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Cloudflare, Inc. (NET)

Q1 2024 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Thank you for standing by and welcome to the Cloudflare First Quarter 2024 Earnings Conference Call. 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] Thank you.

[indiscernible] (00:00:29) turn the call over to your host, Phil Winslow, Vice President of Strategic Finance, Treasury and Investor Relations. You may begin.

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 first quarter of 2024. With me on the call, we have Matthew Prince, Co-Founder and CEO; Michelle Zatlyn, Co-Founder, President and COO; Thomas Seifert, CFO; and Mark Anderson, President of Revenue. 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; and our anticipated future financial and operating performance and our expectations regarding future macroeconomic conditions. These results and other

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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'll 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 months ago.

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 a very strong quarter. We achieved revenue of $378.6 million, up 30% year-over-year. We added 122 new large customers, those that passed more than $100,000 per year and now have 2,878 large customers, up 33% year-over year. Revenue contribution from our large customers during the quarter increased to 57%, up from 52% in the first quarter last year.

Digging into our largest customers, we added a record number of net new customers year-over-year spending more than $100,000, $500,000, and $1 million on an annualized basis. We are successfully moving upmarket and becoming a larger and more strategic vendor to more and more of our customers.

Our dollar-based net retention held steady quarter-over-quarter at 115%. Our gross margin was 79.5%, again, above our long-term target range of 75% to 77% and up from 78.9% last quarter. We delivered operating profit of $42.4 million, representing an operating margin of 11.2%. Our gross margin and operating margin performance underscore Cloudflare's efficiency and increasing operational excellence.

We again meaningfully outperformed on free cash flow, generating $35.6 million during the quarter. We have our hands firmly on the levers of our business. I'm proud of the fact that our team has been able to continue to build our network, service larger and larger customers, and launch entirely new categories of products, including in the AI space while remaining disciplined with our CapEx, gross margin, operating margin, and cash flow. We have an elegant business that works because how all the pieces fit together and leverage our hyper efficient network infrastructure in a way that we believe no competitors can match.

If I reflect back on the history of Cloudflare, it divides fairly neatly into seven-year eras. The first seven years, 2010 through 2017, were all about engineering and little else, figuring out if it was even possible to build the revolutionary network we have today. The next seven were all about product, taking that incredible engineering and packaging it up. As we got great at product, we didn't stop being incredible at engineering. We continue to build on and improve that foundation.

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Looking forward to the next seven years, we will continue to be the best in the world in engineering and product, but we'll add to that world-class sales and marketing. To that end, just 90 days ago, we announced that Mark Anderson will be joining Cloudflare as our new President of Revenue to accelerate our next phase of growth and scale. He hit the ground running and has been enthusiastically embraced by our team. I thought it made sense for Mark to say a few words on what he's seen in his first 90 days. Mark?

Mark Anderson

President-Revenue, Cloudflare, Inc.

Thanks, Matthew. I knew Cloudflare and the team as a board member for the last 4.5 years, but the thing that surprised me the most getting in the trenches is just how incredible the product is. I know this space and we are leaps and bounds better than any of our competitors.

What also surprised me is how much room for improvement there is for Cloudflare's go-to- market organization. The last year has been about clearing the way for a world-class enterprise sales organization to emerge. We've got some great people, great experiences, and gosh, I could see the early results. And now I'm planning to step on the gas, building and enabling this team that can take Cloudflare's best-of-breed products to every single enterprise everywhere in the world. I don't see anything stopping us from becoming one of the most strategic key vendors to every Fortune 500 company out there. I couldn't be more excited.

Matthew Prince

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

Thanks, Mark. Some of the benefits of a world-class leader are hard to measure in the short term, but I'll give you one that can be clearly measured and it stood out to me. The number of applicants for strategic account and enterprise sales positions increased 56% in March versus February following Mark Anderson's appointment. We're definitely hiring. Across all positions, we had over 350,000 applicants in Q1, up 47% over the same quarter last year.

We added several senior go-to-market leaders with proven track records in their areas of expertise, including a new chief partner officer, a new head of global sales and renewals, and multiple regional strategic account sales leaders. If you're a sales professional who wants to win with great products and world-class leadership, the word is out. Cloudflare is the place to bet the next stage of your career.

Beyond incredible hiring, our sales productivity from existing team members improved year-over-year. Sales cycles were similar to last quarter and new pipeline attainment exceeded our expectations. I don't think Mark can take credit for any of that yet, which is actually very encouraging. We have room for improvement, as he said, but now we have the right leadership and foundation to take our go-to-market efforts to the next level. I feel extremely confident and clear in the long-term opportunity that Cloudflare has in front of us.

In the short-term, however, my crystal ball is less clear. We see a lot of signals based on our privileged position running a good chunk of the Internet. Even without that visibility, if you've been watching the news at all, it's clear that the near-term outlook for the world is uncertain: increasing tensions in the Middle East, no end in sight in the Russia-Ukraine war, and potential signs of instability in Asia.

It's not at all certain on anything we see that things will get worse but we do know from even recent history that macro factors can impact short-term sales trends. We're fortunate that we're in the cyber security space, perhaps one of the few sectors that can actually benefit from an increased global tension. We're already seeing that,

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especially in our government business. But we also want to acknowledge the risky world we live in and be, as we always have been, prudent and careful with our investments and our forecast as we look into what is a short-term, cloudy crystal ball. That served us well in the past and I think will prove to be the disciplined approach once again going forward.

The short-term is uncertain, the long-term is bright and so, in the medium term, we're going to keep our hands firmly on the levers of our business and thoughtfully invest in our go-to-market efforts in great engineering and in disruptive new products that deliver incredible value to our customers. That's the winning strategy, especially in uncertain times.

Speaking of customers, let me share some great wins for the quarter. The National Cyber Security Centre, the UK's technical authority for cyber threats, signed a three-year contract with Cloudflare to deliver its Protective Domain Name Service. PDNS protects over 1,400 UK organizations in central government, local government, health care, and emergency services from malware and cyber threats. This is a very competitive process with several vendors and a rigorous technical evaluation. We tightly collaborated with Accenture, a partner we're looking forward to working with even more closely on this landmark UK public sector win.

A leading technology company expanded their relationship with Cloudflare, signing a three-year $40 million pool of funds contract, $8.5 million of which are expansion. This deal is an example of a strategic platform deal that we're increasingly seeing customers opt for with a rate card for more than 40 Cloudflare products and services. These include Cloudflare One, Magic Transit, R2, as well as Workers AI, which the customer was quick to dive in and start trialing. As a textbook land and expand story, this customer first came to us in 2017 for our application security services and has continued to expand over the years with this deal encompassing the vast majority of Cloudflare's platform.

A Fortune 100 financial services company signed a similar four-year $10 million pool of funds deal. This customer represents our largest new logo win with a major financial institution. We successfully completed six different proof of concepts and the main business drivers for going with Cloudflare were resilience, the operational efficiency from a single unified platform, and our ability to meet data sovereignty requirements with complete flexibility at the country level, a requirement that no other vendor was able to accommodate. We anticipate this deal will serve as a beachhead for us to win more financial service customers looking for the same benefits.

A large international energy company signed a five-year $4.5 million contract. This new customer is going all-in with Cloudflare's SASE platform with 6,000 Zero Trust seats along with CASB, DLP, Browser Isolation, Magic WAN, and Magic Firewall. Competing against a first generation Zero Trust vendor, our focus on scalability and efficiency as well as the ability to consolidate several vendors due to the significant value in our overall portfolio were key factors delivering this win.

A large financial institution in Latin America signed a two-year $1.3 million contract for Zero Trust seats for their employees and contractors along with our application security services. This is a very competitive process with 11 participants. Cloudflare's pace of innovation, speed of deployment, superior performance, and integrated platform with DDoS and WAF for agentless access set us apart from the rest.

A leading digital marketplace signed a three-year $880,000 contract for Zero Trust Magic WAN application security. The company was looking to simplify, optimize, and reduce latency in their security architecture and WAN platform. With their incumbent solution, the company found it difficult to roll out consistent security posture where they could manage security and network together. With Cloudflare, this customer is able to consolidate

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seven incumbent products onto Cloudflare's modernized network, merging network and security solution on our unified platform with a single control plane.

A Fortune 100 government-sponsored financial services company signed a three-year $3 million contract for DDoS protection with our Magic Transit, Magic Firewall and DNS Firewall product. This customer was looking for a solution that was more resilient, performant, and better architected than their incumbent solution. With Cloudflare's unified platform, this customer is able to improve attack mitigation outcomes on a single pane of glass and eliminate the need for a dedicated team to run and manage multiple products. Another deal with this customer is already underway.

A leading construction company signed a three-year $720,000 contract for Zero Trust, Magic WAN and Magic Firewall. This customer is looking to shift from a legacy hub-and-spoke architecture, eliminating costly hardware appliances at job sites to a modern cloud-native SASE model, Cloudflare One against the first-generation Zero Trust vendor due to our superior network, pace of innovation, ease of use, and speed of deployment.

A US government agency signed a one-year $800,000 contract for Zero Trust, Magic WAN and R2 Object Storage. The agency was looking to modernize infrastructure and eliminate a complex network of multiple legacy point solution vendors. Cloudflare displaced a first-generation Zero Trust provider due to our ease of use, speed of deployment, and integrated platform with a single control plane. These are all great wins. And again, I think what we're seeing is more and more customers are turning to the complete Cloudflare platform.

Before I hand it over to Thomas, I wanted to spend a couple of minutes talking about Cloudflare Workers, our developer platform. The last few months were incredible for the entire workers ecosystem. First, we crossed over 2 million active developers building applications on Cloudflare Workers. Second, in April, we GA'd a number of key products like D1, our serverless SQL database; Hyperdrive, which makes any traditional database perform like it's globally distributed; and Workers AI, which allows developers to run and tune AI models across our global network. We're ahead of schedule rolling out GPUs across our network, and now have them running in more than 150 cities globally, making us what we believe is the most widely distributed AI Cloud by a huge margin.

Our next generation of servers that begin to roll out in Q2 have GPUs built in by default, and will support faster inference and even larger, more complicated models. Developers are building incredible new applications using Workers AI, and we're making it increasingly easy for them. We added support for Python, the second most popular programming language generally and the most common language for AI applications. We rolled out our partnership with Hugging Face, making it one click simple to deploy most of their catalog of models to Cloudflare's network. And we added other bleeding-edge models, including releasing Meta's Llama 3 to production, simultaneously the day it was announced.

One of my favorite aspects of my job is I feel like I get to see into the future when I talk to developers who are building on Cloudflare Workers. I'm proud that we're delivering the tools they need to build applications that are intelligent, scalable and lightning fast around the world. Internally and externally, our innovation engine continues to fire on all cylinders. And as I said, I've never been more excited about the future for Cloudflare, the Internet and us users who will get to enjoy the benefit of all of this innovation in so many aspects of our lives.

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

Thomas Josef Seifert

Chief Financial Officer, Cloudflare, Inc.

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Thank you, Matthew, and thank you to everyone for joining us. We're pleased with our execution during the first quarter. Sales productivity improved year-over-year again this quarter. Sales cycles were similar to last quarter, and our new pipeline attainment exceeded our expectations. The quarter was highlighted by sustained momentum with large customers, including our largest new logo win with a major financial institution and continued progress in the public sector, including our largest contract with a new foreign government customer.

We're also seeing security remain a high priority for our customers, given the continued geopolitical uncertainty and high-profile cyberattacks, driving demand for our application and network security businesses as well as Cloudflare One. We also maintained our strong commitment to being fiscally responsible, and act as good stewards of investors' capital. During the first quarter, operating profit more than doubled year-over-year, and we generated strong free cash flow of $35.6 million, driven by a notable uptick in collections on our accounts receivable.

Turning to revenue. Total revenue for the first quarter increased 30% year-over-year to $378.6 million. From a geographic perspective, the US represented 52% of revenue and increased 28% year-over-year. EMEA represented 28% of revenue and increased 35% year-over -year. APAC represented 12% of revenue and increased 22% year-over-year.

Turning to our customer metrics. In the first quarter, we had about 197,000 paying customers, representing an increase of 17% year-over-year. We ended the quarter with about 2,900 large customers, representing an increase of 33% year-over-year and an addition of 122 large customers in the quarter.

As Matthew mentioned, we were pleased to see revenue contribution from large customers during the quarter increase again to 67% of revenue, up from 62% in the first quarter last year. We also added a record number of net new customers year-over-year across all three large customer cohorts that is those spending more than $100,000, $500,000 and $1 million on an annualized basis with Cloudflare.

Our dollar-based net retention rate was 115% during the first quarter and consistent 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. First quarter gross margin was 79.5%, representing an increase of 60 basis points sequentially and an increase of 170 basis points year-over-year. Network CapEx represented 8% of revenue in the first 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.

Turning to operating expenses. First quarter operating expenses as a percentage of revenue decreased by 3% year-over-year to 68%, as we remain committed to driving higher productivity and greater efficiency across our operations. Our total number of employees increased 9% year-over-year, bringing our total head count to 3,704 at the end of the quarter. Sales and marketing expenses were $156.8 million for the quarter. Sales and marketing as a percentage of revenue decreased to 41% from 42% in the same quarter last year.

Over the last five quarters, we focused on refining our go-to-market strategies and operations. We're encouraged by the double-digit year-over-year improvement in sales productivity that we again delivered during the first quarter, which continues the upward trend from the trough of early last year for the productivity level we consistently achieved in 2021 and early 2022. We expect this positive trajectory to continue based on the analysis

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of our pipeline and with the onboarding of Mark Anderson and the other senior go-to-market leaders Matthew referenced earlier.

As you've heard us say many times, we are committed to the underlying unit economics of our business, and make data-driven decisions to pace hiring. The improvement in sales productivity and other leading indicators of our business give us confidence to invest in additional go-to-market improvements and further expand sales capacity. As a result, we intend to accelerate head count additions in the coming quarters as compared to the first quarter.

Research and development expenses were $58.7 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 $43.2 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 $42.4 million compared to $19.4 million in the same period last year. First quarter operating margin was 11.2%, an increase of 450 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 and the balance sheet. Our net income in the quarter was $58.2 million or diluted net income of $0.16 per share. We ended the first quarter with $1.7 billion in cash, cash equivalents and available for sale securities. Free cash flow was $35.6 million in the first quarter, or 9% of revenue, compared to $13.9 million or 5% of revenue in the same period last year. Remaining performance obligations or RPO came in at $1.343 billion, representing an increase of 8% sequentially and 40% year-over-year. Current RPO was 70% of total RPO.

Moving to guidance for the second quarter and full year 2024. We are pleased with our execution during the first quarter. However, ongoing mixed macroeconomic data points and heightened geopolitical uncertainty remind us that we continue to operate in a business environment that remains challenging to predict. As a result, we remain prudent in our outlook for 2024.

For the second quarter, we expect revenue in the range of $393.5 million to $394.5 million, representing an increase of 28% year-over-year. We expect operating income in the range of $35 million to $36 million and we expect an effective tax rate of 10%. We expect diluted net income per share of $0.14, assuming approximately 360 million shares outstanding.

For the full year 2024, we expect revenue in the range of $1.648 billion to $1.652 billion, representing an increase of 27% year-over-year. We expect operating income for the full year in the range of $160 million to $164 million. We expect an effective tax rate of 10% for 2024. We expect diluted net income per share over that period to be $0.60 to $0.61, assuming approximately 361 million shares outstanding. 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 their 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.

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QUESTION AND ANSWER SECTION

Operator: Thank you. We will now begin the question-and-answer session. [Operator Instructions] We ask that you please limit yourself to one question and one follow-up. Your first question comes from the line of Matt Hedberg from RBC Capital Markets. Your line is open.

Matthew Hedberg
Analyst, RBC Capital Markets LLC

Q

Great. Thanks, guys. Congrats on the quarter. Maybe one for Matthew first, then one for Thomas. Hey, Matthew, our checks continue to show you're becoming more relevant in SASE. Can you talk a bit more about the progress in that market and why you appear to be taking share of what feels like a more competitive market today?

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

A

Yeah. I think we're really proud of our team for our ability to execute their – SASE, for those people who aren't as familiar with it, is the forward proxy products that we sell. It helps make sure that employees who are using the Internet online are protected from malware, protected from malicious sites, that the networks that you use as part of your business are as secure as possible.

We were able to build our SASE platform on top of Cloudflare's existing network, and the advantage of that is that it means that you get a true platform. Not only do you get those four proxy products, but a lot of times we're bundling in our reverse proxy products. And that total solution is extremely compelling in the marketplace, and it's something that no other SASE vendor can match.

And so, I think we are a newer entrant into the space, but we've caught up very quickly. You can see we have improved more in the Gartner rankings, in the Forrester rankings, than any other vendor in this space. And companies are taking notice. The other thing that I think everybody really loves is most security companies think that performance is sort of a nice to have, not a must have. We never accepted that. And so, our SASE platform is significantly better and faster than anyone else.

And so, anyone who's listening to this, if you're frustrated with the VPN that you have to log into, if you're frustrated with whatever service it's providing, that even if it's a new cloud service, if it's slowing you down and making it harder for you to do work, give us a call at Cloudflare, because we can actually improve that and make it significantly better. And that's what we're seeing from customer after customer after customer, is that our next-generation SASE platform is winning in this space.

Matthew Hedberg
Analyst, RBC Capital Markets LLC

Q

Excellent. And maybe just a quick one for Thomas. I know calculated billings isn't a great metric for you guys based on your model, but I'm wondering how we should think about billings in the context of your expanded usage-based pricing model?

Thomas Josef Seifert
Chief Financial Officer, Cloudflare, Inc.

A

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Especially if you compare fourth quarter to this quarter, fourth quarter was a very strong quarter both in terms of new business, as well as in terms of renewal. But what made this part even more special from a comparability perspective, as Matthew talked about, some very large significant deals, both in the federal as well as in the commercial space.

Some of these very large deals, the pool of fund deals, and they have a very different shape to them from a current RPO and billings perspective. And one indication is RPO, it's up 40% year-over-year where you see this momentum more neutralized and some of the noise taken away, and doubt – without any doubt or because business is becoming more complex. And this is then also reflected in some more noise from quarter-to-quarter perspective. But overall, we are really happy with the performance in the quarter.

Matthew Hedberg
Analyst, RBC Capital Markets LLC

Q

Got it. Thanks a lot, guys.

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

Andrew James Nowinski
Analyst, Wells Fargo Securities LLC

Q

Great. Thanks very much for taking the question, and congrats on a nice quarter. I wanted to start with a question on Workers AI because I think it's one of the most exciting products you have in your portfolio. You mentioned Workers AI and developers are using your platform to build some new AI applications. Can you just give us some examples of maybe what those apps are and why they chose WorkersAI to build out among the many other alternatives out there?

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

A

Yeah, Andrew. As I said, one of the most fun part of my job is getting to see what developers are building. So let me give you, I don't know, a handful of examples off the top of my head and see if any of these are interesting. You can stop me if they get boring. I think one of the largest e-commerce platforms out there is starting to use Workers AI to do image classification and generate keywords for their shops. A start-up in the drone space is taking imagery and turning it into 3D models and using Workers AI to do that. They service around the globe, and so that's interesting.

A handful of the public platform companies are using Workers AI for video transcription, transcribing, translation, all the thing that's AI. A multinational online food ordering company. Every once while, a restaurant doesn't submit a picture for one of the dishes. And so they're actually experimenting with Workers AI to generate pictures of the food that you're serving. Hopefully they disclose that it's not an actual picture.

A handful of photo and video editing platforms are using Workers AI or evaluating it in order to do image enhancement and make that better. There's a start-up that's generating songs in whatever language you speak, and local languages, and they're using Workers AI in order to power their song generation platform.

We're seeing a bunch of large consulting companies, public companies, the big gaming company, all of which are actually worried about shadow AI. And so they're actually using Workers AI Gateway in order to understand how their own teams are using Workers.

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The start-up is using a series of enterprise summarization tools where they can look at a bunch of emails and very quickly summarize them into executive reports. There's another start-up that's creating an AI search engine. There's a public company in the financial services space that's doing real-time fraud detection. There are people who are finding ways to – in the renovation space, how can you imagine, before you hire a contractor, what the spaces is going to look like in another sense.

I mean, I can just go on and on and on with example after example after example. And our team just hands these to us every day. And it's so exciting to see what people are doing in this space and the different ways that they're using it.

In terms of why, what is it about Cloudflare that's unique? I think there are sort of three things that stand out to me about it. The first is just the performance of Cloudflare Workers AI, because we are a distributor around the world and today over 150 locations globally, as we serve customers that serve a global audience, we just give them a much better experience than having to ship all of your code back to some central location.

The second is that we can actually be significantly more cost-effective. If you're using one of the big hyperscale cloud in order to do any sort of AI task, it's up to you to manage efficiency. You have to make sure that you're getting the most out of the GPU that you're renting. Whereas what we do is much more of a serverless AI model where you only pay for the tasks that you actually run. So especially in a lot of the start-ups, they're finding that they can just get significant better efficiencies, significant better cost if they use our platform in order to deliver that AI experience.

And then the third thing is that because we are distributed globally and because of the fact that we have such a rich ecosystem that we built, where you can get a soup to nuts AI experience, that's allowing people to actually fine tune their models. So my silly example of this, is that if you have an AI that's responding back to a British user and describing what something looks like versus a US user, in the UK, you want color to be spelled C-O-L-O-U-R. In in the US, you want it to be spelled C-O-L-O-R.

Because we can regionally tune that, we can actually correspond with all of the local and regional differences all around the world. That's something that you don't get anywhere else. And that, I think, is going to be really important for these inference types. They're going to want to be run locally for both the normative and experience reasons, but also for the regulatory reasons that are out there.

So I'm super excited about what we're seeing in the AI space. I'm really proud of our team for being ahead of our rollout. We had to actually physically get geared to over 150 cities worldwide, and we're still on track to, by the end of this year., we think, be able to do AI inference from nearly every location that makes up Cloudflare's network.

Andrew James Nowinski
Analyst, Wells Fargo Securities LLC

Q

Well, that was an extremely comprehensive answer. Thank you so much, Matthew. Maybe just a quick one for Thomas. You guys have made some great new hires beefing up your go-to-market on the channel side with Tom Evans and, of course, Mark Anderson. I know you talked about the uncertain macro in the short term, but I was wondering if you're factoring in any sort of conservatism into your annual outlook for the go-to-market changes that you guys might make as a reason for perhaps not raising your guidance despite the strong Q1. Thank you.

Thomas Josef Seifert
Chief Financial Officer, Cloudflare, Inc.

A

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As you know, conservative is not a word that we use. When you talk about giving guidance, we tend to be thoughtful and prudent about it. And of course, it's a balance of the tailwinds we see, but also the uncertainty that is out there. And every major go-to-market transformation, in our case, it's actually more an evolution, various risks and it's reflected in our guidance, too.

Andrew James Nowinski
Analyst, Wells Fargo Securities LLC

Q

Got it. Thank you.

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

Brent Thill
Analyst, Jefferies LLC

Q

Thanks. Matthew, on federal, the last couple of quarters, you've had a theme of some pretty big wins. And I'm just curious if you could give us a sense of where you think penetration is. And is it fair to say the flywheel is spinning faster here, at least from what you guys are giving us in terms of the bright crumbs around the federal business?

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

A

Yeah, I think federal is exciting for us. Last year, we achieved a FedRAMP certification. That's opened a lot of FedRAMP or – excuse me federal deals to us. I think we've always had a great relationship with a lot of the members of the federal government. I think the thing which is hard to appreciate that, as I talked to our federal customers, is how much they appreciate that when they ask us to help with something, we step up and help.

So, this year in the United States, obviously an election year, we've been running the Athenian Project since 2016, which provides our services at no cost to anyone who is helping administer an election anywhere in the United States. We've done similar things around the rest of the world. We've looked at the White House on a number of initiatives, including Project Safe Schools, in order to protect the most vulnerable schools and communities across the country.

And that is all the foundation, which I think has built an incredible amount of trust and an incredible amount of goodwill in the federal space. And so, today, as the world is getting scarier and scarier and we're seeing more and more cyberattacks, our federal business, I think, is being driven by the fact that we have great products, the fact that we have the certifications that are required to serve the federal government, and the fact that we've built an incredible relationship as being not just a trusted vendor, but a true partner where we have helped make sure that when there's any public institution that is in true need anywhere across the country, we'd step up and help. And I think that's now turning into more and more business that is also generating significant revenue for us.

Brent Thill
Analyst, Jefferies LLC

Q

And then just quickly for you and Thomas, this AI CapEx war debate, you saw all the big hyperscalers take CapEx way up. How do you do this efficiently? You mentioned bringing gear to 150 cities, you're ahead in GPU rollout. Explain how your – is this only one way to go with costs or is there a way you can do this in a more efficient way than maybe others?

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

A

I'll start, and then Thomas may have more to add. I think the thing which is really magical about Cloudflare's business, which is really elegant, is that it all fits together so well. So, for instance, as we sell more of our Zero Trust and SASE products, those are extremely high margin products, and they don't require a significant additional amount of CapEx.

That then frees up our ability to invest that CapEx in other areas, including in the AI space. I think we made some very smart decisions, specifically reserving space and the equipment that we deployed, knowing that AI would be part of our story at some point in the future. And so we really wanted to make sure that's the case.

That means that as we deploy CapEx, it's literally not shipping an entire server to support AI, but shipping just the GPU cards that go into existing servers that are in the field. That reduces the amount of CapEx that has to be deployed. And again, it works because it is all running on one unified network. The fact that every server across Cloudflare's entire platform is capable of performing any function that we need. That has allowed us an enormous amount of flexibility in how we can deploy things, and that's helped us.

The other part is that a lot of the hyperscale players, what they're really doing is they're renting out a full GPU or a full machine, whereas our business is a little bit different, we're selling the actual work that those machines do. What that means is that we can then be much more efficient at figuring out how to allow multi-tenant use of the equipment that we have provided, and we can make sure that the utilization is extremely high.

And again, these are – I don't know the exact numbers for each of the hyperscalers and they all have slightly different characteristics, but in the average hyperscaler, they're getting maybe 20% utilization out of a CPU or GPU resource that they've deployed. We can often be many times that in terms of the utilization where we're in CPUs, we're seeing almost 80% utilization. So that efficiency allows us to get more out of every CapEx dollar.

Finally, I would say that inference is different than training. And so you need different resources for that. You don't need necessarily the most cutting-edge GPUs in order to do inference tasks. And so that has meant that we haven't had to chase down what is a – GPUs that have limited quantity. It's also meant that we can be much smarter about picking and choosing between different GPU vendors and matching workloads to whoever it is that can provide the best service. And I think, over time, that gives us a significant advantage over people who are just trying to rent one particular type of GPU or rent that and let their customers figure out how to be as efficient as possible.

Brent Thill
Analyst, Jefferies LLC

Q

Thanks.

Thomas Josef Seifert
Chief Financial Officer, Cloudflare, Inc.

A

There's not much to add to this. We were at 8% to 9% of revenue with network CapEx in the first quarter. We said the year will be closer in the range of 10% to 12%, and this includes the rollout of GPU capacity pretty much to every server and every location we have.

I think, just to underline what Matthew just said, the huge variety of use cases we see and that Matthew talked about when he talked about Worker AI (sic) [Workers AI] deployment with developers, gives a huge insight in how

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we optimize this capacity. And there's not one card that is good for AI for every inference task. And this ability to optimize our investment mix and GPU capacity to that need based on the huge variety of use cases we see is, I think, an additional big factor that allows us to be so efficient with our CapEx spend.

Brent Thill
Analyst, Jefferies LLC

Q

Thanks, Thomas.

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

Joel P. Fishbein
Analyst, Truist Securities, Inc.

Q

Thank you. Thanks for taking the question and good execution in the quarter, 30% top line growth. Matthew, one for you and a follow-up for Thomas. Matthew, you talked a lot about the hiring of go-to-market talent and just inflecting on that. There seems to be a war on talent per AI engineers. You've seen a few companies do acqui-hires where they're just draining talent. Curious where Cloudflare is with hiring and retaining talent, and if it's fitting into your normal compensation things capacity.

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

A

Yeah. I mean, I think we are very fortunate that across the board, we are seen as a place where if you want to be innovative, if you want to invent the future, or if you want to sell really incredible products or help market them or, frankly, work on some of the hardest public policy issues or get to work with Thomas on the world's coolest finance team, that Cloudflare is a place where you can go. And so, when you see someone like Mark Anderson, when you see someone like Stephanie Cohen, and you see the engineers who are coming to Cloudflare every day, we had 350,000 people apply to work at Cloudflare in Q1 for, I don't know, 250 jobs roughly, that's extraordinary. And that's up over what was an extraordinary Q1 of last year, up almost 50% year-over-year.

So I think that the talent war is real, but we're in a fortunate position where we are winning that war. We have not seen an uptick in any regrettable attrition. It's been – I think we're very fortunate to be working on some of the world's hardest problems, and some of the smartest people in the world want to come and help us on this.

Joel P. Fishbein
Analyst, Truist Securities, Inc.

Q

That's great. And Thomas, for you, just in terms of sales, productivity, really strong improvement again. Do you expect that to change with the acceleration of new hires, sales hires or are you hiring more experienced people so their time to productivity is shorter?

Thomas Josef Seifert
Chief Financial Officer, Cloudflare, Inc.

A

This is, of course, what the goal is. But even if you hire experienced people, there's a ramp-up curve that comes along with it. We are moving upmarket. We're getting to larger and larger customers and more strategic accounts. They're more complex. There's no overlay. So this balances itself out. We hire great talent, we see great productivity improvement. But as I said earlier, every transformation or evolution on the go-to-market side comes with potential risk. And we try to be thoughtful when we give guidance, that there might be downside implied.

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Joel P. Fishbein
Analyst, Truist Securities, Inc.

Q

That's great. Thank you so much.

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

Jonathan Ho
Analyst, William Blair & Co. LLC

Q

Hi. I just wanted to follow-up on that last question and just try to better understand from a sales productivity standpoint what inning are we in and where do you think Mark can add the most value?

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

A

I'll start and then Thomas can maybe add some more if he has it. I think we are still early in the journey of being really great at enterprise. I think in Mark's comments, he said that our product is great, but our ability to really sell to large enterprises, to understand their needs and drive more of a strategic relationship is something that we are continuing to work on. That is I think the last 18 months were all about sort of cleaning up the sales organization and now with Mark onboard, it's all about now how do we get the real professionals onboard where we can become that strategic vendor for literally every large company in the world. There is no large company that doesn't have a need for what it is that we sell.

What I think is really encouraging is where we have done that, where we have really nailed that, we are becoming one of the largest IT vendors for those companies. And some of those are very large companies. I mean, the fact that we won a very large financial services organization and became a strategic vendor for them that, as I said, is a beachhead for us to go in and take much more share. Almost all the major financial service institutions in United States use us for something, but I wouldn't say that we're a strategic vendor for many of them yet. We're going to be and we can do so many things in the networking and security space that they absolutely need. And as we, I think, mature that process, it's great.

I can't imagine someone who is better for this role than Mark Anderson. And again, it was not the plan when we added him to our board four years ago, but he's gotten to know us over that period of time. And it's just incredible to see the high caliber of talent who is excited to lean forward and work with him going forward.

Jonathan Ho
Analyst, William Blair & Co. LLC

Q

Excellent. And just a quick follow-up. Is there something specific in the macro that's maybe causing you a little bit of pause? Anything that you can sort of point to in terms of that additional concern on the outlook? Thank you.

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

A

I think that we get a lot of signal based on where we sit on the Internet. And what I would say right now is that it's not any one thing pointing in any one clear direction, but there's a lot of noise pointing in a number of different directions that give us, I think, reason to be cautious. And I think that that is in our very nature is always taking as much signal, being data-driven and making sure that we're making investments in a responsible way. And so I think the obvious thing is the geopolitical uncertainty around the world. That absolutely causes changes in buying behavior.

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On the other hand, some of those changes in buying behavior have been positive for us as we're seeing especially in our government business pick up because of that uncertainty. So, there are puts and takes that are out there. What we want to do is just make sure that we are being prudent and responsible and thoughtful as we make investments and as we think through how to handle the responsibility that we have with investors' capital they've trusted us with.

Jonathan Ho
Analyst, William Blair & Co. LLC

Q

Thank you.

Operator: Your next question's from the line of Tom Blakey from KeyBanc Capital Markets. Your line is open.

Thomas Blakey
Analyst, KeyBanc Capital Markets, Inc.

Q

Hey, guys. Great. Thanks for taking my question. I was wondering about the recent Nefeli acquisition around multi-cloud networking and a possible acceleration to [ph] Act 2 (00:51:31). There was a prior question on Zero Trust SASE services. I guess specifically, maybe because the impetus of the deal, maybe there was some pent-up demand that maybe this addition of multi-cloud networking technology could maybe expand Cloudflare's reach from a Zero Trust perspective. I'd love to hear your comments there and I have a follow-up.

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

A

Yeah. We're incredibly excited to have the Nefeli team onboard. We want to make it – we think the space that Cloudflare competes in is in the networking and in the security space. And so making it very easy to get traffic on to our network to connect to any other cloud is just a critical aspect. And it seemed like something that we were either going to have to build or buy. And we came across the Nefeli team in part because they came in through our own Launchpad program, which is a program having customers and startups that use Cloudflare's resources and especially our Workers platform in order to build.

What is powerful about that is we use that same platform to build ourselves. And so, when we find great teams working in a space that we think is exciting, building on the same platform that is the same platform that our own team uses, that just decreases the risk of any kind of technical integration, any kind of sort of Frankensteining of your platform that's out there.

And so, the Nefeli team is really great and we were excited to announce it. We think that, again, our hurdle rate for acquisitions and M&A remains very, very high. But some of these small acquisitions where we found great teams working in interesting spaces has worked incredibly well for us.

A couple other examples that are very similar, Baselime that we acquired is again giving serverless observability to our platform. That's one of the number one things that developers on our platform are looking for. And again, another time where we found some of those using our own platform in order to build out a great observability platform. PartyKit, which is a real-time integration service, again, it's just a natural extension of what it is that we're doing.

So again, none of these are very large acquisitions, but I think they're extremely strategic. I think they accelerate our ability to get into more markets. And what I love is that they oftentimes are using our own existing developer

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platform, which means that they are just incredibly easy for us to integrate with the rest to Cloudflare and decrease the technical risk as we go M&A.

In all three of those cases also, the founders and the team, they're just sort of Cloudflare-like people, and they're people that we're so excited and proud to have on the team. And I think you'll hear more about the wins that we have from all those areas over the quarters to come.

Thomas Blakey
Analyst, KeyBanc Capital Markets, Inc.

Q

Well, that'd be great to get more high margin SASE revenue here. I'd like to go as a segue there back to Brent's question on GPU. And I think he gave a great question about the unique architecture of the platform and this kind of multi-tenancy. But just seeing the explosive growth with other CSPs and the approaches that folks are taking there, is it fair to characterize this way that CapEx would have to go up relatively significantly if, say, a handful of these applications being built on your platform explode to the like of something like a Copilot?

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

A

Well, I think that what I would look at is CapEx as a percentage of revenue. And I think one of the things that's always been magical about Cloudflare has been that we've been able to invest behind the demand, not ahead of the demand. And so, we're really good at rolling out more capacity wherever we need it. And so, that would be an amazing problem to have if we have to – so it may be that we, on a just pure dollars basis, end up spending more on GPUs. But as a percentage of revenue, we feel very comfortable that we can service these applications very well at the percentage of revenues that is in our forecast going forward.

Thomas Blakey
Analyst, KeyBanc Capital Markets, Inc.

Q

Thank you, Matt.

Thomas Josef Seifert
Chief Financial Officer, Cloudflare, Inc.

A

What I would want to add here is that the efficiency of the architecture is really driving this. We talked about the revenue mix, it allows us to invest into GPUs by more and more revenue driven by Zero Trust products. The efficiencies that is driven in the hardware architecture is an additional factor that goes into this.

We're in the rollout of what we call Generation 12 now of our service, better architecture. It's a little bit more than 25% total cost of ownership reduction in this new generation. So, that is 25% more of CapEx we can deploy towards GPUs. So the levers are just in not in one place. They're in many places and the combination of this is really driving this incredible efficiency.

Thomas Blakey
Analyst, KeyBanc Capital Markets, Inc.

Q

That's great. Well, maybe we'll look for you breaking out AI or GenAI revenue one of these days, Thomas.

Thomas Josef Seifert
Chief Financial Officer, Cloudflare, Inc.

A

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As soon as it is the right thing to do. At the moment, I think we shouldn't get tired that the benefit in driving adoption is significantly more important than driving revenue in the short term. This is why the efficiency is so high is we see so many use cases from 2 million developers being on the platform. This farsighted approach has served us well and we'll continue with it.

Thomas Blakey
Analyst, KeyBanc Capital Markets, Inc.

Q

Indeed. Thank you.

Operator: Your next question comes from the line of Alex Henderson from Needham. Your line is open.

Alex Henderson
Analyst, Needham & Co. LLC

Q

Great. Thank you so much. Wanted to ask a question about your comments about the macro conditions. About two years ago, I think it was you guys gave an early warning that the economy had some risks to it and that you were seeing signs of slowdown. And that actually occurred 6, 9, 12 months later.

And so, with this commentary on this call, are you suggesting that you're seeing similar kind of characteristics to the conditions or is this just a little bit more noise to it? And therefore, you're being prudent, but you just don't have any visibility to whether that's going to happen yet. Can you contrast this event to several years ago when you gave that caution?

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

A

Yeah. Alex, so two years ago, I felt like we had pretty clear signal that the economy was slowing down. I would say that we don't have as clear a signal today, that that's the case. We see things that worry us, but we also see things that give us some level of optimism.

And so, I think describing the crystal ball as cloudy is the right thing. What I like, though, is that we have a crystal ball. We can make investments and we can think through what that future looks like in part because we just get much more signal than I think the average enterprise SaaS company gets.

And I think that that has served us well, and I think we try not to be surprising in any way. And so, as we see a up, I would say that there is certainly an uptick in uncertainty and sort of potential downside this quarter over last quarter. But I would not characterize it as the same concerns that I had in Q1 of – what was that, 2022, where we saw what we thought was much, much clearer. So, we continue to watch this.

Again, I feel like I am proud of how well Thomas and the rest of the team have the ability to take that and keep their hands on the levers of our business and continue to execute. But I think my level of concern is not at the same level than it was in Q1 of 2022, but it is definitely heightened over a lot of what we've seen in more recent quarters.

Alex Henderson
Analyst, Needham & Co. LLC

Q

So if nothing's really spooking you here, I'm still struggling with the guidance and the outlook for the back half of the year. You've given guidance that or commentary that you're seeing significant strengthening of your pipeline. You're saying your duration's stable. You're seeing solid closure rates.

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You're adding more sales capacity. You're winning large customer deals at an accelerating rate. You're spending more on hiring people and productivity in your sales force is significantly improving, yet your guidance implies with the first quarter beat and the second quarter above the Street, the back half is much more conservative.

So I guess the question is, is that a function of a specific weakness in a particular geography or due to political issues? Or is it just trying to feather in more opportunity for the sales organization to be realigned as Mark comes on and drives things? Because ultimately, it sounds like the mechanics imply an acceleration, not a deceleration.

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

A

Yeah. Alex, I'll start and then Thomas can give a little bit more color. I would push back on your initial statement, which was that nothing spooks me. A lot spooks me right now. So just because just – and I want to make it clear. We are in a much more uncertain environment and the signal that we're seeing is that uncertainty is up.

In addition to that, I think you're correct that whenever you have a sales leadership change, there is risk that comes with it. And so there's a bit of that, but the primary factor here is that as we look at the signals in the overall macro economy, it feels like there's much more reason to worry in Q1 than there was in Q4. But that doesn't mean that it was the same, just sound the alarm bells that we were seeing back in Q1 of 2022.

Alex Henderson
Analyst, Needham & Co. LLC

Q

Great. So just essentially derisk it. I appreciate it. Thanks.

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

Timothy Horan
Analyst, Oppenheimer

Q

Thanks, guys. We saw the hyperscale cloud revenues really accelerate this quarter. They accelerated guidance and they're actually talking about being kind of capacity constrained and you're kind of the on ramp on to those cloud guys. I guess, why the disconnect between what they're seeing in guide and versus what you're seeing out there right now?

Particularly you're also in like their fastest-growing segments of serverless and low latency. But I guess what's changed other than your concerns on the macro or is anything on the on-ramp thesis?

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

A

Yeah. I think that the big thing, Tim, that I point to is that they tend to be purely usage-based models. And that the good of usage-based models is that they react very quickly both up and down. And so, I think whereas we tend to be much more of a subscription-based model.

And the good of that is that it has a lot more stability and that stability helps you when things are slowing down. So, we had significantly faster growth than the hyperscalers in the last few quarters and we're now around where they are this quarter. And so, I think we are a little bit more moderated than some of the more usage-based models. And I think that explains some of it.

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I think the second thing that I'd add is that for some of the products, especially around the AI products, as Thomas said, we're really optimizing around adoption. And while we published pricing and that pricing was extremely well received in addition to being very attractive for us from a margin perspective, in the last months. That's something that is – it's still not a place where we are heavily monetizing yet. But again, I think as I listed some of the examples, we see plenty of opportunity there and we think that when we decide the time is right to turn on some of those monetization, it will help contribute to our top line growth.

Timothy Horan
Analyst, Oppenheimer

Q

And just two quick follow-ups. Are you seeing any other competitors coming into what you offer in a global serverless, low latency basis? And I guess you're implying at some point revenue growth should really accelerate here, I mean, in a more stable macro environment or more visibility. I mean, everything we've been talking about on this call since like my predecessor said, incredibly positive. And your guide for the second half down to 26% just seems like very, very low versus what it potentially could be, I guess. Do you think these steps will enable you to accelerate in the next couple years?

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

A

So on the competition front, we really don't. We think that we are in a very unique position. We don't see anybody else that is yet rolling out the type of connectivity cloud with true serverless architecture. There are people who are buying some legacy businesses. There are people who sort of talk a good game but it turns out when you pull the covers back, don't have very much business in the space at all.

And so we are, I think, unique in the position that we're offering. I don't think that will stay true forever. Other people will provide services here but we have a clear lead. We have the richest ecosystem and I think that what's great about Cloudflare's business is that we have existing very stable businesses that continue to perform.

We have newer businesses for us like our Zero Trust and SASE businesses, which are just accelerating up the S-curve. And then we have a lot of leading edge opportunity with things like our Workers platform. And so, Cloudflare is all about stacking S-curves one behind another behind another. And so, where I think a lot of companies run out of TAM, run out of market, we are able to continue to add and innovate into new areas in a way that I think will achieve what we want, which is we think we're going to be one of the truly iconic technology companies and we're investing for that long-term, including at times making the choice of optimizing for adoption rather than trying to figure out how we make money from every single customer with every single transaction. And we think that that's the right formula for building what is an iconic technology company over the long-term.

Timothy Horan
Analyst, Oppenheimer

Q

Very helpful. Thank you.

Operator: That concludes our question-and-answer session. I will now turn the call back over to Matthew Prince for closing remarks.

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

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I just want to thank our entire team for executing. I know that in the world right now, there's a lot of scary things going on. There's a lot of tension and what we do every day of making sure that the Internet continues to function, that it continues to be a force that drives the economy around the world going forward, I can't imagine anything more important to be working on. So thank you for the entire team for delivering yet another terrific quarter. We're getting back to work now and we'll see you all again next quarter. Thank you.

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

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