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Cloudflare, Inc. (NET)

Q2 2022 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good afternoon. My name is Emma and I will be your conference operator today. At this time, I would like to welcome everyone to the Cloudflare Second 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, VP 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 second 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, challenge in the general including inflation, rising interest rates, and other impacts of the ongoing COVID-19 pandemic and Russia-Ukraine conflict. Our actual results may differ significantly from those projected or suggested in any forward-looking statements. These forward-looking statements are 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 months ago. We would also like to inform you that we will be participating in the Stifel Tech Executive Summit on August 30, the Deutsche Bank Technology Conference in September 1, and the Piper Sandler Growth Frontiers Conference on September 13.

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

Unverified Participant

Thank you, Jason. Even with the increased economic uncertainty, we had a very strong quarter. In Q2, we achieved revenue of $234 million, up 54% year-over-year. We added a record 212 new large customers, those paying us more than $100,000 per year and now have 1,749 customers over that threshold. These large customers now represent 60% of our revenue, up from 50% six quarters ago. This trend illustrates how large established enterprises increasingly formed the foundation of cloud business. In fact, today, 29% of the Fortune 1000 are already paying Cloudflare customers, a nearly threefold increase over when we went public less than three years ago. Our dollar based net retention remained strong at 126%, down 1% over last quarter. While there may be some noise in that number from quarter to quarter, we won't be satisfied until it's above 130% and best of breed among the companies we consider peers. Our gross margin remains strong at 78.9%, up 90 basis points year-over-year and still over our long term target of 75% to 77%. Our operating margin was right at breakeven, which continues to be our plan so long as we can deliver strong growth. What I'm watching closely is our free cash flow margin. It showed significant improvement quarter-over-quarter and we continue to forecast it will be positive in the second half of the year. On our last earnings call, I got a lot of raised eyebrows from many of you when I said Q1 of 2022, which proved to be the hardest quarter for our industry since Q1 of 2020. It didn't make me particularly popular around the CEO club where the first rule of recession is not to talk about recession. However, transparency has always been one of Cloudflare core values. So I'm going to call it like I see it. In that spirit, let me share some more details of what we saw and are seeing.

In Q1, our pipeline generation slowed, sales cycles extended, and customers took longer to pay their bills. We watched those metrics closely throughout Q2 and saw them all at least stabilize. They're not where we throw a parade yet, but the metrics are trending in the right direction. Given our visibility early in the economic downturn, we rapidly adjusted our go to market message. We shifted our messaging to focus on ROI helping customers save money and consolidating spend from multiple point solution vendors behind classic, broad platform. Messages about saving money and using fewer vendors particularly resonate a year ago, but they do today. Having a broad platform to solve so many customers problem while at the same time saving the money as the super power in times like these. As I look at our wins in the first half of the year, I believe it's fair to say that it's harder today than it was a year ago to sign up a new customer. But it's gotten easier to talk to our broad set of existing customers about doing more with us. And customers are leaning forward to hear about how we can save the money, reduce their IT complexity, all while increasing their security, performance and reliability. I'm not a member of the National Board of Economic Advisors, so I'm not the person to say whether we're in a recession or not, how bad it may be or how quickly we may rebound. But I am the CEO of Cloudflare and while our business remains strong, I believe this is a time for prudence and caution. The metaphor I've been using with our team is to talk about the different conditions you may face driving a car on the road.

A year ago we could see for miles and the road was clear, so it made sense to open up the throttle. Today we find ourselves in what my grandmother used to call a tulip bog. The road ahead is less certain. So it makes sense to keep our hands on the wheel, our eyes on the road, and let up a bit on the accelerator. Whether we're in one or not recession sucks. They hurt everyone. No company is recession proof, but some are more recession resilient than others. Some things I know are universally true. No matter how bad this recession may get, companies aren't going to abandon the Internet. They're not going to give up on the cloud and go back to on-premise boxes and package software. Hackers aren't going to stop hacking, so cyber security will remain a must have not a nice to have. And we're already seeing evidence of all of this with our gross renewal rate in every region for the first half of the year hitting all-time highs since we went public. We are not recession proof, but I wouldn't trade places with any other CEO right now. Personally, if I think back my career has been defined by recessions, I think a lot of peoples are. Recessions have always been hard my career has been defined by recessions, I think a lot of people are. Recessions have always been hard, but they're also formative moments to focus and ultimately improve. In 2000, as the first dotcom bubble burst, the law firm I was supposed to go work force that they didn't need any more securities lawyers, but they could probably find a spot for me in their bankruptcy practice. I just had time to reflect on whether watching companies implode was what I wanted to do with the rest of my life and pivoted to become an entrepreneur. 14 years ago, in 2008, at the onset of the last global recession, Google pulled their full time offers for all their summer interns, which included my co-founder at Cloudflare, Michelle Zatlyn. If that hadn't happened, Cloudflare would have never been born. At the same time, I learned what a margin call way is and deeply, embarrassingly, literally had to borrow money from my mom to pay my rent. That's when I got an extremely personal lesson on the importance of free cash flow. And it's why I'm ensuring right now in this uncertain time that Cloudflare is prioritizing being free cash flow positive. Tough times force you to re-evaluate everything you've done and become better. It's why the best companies come out of tough times even stronger than they went in. So maybe it's a bit masochistic, but I'm looking forward to how Cloudflare gets even better during some of the tough times for the global economy that seem likely ahead. Hands on the wheel, eyes on the road, letting up a bit on the accelerator.

With that background and to avoid being too much of a bummer, let's talk about some great customer wins in the quarter. A Fortune 500 retailer in Europe signed a $1 million three year deal for multiple Cloudflare products. They wanted to reduce their operational complexity by replacing a number of point solution with cloud platform. We became the Web Application Firewall, Content Delivery Network, Thought Management System and a number of other application protection services with our easy to manage platform. Having proven success protecting their infrastructure, we're now talking to them about expanding to zero trust provider too. A Fortune 500 energy company signed a energy company signed a $784,000 three-year deal. They had been using Zscaler. They signed Cloudflare Solution, easier to use more performance and integrated across their full security control plan. As I said last quarter, we like our win rates when we go head to head with Zscaler and Palo Alto networks because our product is better and can scale to meet the needs of complex organizations like this one. And while we're still relatively new to the zero trust space, we're going head to head against them more and more often. Yet another Fortune 500 industrial company signed a $1.3 million five-year upsell agreement. This customer first adopted Cloudflare in Q1 of 2022 and is already seeing ways they can use more of our platform. What's also notable is this is an example of us increasingly working with channel partners. We believe channel sales are especially important in the zero trust space and in Q2 we successfully signed up half of Zscalers top channel partners as new Cloudflare Partners. The State of Arizona expanded their use of our platform, signing a $770,000 one year expansion deal. Arizona has been a long time, about their customer and continues to expand the use of our platform as we launch new product. I still remember their first PO with us from several years back, which specified the address and method of shipping of our product as if we are a hardware vendor. We ship them T shirts, not hardware, and they've continued to grow it ever since. One of the world's largest advertising conglomerates, signed a $1.7 million one year deal. They originally came to us last quarter under an attack that originated out of Russia. Being the power of our platform, this quarter, they expanded their engagement. This was yet another competitive zero trust deal against other leading zero trust vendors. Like we're hearing over and over again, this customer chose Cloudflare because of the strength of our broad platform and our ease of use. In the words of their head of cloud with Cloudflare, everything works. There are no issues. One of the largest online recruiting firms signed a $5.5 million three year deal. They were an extremely technical buyer, who put our entire platform through its paces. In the end, they demonstrated for themselves that we were by far the best of breed. This is also an example of how increasingly we're seeing executives bring Cloudflare to their new workplaces. In this case, the buyer knew us from its previous position and was our champion when he moved job and was promoted. In his words, you don't get fired for buying Cloudflare. Workers continue to gain traction among developers.

Last earnings call, I talked about the importance of building workers into other platforms as the best shortcut to developer adoption. In Q2, we signed deals with one of the largest e-commerce platforms, one of the fastest growing web development platform, and a next generation database platform to embed workers as a service, as a preferred development environment. These deals represent hundreds of thousands of dollars in guaranteed revenue with upside as usage grows. But more importantly, we believe they are the fastest path to catalyzing a robust ecosystem around Cloudflare workers and exposing its power to the broad community of developers.

Another interesting thing to note in the quarter is we're increasingly seeing other security companies adopting Cloudflare as the best of breed solution. It's incredibly affirming when your peers choose your product, a public security compliance vendor, a leading endpoint security provider and one of the largest data security vendors all signed multi-year contracts, each worth more than $700,000. Even our direct competitors often use Cloudflare for detox mitigation and other services where we are the clear leader. This recognition by our peers of our best of breed products continues to validate why I'm confident, Cloudflare will continue to grow even stronger through the tough economic times that may be ahead.

One last thing in the spirit of transparency, before I turn it over to Thomas. We had a bug in our billing system related to how we expire unused credits for pay-as-you-go customers. Before we went public for good accounting reasons, we put in place a policy where we expired unused credits after three years. That system triggered for the first time earlier this year. Unfortunately, a bug in it caused our systems to report a spike in total paying customers last quarter. The revenue involved is not material less than $160,000. So it caused us to over report the number of paying customers last quarter. The correct numbers are 148,184 in Q1 and 151,803 in Q2. Our pay-as-you-go business is only 11% of our revenue today, but we believe it's important to continue to invest in it in order to serve the entire market and protect our client. I'm embarrassed by the mistake and we fixed the bug and put in place checks designed to catch any similar errors in the future. I don't like it when we make mistakes, but I do think it's important we be transparent and own them when we do, which is why I insisted on addressing this today. It also leads to more fun topics for Thomas.

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

Thomas Josef Seifert

Chief Financial Officer, Cloudflare, Inc.

Thank you, Matthew, and thank you to everyone for joining us. We delivered another strong quarter driven by strength in our large customers with a record number of large customer additions, as we continue to build our expansion engine, while success in the first half of this year reflects the investments in our innovation and large enterprise go-to-market initiatives as well as the benefits of operating a durable subscription-based revenue model.

Turning to revenue. Total revenue for the second quarter increased 54% year-over-year to $234.5 million. The growth in revenue was driven by strong adoption of our product portfolio and continued traction with our enterprise customer base. Area 1, the e-mail security company we acquired in April, contributed less than 1% of revenue From a geographic perspective, we saw continued strength in both the US and internationally. The US represented 53% of revenue, and increased 55% year-over-year. EMEA represented 26% of revenue and increased 54% year-over-year. APAC represented 14% of revenue and increased 43% year-over-year. We are pleased to see growth continue to accelerate in APAC.

Turning to our customer metrics, in the second quarter, we had 151,800 prepaying customers representing an increase of 20% year-over-year. We saw a higher level of churn due in part to pay-as-you-go customers shifting down to our free customer tier. As our business continues to move upmarket, the total revenue contribution from our pay-as-you-go business, which largely reflects SMB, continues to decline, representing 11% of revenue in the second quarter, down from 14% in 2021 as disclosed at our Investor Day in May.

Turning to large customers, we ended the quarter with 1,749 large customers representing an increase of 61% year-over-year and their record addition of 212 large customers in the quarter. We were pleased to see large customer revenue contribution increase again sequentially. We continue to move upmarket shipping products and features that are enterprise grade and that is reflected in our large customer cohorts, consistently increasing in size and revenue contribution. Significant expansion from our large customers contributed to a dollar based net retention of 126%, representing a decrease of 100 basis points sequentially and an increase of 200 basis points year-over-year. While we expect EMR to continue to trend upward over time, we expect some variability quarter to quarter.

Moving to gross margin, second quarter gross margin was 78.9%, representing an increase of 20 basis points sequentially. Network CapEx represented 13% of revenue in the second quarter. We continue to expect some level of quarter to quarter variability given strategic purchase positions and continue to expect network CapEx to be 12% to 14% of revenue for fiscal 2022.

Turning to operating expenses, second quarter operating expenses as a percentage of revenue increased 3% sequentially and decreased 2% year-over-year to 79%. We had another strong hiring quarter where we saw our total number of employees increase 49% year-over-year, bringing our total number of employees to approximately 3,060 at the end of the quarter.

As we look forward into the second half of 2022, we plan to slow the velocity of hiring given global macroeconomic uncertainty. We also see an opportunity to raise the bar on new hire additions given dislocations in the market. Sales and marketing expenses were $103.9 million for the quarter. Sales and marketing as a percentage of revenue increased 2% sequentially and decreased to 44% from 45% in the same quarter last year. Research and development expenses were $46.2 million from the quarter. R&D as a percentage of revenue increased 1% sequentially and stayed flat from 20% in the same quarter last year.

General and administrative expenses were $35.8 million for the quarter. G&A as a percentage of revenue stayed flat sequentially and decreased to 15% from 16% in the same quarter last year. Operating loss of $891,000 compared to an operating loss of $4 million in the same period last year. Second quarter operating margin was negative 0.4%, improving 220 basis points year-over-year, if not for our acquisition and continued investment in Area one, we've been operating profit positive.

Turning to net income in the balance sheet, our net income in the quarter or $312,000 or net income per share of $0.00, equity spends for the quarter was $793,000. We ended the second quarter with $1.6 billion in cash, cash equivalents and available for sale securities. Free cash flow was negative $4.4 million in the second quarter, or 2% of revenue, compared to a negative $9.8 million or 6% of revenue in the same period last year. Operating cash flow was $38.3 million in the second quarter, or 16% of revenue compared to $7.5 million or 5% of revenue in the same period last year. We will be diligent in balancing operational discipline moving forward with a heightened focus on free cash flow while maintaining profitability at or near breakeven with continued investment to address the enormous opportunity in front of us. As mentioned in prior quarters, we continue to expect to return to positive free cash flow in the second half of 2022. Remaining Performance Obligations or RPO came in at $760 million, representing an increase of 10% sequentially and 57% year-over-year Current RPO was 76% of total RPO.

Before we move to guidance for the third quarter and full year, I would like to provide additional color on our expectations in light of the uncertainty in the macroeconomic environment. Similar to the early days of COVID, we performed a rigorous analysis to understand both the risks and opportunities in the current environment. However, while COVID particularly affected a narrow set of industries, the current challenges impact a broader set of verticals, which is why we believe it's important for us to be more prudent in this quarter's guidance. Headwinds from foreign exchange have also accelerated, and with our product portfolio priced in US dollars, our products are becoming more expensive internationally. And while we haven't seen a material change in our customer's behavior to date, we are seeing elongated sales cycles at the high end of our business. We are cognizant of the increasingly cautious environment that factored this into our outlook.

For the third quarter, we expect revenue in the range of $250 million to $251 million, representing an increase of 45% to 46% year-over-year. We expect operating income in the range of 0 to $1 million. We expect net income per share of breakeven to $0.01, assuming approximately 342 million common shares outstanding. We expect a tax expense of $1.9 million. For the full year 2022, we expect revenue in the range of $968 million to $972 million, representing an increase of 47% to 48% year-over-year. We expect operating income for the full year in the range of $7 million to $11 million. We expect net income per share over that period in the range of $0.03 to $0.04, assuming approximately 343 million common shares outstanding. We expect the tax expense of $6.4 million.

We are fortunate to be uniquely positioned as a provider of mission-critical services for our customers. And while there are challenges in the economy, we remain excited about the opportunity in front of us. I would like to thank the Cloudflare employees for their continued dedication and resiliency in delivering exceptional service to our customers, partners and communities.

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

QUESTION AND ANSWER SECTION

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

Matthew Hedberg
Analyst, RBC Capital Markets LLC

Q

Great. Thank you very much for the question and congrats on the results in a tough environment. Maybe Thomas for you, Matthew had a lot of helpful commentaries, which I think we appreciate the candor. You mentioned longer sales cycles, but you still increased your full year guide by $13 million or more than $7 million [indiscernible] . Can you talk a little bit more about specifically how you thought about levels, embedding levels of conservatism? And are you seeing things kind of stay the same or maybe gets worse from here?

Thomas Josef Seifert
Chief Financial Officer, Cloudflare, Inc.

A

Yeah. We looked at a lot of different factors impacting guidance this year and you picked up some already. So we continue to see elongated sales cycles at the high end of our business that especially in their $0.5 million to $1 million bucket. And we – we expect to have that to continue. We saw also on that our – our European business was the second best performing region this quarter. And we have seen a deterioration of performance, especially in Europe, over the first and second quarter. So we expect that the trend for sure not to improve. And we also see across the board, I think that companies are, like said, they're becoming more cautious in how they approach the business and things that are discussed twice in order to make sure that cuts have only been be done once. So we – we have not factored in – in our guidance that – that things would improve from – from here from [indiscernible] from here on moving forward and – and performs rigorous analysis across verticals across various regions and customer cohorts. And that's why you see a more prudent and more cautious [indiscernible] for – for the third quarter and the end of the year.

Q

Got it. That makes sense. And then maybe just one for Matthew, the wins that you called out in the workers are exciting. I guess I'm wondering, you know, is there – is there an opportunity in maybe more challenging economic times for – for – for customers to start to use workers in an even more creative and maybe cost effective higher ROI way than they would have otherwise done so, if like you said, the road was kind of clear ahead and no clouds or fog in front of us?

A

Yeah, I think, you know, one of the really powerful things about workers is its efficiency. And so a workload, an equivalent work load running on workers versus running on any of the sort of traditional public clouds, AWSs or Google Cloud or Microsoft's Azure is – is typically significantly less expensive to run. And the technical work in order to make that happen is part of the magic of what workers delivers. And so we are definitely seeing, especially in either new startups or people who are really realizing that they've got to make money go further. The days of just wildly spending on your cloud bill I think are behind us and there are many different ways, both with workers as well as just some of our standard products, that if you put us in front of your typical public cloud, we can often save you quite a bit of money. And so, again, I think that that was a message that didn't really resonate very much a year ago where everyone was just, see, my money was free and people were throwing it at any problem that was out there. But I think in these particular environments where people are trying to figure out how to stretch a dollar even further, workers and Cloudflare's platform as a whole is very effective at helping people save money.

Q

Super helpful. Thanks guys.

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

Q

Hey, guys. Thanks for the questions. Actually interquarter was an interesting release from your guys that you talked about the Cloudflare one partner program and Matthew, in your prepared remarks, you mentioned taking some of your competitors top channel partners. Can you go over some of the detail that you expect in terms of how this is – those program is going to work for you guys? Is it solely focused on security and how this is going to impact your indirect mix and profitability over the next couple of years?

A

Yeah. I think that from the early days of Cloudflare, we explored various partner programs and the challenge was that explored various partner programs and the challenge was that you know for a lot of our earlier products took five minutes sign up and they just worked out of the box. And so there wasn't a lot of value to add as a value-added reseller. And so while -- while we had, you know, what I would call fairly standard success for the SaaS industry in -- in working with partners, I don't think our -- our products really facilitated that getting the most out of the partner ecosystem and especially, you know, if our partner is an order taker, then that's not -- not a lot of value. I think a handful of things have -- have happened. One is that our products have gotten more complicated. And it's great for us because it means that we are getting more leverage in what we're able to deliver on through partners. Second thing is that I think we saw with [indiscernible] that their success with a handful of partners in selling the Zero Trust products was really successful. And those products take more work to actually implement and deploy within an organization that's not a five minute setup. And so in that case, that's an area where we are able to work with partners. And in particular, you know, we're very much following the playbook. And when we talk to the partners that are selling zero trust services, they all want to have more solutions in their basket to be able to bring to customers because in a lot of cases the kind of previous zero trust solution either suffered from a lack of ability to scale real performance bottlenecks or not not having the total global coverage that global companies need. And Cloudflare addresses all of those things extremely well. So I think that that's an opportunity for us In terms of profitability, I think the good news is that these more complex products tend to actually be the highest margin products that we have and so as we were designing the program, we thought that we could have it be both margin accretive to Cloudflare while also still being very attractive to the potential partners that are bringing that to market. And so I think that this is an area that we're watching very carefully. I think it's part that is we're going to continue to invest in. Actually, it's also one of the hidden benefits of us acquiring Area One as they had a lot more experience with the channel and with partners and so working with the team there to really design that program has been great and the reception from partners has been has been terrific. So I think it's a win-win for us and for our partners.

Q

Very helpful, Matthew. Last one for me is a big government quarter coming up here and obviously you guys have a system integrator relationship. I guess what are you seeing on the government agency side and that FEDRAMP program?

A

Thanks, guys. Yeah. Appreciate. Appreciate it. We are – it's like being in line at the DMV that that we've pulled our number and are just waiting for it to come up for us to get our FEDRAMP certification. And so we expect that will have very positive news for that next quarter. But we're basically a number – we're number 84 and it's showing number 83 on the sort of white or red number counting board at the DMV. So that's positive. We see it across the board, not just with federal but the example that I gave is the state of Arizona. We're seeing a lot more people adopt Cloudflare services in that government space. And so I think that that continues to be a place where we have very strong relationships. And as we continue to get the very certification, it will allow us to go even faster.

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

Alex Henderson
Analyst, Needham & Co. LLC

Q

Great. Thank you very much. I was hoping you could talk a little bit about the context of the commentary around economic conditions. It's pretty obvious that to the entire planet, economies globally are decelerating, and particularly Europe is general a lot of duress. But your initial comments was that you saw that start to really manifest in 1Q and that it actually improved somewhat or at least stabilized in 2Q, yet you sound a lot more cautious on your thought process and so forth. And I'm wondering if there's a little bit of a disconnect between those two, the tone of those two doesn't sound like your business has rolled at all in, you know, sequentially gotten worse or more tense. But on the other side of the coin, you sound like you're being much more conservative in your outlook. So you parse between those two a little bit?

A

Yeah, Alex. Yeah, I think that, what we see is that the environment has gotten harder. I think we saw the first signals of that actually going back to December of 2021, and they really started to manifest in various ways, slow down a pipeline slowdown of customers paying their bills in Q1 of this year. And we talked about that on the last quarter earnings call. And I think some people were questioning on the last quarter earnings call. And I think some people were questioning, why we would we do that? What I think we would've been able to do though, because we saw that, we acknowledged that, we don't pretend like everything was normal was really a just to take advantage of this of the situation. And so I think one of the real powers of Cloudflare's business is the diversity of our customer sets both on a geography and also industry basis, the diversity of our products and that allows us to have multiple levers to be able to continue to deliver, even when the times get tough. And I think if you go back to the COVID quarters in that was definitely a time where we had to adjust how we went to market, what we did, what types of customers we focused on. We really transitioned from being a business driven primarily from getting new logos to one that developed a real expertise in how to go to our existing customers and sell them more. And I think there are a lot of analogies that are similar to the sort of adjustments that we've made that allowed us to have a quarter like this. But make no mistake we're still we're still in what my grandmother would call a two leapfrog. We've still got to go out and do the work every day of filling up the wheelbarrow with new leads, sifting through it to look for what's going to be the most promising and then being able to deliver. But what I like about our business is again a diversity across customer types, customer sizes, products, ways that we can go to market and I think our team has done a good job of adapting to what is a much more difficult situation today than it was a year ago.

Q

Alex, maybe one additional point I pointed that out in my script, but – and I didn't mention it in the – in the previous answer. And what we do feel is – are also currency headwinds, especially in Europe. So even with the economic activity for us in terms of data volume and what would be the same, we see the headwinds from a currency perspective in Europe, but also in other parts of the world, Japan, for example, but we need to [indiscernible] (00:37:50).

A

Yeah. That's actually leading it to the second question I wanted to ask is which is the European environment is particularly older, so with 20% currency translation headwinds in the media or inflation rising interest rates, Bank of – Bank of England just raised rates 0.5% today in fact – and given that environment, they're struggling with huge price increases, particularly on systems in local, in – in dollars plus the currency translation and their budgets are currently flat. Now, my understanding is there seems to be a separation of between companies that are selling relatively low priced, high value technologies and companies are selling high ticket technologies. Can you talk about whether your aggressively low price and the fact that your lower ticket upfront gives you a big advantage in that geography because of that characteristic? And whether you're seeing more pressure on the higher value of the higher, bigger ticket transactions, because I think ultimately that seems to be the dividing line between who wins and loses in – in Europe?

A

Well, I think it's certainly a benefit that our products are mission critical, but even then the high end and bigger ACV deal, so decision takes longer. That's where you see the Deal, so decision takes longer. That's where you see the elongated sales cycles. The second factor in our favor is that gross margin is one of their strong points of the business model. And when we deploy that weapon, we always talked a bit about it as a strategic weapon when where it makes sense. So that doesn't mean, price cutting. We tried to be strategic and accommodating where we think it makes sense to build a business relationship and business. But we're using our margin to accommodate for that without any doubt.

Q

Thank you very much.

Operator: Your next question comes from the line of Shaul Eyal with Cowen. Your line is now open.

Shaul Eyal
Analyst, Cowen & Co. LLC

Thank you. Good afternoon, guys. Congrats on set of results. Matthew, the first question up for you. So a lot of discussions throughout the quarter, maybe some chatter around your crypto exposure, potentially implications, maybe good opportunity here to risk cloud exposure, maybe no current thinking on this vertical given the changing dynamics we've seen in recent months.

A

Sure. I mean, I think that we have customers that are in that space, including a number of the large exchanges. But I don't think that there are any of them that would crack being a Top 10 customer. And I think as a whole, I don't know that the exact exposure Thomas may be able to add to it, but I would say that it's not significant enough that it has been brought up as a big risk item internally. So I think that we have always had, I personally have never, I'm – there's a lot of religion around the crypto space where people are either really crypto space where people are either really pro crypto or heavily against crypto. I feel like I'm the only kind of agnostic on crypto where I don't think we have that heavily on it, but at the same time, we've definitely made sure that if there are things that emerge from it, that we're in a position to take advantage of those, but that has not been a meaningful headwind to us.

A

Yeah. And maybe some color, our exposure to crypto was less than what single mid-single digits and percent of revenue are, but under 5% for the second quarter. So not a big – an interesting part in terms of the the size and the amount of customers, but not a big exposure to revenue.

Q

Understood. And Thomas, maybe one for you, question on elongated sales cycle. I know it's a bit tricky. It differs from customer to customer, but maybe can you generalize for us, how long, how much of these cycles being elongated, are we talking two weeks, three weeks, more than that, how should we be thinking about it. The world elongated is a very, very general term.

A

Well, I would say for the main part of our business, we are still far below 90 days from [indiscernible] perspective. So when we talk about elongated sales cycles, it's in the in the upper end of our cohort where you look at the bucket $500,000 to $1 million of ATV where it's moving out, but they're moving out by weeks, not by days.

Q

Understood. Very helpful. Thank you so much.

Operator: We ask that analysts limit themselves to one question, so we may get to everybody today. Thank you. Your next question comes from the line Thank you. Your next question comes from the line of Fatima Boolani with Citi. Your line is now open.

Q

Hey. Good afternoon. Thank you so much for taking my questions. And Matthew or Thomas jump ball for either one of you, thinking about the shift to pay-as-you-go customers, some of your observations and commentary around elongating field cycles that you just addressed. I'm curious if you can just sort of take a step back and bifurcate for us how new logo land purchasing and procurement behavior has changed versus expansion or install base expansion customer behavior has changed over the last three months. And maybe if you can help contextualize this or put this under the lens of your product pillars, whether there is more or less usage or slower adoption of certain pillars versus others, and certainly against the hardware supply chain constraint backdrop that we're in right now?

A

Sure. So as I said in the prepared remarks, I think that it has gotten harder to sign up a new logo since the beginning of the year. But it's actually gotten easier to talk to our existing customers about using more of their platform – more of our platform in order to solve the problems that they that they have. And so, I think that where we benefit, is because we have such a broad product portfolio that allows us, even in these times where signing up new logos is hard, we can go to our existing customers and have a conversation about how we can simplify their IT stack, how we can save them money, how we can make them more secure and I think that that's attractive. So we're still signing up plenty of new logos. But I think that on balance, it has definitely gotten harder to sign up new logos and it has gotten easier to have conversations about expanding usage of our platform and especially adopting different products that are part of our platform. In terms of what products are – have a mix of products is changing? I think security continues to be top of mind that, I think that there was real kind of concern around when the Russian invasion of Ukraine happened that there would be attacks that went out from Russia in retaliation against Western companies that actually did not materialize in Q1. The way I think a lot of people thought it would, but we started to see more of that start to materialize in Q2. It's still, I wouldn't call it a trend yet, but we're seeing more companies come under attack and turning to us when that happens. And so, this is an environment where security products do very well. And across our security portfolio, we're seeing strength.

Q

Thank you so much.

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

Joel P. Fishbein
Analyst, Truist Securities, Inc.

Q

Thank you for taking my question. Matthew, at the Analyst Day, you talked about access in these large market could [indiscernible] go after. Notwithstanding the macro environment, current macro environment, is there anything that has changed in your philosophy about these big markets? And maybe you can just give us an update on these [indiscernible] large markets and where your position maybe specifically around [indiscernible] and the big data that you have going on right now? Thank you.

A

Yeah, so we think of Cloudflare as stacking multiple adoption curves one behind another. And so our first act were how do we protect the infrastructure of customers around the world. And it is incredible to see how we've been able to do that successfully, where today more than 20% of all websites use our infrastructure. We'll continue to sell those products. But I think that where we are earlier in that S curve is with our zero trust products and we're able to go to all of those people who adopted our application security products and now say, hey, we can help you with Zero Trust as well. And I think that that is the big act that we're focusing on right now. Act 3 for us, which I think will really start to hit in a material way around revenue in three to five years is really around workers. And I think we have been very pleasantly surprised how that adoption has happened faster and sooner and earlier than we expected. R2, which is our object store and our S3 -- Amazon S3 competitor went into public beta last quarter and we expect that it will go into GA right at the end of Q3. And so I think that that's an opportunity for us to do more. And we will continue – we continue to invest in it. And again, we think that the real durable nature of Cloudflare is that we're able to continue to stack these acts one behind another, behind another.

Q

Great. Thank you.

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

Q

Hi, guys. Thank you for taking my questions. Matthew, maybe a question on the security angle for you. You talked a lot about having larger platform conversations with your existing customers. Can you comment on when you talk to CIOs, CISOs, that these customers, what is their willingness to really want to transform and modernize their existing security architectures versus perhaps continuing to refresh their existing on premise data?

A

Yeah, I mean, I think Morgan Stanley is a great Cloudflare customer, and we have – we have a terrific relationship with – with the CIO team over there. And it's – and it's definitely an organization that has been willing to embrace change. And we – and we – I think that that's – that's a big, big piece. And I think that most organizations today understand that they have to make that change, and they're very willing to have that conversation. I think the thing that has changed to some extent is even those organizations that thought they could continue to invest in on premise hardware are finding the current situation very difficult, where if you want to get a new firewall today, the lead times can be, you know, nine months before you get it, and at the same time, the firewall vendors are raising their prices. And so I think that a lot of the – in the – in the results, a lot of the sort of RPO that that you saw in – in the traditional firewall vendors was people basically holding their place in line. But it's – it's not a way to make customers happy, telling them they have to pay more and then delaying when the product is going to be there. And so even for some of the organizations that traditionally have said, we don't believe in the cloud or we don't believe in and moving in this direction, I think that tune is starting to change and it's becoming very much the minority opinion that you can solve these problems with on-premise hardware.

Q

Thank you.

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

Q

Hey, guys. And thanks a lot for taking the question. Maybe just for Thomas, I think you talked in the script about being more judicious and slowing hiring in the back half of the year and maybe you could talk a little bit more about which areas are still prioritizing hiring and which ones are kind of slowing a bit more. Thanks so much.

A

Yeah. So we do quite a bit employee head count wise. In the second quarter we said we take the velocity down quite a bit, we still prioritize, go-to-market open positions and put occurring people moving into the second half. So the slowdown is in G&A in some of their R&D functions, but go-to-market, it's still going to continue to higher.

Q

Super clear. Thanks so much.

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

Q

Great. Thank you. Maybe just a follow-up question on the operating income for the year, you your loss in Q2 is actually better than your guidance. I think you just said you're slowing hiring in the second half of the year. So I assume the reason you lowered your operating income for the full year fiscal 20 22 will through the acquisition. And if so, could you just pull that out, maybe tell us what your organic revenue and operating income would have been outside of that acquisition?

A

Yeah. I don't want to keep more – much more specific than the guide that we gave in our script. But it is true with a couple of moving parts. Without the continued investment in Area one, we would have been operating margin positive, probably more in their single digit million dollar range for the second quarter.

Q

And I assume the operating guidance for the year were gone up in absence of that acquisition.

A

We gave guidance for the quarter that took into account a lot of variables and I'm not going to parcel out now what the specific impact if area one would have been if we hadn't done that that acquisition. Guidance is a holistic picture on many things that move and you should take it as that.

Q

Understood. Thanks.

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

Q

Great. Thanks team for taking my question. Matthew, maybe a quick one for you on your comments around DBNR, you mentioned your aspirational goal of 130%. What do you think is – how do you get there? Is it kind of a function, kind of where you're at now based on macroeconomics and just what's going on in terms of budgets or is there something internally that you guys are looking to maybe change and or kind of refocus efforts on in order to drive that number up? Thanks.

A

Yeah. I think that it really is for us about how we bundle products together. Today, 29% of the Fortune 1000 are already Cloudflare customers. If you fast forward with that, I think that that a very significant percentage of the Fortune 1000 are going I think that that a very significant percentage of the Fortune 1000 are going to be customers. And so what we really want to focus on is how do we get them to use more of our platform? And what I think is unique about Cloudflare is we've already got the products in place where we can have those -- those customers adopt our more and more our platform. There is not a single customer that uses every single feature of Cloudflare's platform today in terms of a contracted customer. And so I think that's where we really see that growing. And I think that's a very healthy way to expand spend with customers is to become more and more critical. What we want to be is the network that the Fortune 1000 relies on for connecting to the Internet, making sure that they're secure, making sure that their employees have the best experience possible, and making sure that no matter what happens, they're always going to be online.

Q

Great. Thanks a lot.

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

James Breen
Analyst, William Blair & Co. LLC

Q

Thanks for taking the question. Can you just talk a little bit about CapEx was up a bit this quarter, a little bit higher than the guidance for the year, the range for the year and how you think about that spending going forward? And maybe some of the puts and takes on cash flow relative to top line growth? And there were areas where you can generate cash without too greatly impacting the top line? Thanks.

A

Maybe I get started on topic, but I mean, we're trying to stay within the range that we guided for -- for the year. We said before you would see variability quarter to quarter just in terms of how we purchase, where we see opportunity to call and spend and make sure that we maneuver our sales market around the supply chain disruptions you see, but this is pretty much driving the variability quarter-to-quarter, but we will stay within the – the range we – we guided for – for the year. So from a free cash flow perspective, we – we said we have a lot of levers at hand. One of the biggest levers is – is moving to annual building for our large companies. We are, from a company history perspective, coming from a – from a pay-as-you-go business, where people give us a credit card. Even at the beginning of the second quarter, the majority of our revenue was monthly billing. So we've made first strides into that direction of annual billing and there is a lot of opportunity still in front of us. So this, I would say, is the biggest lever, but we run there a pretty holistic cash conversion project across the company that looks into literally anything that can positively impact free cash flow generation and it's a cross-functional project and it's – we're making good progress and you saw that already reflected in the second quarter numbers.

Q

Great. Thanks.

Operator: Your next question comes from the line of Gray Powell with BTIG. Your line is now open.

Q

All right. Great. Thanks for taking the question and congratulations for the – on the strong results. So, yeah, Matt, you called out the Fortune 500 energy company, where you replace this scalar and then you talked about some other similar wins. I just want to make sure I have [indiscernible] (00:58:45). Are those mainly on the ZTNA side with Cloudflare Access? Or were there some gateway wins as well? And then maybe you can – can you just drill into a little bit more and talk about like why you want? Is it more a price technology or a combination of both?

A

Yeah. So when we sell our zero trust solutions, we really believe that the pieces all fit together. And so those are typically when, sometimes somebody will just adopt one portion of the solution, but we really like to sell that holistic solution and see how all of the pieces fit together. In terms of where we win, I think what we hear from the space is that our products are significantly more performant. We have a much more holistic solution where we can protect mobile devices in a way that a lot of the other providers can't. We can work across the geographies, it would – when I was the same last year, traveling and in Africa using our products, they worked great. Whereas most people in the space don't have that broad of a network that can deliver that. And I think that we are just able to scale much more significantly. We have literally two orders of magnitude more capacity to be able to handle the force and that's why we've been able to displace some companies that have used that have tried to adopt this scalar and found it less user friendly and that it generated a lot of IT support tickets. But that's really not our focus. Our focus is going after all of the on-premise firewalls and hardware and VPN that exist in the universe. And so, I think they can be successful and we can be successful, but I think we have a better product. And over time, I think that will help us win.

Q

Understood. Thank you very much.

A

Emma, can we take a question from one more analyst, please?

Operator: Of course. Your final question today comes from the line of Brent Thill with Jefferies. Your line is now open.

Q

Matthew on Area 1 I know it's early, but can you give us an update of what you're seeing there and given on the last question, can I squeeze one end at the end? Thanks.

A

The Area 1 tech is amazing. So, the product we're seeing really great wins from very large customers and we think of that product as being a gateway to help with people on their Zero Trust journey. If you think about e-mail, the nature of it is it enumerates the employee directory of an organization and it very much then helps us sell the other Zero Trust products that that we have. And so that conversation is going well. It's also a conversation that is going well in terms of talking to our existing customers. It turns out everybody's got a phishing problem. It is for most of our customers. One click to sign up and test whether or not Area 1 can result in that. And so we're seeing $1 million plus win that close in oftentimes in a matter of days or a certain number of weeks, which is – which is it because -because we can just prove how successful that is. I think beyond that, everyone has helped us in a number of other ways. One, as I mentioned earlier, is that they had a much more sophisticated channel program, which is now helped develop our channel program. And I think we're really thankful for that team being on board. And then the third, which I think you'll hear us talk about more going forward, is that they have a really world-class threat intelligence team. And that I think will turn into more products across our entire platform. And because, I like your brand, I'll let you have one more question.

Q

I appreciate that. You had the crystal ball and everyone appreciates your candor. And I think you were the first one to come out and say, hey things are [indiscernible] a little different than they felt. Just trying to understand when you look at the perspective of what's happening now, you mentioned things have stabilized. I mean, I just want to make sure we understand from your perspective, it hasn't gotten worse, it's come-in that your destabilization trend that you're seeing, that you've seen that extend into July and in the rest of the summer. What's your sense of what kind of the trajectory from where things came in? Where are you at now?

A

Yeah, you've got me in trouble with a lot of my peers at your conference, where I said that, the economy was not as rosy as people think. And I think you've heard a lot of those folks make those comments now in Q2. Let me be clear. I think that the economy is still in really rough shape. And I don't know and again, I'm not a member of that, I'm not an economist. But from what we hear from customers, customers are really still suffering and the economy, I wouldn't say that the economy itself has stabilized. What I would say is, we have had the flexibility in our business to be able to adapt to a very difficult environment, that environment continues to be difficult, and I think it will be difficult at least through the rest of the year.

But being able to deliver products that deliver real value, have an incredible ROI, can save customers money and are must haves, not nice to have, puts us in an incredibly powerful position. And as I said in the prepared remarks, I would not trade places with any other [indiscernible] .

A

Thank you.

Operator: This concludes our Q&A portion of the call. Matthew Prince, I turn the call back to you.

Matthew Prince

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

So I'd like to, first of all thank a bunch of the students from the Berklee School of Music to let us use some of their new and original songs after the whole music going, going in to hope over those of you who tuned in the call early, are you appreciated that. I also want to thank the analyst for actually asking [indiscernible] some questions this time. Usually I [indiscernible] the question. Thanks to our team and all of our customers, we've got our hands on the wheel, our eyes on the road. We'll see you all back here next quarter.

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