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Cloudflare, Inc. (NET)

Q1 2022 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Ladies and gentlemen, thank you for standing by, and welcome to Cloudflare's First Quarter 2022 Earnings 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.

Jayson Noland, Head of Investor Relations, you may begin your conference.

Jayson A. Noland

Head-Investor Relations, Cloudflare, Inc.

Thank you for joining us to discuss Cloudflare's financial results for the first quarter 2022. With me on the call, we have Matthew Prince, Co-Founder and CEO; Michelle Zatlyn, Co-Founder, President and COO; and Thomas Seifert, CFO. By now, everyone should have access to our earnings announcement. This announcement as well as our supplemental financial information may be found on our Investor Relations website.

As a reminder, we'll be making forward-looking statements during today's discussion, including, but not limited to, our customers, vendors and partners operations and future financial performance; anticipated product launches and the timing and market potential of those products; the company's anticipated future revenue, financial performance, operating performance, non-GAAP gross margin, non-GAAP net income or loss, non-GAAP net income or loss per share, shares outstanding, non-GAAP operating expenses, free cash flow, non-GAAP tax expense, dollar-based net retention rate, 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 an 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 release on our Investor Relations website. For historical periods, a GAAP to non-GAAP reconciliation can be found in the supplemental financial information referenced a few moments ago.

Before finishing up, I'd like to invite you to join us for our Investor Day next week on Thursday, May 12. It's being held in conjunction with our user conference, Cloudflare Connect, in New York City. This event will start at 9:00 AM Eastern and finish around 11:45, with a live webcast accessible from our Investor Relations website.

Additionally, we will be participating in the Jefferies Software Conference in San Francisco on June 1.

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

Matthew Prince

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

Thank you, Jayson. We had a terrific quarter. In Q1, we achieved revenue of \$212 million, up 54% year-over-year. We added a quarterly record of more than 14,000 new paying customers, up 10% quarter-over-quarter, bringing our total paying customer count to over 154,000.

We added 121 new large customers, those that pay us over \$100,000 per year, up 63% year-over-year to a total of 1,537. Today, 58% of our revenue comes from those large customers.

Our largest customers continue to get larger and larger. Those spending over \$500,000 a year, growing 68% year-over-year; and those spending over \$1 million a year, growing 72% year-over-year. We now have 12 customers and partners spending over \$5 million per year with us. And yet, we remain highly diversified with no customer representing more than 5% of revenue.

Our land and expand motion continues to improve, with dollar-based net retention hitting a new record of 127% in the quarter, up 400 basis points year-over-year. New products and an increased interest in consolidating behind a single trusted vendor for network services has been the key to our continued customer expansion.

Efficiency has always been a hallmark of our business. And even in these inflationary times, we achieved a gross margin in the quarter of 78.7%, up 110 basis points year-over-year. That continues to be above our target gross margin range of 75% to 77%, and affords us the opportunity to selectively target competitors' customers, offering them bundles of products that work seamlessly together, reducing the number of vendors they need and providing them with modern solutions, all while saving them money at the same time.

We are finding this in a especially compelling value proposition when it seems everyone else is raising prices or can't even say for certain when they'll be able to deliver their legacy hardware boxes.

We closed our largest acquisition ever in the quarter, buying Area 1 Security for \$162 million. We have a very high hurdle rate for acquisitions being strongly biased towards internal development, but Area 1's technology and team are special. We started out as their customer.

I remember shortly after we implemented their solution, writing to our Chief Security Officer to ask if something was wrong, I hadn't seen any phishing reports in a few weeks where usually our team would report double digits per day. It turned out Area 1 and their incredible e-mail security tech was the answer. By the way, if you're still seeing phishing messages in your inbox, tell your IT team to call us. We now have a great solution.

Over the last few years, as the customer of Area 1, we got to know their team. At Cloudflare, we're a bunch of geeks. We're good at snipping out when tech is real and when it's BS. The Area 1 team shares the same spirit, so they were fun to work with, and their tech definitely isn't BS. We talked to them briefly about a partnership, but it became quickly clear and made far more sense for them to join Cloudflare and fully integrate with our Zero Trust suite.

Let me give you a sense of how that's going. We extended offers to all the Area 1 team, and even in this hot labor market, 98% of them chose to join Cloudflare. And I'm not giving up hope on that last one Area 1 team member who hasn't yet. I think that says something about how good it fit the two companies are together, the technologies and the culture.

E-mail is the number one source of network threats that no leading Zero Trust vendor has truly integrated e-mail security is a major blind spot the industry was guilty of. As you see others in the space now scramble to build, buy or partner to fill the hole we pointed out in their offerings know that it's the best signal that Cloudflare's Zero Trust solution is resonating in the market and taking share, no matter what they may say. And good luck to them. We got the best team and the best tech in the business.

Let's talk about some customer wins in the quarter, starting with Area 1. In the second half of Q1, Cloudflare and Area 1 sales team started working together. We saw a number of customer wins from existing Cloudflare customers adding Area 1 as well as from Area 1 pipeline deals that accelerated after news broke of our acquisition.

Practitioners trust Cloudflare and know that if we buy a company, the tech works and will scale. New customers who onboarded to Area 1 in the quarter included a major Asian airline, a US bulge bracket investment bank and a Fortune 1000 trucking company.

Let me dig into that trucking company example of it. They were an existing Cloudflare customer. They were in the midst of a pilot-testing a wide range of e-mail security vendors. In those tests, Area 1 caught twice as many phishing e-mails as the next best competitor that the tech was now part of Cloudflare made the decision a no-brainer. The trucking company signed a 7,500 seats, \$385,000 two-year deal. Watch this space. There's going to be a lot more stories like this one.

We continue to see success with our other Zero Trust products. A Midwestern US state bought 75,000 seats in a three-year, \$5.1 million deal. The state was replacing legacy hardware and had decided to move to a cloud-based solution when they began talking to us.

It was a competitive deal, but they preferred Cloudflare's tightly-integrated approach that gave them a single pane of glass with integrated policies and threat intelligence. They also loved our performance and network that had presence inside their state borders. This was an example of a sale in partnership with a major systems integrator, which we expect will be part of more and more large Zero Trust sales.

We are confident our implementation of these products has plenty of margin to support our robust partner ecosystem. A large Indian media platform chose Cloudflare over Zscaler and Palo Alto Networks for their Zero Trust network. They signed a \$150,000 deal for 5,000 seats. They appreciated how much more tightly integrated our solutions were than the competition.

We are going head-to-head with Zscaler and Palo Alto Networks more and more and we like our win rates when we do.

A European Fortune 500 automotive company adopted Cloudflare's Zero Trust approach to help manage their global fleet of more than 10 million vehicles. They signed a contract worth \$320,000 per year. We're seeing more and more of these IoT Zero Trust use cases and believe there's significant opportunity to expand with this customer.

Speaking of expansion, a Fortune 500 software company expanded their relationship with us, bringing their annual run rate to \$15 million per year. The new contract expanded our relationship to another internal IT division. We're helping them build their future scalable, secure, modern network. They repeatedly let us know we were the only vendor they trusted in the space for such a mission-critical service.

On the theme of trust, a large social network signed a \$3 million, five-year contract. They are using our global network to authenticate the security of one of their messaging products. They've built the authentication application on Workers, our serverless compute platform, that Workers can up with their tremendous scale and volume is a testament to its effortless scalability.

Sticking with Workers, a large Australian software company adopted Workers to help power a collaboration tool. They signed a \$145,000 contract. They're using Workers' durable object functionality to build real-time global synchronization into the product. What we're seeing with Workers is that there's a natural expansion as smart software teams realize what they can do when they can write code and effectively deploy it directly into the Internet fabric. We expect this customer will continue to use Workers for more of their projects now that they've proven success with this one.

A Fortune 500 healthcare company signed a \$1.2 million, three-year deal. It's a pretty standard network security and performance use case for us, replacing legacy hardware. What I thought was interesting was that the IT team had moved from a large financial services customer of ours. As they changed jobs, they brought Cloudflare to their new employers. I think we're going to see a lot more of this as practitioners have succeeded in their last job by leaning on us are moving on and moving up in their careers to new opportunities.

A Fortune 500 financial services company went all-in on Cloudflare. They said that they see us as the future. They signed a \$1.5 million, three-year deal. It was driven by their Chief Security Officer. From start to finish, the sales cycle was around four months. They ripped out a number of legacy vendors and consolidated a number of network services behind us. They were tired of trying to find best-of-breed with every product and instead ending up with a Frankenstein map. They realized they could with us have the best-of-breed network that was tightly

integrated with the features all efficient work together. We expect they will continue to grow their contract now that they've bought fully into Cloudflare architecture.

One last story. A Fortune 1000 gaming company signed a \$3.3 million, three-year contract. I love this story. They were using AWS, but found their security couldn't prevent the attacks they were seeing. After struggling to keep their application online, AWS's team eventually told them, you should just use Cloudflare. And so they did.

We're excited let them, and lots of other customers, know that R2 is progressing to open beta next week. And we expect we'll be able to save them lots of AWS egress fees as well.

I wanted to close by talking about what we're seeing in Russia and Ukraine. I mentioned the region at the end of the last earnings call. A number of you reached out to say a theme out of place at the time. Unfortunately, it proved Prescient. At Cloudflare, our global network serves as an early warning sensor for what's happening across the Internet.

In the month leading up to Russia's invasion, we saw characteristics cyber probing and other warning signs that were similar to what we've seen in Georgia and Crimea years earlier. Concerned, we've briefed Western government and offered our services to critical infrastructure providers and government institutions in Ukraine well before the physical invasion began. Many organizations there took us up on our offer of protection.

One of the stories of the war has been the relative lack of cyberattacks. That's not exactly accurate. There have been attacks. However, the number that have been successful are thankfully few. I'm proud of the role that Cloudflare has played to that end.

In Russia, Belarus and the Russian-occupied regions of Ukraine, we terminated all users tied to sanction parties and put additional checks in place for new customers signing up for our services. The region, including Ukraine, represents less than 1% of revenue. So we do not anticipate meaningful financial impact to our business, but we are conservatively reserving for the worst case, just like we did at the beginning of COVID.

One surprising thing that happened in the quarter was that our 1.1.1.1 app rose to number one in the Russian app stores. We build that app and give it away to consumers for free as the world's largest test bed for a key component of our Zero Trust solution. It turned out in what was an increasingly thoughtful network environment inside Russia. Citizens there wanting to see what was really going on, installed the app in order to access Western media.

Now, we won't make any money on this. So some of you may wonder why am I telling you about it during an earnings call. Because it turns out, doing the right thing and being there when someone on the Internet needs us has always been core to Cloudflare and has always turned out to be good business for us over the long-term. It's why I love my job.

Successfully operating inside the hostile network environment that is Russia today makes our mobile app better for our enterprise Zero Trust customers. Ensuring Ukrainian critical infrastructure stays online means we can stand up to the biggest nation state-sponsored attacks for our largest government, financial services and other off-targeted customers. And briefing governments on what's about to happen proves the power and unique insight we get from our global network.

We're in the trust business. We always have been. And in Q1, we built a lot of trust in a lot of quarters. Even in what I believe will prove to have been the hardest quarter for the industry since Q1 of 2020, trust is the secret to

why we continue to grow paying customers at a record pace. It's why we received 133,000 job applications and saw attrition actually ticked down, while many others are struggling to hire, and while we continue to have a seat at the table in conversations around the future regulation of the Internet alongside today's check giants.

We will be there as the Internet needs us, in Ukraine, Russia and everywhere else. And as we are, we are sowing the seeds to build what we intend to become, not just what some of you may think of a SaaS, a steady, efficient, fast-growing SaaS company today, but an iconic trusted technology company that will define the future of the Internet for decades to come.

With that, I'll turn it over to Thomas to dive into our steady, efficient, fast-growing numbers. Thomas, take it away.

Thomas Josef Seifert

Chief Financial Officer, Cloudflare, Inc.

Thank you, Matthew, and thank you to everyone for joining us. We continued the momentum from the fourth quarter and delivered a strong Q1, exceeding the high end of our revenue guidance with strength in multiple areas of the business.

Turning to revenue, total revenue for the first quarter increased 54% year-over-year to \$212.2 million. The growth in revenue was driven by strong adoption of our product portfolio and continued traction with our enterprise customer base.

From a geographic perspective, in Q1, we saw continued strength in both the US and internationally. The US represented 53% of revenue and increased 56% year-over-year. EMEA represented 26% of revenue and increased 57% year-over-year. APAC represented 14% of revenue and increased 31% year-over-year.

We are pleased to see growth continue to accelerate in APAC and see EMEA repeat as our highest growth geography this quarter.

Turning to customer metrics, we exited the quarter with 154,109 paying customers, representing an increase of 29% year-over-year. We ended the year with 1,537 large customers, representing an increase of 63% year-over-year or an addition of 121 large customers in the quarter.

We were pleased to see large customer revenue contribution increase again sequentially. Significant expansion from our large customers contributed to a record dollar-based net retention rate of 127%, representing an increase of 200 basis points sequentially. We continue to see broad-based strength across our enterprise go-to-market efforts, which we look forward to providing additional insights during our Investor Day next week.

Moving to gross margin, first quarter gross margin was 78.7%, consistent with last quarter. Network CapEx represented 9% of revenue in the first quarter. Going forward, we expect to see some level of quarter-to-quarter variability, given strategic purchase decisions and continue to expect network CapEx to be 12% to 14% of revenue for fiscal 2022.

Turning to operating expenses. First quarter operating expenses as a percentage of revenue decreased 2% sequentially and decreased 7% year-over-year to 76%. We had another strong hiring quarter where we saw our total number of employees increased 42% year-over-year, bringing our total number of employees to approximately 2,750 at the end of the quarter.

Sales and marketing expenses were \$89.7 million for the quarter. Sales and marketing as a percentage of revenue decreased 2% sequentially and decreased to 42% from 46% in the same quarter last year.

Research and development expenses were \$40.3 million in the quarter. R&D as a percentage of revenue stayed flat sequentially and decreased to 19% from 21% in the same quarter last year.

G&A expenses were \$32 million for the quarter. G&A as a percentage of revenue increased 1% sequentially and decreased to 15% from 17% in the same quarter last year. We saw continued operating leverage strength in the first quarter with operating margin improving 770 basis points year-over-year.

Operating income was \$4.9 million compared to an operating loss of \$7.5 million in the same period last year. Q1 was our third consecutive quarter of achieving operating profit. And as a reminder, we intend to grow our operating expenses in line with the revenue, staying near or at breakeven and reinvest excess profitability back into the business to address the enormous opportunity in front of us.

Turning to net income and the balance sheet. Our net income in the quarter was \$3.5 million or net income per share of \$0.01. Tax expense for the first quarter was \$1.7 million. We ended the first quarter with \$1.7 billion in cash, cash equivalents and available-for-sale securities.

Free cash flow was negative \$64.4 million or 30% of revenue compared to negative \$2.2 million or 2% of revenue in the same period last year. Operating cash flow was negative \$35.5 million in the first quarter or 17% of revenue compared to \$23.5 million or 17% of revenue in the same period last year. The decrease in cash flow was primarily related to a unique withholding tax payment of approximately \$30 million.

As mentioned last quarter, we expected to see some cash flow variability in the first half of 2022, but we continue to expect to return to positive free cash flow in the second half of this year. Remaining performance obligations, or RPO, came in at \$688 million, representing an increase of 10% sequentially and 57% year-over-year. Current RPO was 76% of total RPO.

Turning to guidance. As Matthew mentioned, we closed the Area 1 acquisition on April 1, which is expected to contribute less than 1% to revenue and the dilutive impact on profitability is reflected in guidance in both the second quarter and full year. Additionally, in the first quarter, we also ended all relationships with users tied to sanctioned parties in Russia, which represented less than a 1% impact to revenue.

For the second quarter, we expect revenue in the range of \$226.5 million to \$227.5 million, representing an increase of 49% year-over-year. We expect an operating loss, including Area 1, in the range of \$2 million to \$1 million. We expect a net loss per share of \$0.01 to breakeven.

For modeling purposes, please note that if we report positive net income in the second quarter, we expect our share count to be 344 million fully diluted shares, versus the 325 million basic shares if we report a net loss. We expect a tax expense of \$1.8 million.

For the full year 2022, we expect revenue in the range of \$955 million to \$959 million, representing an increase of 45% to 46% year-over-year. We expect operating income for the full year in the range of \$10 million to \$14 million. And we expect net income per share over that period in the range of \$0.03 to \$0.04, assuming approximately 345 million common shares outstanding. We expect a tax expense of \$7.7 million.

In closing, it was another very strong quarter. I again want to thank our employees for delivering these great results and for their continued dedication. We look forward to hosting our second Investor Day next Thursday, where we'll do a deeper dive on our product portfolio and recent acquisitions as well as updates on our financial progress and market opportunities.

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

QUESTION AND ANSWER SECTION

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

Daniel Bergstrom

Analyst, RBC Capital Markets LLC

Q

Hey. It's Dan Bergstrom for Matt Hedberg. Thanks for taking our question. So, dollar-based net retention continues to track well; the 127% was really nice to see, obviously, having success with large customer expansion. Maybe a little more, if you could, and what is it that gets customers to buy into the broader set of the platform? And what really gets those enterprise customers to the next level of usage?

Matthew Prince

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

A

Sure. Thanks for the question. I think that what we've seen is that once the customer is on our network, we can see traffic across their systems typically and make intelligent recommendations over what additional products. So I'll give you a specific example. We are – we have an incredible bot management product that is good at stopping malicious automated traffic on a customer's site. One of the things we do is even before someone is using the bot management product, we can look at their traffic patterns, see how many bots they have and then generate a report for them that says, you have a bot problem. Here's what we see. Would you like us to help you with it? And so I think that those sorts of intelligent recommendations have been very good at getting customers to adopt additional products on our platform.

I think, going forward, as we've talked about in previous earnings calls, what you'll see us do more and more is bundle together our services into much broader licenses. And so you can see that with even some of the examples that I brought up on the prepared remarks earlier, where companies that buy into our total infrastructure commit to a certain spend with us, and then they are able to just continuously add additional products and we true that up on an annual basis.

I think we are really unique in that we have that broad set of different products, where once you're using our service, we can start making intelligent recommendations, and we can solve so many problems for customers that those sort of site-wide licenses make sense. And I think that that will continue to be a big piece of our growth going forward. [indiscernible] (00:27:03)

Thomas Josef Seifert

Chief Financial Officer, Cloudflare, Inc.

A

I wanted to add to that, tie back to the incredible innovation engine that you should keep in mind, too. Not only the expansion working, but there are more products and features available to sell every quarter that plays into our DNR strategy moving forward.

Daniel Bergstrom

Analyst, RBC Capital Markets LLC

Q

Very helpful from both of you. And then, new customer generation, really robust in the quarter, a record, as you mentioned. Anything worth pointing out there as a driver or accounting for that strong new customer number?

Matthew Prince

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

A

Yes. I don't mean to critique your work, but your early note that went out suggested that we now have 14,000 customers. In fact, we actually added 14,000 new customers in the quarter – paying customers in the quarter and are now at over 150,000 paying customers across the platform.

I think that that again is just us showing that across – regardless of the size of customer, we've been able to very effectively get them onto our platform, nurture them over time, get them to use additional products and services and grow them into larger and larger customers.

And so I think it's – at some level, when you look at growth like that, there's never one particular thing that you can point to and say, that was what was going on, because, again, we service such a broad set of customers from very small to very, very large. But I'm really proud of the team and the hard work that they've done in order to deliver and continuing to grow our entire customer base. And that's – and it's great to see us have a record add of 14,000 new customers in the quarter.

Daniel Bergstrom

Analyst, RBC Capital Markets LLC

Q

That's great. Thanks, Matt.

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

Joel P. Fishbein

Analyst, Truist Securities, Inc.

Q

Good evening and fantastic execution again. Matthew, a couple of other companies that are cloud-centric have reported that Internet traffic has been trending down over the past several months. I'd love to just get your take on what's happening and how Cloudflare is positioned and how your Internet traffic has been flowing.

Matthew Prince

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

A

Yeah. We haven't seen that. I think it has been continued growth. So to, first of all, answer your question, just straight up, we saw year-over-year traffic growth across our network of 75.8%, quarter-over-quarter growth of 15.9%. And that's in line with sort of the quarter-over-quarter growth that we've seen for the last period.

It's worth remembering that we don't bill primarily based on usage. We bill in a much more predictable way. And so I think that that is a good indication that we are taking share from the rest of the industry. But even in this post-COVID time, the traffic across our network continues to grow, and we do that while still maintaining above what our target gross margins are.

I think the other thing which you didn't ask about, but I think it's interesting to compare is how much CPU usage has grown across our network. And where bandwidth has grown 75.8% year-over-year, CPU usage has actually grown 89.1%. And over the quarter, it's 15.9% for bandwidth and 21.8% growth for CPU usage.

What I think is – why that's interesting and that's important because I think that that's actually showing where people are not just using Cloudflare for moving bits around, but they're using Cloudflare in order to do intelligent processing of those bits, and that intelligence, which is really driven by like our Workers' edge computing product as well as some of our security products, that's actually growing faster than bandwidth. And I think that that delta shows why we're able to continue to grow revenue at the 54% that we did in the quarter. Does that answer your question?

Joel P. Fishbein

Analyst, Truist Securities, Inc.

Q

More than I wanted, but thank you. That was great. Appreciate it.

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

Brent Thill

Analyst, Jefferies LLC

Q

Matthew, the Area 1 acquisition I think is a unique one for you and kind of maybe outside your core lane that you've gone. Can you just talk to that? And then also, when you think about the go-to-market and the synergies among the other suite, can you just talk through how you think that unveils over the next several quarters? Thank you.

Matthew Prince

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

A

Yeah. I think – so, first of all, any acquisition is a bit unusual for us because we have such a strong bias towards internal development and building products ourselves. I think, though, Area 1 and e-mail security, in particular, makes just a ton of sense for us to do something around. If you look across every other protocol that is sent across the Internet, we protect whether it's HTTP traffic or it's your SIP traffic to your phone system or it's SSH traffic, anything that's out there, any protocol, we protect, and we had just not dived into protecting SMTP and the e-mail protocols.

And I think a little bit of that is, honestly, my fault and our CTO, John's fault, because both of us had worked in e-mail security prior to coming to Cloudflare. And I think we have the scar tissue to prove from it. And so all the time, our sales team would come to us and say, hey, customers really would love us to have an e-mail security product. Our engineering team would say, we have a ton of data that could help inform an e-mail security product. We should build it. And I think John and I would often veto that.

I think that that, frankly, was a blind spot on both of our side because if you look at the data, e-mail security is by far the number one source of threats that come into an organization. Almost every headline hacking incident that you've read about in the last two years, e-mail was the initial way that that vulnerability was taken into account. So I think it makes a ton of sense for us to have a solution.

It's also incredibly powerful because we're the DNS provider that we can make it one-click deployment, where it's a customer of ours clicks a single button and instantly, they get the benefits of the Area 1 solution, and they can continue to use whoever their existing e-mail provider is, whether that's Outlook and Microsoft Office or if it's G-

suite or if it's something that they're hosting on-premise. Much like Cloudflare, Area 1 is a proxy, but it's just a proxy for e-mail traffic.

So I think it's a very natural point for us to integrate. I think it's a very easy sales motion for our customers to go through. And to the second part of your question, I think it integrates with the rest of our Zero Trust suite extremely well. So, for instance, when you get an e-mail from an unknown sender, we can automatically isolate that e-mail using our browser isolation product so that any link that you click on in that link don't actually render on your laptop, but they're actually rendered at the edge of our network. So any malicious content that's in those links, we can stop.

And so I think that this is going to be a very effective way to introduce our Zero Trust suite to the market. It gets people to start to adopt a seat-based approach to our products very easy for our existing customers to deploy with one click. And I think it's going to be a gateway to the rest of our Zero Trust products, selling more of our gateway and access and browser isolation products as well. Does that answer your question?

Brent Thill

Analyst, Jefferies LLC

Q

That was very comprehensive. Thank you.

Operator: Your next question comes from the line of James Fish with Piper Sandler. Your line is open.

James E. Fish

Analyst, Piper Sandler & Co.

Q

Hey guys. Nice quarter there. I wanted to hear a little bit more about the wave 2 products like Teams and Magic Transit, Magic WAN are doing, especially as – it seems like these are driving the largest dollar growth still. Additionally, how has Cloudflare for Offices progressed this quarter? And is there any way to think of how many customers or a penetration rate of using some of these wave 2 solutions that I'm talking about here?

Matthew Prince

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

A

Yes. So I think that the wave 2 solutions and – and I would characterize it a little bit differently. I would say that we have products like Magic Transit, Magic Firewall, that really do complement some of our more traditional products. They're all about protecting content, protecting your infrastructure. And then we have products like Gateway and Access and Browser Isolation, which are all about protecting users.

And so I think you pumped those sort of into wave 2. And that's true from a timing perspective, but they actually are slightly different and they – and I think that they are both growing very well, but they are somewhat different in terms of the way that we go-to-market with those products, and in some cases, who the exact buyer is within an organization for those products.

And so I think we've seen really strong adoption for the Magic Transit product. That is replacing a lot of the traditional network DDoS protection services. I think particular strength in carriers that are starting to use the product as well, which I think is – which is a really exciting opportunity. And we're getting that because of the fact that we can just stand in front of much more traffic than possible – as possible through any sort of box-based solution.

I think on the user-based products, we're seeing really good adoption of those, both for customers who are coming first for those products, but then also for us to be able to sell those products to our existing customers. And there's a really natural extension between our traditional Firewall products and the Access products, and those dovetail very well together.

I think Cloudflare for Offices continues to progress really well, although it's very early in terms of what that will look like. We have – in the quarter, we announced some of the hardware that we are deploying and we are starting to build that out within networks. I would say that rather than that us measuring the success of that product today based on the revenue that it generates, I think we are much more measuring the success of that product based on the willingness of landlords and network providers to invite us into their facilities and allow us to directly interconnect.

And I think that that is in every region where we've deployed the Cloudflare for Offices, that is trending at or ahead of what our expectations are.

James E. Fish

Analyst, Piper Sandler & Co.

Q

Thanks for the details, Matthew.

Operator: Your next question comes from the line of Phil Winslow with Credit Suisse. Your line is open.

Philip Winslow

Analyst, Credit Suisse Securities (USA) LLC

Q

Hey, guy. Thanks for taking my question. Congrats on another great quarter. I wanted to focus in on Workers and R2. You talked about some pretty significant wins there, Matthew. One of the things you've also talked about, too, is how sort of it takes a long time to sort of get escape velocity and a platform in terms of developer adoption, et cetera. How are you thinking about sort of where we stand right now? And is there anything sort of surprising you in sort of the rate and pace of adoption of Workers or just sort of [ph] like all (00:39:29) the broader platform when you think about R2?

Matthew Prince

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

A

Sure. So, first of all, as I mentioned, R2 is going to progress from a closed beta to an open beta next week. And next week, we have Platform Week, which is really very much focused on all of the different ways that Cloudflare can be a platform for developers to develop on, but really a focus around the various Workers' products. And I think we'll have some very exciting surprises as part of what we're rolling out over the course of the week as well.

I think that if you study developer platforms, for them to really reach escape velocity, takes between 8 and 12 years. And so Workers was launched in late 2017, so we're continuing to develop it. We're on that curve. I think the thing that has surprised me is that we're seeing very big companies with very sophisticated development teams getting excited about and realizing that Workers is a solution for a lot of the problems they have.

The two examples that I mentioned in the prepared remarks, one major social network, that's a very sophisticated developer team that chose to build using Workers. And I think what we found is that once a team like that sees the power of what they can do with Workers, that really excites them, both within the organization they're at and also as they change jobs and go to other places where they take the technology with them.

The same thing is true with the Australian software company, where doing something like real-time collaboration across multiple continents, if you're trying to do that with a traditional public cloud, it's a ton of work. With Durable Objects and Workers, it almost just works out of the box. And in fact, we have examples of how that's done. And I think that that was something that was, again, incredibly well-received by that very sophisticated software engineering team, and we expect that they will continue to do more with the product.

So I think, again, it's going to be some time before it's something that we would – that is dramatically contributing to revenue. But I am very pleasantly surprised at how many developers are flocking to the Workers ecosystem, and we'll be talking a lot more about it next week.

Philip Winslow*Analyst, Credit Suisse Securities (USA) LLC*

Q

Awesome. Looking forward to it. Thanks a lot.

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

Matthew Terence Wilson*Analyst, Morgan Stanley & Co. LLC*

Q

Hi. It's Matt Wilson on for Keith Weiss. Thank you for taking the questions. Matt, you again mentioned the opportunity to use gross margins as a weapon against customers who are – or against competitors who are more vulnerable to pricing and cost pressures. Can you detail what has allowed Cloudflare to resist these pressures, both on the pricing and cost front?

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

A

I think efficiency is just at our core. And so our network has always been designed in such a way to be able to get – to be as efficient as possible. And so that has allowed us to deliver the services that we do. I think we sometimes get compared with some of the more traditional CDN-type vendors, and that's just never how we have seen ourselves and it's not business that we have chased.

And so I think that where – if you're selling just bit delivery, it turns out that being a little bit faster – really the returns are incredibly diminishing. Whereas, if you're selling security, if you're selling intelligence, which is built into the network, if you're selling the ability to drive that, that has a very compelling use case.

I think from the beginning, we also always said that Cloudflare – one of the first tenants of Cloudflare was never lose on price. And I think that forced us to be efficient from the beginning. And so customers, I think, in this time, where everyone is looking for ways to figure out how they can save money on their IT budgets and where many other vendors are trying to figure out how they can either hold or raise prices, I think we can continue to be pushing forward and taking share and especially taking that high-margin share from both existing hardware vendors who are having a hard time even delivering their products as well as other cloud vendors that, again, I think are not as efficient as we've been.

So I think that's been key to our story since the earliest days. It will continue to be key to our story. And I think it's that efficiency is a hallmark of who we are at Cloudflare.

Matthew Terence Wilson*Analyst, Morgan Stanley & Co. LLC*

Q

Awesome. Thank you for those details. And maybe on this one for Thomas, when can we kind of expect this gross margin strategy to show off in the numbers?

Thomas Josef Seifert

Chief Financial Officer, Cloudflare, Inc.

A

I'm not sure what you mean by showing up in the numbers. I think that we have been able to digest the significant revenue growth that we have been able to digest the significant traffic growth that Matthew just alluded to and been able to scale at a flat to up gross margin, I think, is already a testament to the elasticity of the network.

And I just want to reiterate that because I think that is our – one of our competitive moat, the ability that all products are running on every server in every city. And because of that, the complete network service are your degrees of freedom to manage cost and demand and supply in every server that we add, every city that we add regardless of where in the world at degrees of freedom to manage the flexibility and the elasticity of this network.

So I think you see that already today. We've seen tremendous growth product wise, revenue wise, traffic wise, every metrics that you look at that would measure that and have been able to digest that in stable to slightly up gross margins, I think is already a testament to that.

Matthew Terence Wilson

Analyst, Morgan Stanley & Co. LLC

Q

Understood. Thank you.

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

James Breen

Analyst, William Blair & Co. LLC

Q

Thanks for taking the question. Just sort of on that point a little bit. So are you basically sort of managing to kind of a breakeven non-GAAP operating income line, plus or minus a couple of million here, just to maximize the revenue?

And then just from an expansion standpoint. As you build out more network, more point of presence, does that enable you to go deeper into some of the multinationals that right now maybe you don't have access to because of that? Thanks.

Matthew Prince

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

A

Sure, Jim. So I think that we've been very consistent at saying that we are going to hold as close to breakeven on our operating margin as we can. And I said on a previous call that, if we showed massively positive earnings per share, that would mean something that we did something wrong because if we can continue to grow at the rates that we're guiding toward, there's nowhere else we should be putting that money other than back into the business to grow the business as quickly as possible.

And so I think that we are doing that, we've been very consistent in delivering that message. I don't think there's anything that has changed about that strategy. And again, I think we're managing towards a breakeven on operating margin.

In terms of the POPs, I think that – I mean we're already in well over 100 countries around the world. I think that when multinationals look to us, it's not our POP presence that has ever been – certainly, since we went public, standing in the way of them adopting us. And I think that if you look at the companies that we're highlighting in some of the examples, these are almost all massive, multinational companies that rely on our network and think that is the case.

I think the thing which is powerful about as we build out more POPs is that counter-intuitively, because of the design of our network and because of the efficiency of our network that both Thomas and I just alluded to, it actually drives our cost down over time rather than driving it up. It takes a certain amount of servers in order to process a certain number of requests. So your CapEx is actually driven by the amount of usage of your service more than anything else.

What is powerful is because we have done the hard work on the networking and software side to make it so that any server, anywhere can handle any request, that means that as we continue to expand our network out that we're able to directly interconnect with the various ISPs and eyeball networks around the world and drive our cost down for things like bandwidth, co-location and other variable costs that are part of our business.

And so I think that that's decomposing a little bit what the reason for our ability to continue to expand. And if in the future if we need the darn snorkels and dive to the bottom of the ocean in order – because we can get more efficiency in our network by putting a POP somewhere there, we are going to continue to do whatever is necessary to be able to deliver our services as efficiently and cost effectively as possible.

James Breen

Analyst, William Blair & Co. LLC

Great. Thanks.

Q

Operator: Your next question comes from the line of Adam Borg with Stifel. Your line is open.

Adam Charles Borg

Analyst, Stifel, Nicolaus & Co., Inc.

Hey, guys. Thanks so much for taking the question. Maybe just for Matthew on the federal vertical. I was just hoping you could provide an update just on fed ramp and the opportunities that you see. Obviously, you've seen some traction there with the joint win with Accenture, but just curious how you're thinking about the federal opportunity in 2022 more broadly. Thanks so much.

Q

Matthew Prince

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

Yeah. Federal is a big opportunity for us. FedRAMP, we think we'll continue to unlock that. We got word actually today that we have thumbs up from our sponsoring agency and are just waiting kind of in line with the overall federal agency to get that approved. So we think that's all going well. We've done everything that we can do and it's a little bit like being at the DMV. You've got to kind of just wait for your number to get called. But we're confident that it will get called hopefully sooner than later. And if anyone at the federal DMV is listening in, we – there's a lot of agencies that want to use us. So hopefully, we can meet that requirement. That is not holding us back from working with Accenture as well as other partners and we've continued to see significant interest.

A

I think the thing that I would come back to is the amount of trust that we have built in the sort of C-level equivalent of the federal government. The number of calls that our team, and including myself, have received from the

people who are really trusted with securing the US infrastructure, to understand what's going on in Ukraine, to ask us for help, protecting the infrastructure in the United States, I think that that speaks incredibly well of us.

We actually launched, in partnership with CrowdStrike as well as Ping Identity, in the quarter the Critical Infrastructure Protection Act. I was really honored by the White House stepping up and saying that that was something that they recommended any hospitals, utilities or energy companies adopt as quickly as possible.

So I think that we have an enormous amount of goodwill within the government. I think we are moving forward and think that there is an enormous opportunity to continue to deliver on that goodwill. And any day now, hopefully, the FedRAMP DMV will call our number and we'll be able to announce that that process is formally behind us.

Adam Charles Borg

Analyst, Stifel, Nicolaus & Co., Inc.

Great. Thanks so much.

Q

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

Alex Henderson

Analyst, Needham & Co. LLC

Great. Thanks. First off, I wanted to really compliment you guys on what a great job you've done protecting both the Ukrainian infrastructure as well as the reporters that needed there and continuing to deliver access to Western news flow into Russia. It's really important stuff.

Q

The question I wanted to ask was really around the Internet traffic question asked earlier. And maybe you could give us a couple of data points on the change in your coding total. But the traffic, obviously, up 75%, is well ahead of the growth in the marketplace, which I think is around 30%. So can you update us on where you are in terms of what percentage of Internet traffic you're carrying?

And second, along the same lines, it's my understanding that API traffic has more than doubled over the last 18 months in terms of its rate of growth from over 150% to something in excess of 300%, which ultimately suggests that there's very high rates of growth in the domain, the domain and domain to user traffic, which is obviously a key part of what you guys do, protecting and optimizing and accelerating that traffic.

So can you talk to us a little bit about where you are on the statistics in terms of share? And what the implication of that API growth rate is? I realize you're not being paid per bit, but rather that would imply very rapid acceleration in the number of domains that are being traffic, too. Thanks.

Matthew Prince

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

Yeah, Alex, first of all, thank you for the kudos at the beginning. It's been a quarter where a lot of our team's been working tireless nights to make sure that as much of the Ukrainian infrastructure stays online and that services like 1.1.1.1 continue to allow people in parts of the world where they may not have free access to the Internet for them to be able to see what's happening. And I think that that's something that I'm really proud of our team to have done and I appreciate you calling it out.

A

In terms of Cloudflare's percentage of Internet traffic, I think it's – we don't really – we know what our numerator is, but we don't know what the denominator is. And I don't think there's a good source of that. I think that we look at some proxies for that in other places. One is what percentage of the top million websites are behind us, and that number is around 20% today.

I think what that under-represents is a lot of our other products. It doesn't take into account products like our Zero Trust products. It doesn't take into account things like Magic Transit and other products. But from a just pure what percentage of the web uses Cloudflare on, if you measure that using third-party sources, it's around – it's right around 20%.

For API, I think that that has been a trend that we've seen for quite some time, more and more of the traffic that passes through Cloudflare is API traffic. In the quarter, we announced our updated API protection suite. We've seen really great adoption for that. Again, I think it's one of the things where it's all sort of the same protocols, but being able to understand that this is an API, validate that API, help developers really make sure that the schema that is being sent to and from that API is correct. Those are all things that our network is very good at delivering and we're seeing strong customer interest and strong customer growth from that.

And the last thing I'd say is that Workers is a big – there is no easier way to build an API today than on Workers. And I think that next week, during Platform Week, we're going to have a bunch of examples of customers and companies and developers that are doing exactly that. And I think that that's going to be a bigger and bigger piece of the Workers' story going forward.

Alex Henderson

Analyst, Needham & Co. LLC

Q

If I could just throw one additional question in, India and China, can you give us an update on why that traffic isn't reaccelerating at a faster rate? And when it will start to eclipse the company averages? Thanks.

Matthew Prince

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

A

So, I don't think we've broken out the traffic from India and China and I don't know precisely what the growth rates are.

Alex Henderson

Analyst, Needham & Co. LLC

Q

Yeah, that was a revenue question, Matt.

Matthew Prince

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

A

I apologize. From a revenue perspective. So, again, I think that those are both regions that are interesting to us. They're very different from one another. I think that we have seen a lot of success selling into the Indian market and been able to continue to expand our services there. And we've done a great job at both selling to customers as well as finding ways to interconnect with what is a very complicated ISP model in India.

In China, we've always worked with partners. And so we have been a long-time partner with Baidu. We are a more recent partner with JD Cloud. And I think that in both – in that case, that partnership is going extremely well. And again, it is complicated for any Western company to be operating in China. And so the fact that we have now been doing so since 2015, I think shows the power of what we've been able to deliver.

Also, it's not always the purpose that we're trying to generate revenue from inside of China. The value of us having a network that extends into China is at least in equal part, if not greater, that we can form multinational companies that you can with one single network deliver services to every country on earth, including inside of China. And I think that that is unique for us to be able to do that and have that same features and functionality largely there that we have around the rest of the world.

So I think both of those are markets that have their own complications, but we continue to operate in and see success.

Alex Henderson

Analyst, Needham & Co. LLC

Thanks.

Jayson A. Noland

Head-Investor Relations, Cloudflare, Inc.

Operator, can we take one more question, please?

Operator: Certainly. Your last question comes from the line of Amit Daryanani with Evercore. Your line is open.

Amit Daryanani

Analyst, Evercore ISI

Perfect. Thanks for squeezing me in. I guess I have two as well. I'll ask them at the same time. First off, I was hoping you could just talk about this growing concern of a recession in Europe and in America. So in that context, are you seeing any shift in your customers' buying patterns or deal closing rates or anything? Just any impact from risk of recession to how your sales team is operating? And then, if you can also just clarify, from an M&A perspective, how is that embedded into your revenue and operating profit guide for June quarter? What is the impact from the deals, if you may? Thank you.

Matthew Prince

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

Sure. I'll take the first question and then Thomas can close out with the second. As I said, I think that this will – when the history books are written, turn out to be the most complicated quarter that tech companies have lived through certainly since Q1 of 2020. And I think that there is real risk of a recession going forward. And even aside from that, I think that there's definitely we're all seeing the inflationary environment and the concerns around that.

What I like, though, is I can't imagine a company that is better positioned for a situation like that than we are. We're offering a service which is not a nice to have, but a must-have. We're offering a service in a way which saves customers money over what their existing solutions are. We've deployed the network in such a way that we can make sure that we service customers as we need them. And so what we saw in the quarter was definitely fires concern over what was going on in the world, but in many cases, that was actually having them come to us.

And so I think that as there are challenging economic times, we are extremely well positioned to provide what are critical services to make sure the Internet continues to work. And to me, it feels a lot like the beginning of COVID, where I think there's a lot of concern that's out there. But over time, what we find is, time and time and time again, customers are turning to us, saying we want to consolidate our spend from instead of spending across 10 different vendors, we want to put it all behind you. They like the fact that we have that bundled integrated

approach and they like the fact that we're able to save them money over what their legacy solutions are that are in place.

So I think that that positions us very well for what may be – what I think was already a challenging quarter for many companies and I think it might be a challenging period for companies over the next period to come.

Thomas Josef Seifert

Chief Financial Officer, Cloudflare, Inc.

A

And addressing your guidance question, I think we followed our standard approach of trying to be thoughtful and prudent, when it came to the exposure to Russia, Ukraine and Belarus. So we already mentioned that. We – that was less than 1% headwind revenue in the first quarter. And we reflected this also in the guidance we issued for the current quarter and for the rest of the year.

And as I said in the prepared remarks, the acquisition of Area 1 is also reflected in guidance, both for the second quarter as well as for the full year. And that is true both for revenue, but less than 1% contribution for the year, but it's also true for the dilutive impact on profitability. So all are reflected in the guidance we gave.

Operator: That is all the time we have for questions. I'd like to turn the call back to CEO, Matthew Prince, for closing remarks.

Matthew Prince

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

This has been a challenging quarter as we've watched what world events have taken place. I'm incredibly proud of our team for having made sure that the Ukrainian infrastructure stayed online, that the people in the world could see what was really happening and providing a network with Cloudflare that really can stand up to any challenge that's ahead.

I really appreciate all the work of all of the Cloudflare employees. I appreciate all of our customers. I'm looking forward to seeing many of you at our Investor Day and our Customer Day, which is next week in New York, and stay tuned for a lot of announcements. It's going to be a busy week for us because it's also Platform Week, which is one of our Innovation Weeks, and we're expecting to announce a number of really great features. Thank you so much.

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

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