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Cloudflare, Inc. (NET)

Q1 2023 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good afternoon, ladies and gentlemen, and welcome to the Cloudflare Q1 2023 Earnings Conference Call. At this time, all participants are in a listen-only mode and please be advised that this call is being recorded. After the speakers' prepared remarks, there will be a question-and-answer session. [Operator Instructions]

And now I'd like to turn the call over to Mr. Phil Winslow, Vice President of Strategic Finance, Treasury and Investor Relations. Please go ahead, sir.

Philip Winslow

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

Thank you for joining us to discuss Cloudflare's financial results for the first quarter of 2023. With me on the call, we have Matthew Prince, Co-Founder and CEO; Michelle Zatlun, Co-Founder, President and COO; and Thomas Seifert, CFO.

By now, everyone should have access to our earnings announcement. This announcement, as well as our supplemental financial information, may be found on our Investor Relations website. As a reminder, we will be making forward-looking statements during today's discussion, including but not limited to our customers, vendors, and partners, operations and future financial performance; our anticipated product launches and the timing and market potential of those products; our anticipated future financial and operating performance and our expectations regarding future macroeconomic conditions. These statements and other comments are not guarantees of future performance and are subject to risks and uncertainties, much of which is beyond our control.

Our actual results may differ significantly from those projected or suggested in any of our forward-looking statements. These forward-looking statements apply as of today, and you should not rely on them as representing our views in the future. We undertake no obligation to update these statements after this call. For a more complete discussion of the risks and uncertainties that could impact our future operating results and financial condition, please see our filings with the SEC as well as in today's earnings press release.

Unless otherwise noted, all numbers we talk about today other than revenue will be on an adjusted non-GAAP basis. You'll find a reconciliation of GAAP to non-GAAP financial measures that are included in our earnings release on our Investor Relations website. For historical periods, a GAAP to non-GAAP reconciliation can be found in the supplemental financial information referenced a few moments ago.

We'd also like to inform you that we will be participating in the Moffett Nathanson's inaugural TMT Conference on May 17 and Jefferies 2023 Software Conference on May 31.

Now, before wrapping up, we are excited to host our Investor Day on Thursday, May 4, which is being held in conjunction with our user conference, Cloudflare Connect, in New York City. A live webcast will also be accessible from our Investor Relations website.

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

Matthew Prince

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

Thank you, Phil. Q1 was a quarter of contrast. We achieved revenue of \$290.2 million, up 37% year-over-year. Our gross margin was 77.8%, again above our long-term target range of 75% to 77% and up from 77.4% last quarter. During the quarter, we added 114 new large customers, those that pay us more than \$100,000 per year and now have 2,156 large customers, up 40% year-over-year. Our dollar-based net retention fell to 117%, down 5% quarter-over-quarter. Importantly, we did not see elevated churn across our broad customer base. Instead, we saw slower expansion from existing customers. More on that in a second.

Throughout this quarter of contrast, we saw tailwinds and headwinds. The reacceleration of our new business pipeline during the second half of 2022 continued again this quarter, and we meaningfully exceeded our pipeline plan for the second quarter in a row. Our win rate against the competition remained at record high levels, and renewal rates were consistent with the high levels experienced over the previous four quarters. Those were all positive signs.

On the flip side, the quarter saw new challenges. Macroeconomic uncertainty, which intensified over the course of Q1 with every failing bank, resulted in a material lengthening of sales cycles, a significant decline in closed rates, even as win rates held strong and an extreme back-end weighting to the quarter. To give you some sense, almost half of the new business closed in the last two weeks of the quarter, which is very non-linear for us. All of these factors put pressure on growth. The quarter most reminded me of Q1 of 2020 when businesses were paralyzingly nervous about the impact of COVID-19. I think this parallel shows how with uncertainty in the economy, companies are closely watching their own businesses before committing to new spending. Thankfully, we continue to be a must-have, not a nice-to-have, and most of the deals we expected to close did just later than we expected.

I'm proud of our team's ability to sail through the rough seas that characterized Q1. Although the current economy poses uncertainty for nearly every business in the near term, as Mark Hawkins on our board like to say, when the going gets tough, the tough gets profitable, and we are tough. We have our hands firmly on the till'0er of our

business and are able to adjust to rapidly evolving market conditions in order to deliver our operating profit of \$19.4 million, representing a record operating margin of 6.7%.

Furthermore, in spite of tougher collections in the quarter, particularly in the month of March, we generated \$13.9 million of free cash flow, representing a free cash flow margin of 5%. We continue to be on track to be free cash flow positive for 2023.

As we navigate through the challenging macroeconomic seas facing our industry, this period of external uncertainty presents us with a perfect opportunity to be internally reflective, identifying areas of improvement within our business and taking proactive steps to create an even more successful and productive organization. As I take stock, we are not limited by the size of our market for our products. We are not limited by our ability to innovate. We are not limited by pipeline opportunity, and we are not limited by the sales capacity.

So what are we limited by? As I said last quarter, Marc Boroditsky, our new President of Revenue, has dug into retooling our go to market efforts and identified significant opportunities to improve the efficiency and performance of our sales team. Although we've won a third of the Fortune 500 customers, if we're honest with ourselves, we saw a lot of our success with our enterprise customers because our products were so good and solved the real problem that everyday company faces. That allowed many on our sales team to succeed largely by just taking orders. When the fish are jumping right in the boat, you don't need to be a very good fisherman. But at the risk of mixing watery metaphors, as the tide goes out, you get a clear view who's not wearing shorts. The macroeconomic environment has gotten harder, and we're seeing that some on our team aren't dressed for work.

Digging in with Marc, we've identified more than 100 people on our sales team who have consistently missed expectations. Simply put, a significant percentage of our salesforce has been repeatedly underperforming based on measurable performance targets and critical KPIs. That's obviously a problem, but it's one in this environment with a particularly available and actionable solution. We are now in the process of quickly rotating out those members of our team who have been underperforming and bringing in new talent, where the salespeople have a proven track record of success, grit, and a strong cultural fit.

To give you some sense, these 100-plus people contributed approximately 4% of annualized new business sold over the last year. So we're optimistic we can make this team upgrade without significantly impacting sales capacity.

While team upgrades are always hard, this is a uniquely good time for us to do this. A year ago, the tech labor market was extremely tight. Today, there is an abundance of talent eager to work at Cloudflare. In Q1, we received more than 0.25 million applicants, approximately 40% of which were for sales positions. That's more applications than we received in all of 2021. In addition to the volume, the caliber of the applicants we're receiving is higher than we've seen at any point in our history, especially for go to market positions. While other companies are laying off, we're going to be bringing on great people with proven track records to raise the capability of our enterprise go-to-market team.

We've always had a culture of high performance at Cloudflare. However, with the value of hindsight, I think we and most other businesses got a bit soft during the COVID crisis around performance management. That was understandable at the time, but that time is over. The work we do is vitally important for the healthy functioning of the Internet.

The opportunity ahead of us is massive. We have amazing people on our team who are executing every day to realize that opportunity, and we have an incredibly long line of other proven, talented people looking to step in to

fill the position where some of our current team aren't living up to expectations. Our pace of innovation is not slowing down. Now, more than ever, it's paramount. We continue to innovate and develop unique offerings that deliver value to our customers and differentiate us from the competition. We are great at that.

I want every dollar we put into Cloudflare to be more productive at driving revenue, profit and shareholder value. Innovation is [indiscernible] (00:09:44) so even more productively, profitably and predictably than before. While I've talked about our team that's underperforming, that's only half the story.

Our top salespeople are terrific. On average, the top 15% of our sellers have achieved 129% of quota over the last four quarters. They're incredibly consistent at bringing in new logos, expanding current customers and delivering results and approximately 27% of them started within the last 18 months. We know that if we hire the right people, they can ramp quickly and be successful with a full bag of products we handle.

In that spirit, let me tell you about some of the deals our top performers closed this quarter. A Fortune 500 media company expanded their relationship with Cloudflare, signing a three-year, \$840,000 deal and bringing their total annual spend to \$2.1 million. A customer of our application, performance and security services since 2017, this company expanded into our Zero Trust portfolio with access and browser isolation for thousands of its contractors, displacing two zero trust competitors and even turning down three licenses from one of them.

Cloudflare's products not only performed better than the competition during evaluation but we were the only company that could deliver on the complex requirements needed. This contract is only the tip of the iceberg with the customer, which plans to potentially roll zero trust out to all their tens of thousands of employees.

Responding to our Descaler campaign, a leading e-commerce technology company in Europe expanded their relationship with Cloudflare, signing a three-year \$780,000 deal. The company is going all in on Cloudflare One, Gateway, Access, CASB, DLP and Magic WAN. They were drawn to Cloudflare's platform as a unified pane of glass to consolidate their security modernization and network transformation needs with Magic WAN as a key competitive differentiator versus first generation zero trust competitors.

A global industrial machinery manufacturer expanded their relationship with us by signing a three-year \$648,000 deal. The company was looking to modernize their security infrastructure and is also going all-in on Cloudflare One with Access, Gateway, Area 1 and Magic WAN, displacing multiple competitors. They appreciate being able to consolidate vendors, reduce costs, and increase flexibility with Cloudflare's platform.

A Fortune 1000 SaaS company expanded their relationship with Cloudflare signing a three-year \$8.4 million deal. The company recognized Cloudflare's unique position as a neutral super cloud to manage and strengthen their application security posture and accelerated SaaS platform performance across AWS, GCP and their private data center environments. Additionally, no other solution could compete with our data localization suite to simplify the customer's global regulatory and compliance requirements.

A leading IoT security company expanded their relationship with us signing two three-year deals for a combined \$4.2 million, one for its commercial business and a FedRAMP one for its government business. The company has been a Cloudflare customer since 2020, using core application services and Cloudflare Tunnel for IoT devices. Drawn to our pace of innovation, this customer bought into the Cloudflare Platform Vision, now using over 25 products across core application services, Zero Trust and our developer platform, including R2, our object store and durable objects to combat high egress fees from AWS. They plan to use Cloudflare's FedRAMP authorization to scale operations on both commercial and federal sides of their business and increase their security posture.

A Fortune 1000 retailer signed a \$1.3 million 46-month contract for Cloudflare's core application services to displace their existing vendor. They also added R2. The company has been dissatisfied with the unpredictability of their build and bought-related issues from the current vendor and wanted to switch to Cloudflare, knowing our universal approach to protecting all traffic and our platforms ease of use we're top of the industry.

A leading gaming company expanded their relationship with Cloudflare, moving from a pay-as-you-go customer spending \$200 a month to a contracted customer signing a one-year \$388,000 deal for R2, Workers, and Application Services. The company was looking for a more scalable platform for storage and outperformance that would support their exponential growth because they realized that by moving to R2, they could eliminate egress fees they were incurring from the competitor, easily integrate with S3 APIs and centralized management. In particular, they were impressed with R2's lower latency and better throughput, as well as how R2 tightly integrates with Workers and our core Application Services.

Traction among developers continues to be strong. We now have 4.92 million Workers applications running on our platform, up 146% over the last six months. 33,000 paying customers have activated R2, and are storing more than 7 petabytes of data, up 25% quarter-over-quarter. AI companies, large and small, continue to build on Cloudflare at a breakneck pace. When we asked them why, they said our neutral position, rapid innovation, and modern nimble development environment. One, last month, called us, "the first cloud infrastructure company built for the age of AI". I like the ring of that. And I'm extremely excited about our upcoming announcement at Developer Week next month. We'll announce a lot around how we support AI and make any developer more productive. We are the best in the industry at innovation, and we're making the changes we need to make in investing in our team to be the best [indiscernible] (00:15:50).

As I step back and think about what was a challenging quarter, I'm struck by our opportunity. We are not limited by the market for our products. We are not limited by innovation. We are not limited by pipeline opportunity. We are not limited by our ability to recruit, and we are not even limited by sales capacity. Instead, we are limited by our go-to-market performance. That's something we can fix. And we are committed to turning the current macroeconomic headwinds into a catalyst for positive change and growth at Cloudflare by investing in our top talent, refocusing on performance management, and elevating the productivity of our team to seize the opportunity we have ahead, which we all know is massive.

With that, I'll turn it over 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. In the first quarter, we continue to witness the challenging business environment, which deteriorated significantly in March when negative headlines emerged related to the SVB, the broadening banking crisis and the worsening macroeconomic outlook. With intensifying business uncertainty, companies became increasingly cautious in more deeply scrutinized deals which impacted numerous areas of our business, including a mature lengthening of sales cycles, delays in collections, and a significant backend weighting in the linearity for the quarter.

For some further context, technology, e-commerce and financial services, our largest end customer verticals by revenue. Also, this happens to revenue growth that impacted Cloudflare outside of our control. We remain committed to controlling what we can control, and that is to focus on building great products that customers need while also maintaining our strong commitment to being fiscally responsible, and remain good stewards of investors' capital. As such, we delivered a record quarter in terms of operating profit and operating margin, and

significantly outperformed on free cash flow. We also continue to prudently allocate capital, with a focus on maximizing shareholder value.

Turning to revenue. Total revenue for the third (sic) [first] (00:18:05) quarter increased 37% year-over-year to \$290.2 million. New pipeline growth again remained strong in the first quarter, exceeding our internal plan for the second consecutive quarter, and continuing the trend of accelerating growth and new pipeline generation for a third consecutive quarter. However, the significant incremental caution exhibited by customers resulted in a pronounced decline in our close rate and an extreme backend weighting of ACB bookings during the first quarter, both of which were primarily impacted by the aforementioned longer sales cycles.

More specifically, our average sales cycle during the first quarter was 27% longer than the average of the previous four quarters. Sales cycles increased most significantly in expansion deals with our contracted customers, which were 49% longer than the average of the previous four quarters. However, our win rate against the competition remain high.

From a geographic perspective, the US represented 53% of revenue, an increase of 37% year-over-year. EMEA represented 27% of revenue, an increase of 40% year-over-year. APAC represented 13% of revenue, an increase of 31% year-over-year.

Turning to our customer metrics. In the first quarter, we had 168,159 paying customers, representing an increase of 13% year-over-year. Turning to large customers, we ended the quarter with 2,156 large customers, representing an increase of 40% year-over-year and an addition of 114 large customers in the quarter. Our dollar-based net retention rate was 117% during the first quarter, representing a decrease of 500 basis points sequentially and a decrease of 10 percentage points year-over-year.

We have not experienced elevated churn rate as renewal rates in the first quarter were consistent with the level of experience on average over the previous fourth quarter, which was an all-time high for the company. Instead, similar to the fourth quarter of last year, the decline in DNR was again primarily driven by delayed expansion with our larger customers.

Moving to gross margin. First quarter gross margin was 77.8%, representing an increase of 40 basis points sequentially and a decrease of 90 basis points year-over-year. Network CapEx represented 5% of revenue in the first quarter. For fiscal 2023, we continue to expect network CapEx to be 11% to 13% of revenue.

Turning to operating expenses. We understand that the crucial aspect of our success is our commitment to being responsive to near-term changes in market conditions [indiscernible] (00:21:11) our operations accordingly, without compromising the long-term opportunity ahead of us, which we all know is massive. We again took [indiscernible] (00:21:20) measures during the first quarter to improve operational efficiency and effectively manage spending. As a result of these actions, first quarter operating expenses as a percentage of revenue remained consistent sequentially, and decreased 5% year-over-year to 71%. Our total number of employees increased 23% year-over-year, bringing our total head count to approximately 3,390 at the end of the quarter. We will continue to pace hiring for the year based on market conditions.

Sales and marketing expenses were \$120.6 million for the quarter. Sales and marketing as a percentage of revenue increased by 1% sequentially, and remained consistent at 42%, compared to the same quarter last year. Research and development expenses were \$51.3 million in the quarter. R&D as a percentage of revenue remained consistent sequentially, and decreased to 18% from 19% in the same quarter last year. General and

administrative expenses was \$34.6 million for the quarter. G&A as a percentage of revenue remained consistent sequentially, and decreased to 12% from 15% in the same quarter last year.

Operating income was \$19.4 million, compared to an operating income of \$4.9 million in the same period last year. First quarter operating margin was 6.7%, an increase of 440 basis points year-over-year. These results highlight the efficiency and elasticity of our business model, which remain key elements of Cloudflare success.

Turning to net income in the balance sheet. Our net income in the quarter was \$27.2 million, or a diluted net income per share of \$0.08. During the first quarter, we initiated tax planning strategies and we were able to successfully reduce cash taxes related to bid and other taxes. As a result, tax expense for the quarter was \$3.9 million. We ended the first quarter with \$1.7 billion in cash, cash equivalents and available for sale security. Free cash flow was \$13.9 million for the first quarter, or 5% of revenue, compared to negative \$64.4 million, or 30% of revenue, in the same period last year. Remaining performance applications or RPO came in \$959 million, representing an increase of 6% sequentially and 39% year-over-year. Current RPO was 75% of total RPO.

Before moving to guidance for the second quarter and full year, I would like to begin with our expectations and the provisions we have factored into guidance. Last quarter, we highlighted our expectation for sales cycles to continue to lengthen for both the first quarter and full year 2023. However, the level of elongation experienced in the first quarter was unprecedented and far surpassed our forecast entering the year pressuring revenue growth. As a result, for the second quarter, despite the continued reacceleration of our new pipeline generation and our high win rates against the competition, we presume sales cycle to remain at the elevated levels experienced during the first quarter and has therefore also assumed close rates remain at continued low levels.

From a linearity perspective, we have assumed a continued backend weighting of ACV booked, and have therefore incorporated minimal in period revenue recognition for the second quarter. Also, we believe that currently depressed close rates and elongated sales cycles are temporary in nature. We cannot predict when the increasing caution is exhibited by the customers during the first quarter will recover. As such, we have assumed these headwinds, which intensified in the month of March, will persist through the end of the fiscal year.

Now, turning to guidance. For the second quarter, we expect revenue in the range of \$305 million to \$306 million, representing an increase of 30% year-over-year. We expect operating income in the range of \$14 million to \$15 million. We expect diluted net income per share of \$0.07 to \$0.08, assuming approximately 345 million common shares outstanding. Due to our aforementioned tax planning strategies, we expect an effective tax rate of 6%.

For the full year 2023, we expect revenue in the range of \$1.28 billion to \$1.284 billion, representing an increase of 31% year-over-year at the midpoint. We expect operating income for the full year in the range of \$73 million to \$77 million. And we expect diluted net income per share over that period in the range of \$0.34 to \$0.35, assuming approximately 345 million common shares outstanding. We expect an effective tax rate of 9% for 2023.

After having achieved positive free cash flow in the second half of last year and again during the first quarter of this year, we continue to anticipate being free cash flow positive for the full year 2023. For modeling purposes, we expect free cash flow to trend upward on an ongoing basis, but anticipate near-term variability in our free cash flow generation, with the second quarter anticipated to be lower than the first quarter due to the timing of capital expenditures and other payable.

In closing, we remain confident in the enormous opportunity ahead of us, as well as the elasticity and durability of our operating model. We are focused on becoming more efficient, more productive, not just during the current

challenging macroeconomic backdrop, but also because operational efficiency is a long-term competitive advantage.

I'd also like to thank our employees for their continued dedication to our mission, customers and partners.

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

QUESTION AND ANSWER SECTION

Operator: Thank you, Mr. Seifert. [Operator Instructions] We'll go first this afternoon to Sterling Auty of MoffettNathanson.

Sterling Auty

Analyst, MoffettNathanson LLC

Q

Yeah. Thanks. Hi, guys. I think the big question is around the guidance. I think coming out of last quarter, the perception was that the guidance was actually aggressive and you kind of alluded to the close rates that you had factored in. Now, with the changes that you've seen, and especially in light of the sales changes you're looking to make, what are the elements that investors can look to see the confidence in being able to deliver on the revised outlook?

Thomas Josef Seifert

Chief Financial Officer, Cloudflare, Inc.

A

Yeah. Maybe I'd get started here. Remember when we gave guidance during the last quarter, we actually said the first and second quarter are more challenging than the later half of the year. We looked at close rates and assumed that what we have seen in the third and fourth quarter of last year of elongation would continue. But the deteriorating environment for prices, we saw sales cycles really elongate far beyond our forecast, up to 27% on average, and then the expansion business was essentially for close to 50%. So, those were material differences in the assumptions we had at the beginning of this year. I think we took this into account and adjusted guidance now carefully, also assuming that the linearity deterioration we have seen in the first quarter would continue for the second quarter specifically. We have assumed hardly any revenue recognition from in-quarter ACV generation. So, this, I think, is prudent in light of what we have seen. You heard from Matthew that the sales people that are impacted by this measure contributed very little in terms of overall ACV generation to the current results. So, we think there is more upside in this transition than there is downside in terms of performance and positive impact on sales capacity moving forward.

The good thing to point out, however, is again, that the improvement in pipeline that we have now seen over consecutive quarters has continued in the first quarter. So, as Matthew mentioned, [indiscernible] (00:30:32) the limitation of opportunity we will see in sales cycles extend, but not pipeline slowing down. So, that was a very encouraging sign. But I think the results are prudently now reflected in the guidance and the deterioration we've seen in the first quarter, especially from a cell cycle perspective, had a material impact on how we think about the rest of the year.

Sterling Auty

Analyst, MoffettNathanson LLC

Q

Understood. And maybe one quick follow-up for Matthew. Can you just characterize for us the traction and the AI opportunity in particular? You gave us one example, but when you look at it as a whole, how are you seeing it

track and what should we think about the expansion opportunities from that customer base through the rest of the year?

Matthew Prince

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

A

Yeah. Sterling, the AI [indiscernible] (00:31:20) I think surprised us last quarter in terms of the positive impact and it continues to surprise us. We've seen the revenue that's coming from AI companies just quarter-over-quarter have had substantial growth north of 20% quarter-over-quarter growth from the largest AI companies that use us, and it's not just one or two but from large to small. What we're hearing from AI companies is that as they look to who they're going to use for their infrastructure and they can start with a clean slate, the Cloudflare is a part of that, and that we're helping them go fast, compete, get the most efficiency, be able to protect themselves from some of the significant cybersecurity and fraud risks that they face, and that continues to be something that is delivering really positive results for us. I think you're going to see us during our Developer Week next month in May highlight some of these customers' stories and highlight ways that AI companies are using Cloudflare in order to push that innovation forward. So, I think that has continued to be a real positive for us and that has only accelerated from even Q4.

Sterling Auty

Analyst, MoffettNathanson LLC

Q

Great. Thank you.

Operator: Thank you. [Operator Instructions] We'll go next now to Thomas Blakely (sic) [Blakey] (00:33:07) of KeyBanc.

Thomas Blakey

Analyst, KeyBanc Capital Markets, Inc.

Q

Hey, guys. Tom Blakey with KeyBanc. Thanks for taking the question here. It sounds like there's a lot of pent-up demand, no gross churn, and pipeline making new records. Maybe this is for Matthew. You talked about it. These are critical needs in terms of access and security, not so much nice to have. What are these customers explaining to you that they're waiting on, maybe looking for some indicators in terms of like how long this pause will kind of take a thought, Matthew? That would be my first question.

Matthew Prince

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

A

Yeah. I think that everyone continues to communicate to us that they want to continue to invest with us. I think what we're seeing from IT organization is that they're all looking very critically at their budgets and asking themselves what projects can they delay versus what projects do they have to invest in? So, we continue to see when companies are under duress, when they're under attack, that those deals are closing extremely quickly. But some of the times where people are initiating a new large project around moving to a Zero Trust environment or something else that would be a larger initiative that the sales cycles on those projects are extending beyond where they were before. I think one of the things that's unique about Cloudflare is even with the extended sales cycles, our sales cycles tend to, on average, be significantly faster than the peers in our industry. And so, back in early 2022, we were among the first to call the slowdown in the economy because we could see that sales cycle slowed down. They picked back up. But then, again, are slowing down right now. I think we tend to see that earlier than some of our peers.

And I think that one of the things that has always characterized how we think about our business is real prudence as we look forward. So, no one is telling us that projects are getting cancelled in any significant way. But people are saying, budgets are tight, we're being more cautious. And that is taking our sales cycles to be longer than we have historically seen, and longer even than the elevation that we saw through the back half of 2022. So, we're trying to be very prudent about how we think about this, but customers continue to tell us, they're not switching to another competitor. They're not – we haven't seen any elevation in loss rates to the competition. Quite the opposite. And people are saying, we want to invest with you. We're just being cautious with our IT spend, and that's causing everyone to measure twice before they cut one.

Thomas Blakey*Analyst, KeyBanc Capital Markets, Inc.*

Q

Right. That's helpful, Matt. And maybe as a follow-up, perfect segue actually to the conservativeness of this guide. It sounds like it's increasingly conservative [indiscernible] (00:36:31) Thomas, in terms of maybe any indications of what he's seeing from numbers coming in in April, a month from the end of March, and just kind of trying to gauge in terms of when we could even get back to this 130% long-term [indiscernible] (00:36:49) would be helpful [indiscernible] (00:36:51).

Thomas Josef Seifert*Chief Financial Officer, Cloudflare, Inc.*

A

The early indication on the second quarter do not indicate a material change, neither to the negative nor to the positive. So, we are cruising along, but no indication that it gets materially better. But as I said, no indications that it's deteriorating either.

Thomas Blakey*Analyst, KeyBanc Capital Markets, Inc.*

Q

Okay. Thank you.

Operator: Thank you. We'll go next now to Brent Thill at Jefferies.

Brent Thill*Analyst, Jefferies LLC*

Q

Good afternoon. Matthew, just on the sales side, when you think about what's happening with the new Head of Revenue and ultimately kind of what happens when you change out – I mean, I guess, how confident are you that there isn't a longer transition on the existing team? What's giving you that view that this current team's kind of in place, you've got the right fit, and this is maybe more internal execution than external forces?

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

A

Well, I think it's a combination of both of those things, if we're honest. I think that the fact that the macro economy has gotten harder, exposed some of the weaknesses in some of the sellers on our team when things were cruising along in 2021, again, you don't have to be a really disciplined seller in order to be successful at Cloudflare. And I think that that, combined with some of what happened during COVID, combined with our hesitancy in terms of what the opportunity costs were in terms of replacing people when the tech employment market was overheating, all combined to have us get to a place where we just had a number of people on our team who weren't performing.

And I think Marc has done an incredible job at really identifying specifically who those people are and starting the process of moving those people off. What I see, though, is that if you look at our top sellers, they are enjoying incredible success, and where the lowest performing sellers decelerated substantially during the macroeconomic slowdown are the top sellers on our team have seen around a 1% decrease in their productivity. And so, what that indicates to me is that with new leaders like Marc, the incredible talent which is applying to Cloudflare again, a quarter million people applied to work for us in Q1. I don't know of any other SaaS company that is seeing that volume of talent that is out there. People want to come work for us. The people who are successful at Cloudflare can be extremely productive and can do well themselves as sellers. And I think Marc is bringing a focus and a discipline which is going to pay off. And the thing that's, I think, very encouraging is as we look at the people that we can replace, that they are contributing such a small percentage in terms of our capacity that we actually think that this will – any type of change like this, obviously, is something that we want to do very humanely. And we want to be very thoughtful about taking care of the team that we have.

But we think that as we transition that team out, we're going to not only increase the performance of our high performers, but bring on new performers that give us much higher performing capacity. And Marc, I think, is doing an incredible job at not only identifying who has to be moved out, but, boy, when I talk to the people that we're hiring to replace those people, I just get incredibly excited by what they're able to deliver to us.

Brent Thill

Analyst, Jefferies LLC

Q

And just a quick follow-up for Thomas. It looks like, if I'm looking at this right, the number of net new enterprise accounts was the lowest you've seen in two years at 114 sequentially. So, I guess, it seems like you saw it across both Enterprise and SMB is kind of the way to frame it, that you didn't – there wasn't one sector that stayed stronger.

Thomas Josef Seifert

Chief Financial Officer, Cloudflare, Inc.

A

I think that read is correct.

Brent Thill

Analyst, Jefferies LLC

Q

Great. Thank you.

Operator: Thank you. We go next now to Matt Hedberg of RBC Capital Markets.

Matthew Hedberg

Analyst, RBC Capital Markets LLC

Q

Great. Thanks for taking my questions. Maybe a follow-up to that last question from Brent. Comment on the pay-as-you-go side of your business. Is that being impacted by macros sort of more or less the same as the Enterprise?

Matthew Prince

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

A

I think that what we're seeing is, again, weakness across the entire space. Pay-as-you-go, remember, is a relatively small percentage of our overall business, less than 15% of revenue. So, it doesn't move the needle one direction or another. But we definitely are seeing that there is a lower rate of upgrade. But at the same time, we

are not seeing that there is a lower rate of downgrade. What I am excited by is the developer traction that we're seeing across our business. The fact that we're closing in on 5 million applications running across the platform, the majority of those are coming from pay-as-you-go developers. And that continues to be a pipeline where we see lots of success.

We also have examples like the one that's cited in the prepared remarks where we had a customer that was paying us \$200 a month that, that we identify, worked with, and were able to upgrade to a enterprise customer spending hundreds of thousands of dollars a year with us. So, pay-as-you-go continues to pay lots of dividends, but I think that the same conservativeness where people are just watching their budgets much more carefully shows up across the entire space, and we don't see a significant difference at the low end of our business versus the high end of the business.

Matthew Hedberg*Analyst, RBC Capital Markets LLC*

Q

Got it. Thanks. And then, Thomas, with the reduced 2023 outlook, 31.5%, I think in the midpoint. That's below sort of the implied five-year \$5 billion target that you guys talked about a couple of quarters ago. Just any thoughts on [indiscernible] (00:44:08) environment change, your thought process on getting to that \$5 billion in five years or maybe just some updated thoughts on that.

Thomas Josef Seifert*Chief Financial Officer, Cloudflare, Inc.*

A

Yeah. As Matthew rightfully pointed out, the market is not limiting. It's limiting – and the opportunity is not limiting us. There are some headwinds now. They will be temporary in nature, but they don't take away from the enormous opportunity that is in front of us. So, it doesn't change our thinking around where this journey is going to take us.

Matthew Hedberg*Analyst, RBC Capital Markets LLC*

Q

Thank you very much.

Operator: Thank you. We'll go next now to Keith Weiss of Morgan Stanley.

Keith Weiss*Analyst, Morgan Stanley & Co. LLC*

Q

Excellent, guys. Thank you, guys, for, for taking the question. I [indiscernible] (00:44:58) a little dense here, but I'm not quite getting what happened in the quarter. When I think through like some of the explanations that you guys are giving, the banking crisis was in the, I think, the first two weeks of March. You guys tend to have a pretty linear business. So like I would have expected the comment to be we only closed like 15% of our business in the last two weeks, if that was what the impact was.

And then like with the salespeople, if they hadn't been productive for a while, there's nothing really incremental there. And you guys have been, like, and Matthew, you called out a weaker macro last year, and you're one of the earlier ones that said, hey, listen, it isn't a great environment out there, but you guys were able to operate really effectively all throughout 2022, and you bring to market a really good ROI focus and really good cost, like value proposition. Like, I don't quite get what changed in Q1 in the timeframe in which it changed.

Matthew Prince

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

A

Yeah. Keith, I think that as we've put a floodlight on it, the biggest thing that changes sales cycle [indiscernible] (00:46:02) more than 25%. And so that pushed back a lot of what was happening in the quarter. We would typically see about half of our business closed in the last month of the quarter. I think the fact that you had the uncertainty around the banks, and again it wasn't just customers of SVB or Credit Suisse, but it was entire space spaces, where purchasing departments really said that, I mean, they got very nervous regardless of who they were banking with. And we just saw more companies push pause on that. That pushed a lot of our business into the last half of March. And it pushed some of our business outside of closing within in the quarter. And so what we don't know is whether March is the new reality, in which case, again I think we want to be very prudent as how we think about the business going forward or if the world will snap back fairly quickly.

The early reads that we're seeing are not that where, again, it doesn't feel like it's getting significantly worse, but we don't also see things getting significantly better. But that again, as we sort of shone a floodlight on, what was it that changed? What changed is a material change in the length of the sales cycles – the win rates didn't change but the close rate s did.

Keith Weiss

Analyst, Morgan Stanley & Co. LLC

Q

You guys mentioned that you saw that in both small customers and large customers. Were there any product families that sustained better or worse than others? Was there any variance on that side of the equation?

Matthew Prince

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

A

No. I think we continue to have extremely fast close rate when someone is under duress. So when they see that there is a problem and they need to and they need to address it, I think and that doesn't change quarter-over-quarter for I think obvious reasons. We're able to respond very quickly. And if someone's offline, we bring them back online. And those deals close in often a matter of hours.

The things that – other things that showed a lot of promise in the quarter were things like R2 where we're increasingly seeing large customers bring over larger and larger datasets. But across the board, we were seeing that anything that required sort of a larger IT commitment, customers were again measuring twice before they cut one. And there was a material increase in sales cycles.

What I think is different about us and a lot of other companies is that we see things faster because even with the 25% increase in sales cycle, we're still significantly faster sales cycles than most other companies. And so I think we see things earlier. And what we don't know, again, is that there a radical change to how procurement departments are thinking about IT spending. That is what we are trying to be prudent around when we think about guidance. Or is it something that was just a short-term effect of sort of the anxiety in March around the banking sector. And I think that the next quarter will prove out which direction that goes, but we want to be extremely prudent and cautious as we think about things going forward.

Keith Weiss

Analyst, Morgan Stanley & Co. LLC

Q

Got it. That's very helpful. I appreciate you working through that.

Operator: Thank you. We go next now to James Fish at Piper Sandler.

James E. Fish

Analyst, Piper Sandler & Co.

Q

Hey, guys. Gross margins here are holding above your long-term average as well. And, Matt, you actually just talked about the fact that these larger commitments are taking longer. Is there a thought process here to maybe just try to get that land a little bit smaller and maybe offer discounts kind of near term to try to land smaller deals here?

Matthew Prince

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

A

I think that's always been part of our playbook. And I think that what we are able to do because of the broad set of products that we have is find lots of different ways into a customer's account. And so that's something that we're able to do. And I think we can maintain gross margins that we're within our 75% to 77% target range. I think it's a mistake for us to dramatically take gross margin rate down over time. But I think that we can actually bundle and discount and go after even small deals because of the margin profiles that we have and then use the engineering that we have in order to deliver, still the gross margins that we expect.

So we're not changing what our gross margin targets are. We are not losing deals on price. And we've been able to continue to be extremely competitive and deliver an extremely high ROI, while also delivering software gross margins.

James E. Fish

Analyst, Piper Sandler & Co.

Q

Makes sense. And, Thomas, appreciate all the details around sales cycle lengthening. But on the closed rates, is there a way to think about the magnitude difference you're seeing here? And how much worse could it get for you guys? Is this kind of the bottom potentially a close race that you're assuming or could it get another step lower from here? Thanks, guys.

Thomas Josef Seifert

Chief Financial Officer, Cloudflare, Inc.

A

We always say we are prudent about when we talk about our guidance. I think we try to be prudent for this quarter. We try to take into account what we have seen in the first quarter and we're thoughtful around how we built improvement or non-improvement in those variables. And so the non-linearity we saw in the quarter was significant. We have not incorporated any significant improvement. As I said in this quarter, the second quarter, we have not assumed any significant revenue recognition from ACV during the second quarter. So I think we've been thoughtful about how we have looked at the outlook.

You know what, I just want to reiterate what Matthew said. When you started this year, we sort of thought from our perspective at that point, we said there is the guidance for the first quarter especially, it is probably more challenging than for the remainder of the year, and that's I think how we framed it.

If you look at the first quarter, we came into range of our guidance slightly off the midpoint in primarily because of the non-linearity of the first quarter. What impacted the forward-looking guidance is that elongation of sales cycles. And that is so you push a wave of ACV further out and we looked at that wave and we have not assumed that it's going to pull in significantly over the course of the year. So I think we have been thoughtful about how we put the guidance together.

Operator: Thank you. We go next now to Joel Fishbein with Truist.

Joel P. Fishbein

Analyst, Truist Securities, Inc.

Q

Thanks for taking my questions. And, Matthew, just one for you and really appreciate the color on the changes you're making in go to market efficiency. But I wanted to ask about some of the partnerships that you've established with some of the global sites like Accenture and Shields up and see if you've seen any change in that go to market and maybe just give us an update on how those are factoring?

Matthew Prince

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

A

I think that we're still in the early days of that but encouraging. We were able to win a federal deal which continues to expand in partnership with Accenture. And that has given them confidence to take us to market in a number of other partnership and global deals. I think that Marc has been great in terms of bringing real focus on partnerships and thinking about what are the parts of the market that we want to serve directly versus what are the parts of the market that we want to serve with partners.

And I think as we have these early wins, that begets our ability to win more with the large global systems integrators and other large partners. They're seeing the same thing that we are when I talk to them. They're seeing very much a conservatism around IT spend that I think is less pronounced in the security space.

And so I think that there is more willingness and eagerness to work with us. But when we talk to the systems integrators and other large partners, especially at the high end of the market, I think that they are reflecting the same sort of conservatism of measure multiple times before you cut that they're seeing from their customers. And I think that it continues to be a large opportunity and something that especially in Zero Trust in workers, we're seeing that we can deliver more with them. But I think that that is a place where we've actually seen IT shops look at ways of making sure that they're being as optimal as possible.

Joel P. Fishbein

Analyst, Truist Securities, Inc.

Q

Thanks. Just as a quick follow-up, are the deal sizes there generally bigger than your normal size since you're landing? It seems like to be larger organizations with – with these partners?

Matthew Prince

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

A

Yeah, they tend to be larger than the average deal. But we land \$10 million-plus deals on our own as well. I think over time you'll see us again work more closely with those FIs and other partners to deliver some of the larger deals and make sure that we can make inroads into more accounts and use them as a way to help integrate larger solutions together. So again, I think it's something that is a priority for us. I think we have the early wins, but now we need to continue to scale those programs.

Joel P. Fishbein

Analyst, Truist Securities, Inc.

Q

Got you. Thank you so much.

Operator: Thank you. We'll take our final question today from Mark Murphy of JPMorgan.

Mark R. Murphy

Analyst, JPMorgan Securities LLC

Thank you very much. Thomas, were bookings more heavily impacted on the CDN side of the business or the security side or perhaps elsewhere?

Thomas Josef Seifert

Chief Financial Officer, Cloudflare, Inc.

We never talk about CDN. I would say I come back to what Matthew said, if customers are in difficult situations under duress, we onboard fast. Those products tend to be security products. And so if there's a statement that all product-wise is that security product suites are doing better statement than the application services.

Mark R. Murphy

Analyst, JPMorgan Securities LLC

Okay. Understood. And then, Matthew, when you look back on it and I think Brent asked about this a bit earlier, but the change in Head of Sales position last November, the goal was to introduce more rigor and discipline. And I think you acknowledged at the time that that those changes can take time. I'm curious to what extent you might have actually seen disruptions from sales org changes, whether it be account mapping or territory assignments or commission structures or anything along those lines which, which you could look at and say, well, this might actually stabilize a little later in the year.

Matthew Prince

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

Y eah. I understand that that would be handy if we could point to that. I don't think that that's what we're seeing right now. I think that we have actually seen our top sellers be more productive. I think that the changes that Marc is putting in place really, you know, are starting with these changes now. And that obviously does introduce uncertainty. We think we have our handle around that. I think we've planned that extremely well. And again I think that as we look out at the caliber and quality of the people who we can bring on board and how we can invest in our top performers today, just getting our sales performance to look much more like a normal distribution than what today is much more of a bimodal distribution is an extremely effective way for us to reaccelerate the growth that we have.

And so the changes that Marc is making are the right changes. Our team, the highest performing individual contributors and managers on our team are leaning forward and emailing me every day about how great it is to have an additional amount of rigor and discipline, there may be bumps along the road, these transitions do take time, but I think we are on the right path. Marc is the right person across our team, the feedback that we're getting is extremely positive, and again we're not limited by the market for our products. We're not limited by innovation. We're not limited by pipeline. We're not even limited really by sales capacity even as we transition people off of our team. And so that gives me a lot of confidence going forward that while we will continue to see pressure from the macroeconomic conditions over the next year, I really am excited for as we have our sales engine match our innovation engine, what we're going to be able to deliver as a company.

Mark R. Murphy

Analyst, JPMorgan Securities LLC

Thank you very much.

Operator: Thank you. Ladies and gentlemen, that is all the time we have for your questions this afternoon. I'd like to turn the conference back over to Mr. Prince for any closing comments.

Matthew Prince

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

Thank you so much. Really appreciate everybody tuning in for the call. This has definitely been a quarter of contrasts, but it is an incredible opportunity for us to continue to make Cloudflare a better company. I appreciate all of the hard work from all of our team. We are excited for the quarter ahead. I hope to see many of you at our Investor Day on May 4 and make sure to tune in the following week, the Developer Week. There are a number of incredible announcements coming. Thank you so much.

Operator: Thank you, Mr. Prince. Ladies and gentlemen, that will conclude the Cloudflare Q1 2023 earnings call. Again, we'd like to thank you all so much for joining us and wish you all a great evening. Goodbye.

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