prince**

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

A

Yeah. So I'll take that. I think that Marc is doing a really great job. Looking across the organization, I think one of the things that we really highlighted last quarter was that we had some underperformance across the org and we addressed that. What I was – that's – I, over the course of the last three months, have kept very careful sort of my fingers on the pulse of the organization. Met with a ton of our team.

And what I'm hearing from the team is that they're super invigorated, they appreciate the additional training and enablement that we've implemented, and that we're seeing our sales team get the tools that they need in order to make sure that they can close great deal. And we, again, still have very strong pipeline. And I think that what you'll see is that that gets reflected as we have those new reps that are coming on, as we do more enablement with our existing reps. And that I think is something that's very bullish for what we have going forward.

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**John Weidemoyer**

*Analyst, William Blair & Co. LLC*

Q

Thank you.

**Operator:** We will take our next question from Brent Thill with Jefferies. Your line is open.

**Brent Thill**

*Analyst, Jefferies LLC*

Q

Good afternoon. Matthew, if you take your crystal ball out in the second half of the year, I'm just curious if you feel things are starting to slowly improve, it seems like a lot of your security peers are starting to see some decay and perhaps you're gaining some share here relative to your architecture and the platform. I'm curious if you can kind of maybe stitch the back half together and how you see it at a 40,000-foot view.

**Matthew Prince**

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

A

Yeah. I don't know how accurate my crystal ball is, but I think that I'm going to say that it feels like things are improving. It feels like things are plateauing. Q1 was really hard. The fact that we had in one quarter sales cycles increase 20% was a very big and frightening occurrence. And I think that we were pretty early in earnings season to call that there was a real concern across IT buyers, but that got reflected by many companies that came after us.

What we saw in Q2 was that sales cycles returned back to be more in line with what we were seeing last year in 2022. 2022 was still elevated [audio gap] (00:38:50) in the several years prior to that. So what it feels like to me is that we're in for a grind and not Cloudflare, in particular, but across the entire economy. And that that grind is going to be hard. But I think it is actually serving us quite well because it's forcing us towards operational excellence. And across our entire team, people are digging in, they're working hard, and they're making sure that every process is as efficient as possible.

And I think that you're right. One of the things that is unique about us versus a number of others is, as we look at our products that we've been able to achieve very high gross margins. I think that's the best – one of the best indicators that we have a really differentiated platform. And as customers are looking for ways to consolidate their vendors, to find how to get more ROI out of everything they're doing, they're turning to us. And our team is ready and we have the right products. And so I think the grind that's ahead is actually something that is going to be hard, but it's something that I think I'm looking forward to. And we're going to become a better company as a result of it.

**Brent Thill**

*Analyst, Jefferies LLC*

Q

Thank you.

**Operator:** And we will take our next question from Keith Weiss with Morgan Stanley. Your line is open.

**Keith Weiss**

*Analyst, Morgan Stanley & Co. LLC*

Q

Excellent. Thank you, guys, for taking the question. And definitely glad to hear things are stabilizing. Matt, I just wanted to dig into the comment that you made both in the press release and on the conference call about Workers and Cloudflare being a really good platform for inference.

Can you talk to us about sort of the underlying technical why [indiscernible] (00:40:37) it's still pretty early days with these technologies and we're all trying to figure out how inference plays out over time. So I think your view would be helpful to the overall kind of industry conversation as well as the Cloudflare conversation on why you guys are well-positioned.

And then the follow-up is for Thomas. Whenever we hear inference, we're thinking that this is GPU intensive and computing intensive type stuff and typically lower gross margin. It sounds like you're pretty comfortable that this isn't impacting the gross margins in the near term. Is that just because it's still relatively early days and relatively small volumes? Or should we be thinking that this could – as this ramps, this could potentially have a bigger gross margin impact over time? Thank you.

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**Matthew Prince**

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

A

Yeah. So, Keith, I appreciate both questions. They're really, really important to understand the advantages that we have in this space. So, first of all, what are the challenges with inference? And I think there are really two. One seems like a bigger deal and is probably actually not as big a deal. And the other doesn't seem like it's a big a deal, but it is a really big deal. And in both, I think that they shape how we think the inference market is going [indiscernible] (00:41:50).

But the one that kind of feels like it's a bigger deal is around performance, which is that if you're playing with the various generative AI companies, if you're trying to do something, that wait time between when you submit a query and when you get back response, that's going to become a bigger and bigger differentiator between different AI platforms. And so anything that you can do in order to make that performance as fast as possible is advantageous. And one of the ways to do that is to move the actual inference as close as possible to the person who's requesting it.

And so, again, we think that inference will primarily be done on device or very close to where the end user is inside the network. We won't get – again, if the ball is bouncing across the street, you want that inference to be done on the device, on the driverless car itself. So we won't win every inference task, but there will be a lot that makes sense to be running in the network where we have, again, almost infinite network capacity, almost infinite storage and memory and very, very significant CPU and GPU resources to be able to run those inference tasks.

That I actually think will be the lesser of the two adventures for us. The larger one, which again doesn't feel like as big a deal, but we're already seeing it play out in some of the regulatory efforts that are happening around the world, is that a lot of times for the inference tasks, the data that's there is very private, and people – and governments want that to stay as close to the actual end user as possible. So we've already seen action in Italy that has restricted the use of certain AI tools because it sends data out of the country.

What Cloudflare can uniquely do, because we're positioned across more than 250 cities worldwide, we're the vast majority of countries worldwide, is that we can actually process that information locally. So, again, we think that on-device we're very close to where the user is on Cloudflare's network is going to be the place where inference is going to take place.

I'll take a quick stab at your second question as well and then hand it off to Thomas for anything that he would add. I think...

[indiscernible] (00:44:00)

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**Keith Weiss**

*Analyst, Morgan Stanley & Co. LLC*

Q

...actually like one clarification. So, in that world view, it sounds like you think we're going to see more kind of smaller open source and distribution of a lot of very small model versus like a world view that everything is going to come up into a big GPT or LaMDA model over time. Is that correct?

**Matthew Prince**

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

A

Not necessarily. But we run enough capacity out at the edge of our network that we can run fairly large, I mean, very, very, very...

**Keith Weiss**

*Analyst, Morgan Stanley & Co. LLC*

Q

Okay.

**Matthew Prince**

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

A

...large models out at our network. And what I think is a little bit confusing is most of – if you're trying to do the training of the models, then having the absolute latest, greatest GPU that H100 from NVIDIA right now, there's a lot of constraint in getting those chips, but there's actually a sweet spot for inference tasks which isn't necessarily at the absolute cutting edge of the models. And so Cloudflare is not the right place to actually process the training of models. That makes much more sense to do in a more traditional centralized data center model, much like much of the traditional hyperscale public clouds.

And in those cases, you have to have the latest, greatest GPUs. But when you're doing inference, again, a lot of that's going to run on your device and a lot of that is also going to run inside the network. And we're going to be able to, with a much lower CapEx spend, leverage the edge of our network in order to be able to do that processing extremely efficiently. And maybe we don't need the H100s, maybe we can live with an A100 or whatever, again, a generation or two behind. But that's also the difference between training and inference. And inference doesn't need necessarily the latest greatest GPU. Does that make sense?

**Keith Weiss**

*Analyst, Morgan Stanley & Co. LLC*

Q

Yeah. Super helpful. Thank you.

**Thomas Josef Seifert**

*Chief Financial Officer, Cloudflare, Inc.*

A

So, Keith, what I would add is, I always remind people, to truly understand the competitive mode of Cloudflare and the efficiency of the business model. You have to start with a network and how it's officially targeted using off-the-shelf hardware, completely integrated homogeneous software set that allows you to run every product on every server in every location. So you have this now massive, globally distributed network that is not only efficiently designed to handle large volumes of data, but also large volumes of simultaneous requests.

And that makes it already today very well-suited for inference costs, which by nature often was to processing request simultaneously. And it requires less computational power than training model. So I think the architecture of the network itself puts us in this really advantageous position, and that's why we're so confident that the

business model is going to hold. And it's one of the reasons why we're able to even guide CapEx ratio down for the year despite the fact that AI workloads are putting – are being put more and more on our network. So you really have to – as we always say, go back and really understand the efficient architecture of the network itself, and you'll find the answer there.

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**Keith Weiss**

*Analyst, Morgan Stanley & Co. LLC*

Q

Excellent. Super interesting, guys. Thank you.

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**Operator:** And we will take our next question from Andrew Nowinski with Wells Fargo. Your line is open.

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**Andrew James Nowinski**

*Analyst, Wells Fargo Securities LLC*

Q

Okay. Thank you and congrats on another great quarter. I wanted to shift gears and ask about Zero Trust. Is there any more details you could provide on that record Zero Trust contract you talked about and whether that was a displacement of another vendor and maybe why they selected Cloudflare? And then I have a quick follow-up. Thank you.

---

**Matthew Prince**

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

A

Sure. I think that in almost all of the Zero Trust deals that we see, we are at least in competition with some of the first generation zero trust vendors. In many of them, it's there – there's an incumbent vendor and we are displacing them. Usually when that happens, it's because the usability of the existing zero trust vendor has been really bad. It's crazy that, with some of the leading zero trust vendors, if you try to use your laptop when you're on a United Airlines WiFi flight that the captive portal on United Airlines doesn't work. That's obviously unacceptable. Maybe that was acceptable in the pandemic when no one was traveling. But now that people are traveling that's something that just doesn't hold up anymore.

And so I think the thing that has been an advantage of Cloudflare is that because we almost think of ourselves at times as a consumer company and we have a zero trust product that you can download to your phone right now and use 1.1.1.1, that is running on so many millions of devices. And as we work with device manufacturers to actually build our network directly into their application. Those things give us the visibility to be able to focus on performance, to be able to focus on end user experience, and to be able to directly replace oftentimes what have been those sort of first generation zero trust vendors that, frankly, don't have the same user experience and the same performance. And so, in many of these cases – in all the cases, we're at least competing with the other more traditional zero trust vendors. And in many cases now, we're displacing them.

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**Andrew James Nowinski**

*Analyst, Wells Fargo Securities LLC*

Q

That's great. Thank you, Matthew. And then as a follow-up, I think most people assume that Microsoft's new Entra solutions will be targeted at that SMB sector at the lower end of the market. But that is a market that I think Cloudflare can also serve. So I'm just wondering what you're seeing in terms of competition with the new Entra solutions.

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**Matthew Prince**

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

A

Yeah. That's not my sense of how Microsoft is thinking about this. And in fact, Microsoft's long been a really great partner of ours. And specifically, in even their announcements of this, looked for ways to actually highlight the part of the market that's the SMB market. But we're not satisfied just winning the SMB market. We're winning some of the largest enterprises. And I think it's the biggest enterprises that have the most interest here.

And so, I think Microsoft has been a great partner to Cloudflare. We're directly integrated into their Edge browser. The network that we have delivers them very unique benefits, but we also respect them as a competitor. And so, I think what we have as an advantage is that network, a network that they use themselves. But it's something where, over time, I think their entry into the market has just validated the market. It's defined it. And we look forward to competing in the places that we do and cooperating in the other places where we don't.

And what we see is that what customers really want is a network provider that can protect your front door and your backdoor. What customers really understand is that there's a reason that we have accountants and auditors and those are separate things. And that what customers really want is they want a solution that works across not just one vendor's products, but the entire IT stack. And I think that's what we see time and time again as the reason why customers are selecting Cloudflare's Zero Trust solutions.

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**Andrew James Nowinski**

*Analyst, Wells Fargo Securities LLC*

Q

That's great. Thank you very much.

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**Operator:** And we will take our next question from Mark Murphy with JPMorgan. Your line is open.

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**Mark R. Murphy**

*Analyst, JPMorgan Securities LLC*

Q

Thank you. And I'll add my congrats. Matthew, can you elaborate on your vision for how Cloudflare can protect companies from leaking sensitive data out and maybe having some of that land inside a generative AI model? What kind of opportunity do you see? And since that traffic to Microsoft and OpenAI is so tremendous in that area and you have the partnerships there that you've mentioned, is there a role you can play directly to try to help control some of the data flows in that Azure/OpenAI service?

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**Matthew Prince**

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

A

Yeah. I think that this is an area that we really listened to what customers' concerns were and built a product that specifically addresses the concern that you're highlighting. Because it's one that is on the mind of just about every GC and CISO that's out there. And that is that whether they're telling their employers or not the best data is that almost half of workers in knowledge industry companies are using AI in one way or another in their jobs. And the risk with AI is that if you send a piece of information up to one of these models, it gets incorporated in the same way that if your two-year-old hears a bad word. It's really hard to get them to unlearn that thing.

And so the key is really making sure that the data doesn't actually leave. And so what we've created is leveraging our existing Data Loss protection products, the DLP products, and making them specific to tag data in such a way that you can say, here's a piece of information, maybe it's from our marketing website. I am totally fine with that going out to the public AI vendors and being able to train on that. In fact, it's great if they're trained on my marketing messages.

Here's another piece of information which is much more sensitive where maybe I'm going to restrict that specifically to my own internal or sandboxed solutions that are the AI training models for that. And then maybe there's something else. The sort of cliché example of the secret formula of Coca Cola or maybe what all of your internal pay schemes are maybe that you don't ever want to get out to anything. And so we've used our DLP solutions in order to specifically address the concern that CISOs and general counsels have about data leaking out.

And what we think that that can do is, over time, add not only those controls but then start to add things like this particular attack has a strong value. So I'm going to send that to maybe GPT 3.5 rather than GPT 4 to save money on that. And so we think that because of the position we're in, because so much of the AI universe relies on us that it puts us in a great position to not only provide the security to the AI companies, but also provide security to anyone who is using AI in their business. And so we can benefit from both sides of the equation.

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**Mark R. Murphy**

*Analyst, JPMorgan Securities LLC*



Thank you. That's extremely helpful.

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**Operator:** And we will take our final question from Alex Henderson with Needham. Your line is open.

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**Alex Henderson**

*Analyst, Needham & Co. LLC*



Great. Thanks so much. I was hoping you could talk a little bit about the fairly massive change in tone between the 1Q call and the current call, which highlights an improvement in pretty much every metric that you track. And specifically, maybe call out some of the differences between various geographies, whether the improvement was in large enterprise, was it also in the mid-market in the SMB market.

Can you give us some granularity as to where that tone is changing? Because, ultimately, you've called out [ph] the year (00:56:15) – one of the advanced bellwethers over the last year. And if you're seeing that change in inflection and tone, would love to know where it's coming from.

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**Matthew Prince**

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



Yeah. I'll start and then Thomas will have some more. I think the Q1 was scary because having a 20% increase in your sales cycle in a single quarter and we've seen something around that around 20% of an increase, but over the entire course of 2022. And so when that then spiked in Q1, what we didn't know was whether that was going to be – whether we were going to be another 20% longer in sales cycle in Q2. And thankfully, that's not what happened. It came back down.

But, again, I wouldn't say that it's come back down to a point where we feel super optimistic about the macro. I think the macro is still very hard in that the next period of time is going to be a grind. But it is – we didn't have the same just explosive expansion in sales cycles that I think we and a lot of other peers in the industry saw in Q1.

And so I think that has been – that's what led to the conservatism that we had in Q1. And I think that returning to something which, again, is still elevated, but not – but is back to what we were seeing in Q4 – or more around what we were seeing in Q4, that is – I think that's the primary driver at least from my perspective in terms of what is maybe is what you put it as a more optimistic tone.

**Alex Henderson**

*Analyst, Needham & Co. LLC*

Q

Any sense of specifically any verticals or any categories or geographies or any size business that changed most dramatically?

**Thomas Josef Seifert**

*Chief Financial Officer, Cloudflare, Inc.*

A

Let me give you some more color. We saw a lot. We saw forward improvement. We talked about this. We also saw a lot of inconsistencies in this in the environment that made it much harder to predict what the second half is going to carry. APAC was very promising. As we said before, we saw a lot of very large deals, especially coming from APAC, the European business was very much security-driven and very encouraging, probably because of the very specific geopolitical situation Europe is in. And then the Americans were more muted in general.

We saw very specific performance, really good performance in the Middle East, but also in South America. North America was probably more muted than anything else. Vertical wise there's not a lot to talk about it, but very consistent performance. I would say there's not one vertical that I would pick out in terms of overall underperformance.

**Alex Henderson**

*Analyst, Needham & Co. LLC*

Q

Great. Thank you so much.

**Operator:** Ladies and gentlemen, I would now like to turn the conference back to Matthew Prince for closing remarks.

**Matthew Prince**

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

Just want to take a second to thank everyone at Cloudflare. Again, as the macro environment continues to be challenging. I'm proud of how our team has stepped up and executed towards operational excellence. Everyone is working incredibly hard to help live up to our mission of helping build a better Internet.

So thank you to all the Cloudflare employees, to all of our customers and all of the investors. And we really appreciate everything that you're doing for us.

**Operator:** Ladies and gentlemen, this concludes today's call, and we thank you for your participation. You may now disconnect.

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