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Cloudflare, Inc. (NET)

Q4 2023 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good afternoon and welcome to the Cloudflare Q4 2023 Earnings Conference Call. Please [indiscernible] (00:00:14). All lines have been placed on mute to prevent any background noise. After the speakers' remarks, there will be a question-and-answer session. [Operator Instructions]

I would now turn the call over to Mr. Phil Winslow, Vice President of Strategic Finance, Treasury & Investor Relations. You may begin your conference.

Philip Winslow

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

Thank you for joining us today to discuss Cloudflare's financial results for the fourth 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 the 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 uncertainty, 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 Baird's Software Silicon Slopes event on February 28 and the Morgan Stanley Technology, Media & Telecom Conference on March 6.

Before wrapping up, please save the date for our Investor Day on Thursday, May 30, which is being held in conjunction with our user conference, Cloudflare Connect, in New York City. A live webcast will also be accessible from our Investor Relations website.

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

Matthew Prince

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

Thank you, Phil. We had an exceptionally strong quarter. We achieved revenue of \$362.5 million, up 32% year-over-year. We added 198 new large customers, those that passed more than \$100,000 per year, and now have 2,756 large customers, up 35% year-over-year. We saw particular strength in our largest customers with a record number of net new customers spending more than both \$0.5 million a year and \$1 million a year on an annualized basis. We signed our largest new logo with an expected total contract value over \$30 million and our largest customer renewal with a total contract value of \$60 million.

We blew away our previous record for new ACV booked in a quarter. In Q4, new ACV booked grew nearly 40% year-over-year, making it not only our record in [ph] absolute (00:04:01) ACV but also the fastest percentage growth we've seen since 2021. Our pipeline close rates, sales force productivity, average deal size, and linearity all improved markedly quarter-over-quarter. I continue to be encouraged by the early results we're seeing from our new sales, recruiting and training programs.

During the fourth quarter, the pipeline generated by the cohort under the new program was 2.1 times higher than the year-ago cohort and account engagement increased by 3.5 times compared with a year ago. I'm excited by our maturing sales execution and believe it will pay dividends in 2024 as these sales professionals fully ramp.

Our dollar-based net retention ticked down 1% quarter-over-quarter to 115%. Our gross margin was 78.9%, again above our long-term target of 75% to 77%, and up from 78.7% last quarter. We delivered an operating profit of \$39.8 million, representing an operating margin of 11%. We also meaningfully outperformed on free cash flow, generating \$50.7 million during the quarter and approximately \$120 million in free cash flow for the year.

I'm proud of our team for their continued execution. The machine that underlies Cloudflare is firing efficiently on all cylinders and we've been able to execute even as the macro environment remains choppy.

Key to that execution has been improvement in our go-to-market efforts. Fifteen months ago, we brought on Marc Boroditsky to execute effectively a turnaround of Cloudflare's go-to-market team. At the time, we had enterprise customers but we hadn't operationalized repeatedly and consistently landing them. We were also suffering from a COVID hangover, and like much of the industry, have been slack on performance management. Marc changed all that. He's brought in the process and discipline we needed to be world-class in sales the same way we already were in product and engineering. It's hard to be the turnaround guy and we owe Marc a huge debt of gratitude for playing that role.

But there's someone we always whispered about as our ideal go-to-market leader if we could ever have him as a full-time member of our team, Mark Anderson. He built Palo Alto Networks' world-class sales organization into the machine it is today. He has an incredible domain expertise and contacts in our industry. He's one of the great B2B sales software leaders. And as we were getting ready to go public, we couldn't quite convince him to run our go-to-market org but we did the next-best thing, inviting him to join our board.

Over the last four years, we've gotten to know each other on Cloudflare's board. From there, he's provided invaluable counsel to me, Michelle, and our go-to-market leaders. And so, after Alteryx, the company he'd been running as CEO, agreed to go private, he reached out and asked whether we'd be interested in not just having him as a coach but also a player on the field, rolling up his sleeves and getting back to what he's best at, running a world-class go-to-market organization, selling great products, and delivering incredible value and support to customers. Given the deep relationship and trust we developed and his expertise and leadership in our field, it was as close to a no-brainer as I can remember in a long time.

I wanted to invite Mark Anderson to the call to say a few words. Mark?

Mark F. Anderson

Director & President-Revenue, Cloudflare, Inc.

Thank you, Matthew. I've had the privilege to work closely with the great leadership team here at Cloudflare in my role as member of the board of directors for the last 4.5 years. And I've been amazed, not at just what Cloudflare has accomplished to date, but more importantly, how the market is increasingly moving to where Cloudflare is already uniquely positioned. The time to capitalize on these major technology shifts is now.

When I [ph] started (00:08:06) to think about where I could make the most impact during the next stage of my career, I reached out to Matthew and Michelle to see if I could help elevate Cloudflare's go-to-market organization to the next level. Operationalizing productivity at scale in Cloudflare will involve, one, augmenting foundational systems and tools that are already in place with a framework of execution that applies discipline and rigor to all that we do for customers and, two, bringing on more stage-appropriate talent to blend with our amazing sales team to best capture the massive market opportunity ahead of us.

We all agreed that my skill set and experience building and enabling world-class go-to-market organizations matched perfectly with Cloudflare to further accelerate its next stage of growth at scale. And I'm extremely excited to work together with Matthew, Michelle, and all of my fellow Cloudflarians to make Cloudflare one of the most iconic technology companies in the history of the industry.

Matthew Prince

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

Thanks, Mark. I want to again thank Marc Boroditsky for getting us to this place. We couldn't have done it without him. He will continue to be an advisor to Cloudflare for the next several months to make sure Mark Anderson is

set up for success. He will always be part of the Cloudflare's team and I'm excited to hear what challenges he takes on next.

I also wanted to take this time to reaffirm that Michelle and I aren't going anywhere or changing our roles in any way. I wake up every morning more excited about the opportunities we have to fulfill our mission of helping build a better internet. If you study the iconic technology companies, they're often mission-driven, founder-led, but include a dynamic and evolving leadership team surrounding the founders who bring a wealth of experience for each stage of the company's journey. That a leader like Mark Anderson can get to know us over the last four years from his seat on our board, and then choose to join our team standing side to side with the other senior team we have assembled, gives me confidence that we're on a path to being one of the iconic technology companies ourselves. We're not there yet, so I'm not satisfied, and I remain fully committed to that journey.

With that, let me walk through some of the customer wins we had in the quarter. We were awarded a three-year contract with a ceiling value of \$33 million for the U.S. Department of Commerce, which will be deploying services across our SASE application performance and security solutions. We believe deals like this validate the criticality of converging application performance, security, network, and Zero Trust services on a unified platform, and how Cloudflare can deliver a comprehensive, commercially off-the-shelf platform from a single vendor as compared with numerous point-product competitors.

A leading technology company expanded their relationship with Cloudflare, signing a three-year \$6.6 million contract for Cloudflare's Zero Trust suite to protect access for 10,000 employees and contractors. Given the company's highly complex and secure environment, implementing a first-generation Zero Trust vendor proved to be a challenge. This company had done a Zero Trust RFP a year prior, but when they reviewed Cloudflare's Zero Trust solution again, they were impressed by our significant progress in innovation. Not only was our rate of innovation a key differentiator, but with Cloudflare, they're able to simplify and consolidate Zero Trust application performance and security all on a single platform.

A Fortune 500 hospitality company expanded their relationship with Cloudflare, signing a five-year \$4.3 million contract for 20,000 Zero Trust seats. This company approached us 15 months ago with a basic Zero Trust use case. The scope quickly expanded from one to several as this company sought to re-architect their entire Zero Trust approach. The lack of platform integration and the absence of strategic vision from their incumbent vendors, including a first-generation Zero Trust competitor, led them to Cloudflare for our easy-to-use comprehensive platform with a cloud-first architecture.

Although performance improvement was not an important consideration early on, after a six-month paid pilot, the team was blown away by how much improvement they saw with Cloudflare, stating [ph] holy bleep (00:12:36), I've never seen [indiscernible] (00:12:38) go this fast.

A sophisticated tech company with one of the most technical and daring engineering teams signed a two-year \$646,000 contract. The company had recently experienced a breach, driving them to increase their security posture and adopt a Zero Trust approach. This company considered nearly every relevant vendor in the market, over 13 in total, and Cloudflare and one other competitor were selected for a proof-of-concept and 30-day pilot. After just 14 days, Cloudflare was fully configured and completed all success criteria, whereas our competitor was unable to get off the ground. The ease of deployment was key for this company who needed to design a solution in a very complex environment. With Cloudflare, everything worked out of the box.

A Fortune 500 technology company signed a two-year \$6 million contract for advanced application security. The company was experiencing an increased DDoS attack that a large hyperscale public cloud was unable to

mitigate. These unmitigated attacks created significant latency, resulting in a loss of traffic and potential revenue. They viewed Cloudflare as the leading expert in DDoS mitigation based on our [ph] HTTP/2 Rapid Reset (00:13:55) publication and the compatibility of our layer 7 security bundle with their self-hosted technology and public cloud vendors made Cloudflare an easy choice. It's just the beginning with this customer.

A large US commercial airline expanded their relationship with Cloudflare, signing a two-year \$857,000 contract to procure Zero Trust seats. A great land and expand example, this is the third deal we've done with this customer in 2023 as they undergo a digital transformation project. They're using our full Zero Trust suite along with application services. They love our unified network, single pane of glass, and speed of implementation. A fourth deal with them is already on the horizon.

A local government authority in the UK signed a five-year \$2.1 million contract for 4,700 Zero Trust seats. The government authority was pursuing a very large digital transformation project to modernize and improve security posture with a complete network refresh and the adoption of Zero Trust. Following a three-year engagement process, the authority was evaluating two competing zero trust vendors. Cloudflare entered the process in the late stages. Cloudflare One was selected as the core component of their modernization program due to our ease of use, seamless integrations and expansive platform with a single control plane. In their words, "Cloudflare is easy. It just works".

These days, no earnings conference would be complete without an update on AI. As of the end of 2023, we deployed GPUs in 120 cities globally, meaningfully ahead of our target of 100 cities. By the end of 2024, we plan to have inference-tuned GPUs deployed in nearly every city that makes up Cloudflare's global network and within milliseconds of nearly every device connected to the Internet worldwide. The breadth and potential impact of the use cases we are seeing with Workers AI are extraordinary and we're super excited about the opportunity to establish Workers AI's serverless model built on Cloudflare's trusted global network as the best infrastructure for running AI inference tasks.

From our launch in September to the month of December, the average number of daily Workers AI requests increased 9x. Furthermore, one-third of the thousands of Workers AI accounts are new to the Workers platform, suggesting that Workers AI is not just significant opportunity in and of itself, but also a potential accelerant to adoption of the Workers overall platform. Inference, however, is only part of the AI equation. We are also extremely encouraged by the interest in Vectorize our vector database, which makes it easy, fast and affordable to index and store vectors to support use cases that require access, not just to running model, but customized data too, as well as AI Gateway, which gives organizations the tools to cache, rate limit and observe their AI deployments regardless of where they're running. AI on Workers platform is just getting started, and there are exciting things on the roadmap that we look forward to sharing with you in the not too distant future.

As I reflect back on the last quarter, I'm proud of our team. It feels like we're once again firing on all cylinders, but a quarter is only one data point. As we talked about throughout the last year, the macro environment remains challenging. IP buyers are still skittish. The world is not getting any less complicated. And as a company, we still have a ton to prove. Those were the dominant themes of 2023, and I think it's likely they'll remain the themes of 2024. So while I'm encouraged by our results, we continue to remain prudent and focused on disciplined execution. Building and improving our team, delivering exceptional value to our customers, and solving some of the hardest engineering challenges the Internet faces.

With that, I'll hand it over to Thomas to walk through our financials. Thomas, take it away.

Thomas Josef Seifert

Chief Financial Officer, Cloudflare, Inc.

Thank you, Matthew, and thank you to everyone for joining us. I wanted to take a moment to welcome Mark Anderson to the Cloudflare team too. Mark, we're incredibly excited to have you on board to further accelerate our next phase of growth at Cloudflare.

Turning to our financial results. I'm pleased to share that the positive momentum from our focus on refining our go-to-market strategies and operations continued during the fourth quarter. As Matthew mentioned earlier, pipeline close rates, sales productivity, average deal size and linearity all improved compared with last quarter. Strength in our business this quarter was driven by robust momentum with large customers, significant progress in the public sector and growth in Cloudflare One, including the largest new customer win in the company's history with a contract ceiling value of \$33 million. Importantly, we also continue to maintain our strong commitment to being fiscally responsible and act as good stewards of investors capital. Operating profit increased nearly 2.5 times year-over-year, and we significantly outperformed on free cash flow, generating a record \$50.7 million during the fourth quarter.

Turning to revenue. Total revenue for the fourth quarter increased 32% year-over-year to \$362.5 million. From a geographic perspective, the US represented 52% of revenue and increased 30% year-over-year. EMEA represented 28% of revenue and increased 38% year-over-year. APAC represented 13% of revenue and increased 25% year-over-year.

Turning to our customer metrics, in the fourth quarter we had 189,791 paying customers representing an addition of roughly 27,700 paying customers in 2023 and an increase of 17% year-over-year. We were pleased to see revenue contribution from large customers during the quarter increase again to 66% of revenue, up from 63% in the fourth quarter last year. For fiscal 2023, revenue from large customers represented 64% of total revenue, compared to 61% in 2022 and 54% in 2021.

As Matthew referenced earlier, we added a record number of net new customers spending more than \$500,000 and \$1 million on an annualized basis with Cloudflare. For the full year, we ended the year with 346 customers that spend over \$500,000 with us, a 56% increase year over year. And we ended the year with 118 customers that spend over \$1 million with us, a 39% increase year-over-year.

We also exited 2023 with three customers spending at least \$20 million on an annualized basis with Cloudflare, one of which signed the largest total contract value renewal agreement in our company's history of \$60 million in the fourth quarter. Our dollar based net retention rate was 115% during the fourth quarter, representing a decrease of 1 percentage point sequentially. As we mentioned last quarter, there can be some variability in this metric quarter to quarter, but we continue to believe the prior decelerating trend in DNR is stabilizing near these levels.

Moving to gross margin. Fourth quarter gross margin was for 78.9%, representing an increase of 20 basis points sequentially and an increase of 150 basis points year-over-year. Gross margin was 78.3% for fiscal 2023, remaining above our long-term target range of 75% to 77%. Network CapEx represented 8% of revenue in the fourth quarter, as we continue to benefit from our focus on driving greater efficiency from our infrastructure and the uniqueness of our platform to onboard new workloads. We expect network CapEx to be 10% to 12% of revenue in fiscal 2024. With the evolution of the composition of our infrastructure, we undertook an assessment of the useful life of our service and network equipment. In January 2024, we determined that continuous advancements in hardware, technology and improvements in our data center designs have increased the efficiency in how we operate our equipment, resulting in the estimated useful life of these assets, extending from

four to five years starting in fiscal 2024. We estimate this change will reduce depreciation by approximately \$20 million for fiscal 2024, for assets in service as of December 31 of 2023, recorded primarily in the cost of revenue.

As we discussed previously, we view our margin efficiency as one of Cloudflare's key competitive advantages, and we intend to leverage this opportunity as a strategic weapon to increasingly disrupt markets through continued innovation on our platform and differentiated product packaging.

Turning to operating expenses. Fourth quarter operating expenses as a percentage of revenue decreased by 3% year-over-year to 68%. Our total number of employees increased 14% year-over-year, bringing our total head count to 3,682 at the end of the quarter.

We'll continue to pace hiring based on the market conditions over the course of fiscal 2024 and remain committed to driving higher productivity and greater efficiency across our operations. Sales and marketing expenses were \$145.2 million for the quarter. Sales and marketing as a percentage of revenue decreased to 40% from 41% in the same quarter last year. Research and development expenses were \$59.5 million in the quarter. R&D as a percentage of revenue decreased to 16% from 18% in the same quarter last year. General and administrative expenses were \$41.5 million for the quarter. G&A as a percentage of revenue decreased to 11% from 12% in the same quarter last year.

Operating income was \$39.8 million, compared to \$16.8 million in the same period last year. Fourth quarter operating margin was 11%, an increase of 490 basis points year-over-year. These results highlight our continued focus on becoming more efficient and more productive, given that operational excellence is a long term competitive advantage.

Turning to net income in the balance sheet, our income in the quarter was \$53.5 million, while diluted net income per share of \$0.15. We ended the fourth quarter with \$1.7 billion in cash, cash equivalents and available for sale securities. Free cash flow were \$50.7 million in the fourth quarter, or 14% of revenue, compared to \$33.7 million or 12% of revenue in the same period last year. Remaining performance obligations or RPO came in at \$1.245 billion, representing an increase of 15% sequentially or 37% year-over-year, current RPO was 73% of total RPO.

Moving to guidance for the first quarter and full year 2024. We are encouraged by the progress we delivered during the fourth quarter in terms of improving close rates and productivity metrics. However, mixed macroeconomic data points serve as a reminder that we are operating in a business environment that also showing signs of improving, exiting 2023 continues to be challenging to predict. As a result, we remain prudent in our outlook for 2024 and we are fully committed to continuing to adapt our tactics and strategies in response to any positive or negative external variables, just as we did in 2023.

Now turning to guidance. For the first quarter, we expect revenue in the range of \$372.5 million to \$373.5 million, representing an increase of 28% to 29% year-over-year. We expect operating income in the range of \$34 million to \$35 million and we expect an effective tax rate of 11%. We expect diluted net income per share of \$0.13, assuming approximately 356 million shares outstanding. For the full year 2024, we expect revenue in the range of \$1.658 billion to \$1.652 billion, representing an increase of 27% year-over-year. We anticipate the weighting of revenue in the first half versus second half of 2024 to be similar to 2023. We expect operating income for the full year in the range of \$154 million to \$158 million. We expect an effective tax rate of 11% for 2024. We expect diluted net income per share over that period to be \$0.58 to \$0.59, assuming approximately 358 million shares outstanding.

After having achieved significant free cash flow of approximately \$120 million in 2023, we expect free cash flow to be relatively consistent with operating profit for the full year 2024, with the first half lower and the second half higher compared with operating profit.

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 the dedication to our mission, as well as our customers for trusting us to help them solve some of the hardest problems that they face when modernizing, transforming, and securing their businesses. 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] Please limit yourself to one question and one follow-up. Your first question comes from Brent Thill with Jefferies. Please go ahead.

Brent Thill

Analyst, Jefferies LLC

Q

Matthew, it seems like there's a confluence of factors that led to your outperformance. I was wondering if you could just unpack a little bit deeper in terms of some of the common themes. I know you mentioned enterprise strength, but what else are you seeing that's leading to this magnitude of outperformance?

Matthew Prince

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

A

Yeah. Thanks, Brent. I think the first thing really is what we talked a lot about on the call, which is just real focus on go to market excellence. And I think Marc Boroditsky, who really worked hand-in-hand with Mark Anderson on our board, has done a great job over the last 15 months of really focusing on how we make sure that we're as great in go to market as we have been in product and engineering. And I think that's the biggest thing to point out. I think the second thing is that, we've really seen strength in our Zero Trust and SASE products. Some of the biggest wins that we saw in the quarter were big zero trust deals. And I think that those products have caught up significantly. And you'll see in the analyst – the industry analyst reports and others that we're very quickly becoming one of the real leaders in that space. And I think over time we will surpass many of the first generation zero trust vendors, and that really opens up another leg on the stool.

And then and then lastly, I just continue to be really astonished by the rate at which our Developer Platform is growing. AI is not yet contributing materially to revenue, but it has contributed materially to developer excitement over the platform. And we're seeing more and more large deals, more and more interesting applications coming in using the Workers platform and that that is – has gone well as well. So I think operational excellence and go-to-market I think that really strength around our Zero Trust products and then just continued outperformance on our Developer Platform. And those things all came together in Q4 of 2023.

Brent Thill

Analyst, Jefferies LLC

Q

Thanks, Matthew.

Operator: Your next question comes from Matt Hedberg with RBC Capital Markets. Please go ahead.

Matthew Hedberg

Analyst, RBC Capital Markets LLC

Q

Great. Thanks for taking my question, team. Great hire in Mark Anderson, I realize it's fresh, still fresh. And Matthew, you talked a little bit on the call about what he's going to be focused on. But I guess maybe just I wanted to double click on that. Are there some specific sales processes or partner motion that you think Mark's going to be focused on to really drive that next level of enterprise growth? And maybe could you talk about overall rep productivity, which I know has been a big focus for you all over the last year?

Matthew Prince

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

A

Sure, Matt, I appreciate it. So first of all, I think working with Mark Anderson has been a big piece behind the scenes of the improvements that we've seen in the go-to-market performance that we've had had so far. And so his as a board member, his hands have been involved in a lot of the strategic decisions we've made, a lot of the focus that we've made. And so I think this is less of a radical change in terms of the strategy and it's more of a continuation of what we have done. That said, I think that the thing which Mark brings, which is unique and as we thought of, who would be our ideal sales leader and we really started thinking about that before we went public., Mark was top of the list because of the domain expertise, because of the relationships that he has, because the trust that he's built in the industry, and because of the other sales professionals that that really have worked with him and want to follow him and have their own, again, expertise and relationships in the industry as well.

And so I think that Mark Anderson will continue a lot of what Marc Boroditsky has done, continue to professionalize our organization, continue to move up market, continue to really focus on rep productivity, focus on making sure that we have all of the right training, all of the right ramping resources that reps need, focused on making sure that our sales process is as efficient as possible. And I think that will be a big piece of what he is delivering. I think if you zoom out from that, the other thing, which is a big initiative for us, is just looking at our overall platform and saying how can we make it actually much easier, not only for our internal team to sell, but also for partners to sell as well. Right now, we have a ton of different products and I think bringing that together and finding ways to make that – those products, not just individual products, but as a platform and an overall platform, that's where we tend to win is when people buy that overall platform and that's where there really isn't a ton of competition when people are comparing the total platform that Cloudflare offers versus anyone else in the space. We are able to deliver a much more robust network security performance reliability package than any other vendor that's in that space. And I think Mark helps us deliver that and continue again on some of the great work that Marc Boroditsky had started and really set him up for success.

Matthew Hedberg

Analyst, RBC Capital Markets LLC

Q

Great. Great color. If I could ask one follow-up to Thomas, your guide for 2024 revenue. I think it calls for about 600 basis points of deceleration. Obviously, you talked about a lot of positive sequentially, but also some of the caution that you still have about the macro. Just wondering if you could unpack a little bit more some of the assumptions there. I think you noted maybe in NRR might be nearing a bottom, but just, what's built into that in terms of like logo adds maybe an improvement in NRR, but just sort of unpack that a little bit more. Thank you.

Thomas Josef Seifert

Chief Financial Officer, Cloudflare, Inc.

A

Yeah. Obviously, we had a very, very good fourth quarter with a lot of good data points pointing in the right direction. The improvement that Matthew was talking about on the go to market side, not only in terms of productivity, but pipeline improved there and deal sizes improved, linearity went better. We also saw their best

quarter over quarter improvement from an RPO perspective. And this is all pointing in the right direction, but we still have to cope with the fact that one data point alone is hard to change your prediction and your trajectory. So we are still cautious about everything else that is going on. Matthew mentioned in his part that the big themes that we saw last year from a macroeconomic perspective, skittishness of buyers and budget releases are still continuing. And I think this informed our view for the year. And obviously, we'll adjust our strategy and our approach to the year as we have, and as we collect more data points. But it's served us well over the last four years as a public company to look really hard at the data we have and draw the right conclusions from it. And I hope that 2024 will get us to the same outcome.

Matthew Hedberg

Analyst, RBC Capital Markets LLC



Thank you.

Operator: Your next question comes from the line of Andrew Nowinski with Wells Fargo. Your line is open.

Andrew James Nowinski

Analyst, Wells Fargo Securities LLC



Thank you so much for taking the question and congrats on a great quarter. I wanted to start with a question on SASE. So you rattled off about a dozen large Zero Trust deals in your prepared remarks, and you're clearly seeing some very strong demand from large customers, which I think coincides with a lot of the feedback we've been hearing about how Cloudflare is having more success, penetrating that mid and large enterprise space with your Zero Trust solution. So maybe if you could comment on your sort of secret to success in getting these large deals closed because it seems like it's – there's more to it than just the maturation of your platform.

Matthew Prince

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



Yeah, Andy, I think I think that first of all, the – we didn't start out as a company that had a Zero Trust platform. And so that's something that was a very natural add-on to our network, we think it's very complementary with the other services that that we offer. And I think that as we studied the industry and studied the space, it was clear that this set of solutions ended up squarely in our bailiwick of what it was that we were delivering. And so that I think that that that was a very natural place. But we are new to this space and things take time. And especially in the larger buyers, they want validation like Gartner and Forrester or another industry analysts saying that you should be in the consideration set. And so there's a bit of a chicken and egg issue where you have to sort of start to get your first large customers and your early adopters in order for the Gartners and Forresters to put you in consideration. And then from that, you start to build that reputation with the industry analysts and that gets you in more deals.

And what we find is when we're in the consideration set, we're just a next generation platform and we're faster, we're more secure, we're more reliable, and we're a better solution for a lot of vendors. And so not only are we winning the greenfield opportunities, but we're increasingly winning opportunities from first generation Zero Trust vendors where their customers aren't satisfied with the solutions they have and they're moving fully to us. So I think that a lot of it has been just the maturing of our platform, but not just from a technology perspective. We're pretty good at that and we have a lot of control of that. But also just from a an understanding in the industry that this is something that we offer, an understanding of how the various components of Cloudflare fit well together. And I think that that's something that that becomes itself a flywheel which we expect will continue to deliver success for us in the space over time.

Andrew James Nowinski

Analyst, Wells Fargo Securities LLC



[ph] Sounds like, especially (00:40:09) with Mark Anderson joining now as well, too. I want to ask a quick follow up on Vectorize, because I think it's really interesting in how it may potentially be driving growth of R2 as well. From talking to some industry folks, it sounds like customers are starting to recognize how important a vector database is as it relates to inference and fine-tuning models. But I'm curious, I know it's still early days, but what is the feedback on Vectorize and are you actually seeing a pull through or a sort of a push to revenue on onto R2 as well from that? Thanks.

Matthew Prince

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



Yeah. The way that we're – we see this, the space in general is we want to have all of the different components that you need in order to build just a full featured AI application. And there – and that means supporting as many models as possible. And some of the work that we're doing with the major model vendors like the Metas of the world, the marketplaces like Hugging Face gives us that. We want to have the best place for inference. And we think that, that we're Goldilocks in that space where the centralized public clouds are too far away and your device that you're holding in your hand or wearing on your wrist is often doesn't have enough power.

But where we are sitting in between gives that really incredible place for inference. But then the next step of that is you have to be able to take models and make them your own. And that's exactly what Vectorize does. It allows you to customize those models and tune them, do the fine tuning around making them your own. And so what's been interesting about that is that being local and having presence all around the world ends up mattering in various places. And the example that a customer gave us the other day was that if you have a model and it responds in the United States and it spells color, C-O-L-O-U-R, it feels very foreign. Whereas if it's in the UK and it spells it C-O-L-O-R, it also feels very foreign. And so the ability to not just tune models, but tune them locally while still having the power of [ph] BC (00:42:31) GPUs that can then run the inference task that's a really killer combination. And as you said, it's built on top of the existing [ph] primitives (00:42:40) that we have, including R2, which is our object storage space. And so while it's early in the entire AI space, I think we are very well positioned and very strategic. And if you look at things like, the various downloads of our library on public open source [ph] repos (00:42:58), they are taking off like crazy. And it's it is incredibly encouraging and I think will become a larger and larger part of our business going forward.

Andrew James Nowinski

Analyst, Wells Fargo Securities LLC



Thank you.

Operator: Your next question comes from the line of Hamza Fodderwala with Morgan Stanley. Your line is open.

Hamza Fodderwala

Analyst, Morgan Stanley



Hey, good evening. Thank you for taking my question. Maybe to stick on the edge AI theme, Matthew, I'm just curious. I know it's very early days, but as you deploy, these GPUs at all your locations worldwide, how are you feeling from a capacity standpoint, from a CapEx perspective in your ability to meet the demand as some of the sort of inference starts to ramp? And then maybe a follow-up for Thomas. I think variable revenue is a very low percentage of your overall sales. Can you give us any context of how that looks for Q4 relative to Q3? Thank you.

Matthew Prince

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

A

Yeah. So I'll take the first question and Thomas can take the second. I'll start with a – in a place that you might not expect, which is that our success in the Zero Trust market has actually helped empower our ability to invest in the Developer Platform and especially the AI market. To understand that, the nature of how our business works is that every single service that we run is capable of running on every single piece of equipment that's out there. So we don't run a different network for our security products than we do for our performance products. We don't run a different network for the CASB service that we have versus our access versus our DDoS mitigation. It's all the same machines that are running across that. And so one of the secrets to Cloudflare's success has been that we've been able to always look for places where there is more sort of unused capacity and then effectively act as a giant scheduler in order to make that capacity more productive. And what's been interesting about the zero trust space is that the very nature of how that traffic works, where first – our first generation services were all reverse proxy services. The traffic was flowing kind of in one direction, whereas our Zero Trust services are all what's called forward proxy services. The traffic is flowing in the other. But it turns out that you can actually have traffic flow both directions without having additional CapEx cost. And so as a bigger and bigger part of our revenue is these Zero Trust products, it means that it actually frees up CapEx as a percentage of revenue for us to go after other opportunities. And so that's what has freed up us to go after a lot of the AI opportunities that we've had. It's what freed up our ability to acquire the GPUs and invest behind the demand that we're seeing. And I feel really good because, at core, what we are really good at is running a giant network as a giant scheduler, and then wringing as much efficiency and utilization out of that as possible. And so, we have been able to stay ahead of the demand that we've seen for the GPUs and other resources that we need for some of these newer products. And we're complementing that by also adding revenue, which is just much less CapEx-efficient because it's – or much less CapEx-intensive and much more CapEx-efficient, because it's running on top of the same platform.

Hopefully that makes sense. But it really is part of the key to our business and it's part of why we have the gross margins that we do where some of the other companies that are point-solutions-only doing one of these things have much worse margin profiles.

Thomas Josef Seifert

Chief Financial Officer, Cloudflare, Inc.

A

And before I answer your second question, maybe a bit more color to what Matthew just said. I mean, you really could see the inherently efficient architecture of the network in the fourth quarter. Our network CapEx was 8% of revenue in the fourth quarter. And we were ahead of delivering GPU capacity, we were at 120 cities, ahead of our plan of 100. And the guidance of 10% to 12% of revenue for this year includes a full built-out and bringing GPU capacity into pretty much every location we have. And on top of that, making sure that the network grows with the traffic that we put on our network.

So that is, I think, one of the key competitive advantages we have is the network architecture, and that's just another proof point in the fourth quarter.

And regarding your question on variable revenue, variable revenue in the fourth quarter was a bit higher than it was in the third quarter, but it's still a small percentage of our overall revenue. This will change over time, as our packaging and the offerings we bring to the market will have higher variable components. But for the fourth quarter, it was still a small part of our overall revenue and our revenue mix.

Hamza Fodderwala

Analyst, Morgan Stanley

Q

Thank you.

Operator: Your next question comes from the line of Jonathan Ho with William Blair. Your line is open.

Jonathan Ho

Analyst, William Blair

Q

Hi. Good afternoon. Matthew, you mentioned that a third of Workers AI accounts are new to Workers. How could this be potentially an accelerant to your Developer Platform overall? And could you maybe give us some color on the adoption of Workers in terms of the serverless model by developers relative to competitors?

Matthew Prince

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

A

Yeah. It's – I think that if you study developer platforms, they inherently take some time to really take off and take hold. And an average is about 10 years from when they launch before they seem like they're getting to that. And the reason for that is because of the fact that, you need early adopters, those early adopters need to build something which is a killer app, which people say, wow, I couldn't have built that in any other way. Some of the people who are behind that first killer app need to then go on and start other services, other companies, build other things. There's an ecosystem that has to develop around all of that, and that inherently takes some time to take off.

Developer platforms are adopted. They're not sold. And so again, I think that we've been very excited about the rate at which things have been adopted at Cloudflare for our Developer Platform, but we've also been realistic that for that Developer Platform to take off, inherent in how these develop, there is some time.

There are handful of ways that you can have shortcuts. One of those is to attach yourself to other developer ecosystems which are really robust. And so, some of the ways that we are effectively providing the underlying infrastructure for some major other platforms that are out there, a number of the big e-commerce platforms and other things, that helps train developers early on on how to build with us, and again is one of the shortcuts to get there.

Another one is attaching yourself to wherever there's a lot of interest in the developer ecosystem. And so, I think that as you look out at the AI space, and we try to survey what are the most common cloud platforms that are being used across the hottest AI startups and companies that are out there, Cloudflare is the most common to that. And I think that that again accelerates the rate at which you're able to get that adoption.

And so, if you look at things like [ph] NPM downloads (00:51:19) of packages and you compare sort of the things that you would download to run on Cloudflare Workers versus competitors like AWS' serverless offering. It's been pretty amazing that we've actually caught, and now passed, AWS by some measures in terms of the packages which are being downloaded that are out there. And again, we're a much newer platform, and so I'm encouraged that we'll be hopefully taking that average time for new developer platforms to [indiscernible] (00:51:55) down, because of some of the success we've seen. And again, I'm really proud of our team and how they've executed in delivering this.

Jonathan Ho

Analyst, William Blair

Q

Excellent. Thank you.

Operator: Your next question comes from the line of Tim Horan with Oppenheimer. Your line is open.

Timothy Horan

Analyst, Oppenheimer

Q

Thank you. Related to the previous question, can you maybe update us on your best guess on timing when the Workers platform starts to drive some material revenue when it starts to move the needle? And maybe the same thing for AI, I know you said kind of not this year. [ph] And (00:52:29) what do you think for both these platforms, what does this mean for overall growth rates for the company? Thank you.

Matthew Prince

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

A

Yeah. I think what has been interesting has been that Workers is a big piece of a lot of the deals that we see. So it's still in somewhere around 20% of the large deals that we closed have some Workers component to it, and that's held actually fairly steady. But those deals have continued to go up and up. So it depends on how – we don't break out the various pieces of Cloudflare because we think that the platform functions very well as one unified platform. And we closed more deals because we have Workers involved. But a lot of times, that includes our reverse proxy security services, it oftentimes include our Zero Trust security services.

And what we really want to be is not a one-trick pony for any one of our customers. We want to actually have multiple different things that they rely on and be that strategic vendor that provides a broad set of solutions to them. So I think it's already materially driving new business and large deals, [ph] but – as (00:53:51) the Workers platform.

I think the AI space, I think a lot of the money which is being spent on AI right now, especially with some of the hyperscale public clouds, a lot of that is for training of models that is not – we are not the right place to actually do model training. But as that transitions over time and people start to figure out how can you take those – the models that you've built and turn them into real products, I think that's where you'll start to see a much more significant share of – you'll start to see revenue that is showing up as meaningful to us in terms of delivering the value in the AI space.

But I think it's – we're still so early, and I think that the thing to track is less about us, it's more about how long does it take product managers and engineers to really figure out how to harness these new tools into providing customer value. I think we've seen a ton of – I mean, the challenging thing with AI is it is really easy to make a demo, but it's very hard to make a product. There's a ton of value that will be created here. But I think it's still – it's going to still take some time and I think it's going to be up to some things that are somewhat out of our control. But I can't imagine being better-positioned than we are.

Timothy Horan

Analyst, Oppenheimer

Q

Thank you.

Operator: Your next question comes from the line of Trevor Walsh with Citizens JMP Securities. Your line is open.

Trevor J. Walsh

Analyst, Citizens JMP Securities, LLC

Q

Great. Hi, team. Thanks for taking my question. Matthew, maybe for you. [indiscernible] (00:55:41) round up all the different kind of themes and things that you've been talking about throughout. You've got a platform of platforms where you're playing in AI, you're playing with developers and Workers and Zero Trust, et cetera, creates a big TAM. But then at the same time, from a go-to-market perspective, you have a lot of different stakeholders and buyers within an organization, and you have to try to round up and sell that vision.

So where do you think you need to go from just a go-to-market perspective, especially with Mark coming on board now in terms of whether it's internal enablement, simplifying pricing and packaging like you talked about, kind of how do you thread that needle, I guess, of all those different kind of people? And how do you see that kind of playing out, kind of this coming year and beyond? Thanks.

Matthew Prince

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

A

Yeah. So I think our strategy remains our strategy, which is, land with one product, and then demonstrate, build trust, demonstrate value, and then expand to help customers both create more value and save money across their overall platform. And what we see over and over again is that the customer that just this last quarter signed a \$60-million total contract value renewal, they started with one product and were a [ph] \$60,000-customer-a-year (00:56:57) when they first started. So that works.

I think operationalizing that now is the thing which we've made huge strides on over the last 15 months, and I think Mark Anderson will continue to help with that. What I think is really attractive about Mark Anderson is, yes, he knows the security space and the network security space from his time at Palo Alto Networks. But also from his time with Palo Alto Networks, they went from really a one-product company to a platform company. And that's something which we really admire and think is rare when companies figure out that play.

We've got that set of products. We've got a lot a lot of customers. And now, it's how do we, again, continue to demonstrate value, adding, bringing on incredibly talented leaders like Mark Anderson, who are trusted and respected in the space, who have run this play before and been successful with it. And it can now take the breadth of products that we have and the opportunity we have, and build an iconic company and an iconic go-to-market organization. Again, I'm incredibly honored to have him on board, and his first day was today and he's already rolling up his sleeves and getting to work.

Trevor J. Walsh

Analyst, Citizens JMP Securities, LLC

Q

Great. Appreciate it.

Operator: Your next question comes from the line of Joel Fishbein with Truist Securities. Your line is open.

Joel P. Fishbein

Analyst, Truist Securities, Inc.

Q

Thanks for taking the question. Matthew, just two quick ones. You mentioned in the prepared remarks about the public business just getting – being fairly strong and you mentioned the U.S. Department of Commerce. Can you give us any color about on adoption in the public sector? And then just tied to that, you are very early and very right in talking about the macro becoming weak several years ago. And I'm just curious, I know, I listened to your prepared remarks and just wanted to take your temperature about how you're just feeling in general about the way that the demand environment is currently. Thanks.

A

Matthew Prince

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

Yeah. So sort of related questions actually. I think that our federal business as well as our SLED business, state, local, education, and our global government business has all been real signs of strength. And I think that that in part is because of the fact that the world's getting scarier. And we're seeing more attacks, 2022 was actually very quiet on the cyber front, whereas the back half of 2023 and especially after the Hamas invasion and kidnappings in Israel, really took off in terms of cyberattacks that were going on around the world. And I think governments recognize the importance of staying safe and secure.

More than half of the world's population will vote in [ph] 2023 (01:00:20) in elections. And so I think the fact that we've been leaders in protecting elections and making sure that elections are run without cybersecurity being part of the story has gotten us in the conversation in a lot of places around the world. And I think that we have a maturing set of just go-to-market motions and a really great leadership around our state and local business – or excuse me, our federal and state business, which is showing real signs of promise. So I would expect that that business continues to be strong throughout 2024.

Your second question is kind of the flip side of that, which is, I think that the macro continues to be challenging. There are two hot wars going on right now. I think we are not out of the woods economically [ph] in (01:01:27) terms of getting totally ahead of inflation. Again, I think in the US that looks better than some of the other places in the world. There's a lot of ways that you can imagine the world continues to get more complicated.

And I think IT buyers continue to be skittish. Q4 definitely felt like people were starting to make decisions and they were starting to say that there are certain things that are must-haves versus nice-to-haves, and I think we continue to be sorted into the must-have bucket. But we continue to be very prudent and very thoughtful as we think about our business. We're trying to scale behind the demand that we see, not get cocky about ramping anything too fast. But in a world that is increasingly difficult and increasingly complicated, I'm glad that we're in the business of helping provide cybersecurity, and I'm incredibly proud of our team for living up to our mission of helping make sure the internet stays safe, secure, and reliable.

Operator: That is all the time we have for questions today. I will turn the call back to Matthew Prince for closing remarks.

Matthew Prince

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

I just wanted to thank the entire Cloudflare team for just all the incredibly hard work over Q4 and into the beginning of 2024. And we're just so incredibly proud of the work that everyone is doing. I'm excited to add Mark Anderson to our team full-time. He started actually today, as I said, and is already rolling up his sleeves. Wanted to thank Marc Boroditsky, who will continue to act as an advisor to Cloudflare and help with the transition. He's been nothing but a class act throughout this and we couldn't have gotten here. Thanks to all of our customers, investors, and we'll see you back here in about three months. Thank you.

Operator: This concludes today's conference call. We thank you for joining. You may now disconnect your lines.

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