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Cloudflare, Inc. (NET)

Q2 2020 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Ladies and gentlemen, thank you for standing by, and welcome to the Cloudflare Q2 2020 Earnings Conference Call. At this time, all participants are in a listen-only mode. After the speaker presentation, there will be a question-and-answer session. [Operator Instructions]

I would now like to hand the conference over to your speaker today, Jayson Noland, Head of Investor Relations. Thank you. Please go ahead.

Jayson Noland

Head Of Investor Relations, Cloudflare, Inc.

Thank you for joining us to discuss Cloudflare's Financial Results for the Second Quarter 2020. With me on the call, we have Matthew Prince, Co-founder and CEO; Michelle Zatlyn, Co-founder 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 in our Investor Relations website.

As a reminder, we'll be making forward-looking statements during today's discussion, including but not limited to, the impact of the COVID-19 pandemic on our and our customers, vendors and partners operations and future financial performance, anticipated product launches and the time and market potential of those launches, the company's anticipated future revenue, financial performance, operating performance, non-GAAP gross margin, non-GAAP net loss from operations, non-GAAP net loss per share, shares outstanding, non-GAAP operating expenses, free cash flow, non-GAAP effective tax rate, dollar net retention rate, free and paying customers and large customers.

These statements and other comments are not guarantees of future performance, but rather are subject to risks and uncertainty, some of which are beyond our control, including but not limited to, the extent and duration of the impact of the COVID-19 pandemic and adverse conditions in the general domestic and global economic markets. Our actual results may differ significantly from those projected or suggested in any forward-looking statements. These forward-looking statements apply as of today and you should not rely on them as representing our views in the future. We undertake no obligation to update these statements after this call.

For a more complete discussion of the risks and uncertainties that could impact our future operating results and financial condition, please see our filings with the Securities and Exchange Commission, as well as in today's earnings press release. Unless otherwise noted, all numbers we talk about today, other than revenue, will be on adjusted non-GAAP basis.

All current and prior period financials discussed are reflected under ASC 606. You may find a reconciliation of GAAP to non-GAAP financial measures in our earnings press release on our Investor Relations website. And for historical periods, a GAAP to non-GAAP reconciliation can be found in the supplemental financial information referenced a few moments ago.

We would also like to inform you that we will be virtually participating in the Oppenheimer Annual Technology Internet & Communications Conference on August 11th, KeyBanc Future of Technology Series on August 18th, and the Jefferies Software Conference on September 14th.

Now, I would like to turn the call over to Matthew.

Matthew Prince

Chairman & Chief Executive Officer, Cloudflare, Inc.

Thank you, Jayson. We had a very strong quarter. Our Q2 revenues came in just shy of \$100 million, up 48% year-over-year. We saw strength from our customers of all sizes. We grew our large customer account, those paying us more than \$100,000 annually by 65% year-over-year. We also added nearly 7,000 new paying customer count to over 90,000. At the same time, we saw strong growth across our existing customer base as they adopted more features of the Cloudflare platform.

While we are very happy with our results, our nature is always to be on the lookout for what could go wrong. As I talked about last quarter, we were concerned about concessions and the risk of bad debt caused as the result of the COVID-19 pandemic. While we are not out of the woods, we see good reasons to be optimistic. COVID-related concession requests peaked in early April and have since tailed off. We came in well below what we forecast for potential downside.

Today, much more so than on our last earnings call, we feel we have clear visibility into the effects of the pandemic on our business. That has given us the confidence, as Thomas will detail, to raise both our Q3 and our annual guidance. That confidence comes foundationally from our very predictable and consistent business model. The vast majority of our revenue, more than 95% we bill upfront on a subscription basis. That generally gives us good visibility into our future results.

Another consequence appears to have been that we saw the peak in customer concession requests earlier than other companies that bill in arrears on a more volatile usage basis. One thing we are seeing increasingly is customers who are surprised at their large usage-based bills at other vendors now coming to us for predictable,

consistent pricing. No one likes to be surprised by a bill. And we believe the consistency of our SaaS approach is not only more predictable for us, but also builds trust and wins loyal customers over the long-term.

While concessions ended up lower than we had forecast, I'm proud of how our team worked to accommodate those of our customers that were struggling due to COVID. These are tough times for many businesses. Great partnerships are often built during tough times. Consistency and predictability are especially valued when so much else seems uncertain. The customers I've talked to have been thankful that we've been there as a good, reliable partner with them through the challenges in the last five months.

For our own business, we are relentlessly paranoid. So, we've been watching a handful of metrics in order to help understand the impact of these unusual times. As I mentioned on our last earnings call, our sales cycle had ticked up by a few days in Q1 then trended back down in Q2 and remains well under a quarter and at the low end of our historic range. We were worried sales productivity may slow as our team adapted to working remotely. Instead, sales productivity per ramped rep hit a new record high.

Deeper into the weeds, we watched our receivable collection period closely. We speculated that as businesses struggled during the pandemic, our collections period may lengthen. We were pleasantly surprised to see our collections period stay stable over the last two quarters. So, what's going on? We believe the pandemic forced companies to sort their vendors into two buckets, nice to have and must have. All indications from the quantitative metrics we're watching as well as the qualitative conversations we're having with customers are that Cloudflare is squarely in the must have bucket.

Of course, we are part of the larger global economy, and lest we forget, we're still in the midst of a global pandemic. So, lots of risk remain, but we've seen no indication that we are uniquely exposed to the effects of the crisis, quite the opposite. For example, for new customers, segments that have traditionally been slow to adopt the cloud are increasingly embracing their digital transformation and turning to us for help. In Q2, we saw particular strength in Europe, industrial companies and small businesses. Those are not the first three segments you think about when you think cloud adoption. And yet, COVID has caused even those segments of customers that traditionally are slow to change to adapt in order to survive.

The nimbleness of our go-to market team and our short sales cycle have allowed us to adjust our playbooks and be there from new customers in these segments as they've unexpectedly accelerated their digital and network transformation plans. It also helps that customers need our services more than ever. We talked last earnings call about the incredible increase in consumption of Internet services generally.

The global growth of Internet traffic largely plateaued in Q2. And we believe it will remain largely flat in Q3. What did not plateau were cyberattacks. We blocked 37% more cyberattacks per day for the same cohort of customers in Q2 than Q1. Think of that metric as our cyberattack equivalent to same store sales. If you include new customers, the growth in mitigated attacks was 63%. When companies face online cyber threat, they increasingly turn immediately to Cloudflare.

May was the busiest month the Internet has ever seen for distributed denial-of-service attacks. June, we saw an attack against one of our customers that lasted 4 days and peaked at more than 750 million packets per second. Our network didn't flinch. The targeted customer's infrastructure never slowed down, and they weren't even aware until our systems alerted them.

Suffice it to say none of us expected 2020 to work out the way it has. I'm thankful for our team and our technology's flexibility, and proud of all the customers we've helped ensure have a fast, reliable and secure

Internet through these challenging times. I swore after last earnings call where I had literally repeated the word four times, I would never again call anything unprecedented, but here we are.

Back in April, I spoke to our team at our Q2 kickoff. I emphasized that great companies use crises to focus on what's most important, but also to invest in the future while others pull back. Our team rose to that challenge. It's been incredible to see the rate of innovation that has continued and in fact accelerated even as we've had to adapt to a new work environment.

One place you can measure that investment is in hiring. Unlike many others in the industry we did not slow down. We hired 257 new team members in Q2 which is a record for us and ahead of our hiring plan. But what's behind those numbers is even more impressive. We had nearly 47,000 applicants, up 750% year-over-year. If you do the math that means we extended offers to less than 0.6% of applicants. We had a 96% offer acceptance rate company-wide and a 99% rate in our sales organization. This talent we're seeing is incredible.

My parents were proud when I got into HBS [ph] turns out the odds of getting a job at Cloudflare (00:11:04) these days are much harder. When 18 months from now you hear about some incredible new feature or a big customer win, know that the investments in the people who made that happen came during this time when we stepped on the gas, while others were pumping the brakes.

Even as we made these investments, we continued to make substantial progress on our path toward profitability. This quarter we delivered nearly 2,000 basis points in operating leverage year-over-year. And even as we saw unprecedented spikes in traffic and cyberattacks, our gross margins remained north of 76% and within our long-term target model. But of course, there's no metric more important to judging the health of any business than its ability to win the trust of customers. To that end, I wanted to walk through a handful of customer (sic) [new customer] stories for the quarter.

One of the largest and oldest European financial services firms signed a three-year deal worth \$450,000 per year for Cloudflare for Teams, our zero trust cloud-based replacement for legacy VPNs and firewalls. They talked to many of the major zero trust file security players and chose Cloudflare for the capabilities of our current offerings, as well as what they described as our future proof roadmap. We believe there will be an opportunity to further expand this customer as our browser isolation technology is rolled out in the second half of this year.

A large US-based industrial manufacturer signed a deal worth \$350,000 per year to adopt Cloudflare's Web Application Firewall solution. They were moving to the cloud as part of their digital transformation replacing legacy on-premise hardware and saw Cloudflare as the clear winner in cloud security. Having established a trusted relationship with them last quarter, this quarter, we are talking to them about adopting our Cloudflare for Teams solutions for their 50,000 employees.

A leading identity and access management provider signed a two-year deal worth \$0.5 million per year. They moved workloads away from Amazon Web Services due to better speed and flexibility of our platform. They are part of a general trend we are seeing from the most security savvy organizations, who tell us they trust Cloudflare's platform, respect our team, believe in our ability to continue to innovate, and are betting on our technology.

A born in the cloud gaming platform signed an expansion of their existing Cloudflare contract for an additional \$1.8 million annually. This platform which, if you have kids at home, they're almost certainly using, chose Cloudflare to ensure the best possible experience for all their users worldwide. I've been excited to watch how

they use Cloudflare Workers, our serverless computing platform to scale and empower the explosive growth they've seen over the first half of 2020.

That's one great example of a Cloudflare Workers customer. But I wanted to finish by giving you a picture of how developers generally are adopting our serverless computing platform. Cloudflare Workers launched nearly three years ago. Part of what was powerful about Workers was that it was a true Turing-complete, serverless computing platform that allowed developers to build sophisticated applications and run them edge-to-edge across our entire network.

Today, approximately 10% of traffic flowing through Cloudflare's network is powered by Workers. About 20% of new large customer deals include Workers, and in Q2 alone, 22,000 new developers wrote their first application using Workers, up of 440% year-over-year. We're not satisfied being just a niche edge computing platform, we want to be the go-to serverless computing platform for all developers and applications.

To that end, last week we announced a number of new Cloudflare Workers features. We significantly raised CPU limits allowing customers to build even more sophisticated applications. We released pricing that is up 75% less expensive for the same workloads than AWS Lambda while still being margin accretive for us and we expanded our tools to support the languages developers already know and love like JavaScript, C, C++, Python, Rust, Scala and even COBOL.

What I'm excited to see is that developers choosing Cloudflare Workers aren't doing so just because it's the fastest, but also because it's the most consistent, secure, cost-effective computing platform that's easy for them to use and helps solve the thorny global compliance issues their CIOs increasingly care about. Watch this space. As Michelle likes to say, we're just getting started.

With that, I'll turn it over to Thomas to walk through our financial results for the quarter. Thomas, take it away.

Thomas J. Seifert

Chief Financial Officer, Cloudflare, Inc.

Thank you, Matthew, and thanks again to everyone for joining us. As Matt mentioned, we continued the momentum from our first quarter, saw less headwinds from the COVID pandemic than previously anticipated and delivered another outstanding quarter with strength in multiple areas of the business. Total revenue for the second quarter grew 48% year-over-year to \$99.7 million. The growth in revenue was driven by another quarter of strong customer demand both in terms of new logo acquisition, as well as expansion within our existing customer base.

From a geographic perspective, the US represented 49% of revenues and increased 46% year-over-year. Our international business represented 51% of revenue and increased 50% year-over-year. International growth was driven primarily by EMEA, which saw a record year-over-year growth of 62% helped by new product adoption from large enterprises.

Turning to our customer metrics; we exited the quarter with more than 3 million total free and paying customers, representing an increase of 40% year-over-year. As a reminder, beginning last quarter, we shifted to revenue-based KPIs and away from billings as the basis for our KPIs. We added a record number of large and paying customers in the second quarter on both a sequential and year-over-year basis. We added roughly 7,000 paying customers in the second quarter bringing the total number of paying customers to over 96,000.

We added more than 80 large customers sequentially ending the quarter with 637 paying customers with greater than \$100,000 in annualized revenue which is up 65% year-over-year. Roughly half of the 637 large customers have been on the platform for more than a year and the other half for less than one year.

For second quarter, dollar-based net retention was 115% which decreased 2% sequentially and 7% year-over-year. The decline was primarily driven by non-strategic accounts in Asia Pacific that churned off our platform. Outside of the Asia Pacific region overall expansion in the quarter from large enterprise customers was strong with 9 of our top 10 deals in terms of new ACV coming from existing accounts.

A meaningful number of large expansion deals came from customers that hasn't yet been on the platform for a year and therefore have yet to contribute a dollar net retention. We view this as a healthy indication of our ability to expand our new customers quickly and expect this trend to continue into the second half of 2020.

Second quarter gross margin was 76.8% down 150 basis points sequentially and 130 basis points year-over-year which is in line with the expectations we shared last quarter and our long-term target of 75% to 77%. We have been able to absorb Internet traffic levels 30% to 40% higher than pre-COVID without a significant impact to gross margin.

Turning to operating expenses; we remain focused on building a long-term business with sustainable growth while improving the operating leverage in our business. Second quarter operating expenses as a percentage of revenue decreased 8% sequentially and 20% year-over-year to 86%. As Matthew mentioned, we achieved record hiring in the second quarter with a focus on key geographies like Austin and Lisbon, increasing our head count by 44% year-over-year and bringing our total number of employees to 1,535 at the end of the quarter.

Sales and marketing expenses were \$47.4 million for the quarter, representing an increase of 9% sequentially and 33% year-over-year. Sales and marketing as a percentage of revenue remained flat at 48% sequentially and decreased 5% year-over-year. To add to what Matthew mentioned, we had a record quarter in terms of sales hiring including quota-bearing reps, which is important as we look out to fiscal year 2021.

Research and development expenses were \$21.3 million in the quarter, representing an increase of 4% sequentially and 15% year-over-year. R&D as a percentage of revenue decreased to 21% from 22% last quarter and 27% in the same quarter last year. We've seen excellent progress building out our Lisbon office which we expect to contribute to long-term R&D leverage.

G&A expenses were \$17.4 million for the quarter, representing a decrease of 21% sequentially and constant year-over-year. The sequential decrease was primarily driven by lower than expected bad debt expense and a reduction in events and office expenses. G&A as a percentage of revenue was 17% representing a decrease of 7% sequentially and 8% year-over-year.

We continue to see operating leverage in the business as operating margin improved by over 1,800 basis points year-over-year and 600 basis points sequentially. Operating loss was \$9.5 million in the second quarter compared to \$18.7 million in the same period last year. We accelerated hiring in the second quarter in order to remain on track to achieve full year hiring plans and as such, expect to see variations in the magnitude of operating leverage going forward.

Net loss in the quarter was \$9.6 million or net loss per share of \$0.03. Our effective tax rate for Q2 was negative 12.2%. We have a strong and flexible balance sheet ending the second quarter with \$1.1 billion in cash, cash equivalents and available for sale securities. Earlier in the quarter, we issued a \$575 million convertible note

offering with total net proceeds of \$562 million. In connection with the offering, we bought a capped call with 100% premium in order to protect our common shareholders from dilution.

Second quarter free cash flow was negative \$20.2 million or 20% of revenue compared to a negative \$16.9 million or 25% of revenue in the same period last year. Operating cash flow was positive \$4 million in the second quarter. The improvement was primarily due to greater profitability and improved working capital helped by strong collections. Our DSOs remained well within the historical range, which we view as encouraging against the recessionary environment. We expect to see variability in operating cash flow due to ongoing fluctuations in working capital and the growth in our enterprise business.

Before moving to guidance for the third quarter and full year, I would like to provide an update on the COVID-related impacts and associated provisions we shared last quarter. Last quarter, we disclosed that customers highly affected by COVID-related challenges, particularly those in macro sensitive industries such as transportation, hospitality and retail represented approximately 8% of our business.

In the second quarter, this cohort grew mid-single digit sequentially but decreased slightly as a percent of total revenue. Customers in these industries are seeing challenges, but continue to invest to build out a web presence in order to remain relevant and competitive.

We also disclosed last quarter that we saw customer concessions uptick in March and decline in April. We are pleased to share that second quarter contract modifications came in well below the \$2 million headwind we anticipated with these customer modification requests having trended down during the quarter to historical levels. During the quarter, we were pleased to observe a slight decrease in our sale cycle and remaining within the range we've seen historically.

In addition, we also saw an uptick in our sales productivity, which improved 7% sequentially. We continue to exceed our new ACV and customer renewal targets. July has trended as planned from a net new ACV and renewals perspective. And despite the current environment, we observed a sequential increase in win rates which return to historical ranges.

Remaining performance obligations or RPO ended the quarter at \$274 million, up 18% quarter-over-quarter, and up 58% year-over-year. Although uncertainties remain in the current environment. We are confident in the continued growth of our business and the durability of our subscription model, with variable revenues continuing to less than 5% of total revenues. Therefore, we are pleased to raise guidance both for the third quarter as well as for the fiscal year.

For the third quarter, we expect revenue in the range of \$102.5 million to \$103.5 million, representing an increase of 39% to 40% year-over-year. We expect operating loss in the range of \$16 million to \$15 million. We expect net loss per share in the range of \$0.06 to \$0.05 assuming approximately 302 million common shares outstanding and we expect an effective tax rate of negative 6.2%.

For the full year 2020, we expect the revenue in the range of \$404 million to \$408 million, representing an increase of 41% to 42% year-over-year. We expect operating loss for the full year in the range of \$55 million to \$53 million. We expect net loss per share over the period in the range of \$0.18 to \$0.17 assuming approximately 301 million common shares outstanding. We expect an effective tax rate for 2020 of negative 8.6%.

In closing, we are optimistic about the continued durability of our business and the efficiency of our platform. We are thankful for the resiliency of our employees, the strength of our customer relationships, and overall

productivity in a work from home environment. As such, we believe we are well-positioned to execute despite these challenging times.

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

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] We will pause for just a moment to compile the Q&A roster. Your first question comes from the line of Matt Hedberg with RBC Capital Market.

Matthew Hedberg

Analyst, RBC Capital Markets LLC

Q

Okay, guys. Thanks for taking my questions and congrats on a really strong quarter. And certainly, it's a tough environment that does not go unnoticed. What really stood to me is growth in large customers. I think it was 65%. And also, Matt, you talked about record productivity and really strong new hires when others are pulling back. I guess given like these trends seem to be accelerating your large enterprise expansion, does this typically mean you're displacing a legacy on-prem vendor or rather, it's just greenfield wins to support net new cloud workload?

Matthew Prince

Chairman & Chief Executive Officer, Cloudflare, Inc.

A

Yeah. Matt, thanks for the question, and thanks for the kudos. We've been really happy with our ability to close larger and larger customers. We're up to now about 16% of the Fortune 1000 are using or using Cloudflare. That's up from 13% in Q1. I think we see a number of different places that people come to us, but our belief is there are no new dollars in the world. And so, we don't think of it as a greenfield opportunity, but rather traditionally that we are replacing what is usually a existing on-premise hardware-based solution as part of the digital transformation that enterprises are going through right now, whether they were planning on doing that in 2020 or not.

Matthew Hedberg

Analyst, RBC Capital Markets LLC

Q

Got it. That's helpful. And then the other thing obviously, it's been in the news with Workers Unbound. Personally when we talk to partners and customers alike, we think Workers could be one of the biggest long-term opportunities you have. And you did give a lot of helpful metrics to think about this opportunity. Could you give a little bit more details about what Unbound actually means for adoption of that service? It strikes me that there's a number of positives there, you highlight some of them but just maybe a little bit more details on Unbound?

Matthew Prince

Chairman & Chief Executive Officer, Cloudflare, Inc.

A

Yeah. So we've had a, edge computing offering in the market now for nearly three years and I think over that period of time, we've learned a lot about what developers really want from a computing platform and I think that when you and I spoke three years ago, I probably talked about powering IoT devices and driverless cars and how being faster was really the killer feature for that edge computing products.

I think what we've learned over the last three years is that actually when developers think about what they're doing, one of the terms in computer science is that you don't want to have premature optimization. That's actually

a real mistake. And so fast is great, but if you think of it as sort of Maslow's hierarchy of developers needs fast is like self-actualization, it's the last thing that you get not the first.

And so what we are really building with Unbound is something that is just an edge computing platform which we think are going to be largely niche application, but instead think of it as a true serverless application that can provide a number of different functions and the one that I think is the most interesting and encouraging for us and we think it's just an enormous opportunity is around something that's incredibly boring in some respects which is compliance.

As we have more and more countries around the world requiring data localization and keeping their citizens' data inside the borders of their countries, that's where you need a network like Cloudflare. And the fact that today we're already in more than 100 countries around the world and you can as a developer write to one platform and be in compliance with those increasingly complicated requirements. I think that's going to be a really very large opportunity for us and that's what we're hearing from the largest customers that are interested in Unbound.

Matthew Hedberg

Analyst, RBC Capital Markets LLC

Q

Thanks a lot. Congrats guys.

Operator: And your next question comes from the line of James Fish with Piper Sandler.

James E. Fish

Analyst, Piper Sandler & Co.

Q

Hey, guys. Congrats on the quarter and appreciate the details on Workers there this quarter Matthew and the color on the call Thomas. In our checks heading into the quarter we were able to have a lot more conversations than normal regarding Cloudflare who – we typically don't see as much really channel adds. In fact, you guys even disclosed how much is coming from indirect sources. But can you talk about how your go-to-market is changing and what you're seeing from more the traditional channel and integrators out there including between landing net new customers versus expansion?

Matthew Prince

Chairman & Chief Executive Officer, Cloudflare, Inc.

A

Yeah. I think that channel is something where we see a lot of opportunity for us to continue to grow and improve. We continue to move up market and we're working with partners that can help us do that. And I think there are two areas that I'm particularly excited about. One of the things that was difficult about the channel for us in the beginning was we made Cloudflare so easy to sign up for that there wasn't – it wasn't clear what value a reseller could add, as a value-added reseller.

And so, I think that was a trickier place for us. With products like Workers what we're increasingly seeing is channel partners that have real specialties in certain areas being able to really bring real value and develop IP on our platform that they can then sell over and over and over again. So, I think it's still early days of that but we're seeing that from large partners like an IBM and other system integrators that are able to deliver that and really seeing value across our platform.

I think the second thing is that the [indiscernible] (00:33:39) suite, if you look at other companies that have cloud-based zero-trust solution, a lot of them have gone to market through channel partners. And so, I think we are taking that and putting that as an extra tool in the bags of those channel partners, and I think that's going to be an

opportunity for us to really build our relationship with those partners and then hopefully educate them over time to sell the full suite of Cloudflare products.

James E. Fish

Analyst, Piper Sandler & Co.

Q

And then, Matthew, just to kind of follow-up. Obviously, there's a lot of political news out there going on, but can you kind of help us frame up if we shouldn't expect any impact related to any of the bands that are going on to your business? More related to you guys do have a larger China presence including a couple of large China relationships? I guess how are you guys thinking about that for the back half of the year potentially?

Matthew Prince

Chairman & Chief Executive Officer, Cloudflare, Inc.

A

That's something that we're following closely, and obviously we don't have a crystal ball in terms of how those relations develop. On a pure metrics basis, China revenue is low-single digits for us, much less than 5% of total revenue. And so, even in the worst case scenarios, we don't see that as a significant change in our business. What I think is more important is that the long-term strategy of the United States [indiscernible] (00:35:08) we sell more as a US company to the Chinese market.

And so, we actually think that by being the infrastructure that helps US companies' better sell to the Chinese market, we actually think that's aligned without the long-term interests, actually on both sides with the political, both sides of the Pacific Ocean are. And so, so far, we haven't seen anything that makes us suspect that we will face unusual challenges, but even if we do, again it's a small part of our business.

James E. Fish

Analyst, Piper Sandler & Co.

Q

Makes sense. Thanks Matthew. Thanks, guys.

Operator: Your next question comes from the line of Sterling Auty with JPMorgan.

Q

Hi. This is [ph] Drew (00:35:58), on for Sterling. You kind of touched on this a bit but I was just wondering if you could provide some more color on how the China opportunity is ramping particularly with the JD Cloud data center additions. And what kind of demand you're seeing in that region?

Matthew Prince

Chairman & Chief Executive Officer, Cloudflare, Inc.

A

Yes. So, we continue to see demand from Chinese companies, or let me say it differently. I think there are two different directions that we're seeing demand. So, one is from Chinese companies which are trying to sell outside of China. And the second is for US companies that want to sell into China. I think the former of those we've seen continued strength in, I think there's a little bit of uncertainty around the latter. But again, it's been a relatively small piece of our business.

The JD Cloud partnership is going very well. We expect that, that will turn on in the first half of 2021 which is what it was on schedule for. And they have so far been a terrific partner for us. And the same is true of Baidu. They've now been a partner for us for over five years. And again, we think that it's very much aligned in being the

infrastructure that can help more companies sell into China. And we think that, that's a very unique opportunity that we can provide to the market.

Q

Great. Thank you.

Operator: Your next question comes from the line of Phil Winslow with Wells Fargo.

Philip Winslow

Analyst, Wells Fargo Securities LLC

Q

Great. Thanks guys for taking my question. Congrats on another great quarter. I actually just have two of them. First, one of the things that you talked about is how customers benefit from the new products without changing their infrastructure just because of the way that your network is built. When you think about I guess the tipping point, especially sort of in a COVID world of having a sort of multiple functions from Cloudflare, are you starting to see adoption of more functions because of the COVID world? How are you thinking about that tipping point? And then just have one follow-up to that.

Matthew Prince

Chairman & Chief Executive Officer, Cloudflare, Inc.

A

Yeah. I think our strategy from the beginning has been how can we get customers on to our network, how can we get traffic flowing through our network, learn from what that is, and then help migrate customers to use more and more of our platform. And so I think we are seeing that in two directions. One is we are technically able to recommend other products to customers.

So, a very consistent play that we're running right now is we may be helping somebody with their basic firewall application, but we see that they are experiencing a lot of automated bot traffic. We can do analysis on that bot traffic and then recommend that as an additional solution to them. And so that is helping us expand across those customers.

The second part is much less technical, but just simply that we've really built trust as a provider that offers an enormous and very compelling return on the investment that they have made. And so that allows us with that trust to go back to them, get introductions inside of the organization, let our sales team move laterally and build much more long-term and dynamic relationship-driven sales. And so, we really think that the secret of Cloudflare is that one plus one equals three, and I think that what you're seeing in the market, what you are seeing from our customers is that, we're seeing that same pattern happen over and over again.

One thing that has been really interesting has been how quickly that's happening and I think a little bit of that might be coming due to COVID where we are oftentimes now having a customer land with one product and then as Thomas said, sometimes it's just the very next quarter expand with an additional product. And so, we're seeing really strong adoption and really strong expansion that doesn't necessarily always happen over multiple years though. And so, I think that that in some ways is why we actually internally see a much stronger expansion that you might see in something like that dollar-based net retention statistic.

Philip Winslow

Analyst, Wells Fargo Securities LLC

Q

Got it. Great. And then just one follow-up. Obviously, nobody loves Workers more than us, but I want to talk about two of your other new products, Magic Transit and Teams. For Teams, wondered if you can give us a sense of just how many customers are just users you're up to now with Teams? And then also Magic Transit, just sort of any update there on the progress?

Matthew Prince

Chairman & Chief Executive Officer, Cloudflare, Inc.

A

Yes. So, with Teams, we haven't disclosed exactly how many customers we have on the platform. That's sold on the seats basis, but we have been – as we said in the last call, we've been really, really heartened by how many people we've been able to help during COVID and we had over 2,000 companies sign up for our promotion that gave that product away through September of this year.

And so we've been now reaching out to those customers and have been encouraged by those early conversations of converting what have been on that free COVID plan into paying customers. And we think that Teams is one of the products that we're most excited about and will be a meaningful driver of revenue especially in 2021.

For Magic Transit, it really is one of those sleeper products that's taken off. And one of the announcements that we had earlier this week is that you can now directly interconnect your network directly into ours. And so I think watch that space. We're getting larger and larger wins. And that is more deeply integrating into the infrastructure of our customers, which we think makes Cloudflare a very sticky product and allows us to provide more solutions to our customers over the long-term.

Philip Winslow

Analyst, Wells Fargo Securities LLC

Q

Great. All right. Thanks, guys. Keep up with the good work.

Thomas J. Seifert

Chief Financial Officer, Cloudflare, Inc.

A

Thanks.

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

Alex Henderson

Analyst, Needham & Co. LLC

Q

Thank you very much. So I wanted to step back from the granularity of the quarter a little bit to what I think is probably the key longer term picture. It seems pretty clear to me that with the billion applications growing at a 40%-plus clip and with Kubernetes' orchestration going from 15% of new applications of being deployed to over 50% in the next three years; you guys really are the best connective tissue between those applications to other applications domain to domain and from applications to users. So in that context, how do you view this broader picture as Kubernetes' adoption accelerates?

Matthew Prince

Chairman & Chief Executive Officer, Cloudflare, Inc.

A

So internally, we're a big Kubernetes fan and a user ourselves. What I will say is that what we're hearing from developers is that even Kubernetes is really a step-on on sort of the journey towards developer nirvana which is,

can you get rid of having a tech ops team entirely? Can you stop having to think about the underlying infrastructure? Can you just write code and it automatically will scale up or scale down to what you are delivering?

And that's really the magic of what we have built with Workers and that's really the promise of a serverless platform. And so I think you're exactly right that the fact that Cloudflare is this connective tissue as the network puts us in a very strategic relationship. But we actually think that the world beyond VM, the world beyond containers, the world beyond that kind of orchestration platform is something where an individual developer could on their own build a \$1 billion company without ever having to have a tech ops team.

And I think that that's really the promise that products like AWS Lambda, that Google Cloud function, that Azure function are targeting. And what we're proud of is that Workers is taking those workloads and being able to deliver that to developers in a way that is faster, more consistent, more cost effective, easier to use and over time I think is going to be a much more compliance-friendly platform especially as the Internet development ecosystem gets more and more complicated over time.

Alex Henderson

Analyst, Needham & Co. LLC

Q

So, going to the second part of the question, you're directly heading in the direction I was going which is to the extent that Workers enable serverless and drives probably the most efficient platform for coders to move to. Can you talk a little bit about why yours is better than the competition in terms of the way your platform is designed, particularly with the isolates and the [indiscernible] (00:45:43) cold starts, why that is so differentiated versus the competition?

It's a critical point that you guys not only have the most open platform for the way you're writing it, i.e. you're not just doing say one language like Varnish, but rather doing all the programming languages of the customers i.e. the coders, want and have at the same time a platform that delivers exceptional security and very fast performance on the edge.

Matthew Prince

Chairman & Chief Executive Officer, Cloudflare, Inc.

A

Yeah. When I was a network administrator back in the early 1990s in my college, when we wanted to turn up a new application, we had to actually physically buy a new server. And at that time we actually bought servers from Gateway and [indiscernible] (00:46:39). And the time to turn up a new application took a lot of time.

And then along came VMware and virtual machine. And what that allowed was multiple different applications to run on a single machine. And that gave rise to the very first cloud providers that were out there. But even virtual machines had a lot of overhead as they ran. So that's where you had companies like dotCloud which became Docker and a real revolution in containers which were a lighter weight version of a virtual machine.

The goal here is always to make sure that you can run code in a secure, safe, multi-tenant environment and containers were the slightly lighter weight version. And that's what most of the serverless platforms out there today are building on top of, are those containers.

And the downside of that is that those containers when you have to scale up it takes a lot of time. So, for example, with something like AWS Lambda, it will automatically spin up another machine and with another container when there's load that demands it. But the problem is that it can take hundreds of milliseconds to up to seconds for that application to be ready. And that inconsistency is a really bad experience for users, which is really the knock on a lot of the serverless platforms that are out there today.

What we realized was that in order to make Workers as powerful as we wanted it to be, we needed to make it a platform that was even more efficient than what you could get with containers. And that's why we moved to a technology called isolates. And so, isolates are just the next generation. And it gives us some real advantages.

It means that we can have literally – we announced last week zero microsecond – zero nanosecond cold start times where your application is ready the minute you want to run it. It means we can support a wide variety of different languages. We don't require developers to have to learn our language. We want to go to them not have them come to us.

And I think one of the really important things is that that efficiency has actually allowed us to price the product in a way which is incredibly competitive, again as much as 75% less expensive than AWS Lambda for the exact same workloads. And that means that – and the reason we can do that is because we just have much less overhead.

So, we think that this is the next step and the next generation in the same way that VMs were revolution from bare metal and containers were revolution from VMs. We think containers are – excuse me that isolates are the next step. And that's what powers Workers and that's how we can be as efficient and flexible as we've been able to become.

Alex Henderson

Analyst, Needham & Co. LLC

Q

So, if I can just follow this one last point on that. So, as [indiscernible] (00:49:32) microservices out consistently and constantly those cold starts are very frequent. So, that would mean that it has to happen that way in order to have the [indiscernible] (00:49:44) work in that environment, right. Is that the right conclusion?

Matthew Prince

Chairman & Chief Executive Officer, Cloudflare, Inc.

A

I think that's right and I think that actually as you distribute – we think that the distributed nature of building this into the network is good because it makes it faster by reducing network latency. But if we hadn't been able to reduce cold starts down that far then – the load is spread across more machines which makes that worse and worse problem. So, by solving that I think we have overcome one of the biggest limitations of an edge computing platform.

And again, this isn't a beta. This isn't vaporware. This isn't something – this is something that last quarter 22,000 developers wrote their first Workers' application on and it's just been really amazing to watch it develop in the market over the last three years.

Jayson Noland

Head Of Investor Relations, Cloudflare, Inc.

A

Thanks, Alex. Operator can we move on...

Alex Henderson

Analyst, Needham & Co. LLC

Q

Thanks.

Jayson Noland

Head Of Investor Relations, Cloudflare, Inc.

A

...to the next analyst please.

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

Brent Thill

Analyst, Jefferies LLC

Q

Thanks. Just back in the enterprise momentum I'm just curious if you could give us your view in the back half of the year in how that pipeline is shaping up. And Matthew what are you hearing as kind of the biggest constraint right now for you to open up the enterprise even more than you have today. What key things do you need to pass through to really make this move quick? Thanks.

Matthew Prince

Chairman & Chief Executive Officer, Cloudflare, Inc.

A

Yeah, I'm going to let – I'll answer the second half of the question, and I'll let Thomas talk through a little bit of what we're seeing in terms of backlog. So, I think that our strategy, when we launched from the beginning, was to start at the low and move up over time. And I think we've done that incredibly well with well over 600 now customers that are paying us over \$100,000 a year; 16% of the Fortune 1000, and taking off a lot of the requirement that those larger more sophisticated customers are requiring in terms of compliance and other features that a more sophisticated customer has.

And so, I really think that we have proven that we can land those largest of the large customers. We're building the case studies around that. And I think that you'll see more and more of the largest enterprises in the world adopting Cloudflare. They may start on just one of our products. But again, I think we've demonstrated that once we have someone using any part of our platform, we can expand that over time. Thomas, you want to talk about backlog?

Thomas J. Seifert

Chief Financial Officer, Cloudflare, Inc.

A

Yeah. So, we've seen really strong performance from a new ACV generation perspective there. The sales team has done an outstanding job and because of that, our RPO has gone up 18% quarter-over-quarter, 58% year-over-year, and that means that from a guidance perspective, 75% of the third quarter is already rolling off the balance sheet.

We also think that the strong momentum we have seen on large expansion deals, I mentioned in my script that 9 out of the 10 large deals were expansion deals with existing customers. If we look at our pipeline, we think that trend is also going to continue for the second half of 2020.

Brent Thill

Analyst, Jefferies LLC

Q

Great. Thanks.

Operator: Your next question comes from the line of Shaul Eyal with Oppenheimer.

Shaul Eyal

Analyst, Oppenheimer & Co., Inc.

Q

Thank you. Good afternoon, guys. Congrats on my end as well with respect to the quarterly performance and guidance. Question for Thomas. It might be correlated building on the prior question. I'm trying to get a sense with respect to guidance just directionally.

Clearly, last quarter was what appears to be playing more defense on all fronts, pandemic just kicked off. You kept your guidance intact mostly. But this quarter we are getting a beat and a raise. Those of us working with you historically in prior positions, we call your thoughtfulness on guidance, I might even say conservatism level. Just trying to gauge an understanding and maybe some sort of a compare, contrast view on guidance this quarter versus the prior. And I have a follow-up.

Thomas J. Seifert

Chief Financial Officer, Cloudflare, Inc.

A

Yeah. Thanks for the question. We wouldn't call it conservative. We would call it prudent. And you're right, guidance last quarter was – there was a lot more uncertainty out there. And we were very open communicating that we wanted to keep the hands on the steering wheel as Matthew called it, making sure that we show that we are in control of our business. We think we were. And the guidance was about protecting the down sides of us leaning in and reiterating guidance for the year.

For this quarter, we have a lot more data points. So, we finished the second quarter, that is very strong. We have good insight into our pipeline. We have good visibility of what going to roll off from a balance sheet perspective. So, that's less uncertainty from what we can control. We've seen significantly less headwinds from a concession and from a bad debt perspective.

And so, that allowed us to maybe lean in a bit more. But still, despite all that, you know, there's still a huge amount of uncertainty out there. So, we updated our models and we ran our simulations. And I would call it still prudent. But in light of a lot more data points we have and a lot more visibility we have worked with pipeline and customer momentum looks like for the second half.

Shaul Eyal

Analyst, Oppenheimer & Co., Inc.

Q

That is fair enough. That's fair enough. And a tricky one, I don't know whether, Thomas, you want to take it, maybe Matthew, it was also – I think was asked maybe by Phil, but I want to try and approach it a little differently. So, the VPN acts as the team product, currently you've given free as a public service to new users until September 1st. Have you run some sort of a back-over-the-envelope analysis? What's the potential revenue you could have been generating? It doesn't have to be [indiscernible] (00:56:27) so any qualitative commentary, maybe some color on that will be highly appreciated. Thank you for that.

Thomas J. Seifert

Chief Financial Officer, Cloudflare, Inc.

A

Let me have a run at it first, and then Matthew is going to jump in. It's not like we have no paying customers on the Teams product. Matthew in his script mentioned one of the oldest financial institutions in Europe that signed up for Cloudflare Access. And, of course, that is a paying customer. When we talk about free, it's really the customers that we signed up when we opened it up at the beginning of the crisis. And we have looked at conversion scenarios. It's fair to say that little of that almost none of that what is today free is reflected in our guidance for the year because we want to be really considerate about how we approach that.

The crisis is not done. There are a lot of customers that are still struggling and depend on us being a good business partner. So I think we will have a lot more to talk to you about when we come to our next earnings call. But in terms of forecast, very little of this conversion is reflected in the forecast today.

Shaul Eyal

Analyst, Oppenheimer & Co., Inc.

Yeah.

Q

Jayson Noland

Head Of Investor Relations, Cloudflare, Inc.

Operator, can...

A

Matthew Prince

Chairman & Chief Executive Officer, Cloudflare, Inc.

Sorry. Just quickly, we're going to optimize for doing the right by – doing right by our customers. And for the long-term and so again I think we're trying to be very prudent in terms of forecasting anything for those customers right now.

A

Shaul Eyal

Analyst, Oppenheimer & Co., Inc.

Thank you.

Q

Jayson Noland

Head Of Investor Relations, Cloudflare, Inc.

Thanks Shaul. Operator, can we take questions from one more analyst please?

A

Operator: Yes. Your next question comes from the line of James Breen with William Blair.

Jim Breen

Analyst, William Blair & Co. LLC

Thank you. Thanks for taking the questions. Just a couple [indiscernible] (00:58:26-00:58:50)

Q

Thomas J. Seifert

Chief Financial Officer, Cloudflare, Inc.

I'm sorry. You are breaking out. Maybe we – yeah, I think we jump to the next question in line.

A

Jayson Noland

Head Of Investor Relations, Cloudflare, Inc.

Operator, can we take questions from one more analyst please?

A

Operator: And your next question comes from the line of Patrick Walravens with JMP Securities.

Joe Goodwin

Analyst, JMP Securities LLC

Q

Hi. This is Joe Goodwin on for Pat. Thank you so much for taking our questions. Can you give us an update on the size of the enterprise sales force? I believe it was around 25 or 30 reps not too long ago. And then just on the enterprise opportunity, what are some of the key changes you're seeing in the conversations that you're [indiscernible] (00:59:32)?

Thomas J. Seifert

Chief Financial Officer, Cloudflare, Inc.

A

Let me take the first part and then Matthew is going to jump in answering the second part. We are not going to give a lot of color in specific numbers so that is developing. But you heard in the script [indiscernible] (00:59:48) talking about it from a hiring perspective. This was a very strong quarter for us on the sales side especially also from quota-carrying rep perspective.

So, we are really happy with the progress we are making at building out the team and letting it scale from a head count and from an expense perspective behind the demand curves we see. I think that was one of the unique things about our business model is that we don't have to invest ahead of demand but, you know, our ramp up follows customers from a size perspective and from a geographic perspective and we are making good progress, but we staying true to our model, keeping our go-to-market efficient and our customer acquisition cost in line.

Matthew Prince

Chairman & Chief Executive Officer, Cloudflare, Inc.

A

And think from our conversations with customers' perspective, I think that the thing that has been the most surprising I think to us and is driven I think a little by COVID has been that customers that traditionally have been slow to adopt the cloud from regions of the world like Europe, which has been a little bit more conservative from areas like manufacturing and industrial which have been a little bit slower traditionally that we are hearing more and more of them say, okay, we get it, we really have to do this, and we can't wait any longer.

And so, I think that's been the very positive thing that we're hearing and that they really are starting to understand that Cloudflare is the next-generation network that can solve a lot of the problems that they used to have to buy boxes for. And that makes sense as part of – and large part of their overall digital transformation strategy.

Joe Goodwin

Analyst, JMP Securities LLC

Q

Thank you.

Operator: And there are no further questions at this time. And I'll turn it back over to the speakers for any closing remarks.

Matthew Prince

Chairman & Chief Executive Officer, Cloudflare, Inc.

Just wanted to say thank you to our entire team at Cloudflare, it's been amazing to watch everyone adopt to, over the last five months, a remote working environment. I'm really proud of how productive everyone has remained. Thanks to everyone. As a shareholder, we're going to keep going forward. And as Michelle likes to say, we're just getting started. Thank you.

Operator: This concludes today's conference call. You may now disconnect.

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