

01-Aug-2024

# Cloudflare, Inc. (NET)

Q2 2024 Earnings Call

## CORPORATE PARTICIPANTS

### Philip Winslow

*Vice President-Strategic Finance, Treasury & Investor Relations, Cloudflare, Inc.*

### Thomas Josef Seifert

*Chief Financial Officer, Cloudflare, Inc.*

### Matthew Prince

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

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## OTHER PARTICIPANTS

### Matthew Hedberg

*Analyst, RBC Capital Markets LLC*

### Adam C. Borg

*Analyst, Stifel, Nicolaus & Co., Inc.*

### Shaul Eyal

*Analyst, TD Cowen*

### Fatima Boolani

*Analyst, Citigroup Global Markets, Inc.*

### James E. Fish

*Analyst, Piper Sandler & Co.*

### Hamza Fodderwala

*Equity Analyst, Morgan Stanley & Co. LLC*

### Andrew James Nowinski

*Analyst, Wells Fargo Securities LLC*

### Trevor J. Walsh

*Analyst, Citizens JMP Securities LLC*

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## MANAGEMENT DISCUSSION SECTION

**Operator:** Thank you for standing by. My name is Kathleen and I will be your conference operator today. At this time, I would like to welcome everyone to the Cloudflare Second Quarter 2024 Earnings Conference Call. All lines have been placed on mute to prevent any background noise. After the speakers' remarks, there will be a question-and-answer session. [Operator Instructions]

I would like to turn the call over to Mr. Phil Winslow. Please go ahead.

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### Philip Winslow

*Vice President-Strategic Finance, Treasury & Investor Relations, Cloudflare, Inc.*

Thank you for joining us today to discuss Cloudflare's financial results for the second quarter of 2024. 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 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 may 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 would also like to inform you that we will be participating in the Stifel Tech Executive Summit on August 26 and the Goldman Sachs Communacopia and Technology Conference on September 10.

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

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## Matthew Prince

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

Thank you, Phil. We had a terrific quarter, even with the continued macroeconomic uncertainty. We crossed \$1.6 billion in annualized revenue, achieving \$401 million in the second quarter, up 30% year-over-year. During the quarter, we added 168 new large customers, those that pay us more than \$100,000 per year, and now have 3,046 large customers, also up 30% year-over-year. Revenue contribution from these large customers during the quarter remained consistent at 67%, up from 64% in the second quarter last year. Our dollar based net retention was 112%, down 3 percentage points quarter-over-quarter. Our gross margin was 79%, again above our long-term target range of 75% to 77%. We delivered an operating profit of \$57 million, representing an operating margin of 14.2%, underscoring our commitment to operational efficiency and productivity. We generated strong free cash flow of \$38.3 million during the quarter ahead of our expectations. This wasn't an easy quarter, but we continue to execute and deliver strong results. While I think we benefit from being in must have, not a nice to have, we still had to fight for every deal as the IT buying environment continues to be challenging. But our investments in go-to-market improvements are showing dividends. Turns out when you have the right players on the field, you can still play and win even in the rain.

In the second quarter, we again delivered another double-digit year-over-year improvement in sales productivity. In addition, closed rate and sales cycles both also improved quarter-to-quarter and year-over-year. I'm proud of our team's execution. I also couldn't be more pleased about the early returns from Mark Anderson and the other go-to-market leaders with proven track records who have joined the team. In Q2, Mark hired a new VP of Sales in the Americas, a new VP of Revenue Operations and a Global Head of Customer Success. These are world-class go-to-market executives who recognize that we have the product, engineering and go to market leadership for them to bet their careers. As Mark continues to focus on operationalizing productivity at scale and building a world class, go to market engine, our key focus in the second quarter involve making changes to the composition of our organization and bringing on more stage appropriate talent. This really shows in the numbers. The sales manager and AE hiring in Q2 was up 150% quarter-over-quarter and 163% year-over-year. Again, the key to the quarter was excellent execution. We expect these additions to our go to market team to further add to our already building momentum with large enterprise customers, partners and the public sector that we again delivered during the second quarter. That's a great segway to discuss some of our wins in the quarter.

A leading Australian technology company expanded their relationship with Cloudflare, signing a two-year \$17.5 million contract, \$7.2 million of which is expansion. They started with Cloudflare back in 2016 as a free customer, and today used nearly all our products, spanning use cases as diverse as remote application access, [ph]

Workers serverless (00:06:19) development and bot management. Over the next two years, this customer expects to transmit over 180 petabytes and 3.9 trillion requests per month. And they see Cloudflare as essential to handling that level of connectivity while maintaining security. This is a great example of a land and expand customer who started with our free tier, seize the value and expands over time. Sticking down under, another leading Australian technology company expanded their relationship with Cloudflare, signing a three-year \$2.6 million contract for 18,000 seats of Gateway, Access, Browser Isolation, CASB, DLP and also our Workers development platform. This customer evaluated Cloudflare against three leading vendors in the market and selected us due to our superior technical solution, network performance and future roadmap. The customer called us after the deal closed and said, "you were the best solution today, but also for the future and the most strategic. We're very excited for this".

One of the largest universities in the United States signed a five-year, \$5.7 million contract. This customer is going all in on Cloudflare SASE platform with 20,000 seats of Zero Trust, CASB, DLP, email security, Magic WAN and Magic Firewall. This university approached us looking to modernize and scale their global network as their incumbent on premise solution create bandwidth challenges and poor performance. With Cloudflare, they're able to replace multiple legacy vendors with a unified platform and cloud first architecture.

A large global research and development organization expanded their relationship with Cloudflare signing a two-year \$846,000 contract for Cloudflare SASE portfolio, with 3,500 seats of Access, Gateway, CASB, DLP, Browser Isolation and Magic WAN along with our advanced application security bundle. This was a very competitive process to displace legacy VPN providers, and Cloudflare was selected over three SASE competitors due to our superior network performance, ease of use and configuration as well as our unified platform.

A Fortune 500 financial services company expanded their relationship with Cloudflare, signing a one-year \$895,000 contract for Magic Transit and Magic Firewall. [indiscernible] (00:08:53) their incumbent products with two on-premise vendors left this customer vulnerable to attacks, creating significant urgency for our placement solution. A number of channel partners mentioned Cloudflare as a leader in DDoS to this customer and we were quick to come in and get this customer fully deployed, operational and protected in just 10 days.

A Fortune 500 gaming company signed a two-year \$3 million contract for advanced application security and performance along with R2 Storage. This customer was looking to improve availability for a technical infrastructure to support its large global distribution of games. They're migrating all services from two incumbent vendors to Cloudflare due to the completeness of our solution, our superior network performance and scale and unified platform giving them a single control plane.

A leading AI company signed a one year \$500,000 contract with Cloudflare to be their platform for AI for inference, storage, image optimization and application security. This company was an existing R2 customer allowing them to unlock the best prices and performance across multiple cloud providers. However, doing both training and inference with a centralized hyperscale cloud created poor performance for their end users. With Cloudflare, this customer now has access to GPUs deployed across our network close to their end users. Not only will inference task be more performant, but this customer is also realizing a 40% cost improvement with Workers AI.

A leading technology company expanded their relationship with Cloudflare, signing a two-year \$4.8 million contract. This customer is focused on growing their enterprise and FedRAMP product line, and uses Cloudflare for Government along with Cloudflare Workers to dynamically route traffic in order to optimize reliability. This customer has significant increased their usage as they unlock new use cases and lean further into standardizing

on Cloudflare wherever possible across all their business units. After signing this deal, their team reached out to express interest in our AI products. So, there should be more to come from this customer.

I think there are two trends that stand out across all those customer stories. First, customers are adopting Cloudflare's broader platform and signing pool of fund deals that can have some revenue recognition and DNR impacts. But we believe it is actually an extremely healthy sign as when customers buy into our broad platform that we know of no competitors that can match our feature set. Second, you'll notice that more and more of these large deals include Cloudflare Workers, our developer platform. Last quarter, I announced that we crossed 2 million active developers on the platform. I checked in just the other day and we're already up to more than 2.4 million active developers and over 20% increase in just the last four months. This accelerated adoption following the announcements during our Developer Week in early April reinforces how developers are increasingly seeing Cloudflare as offering a complete solution for them to build and ship full stack applications. Workers AI is growing even faster, with developer accounts taking advantage of our AI functions increasing 67% quarter-over-quarter. Today, we have inference-tuned GPUs live in 167 cities worldwide, making us we believe the most global cloud inference solution, and inference requests powered by Cloudflare AI increased more than 700% quarter-over-quarter. Developers are turning to Cloudflare for their AI tasks that need to be fast, global and compliant with an increasing patchwork of AI regulations.

There's external validation as well. Stack Overflow recently surveyed a broad base of developers on what platforms they're using today. Cloudflare came in fourth, just off the podium, ahead of 22 other developer platforms and behind only the three traditional hyperscale public clouds. What's even more exciting, however, is what the survey tells us about the future. When developers were asked what platform they were the most excited to work on in the coming year, Cloudflare came in second, ahead of AWS, Google and Microsoft Azure. Cloudflare didn't even make the survey in 2022. So, we're coming up fast. If we continue to increase developer interest at the same rate, it won't be long before we [ph] medal (00:13:26), and rest assured, our team won't be satisfied with anything short of gold.

With that, I'll hand it off to Thomas, who looks after our gold, to walk through our financial results. Thomas, take it away.

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## Thomas Josef Seifert

*Chief Financial Officer, Cloudflare, Inc.*

Thank you, Matthew, and thanks to everyone for joining us. We are pleased with our execution during the second quarter as we made continuous progress on our go to market transformation. We again delivered another double-digit year-over-year increase in sales productivity during the second quarter and we also saw an uptick in close rates and an improvement in sales cycles. The quarter was highlighted by sustained momentum with large new customers, ongoing significant progress in the public sector, and continued high prioritization of security by our customers. Continuing our strong commitment to being fiscally responsible and acting as good stewards of investors capital, operating profit again more than doubled year-over-year, and we generated free cash flow of \$38.3 million during the second quarter.

Turning to revenue. Total revenue for the second quarter increased 30% year-over-year to \$401 million. From a geographic perspective, the US represented 51% of revenue and increased 28% year-over-year. EMEA represented 28% of revenue and increased 32% year-over-year. APAC represented 13% of revenue and increased 29% year-over-year. We were pleased to see a notable uptick in both sequential and year-over-year growth in APAC as a number of go to market initiatives in the region begin to deliver early returns.

Turning to our customer metrics. In the second quarter, we are at about 210,200 paying customers, an increase of 21% year-over-year. We ended the quarter with about 3,050 large customers, representing an increase of 30% year-over-year and an addition of 168 large customers in the quarter. Our dollar based net retention rate was 112% during the second quarter, representing a decrease of 3 percentage points sequentially. The decline in DNR was driven by slower net expansion in our larger customer cohort, increased platform deals in the form pool of funds contracts which reduce friction to adoption across our product portfolio, but can impact the shape of revenue recognition as well as deferred revenue and current RPO, especially for existing customers that transition into this structure. And anniversarying the price increase to our Pro and Business payable plans last year. For the next several quarters, we expect new customers to contribute a higher percentage of our overall year-over-year revenue growth, similar to the second quarter.

Moving to gross margin. Second quarter gross margin was 79%, representing a decrease of 50 basis points sequentially and an increase of 130 basis points year-over-year. Network CapEx represented 6% of revenue in the second quarter. Based on the timing of certain investments, we expect network CapEx to increase in the second half to reach 10% to 12% of revenue for full year 2024.

Turning to operating expenses. Second quarter operating expenses as a percentage of revenue decreased by 6% year-over-year to 65% as we remain committed to driving higher productivity and greater efficiency across our operations. Our total number of employees increased 15% year-over-year, bringing our total head count to 3,902 at the end of the quarter. Sales and marketing expenses were \$149.5 million for the quarter. Sales and marketing as a percentage of revenue decreased 37% from 41% in the same quarter last year. This decline was primarily due to the transition in our go to market organization to focus on more stage appropriate talent. We're encouraged by the acceleration in account executive hiring exiting the second quarter, which Matthew mentioned earlier, and we expect this trend to continue in the second half of 2024.

Research and development expenses were \$65.4 million in the quarter. R&D as a percentage of revenue decreased to 16% from 17% in the same quarter last year. General and administrative expenses were \$44.7 million for the quarter. G&A as a percentage of revenue decreased to 11% from 13% in the same quarter last year. Operating income was \$57 million, compared to \$20.3 million in the same period last year. Second quarter operating margin was 14.2%, an increase of 760 basis points year-over-year. These results highlight our continued focus on becoming more efficient and more productive, given that operational excellence is a long-term competitive advantage.

Turning to net income and the balance sheet. Our net income in the quarter was \$69.5 million or diluted net income per share of \$0.20. We ended the second quarter with \$1.8 billion in cash, cash equivalents and available for sale securities. Free cash flow was \$38.3 million in the second quarter, or 10% of revenue, compared to \$20 million, or 6% of revenue, in the same period last year. Remaining performance obligations or RPO came in at \$1,421 million, representing an increase of 6% sequentially or 37% year-over-year. Current RPO was 69% of total RPO.

Moving to guidance for the third quarter and full year 2024. We are pleased with our execution during the second quarter and we remain prudent in our outlook for 2024. For the third quarter, we expect revenue in the range of \$423 million to \$424 million, representing an increase of 26% year-over-year. We expect operating income in the range of \$50 million to \$51 million and we expect an effective tax rate of 11%. We expect diluted net income per share of \$0.18, assuming approximately 359 million shares outstanding.

For the full year 2024, we expect revenue in the range of \$1,657 million to \$1,659 million, representing an increase of 28% year-over-year. We expect operating income for the full year in the range of \$196 million to \$198

million. We expect an effective tax rate of 11% for 2024. We expect diluted net income per share over that period to be \$0.70 to \$0.71, assuming approximately 358 million shares outstanding. We are currently analyzing our ability to implement certain tax planning strategies in order to manage current and future cash tax liabilities. We will provide an update once this tax planning review is completed if the outcome were to impact our expectations for Cloudflare's non-GAAP effective tax rate in the second half of 2024. We expect free cash flow to be consistent with our implied prior guidance of approximately \$160 million to \$164 million for the full year 2024.

In closing, our team remains committed to driving operational excellence, ensuring long-term growth and delivering significant shareholder value. I'd like to thank our employees for their dedication to our mission, as well as our customers for trusting us to help them modernize, transform and secure their businesses.

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

## QUESTION AND ANSWER SECTION

**Operator:** Thank you. We will now begin the question-and-answer session. [Operator Instructions] Your first question comes from the line of Matt Hedberg of RBC Capital Markets. Your line is now open.

### Matthew Hedberg

*Analyst, RBC Capital Markets LLC*

Q

Great. Thank you very much, guys. Congrats on the quarter. Obviously, it's a challenging environment. And to see the consistency is really, really great. Matt, maybe to start with you. [ph] As we can see (00:22:56) another quarter of double-digit sales productivity improvements, I guess, what are some of the most important changes Mark Anderson and I guess the broader team is implementing to drive that result? And given that you said macros remain challenging, is increased productivity also helped the cause of really accelerating sales cycles and improve close rates?

### Matthew Prince

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

A

Yeah. Thanks, Matt. I think we've tried to be very transparent about what we were seeing. I think the real nadir for us in sales productivity was in Q3 of 2023. And then this quarter, we're back to the same sales productivity that we saw back in mid-2022. So, we're – it is rebounding well. I think Mark Anderson gets a lot of credit for that over the last bit. But the real changes started even before Mark joined us. And I think we're starting to – we're already seeing the benefits of the changes of just really putting in place much better operational metrics, putting in place much better training, really upleveling our team, having the discipline to do performance management, and then have that flow through. And I think that's a lot of what you're seeing today.

What Mark is doing is accelerating that even more. And that starts with hiring really excellent lieutenants and really excellent leaders. It's a dramatic upgrade across our entire sales organization. And then what's been just amazing to watch is great people want to follow great people. And so, Mark has a huge number of amazing people who want to follow him. Those people who have followed him now are bringing in and upleveling our team. And what we're seeing is not only are they more productive, but then they're helping our existing team who are really amazing people get more productive as well. So, I think discipline, execution, that started before Mark Anderson. I think it's accelerating with Mark Anderson. And we have never had a product problem, we've never had a demand problem that's here. And what every sales leader who comes in says, I just can't wait to roll up my sleeves, put in place the real discipline and get out selling what is an incredible product.

**Matthew Hedberg**

*Analyst, RBC Capital Markets LLC*

Q

That's great. [ph] Something like a real (00:25:25) flywheel effect. And maybe just a quick one for Thomas. In your prepared remarks, you noted that DNR ticked down 3 points sequentially. And obviously, this is a trailing 12-month metric and you called out a number of factors that negatively impacted that metric. I guess the fact that you raised full year revenue guidance more than the Q2 [ph] beat (00:25:42), does that imply DNR has bottomed or could it see some further pressure given that you noted a larger percentage of revenue growth will come from new customers in the future?

**Thomas Josef Seifert**

*Chief Financial Officer, Cloudflare, Inc.*

A

Yeah. So, as we said on the – in my prepared remarks, the decrease was driven by slower net expansion, but it was also impacted by what Matthew described, a large pool of funds deal. So, as we entered this fiscal year, we've entered into several of these pool of fund deals. They're all very large in nature. The biggest ones, anywhere between \$40 million to \$60 million of total contract value. As a matter of fact, 4 of our top 10 customers are now pool of funds customers. And these pool of fund deals are generally built monthly as compared to an upfront annual billings, and they tend to have a longer durations. So, most of these contracts are north of three years. And as a result, the financial impact of these pool of fund deals is very different, it's very different on revenue and it's different on the current RPO and it's very different on deferred revenue. And if it's an existing customer that transitions, it also impacts DNR.

So, as it relates to revenue, the revenue is now recognized as the customer consumes the service. And as a result, the revenue recognition might be non-linear and might ramp over time with respect to deferred revenue because those deals have monthly billing terms. We do not record upfront deferred revenue, and this can result then in lower deferred revenue growth. And then current RPO is also impacted, because the contract duration is longer. So, you recognize upfront less in current RPO. So, while the deals are very beneficial and healthy to the business, they generate some noise in this transition in our DNR and in the other metrics. So, very healthy trends, will make the business a little bit more lumpy as of last year. I still think those KPIs are the right KPIs. But I think you have to look at them more from a rolling average perspective. But a very healthy development, very large deals, but with some noise and lumpiness in the transition.

**Matthew Hedberg**

*Analyst, RBC Capital Markets LLC*

Q

Super helpful. Thank you.

**Operator:** Your next question comes from the line of Shaul Eyal from TD Cowen. Please go ahead.

**Shaul Eyal**

*Analyst, TD Cowen*

Q

Thank you. Good afternoon and congrats on the results and what appears to be a swift action by Mark and the entire team. Matthew, given the recent CrowdStrike IT outage, which was on-premise predominantly, my question is whether Cloudflare was called by some customers to assist given your cloud connectivity capabilities and focus, and whether you could be seeing some longer-term benefit given this focus. And I have a follow-up.

**Matthew Prince**

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

A

Yeah, Shaul. I think we get called to help customers all the time, but we don't have a product that directly competes or replaces CrowdStrike. I think the first thing I'd say is that our whole team, we offered to help CrowdStrike directly in any way that we could, helping them get patches out or [ph] leases (00:29:21) out, helping review any communications that they had. And they have been a great partner. We are a customer of theirs. And we continue to have faith in their product and then George and the rest of his leadership team. I think more generally, though, the word of the day is going to be resilient, which is that customers are going to want to make sure that they are not sole sourced on any one vendor. And that includes with vendors like the ones that are providing network security like we do at Cloudflare. And so, when we're talking to large financial institutions, what they're saying to us is, we want to use you and someone else. That I think is going to put pressure on some of the older, more legacy providers. I think for us, it actually is potentially tailwind for us, because in places where before we had to convince someone to rip and replace, now instead we just have to say you need to have a second provider in place.

And since we have been the disruptor in the market moving from the low end up, and increasingly going into larger enterprises, I think it actually opens up more and more opportunity for us over time. So, what I'm hearing from customers is that resilience is key, that people are increasingly not wanting to be entirely reliant on any one vendor. And I think that especially in our larger – in the larger accounts that we're going after, that is actually going to open up an opportunity for us to get in, because it means we can sit side by side with someone else.

What's great though is our performance is better, our security is better and we know time and time and time again, if you put us next to anyone else in the CASB space, anybody else in the SASE space, anyone else that these vendors are looking at, we may start out as the number two vendor, but very quickly they realize that we should be number one.

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**Shaul Eyal**

*Analyst, TD Cowen*

Q

Understood. And I was listening carefully to your prepared remarks as it relates to the product, [ph] things (00:31:34) as if you're hitting on all cylinders, Magic Transit, Virtual Firewall (sic) [Magic Firewall] (00:31:39), SASE, Workers, R2, you name it. But the question is whether there was any specific one or two product, services that stood out specifically this quarter.

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**Matthew Prince**

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

A

Yeah. I think the first thing I'd say is that, and this really echoes what Thomas was just talking about, when we say that people are signing up for pool of fund deals, what they are really signing up for is to use the entire Cloudflare platform. And so more and more, we're seeing that people are saying, I'm not picking you for one feature or another, I'm picking you because the entire platform gives me a solution to all my network performance, security and reliability needs. And so I think that's what's driving a lot of our larger deals with our larger customers and think that's an incredibly encouraging result.

If you force me to pick one area that's really standing out, it's got to be the developer platform. I was blown away that just quarter-over-quarter, we'd seen a 20% increase in active developer accounts. That is especially showing up in the Workers AI platform. We've been able to partner with folks like Meta to be able to get the latest versions of Llama out on our platform. And developers are just flocking to it. And so, I think that if you look around in our developer channels or Discord channel, if you look around on Twitter, you'll see that more and more developers are betting the future of whatever their application is on the Workers platform, and they've found that they can use us and us alone to build future applications, which again, every day I get a new report from our team just saying

you won't believe what somebody built on Cloudflare Workers. So if you force me to pick one thing, and let's say Workers was the real standout of the quarter, but generally it's been the platform.

**Shaul Eyal**

*Analyst, TD Cowen*

Q

Thank you. Well done.

**Operator:** Your next question comes from the line of Jim Fish of Piper Sandler. Please go ahead.

**James E. Fish**

*Analyst, Piper Sandler & Co.*

Q

Hey, guys. Thanks for the questions here. Look, I know it's not a metric you guys completely focus in on, but it was the largest net customer additions I think you guys have had as a public company in aggregate. So, Matthew, you've had a phenomenal track record of really calling out IT spending trends and you did say some tightness still. And so, my question really is, how are customers balancing this tightness with sort of that potential total cost of ownership savings by moving on to a Cloudflare versus kind of new projects and how are you kind of thinking this could change in terms of IT spending if at all in the second half as budgets begin to be set later this year for next year, actually?

**Matthew Prince**

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

A

Yeah. Maybe I'll start and then Thomas might have something else to add. So, I do think that it continues to be a challenging IT buying environment and this was by no means an easy quarter. I'm proud of our team and execution was really the name of the game here. And I think that that increased execution will pay dividends even as the IT environment inevitably does rebound over time. But our crystal ball still shows that it's challenging, sledding for the overall IT environment over the quarters ahead. I do think that we benefit by being something that companies must have. While IT budgets might be getting cut in marketing tech, in productivity tech, in other spaces, I think security is one of the areas and we've had so many high-profile security incidents over the first half of this year, and security is an area where people are continuing to invest.

But what I think is really powerful about Cloudflare is we don't just solve one security need, we solve the totality of a customer's security needs. And so oftentimes when a customer is signing one of these pool of fund deals, they're replacing two, three, four different vendors and consolidating behind Cloudflare. And so, I think that what we see over time is that the network security space is the area that we want to own soup to nuts, and that we can completely have that as a solution for customers. And in times where IT budgets are tough, that is a place where people want to consolidate. They want to consolidate on a single vendor and we are a beneficiary of that.

[indiscernible] (00:36:16)

**Matthew Prince**

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

A

Go ahead, Thomas.

**Thomas Josef Seifert**

*Chief Financial Officer, Cloudflare, Inc.*

A

Yeah. I just wanted to add to your introduction. But it was a very strong net customer [ph] add quarter (00:36:25), mainly driven by three effects. So, we had a one-time benefit because we migrated the billing platforms and there was a catch up. But beyond that one-time benefit, it was a very strong net customer [ph] add quarter (00:36:40) driven by our two customer increase, up 32% quarter-over-quarter in the second quarter as well as the increase in developers on their Workers platform that Matthew talked about. So those three factors were driving the [indiscernible] (00:36:58). So very strong quarter.

**James E. Fish**

*Analyst, Piper Sandler & Co.*

Q

Makes sense. And you guys obviously – pool of funds is another theme of this quarter. And Thomas, you addressed that a few moments ago. I believe that it was 4 of the top 10 customers are now on this type of contract. So, is there a way to understand how much of RPO is now on the sort of pool of funds path? Even just those four at that kind of [ph] \$50-ish million (00:37:25) average rate would imply about 15% of RPO today. And additionally, what could that look like kind of a few years down the road?

**Thomas Josef Seifert**

*Chief Financial Officer, Cloudflare, Inc.*

A

Well, I will not give you that kind of information. But what you just said, I think it's a good indication. We've always been asked how we drive customer revenue up and how you can get to three-digit million dollar ACVs and TCVs, pool of funds will be that path. And Matthew outlined the reasons for that. In addition to the pool of fund deals, we – in the second quarter, we also entered into a handful of very large subscription arrangements, all well north of \$5 million. And those are more predictable from a revenue recognition and forecasting perspective, but there's very similar impacts on RPO and deferred revenue. So, in addition to the pool of fund structure impacting us, generating this lumpiness in the quarter, we are also successful signing very large subscription arrangements in the second quarter, too.

**James E. Fish**

*Analyst, Piper Sandler & Co.*

Q

Great. Thanks, guys.

**Operator:** Your next question comes from the line of Andrew Nowinski of Wells Fargo. Please go ahead.

**Andrew James Nowinski**

*Analyst, Wells Fargo Securities LLC*

Q

Okay. Good afternoon. Congrats on another amazing quarter. So, I wanted to ask a bit of a techie question to start here, as it relates to your edge AI and your OHTTP offering. Now, I know you're one of the Co-Founders of OHTTP, but I was wondering if you could comment on how your customers might be using it as a way to preserve data privacy and maybe give us an idea on the revenue opportunity there.

**Matthew Prince**

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

A

Sure. And this might – I'm not sure how to do this and not make a little bit geeky. But OHTTP, the original [ph] spin (00:39:29) of the [indiscernible] (00:39:31) – the original [ph] spin (00:39:33) of the Internet is that your IP – forget cookies, forget anything else. Your IP address alone reveals a ton about who you are, where you are, and a bunch of other things. Your IP address in your home, for instance, doesn't change all that often. And so even without cookies, even without anything else, people can build profiles of you. As privacy has become more and

more important and then recognized as being more and more important online, I think one of the things that our team with a number of other industry partners and leaders has really focused on is how can we eliminate that original [ph] spin (00:40:14), how can we disassociate your IP address from your identity.

And so OHTTP is a technology that does it. The best way to think about it is it's essentially two hops in the system. So, if your device connects to the first proxy that is out there, that proxy knows what device is connected to it. But then it can use encryption to wrap that identity piece up, much like putting it in an envelope and handing it off to a second proxy. And that second proxy is the only thing that knows where that traffic is going. So one party can know who is behind something and the other party can know where they're going, but neither party knows both – where any one individual is going. So, you can imagine in the case of like a handset manufacturer, they may operate that first proxy, because they operate the handsets themselves, but then hand that off to a party like Cloudflare in order to never have the information about where their customers go online. I think that what's interesting about this is that the very nature of the protocol requires an independent third-party. So at no point can the handset manufacturers say, we're going to complete this soup to nuts. They have to have an independent third party and the third-party of choice and that's, I think, a large part because privacy has been so core to who Cloudflare is and what we do is one of our five core values in terms of when we think about products.

And because of just our breadth and technical expertise, as more and more companies are thinking about this and recognizing that, for philosophical reasons, but then also for regulatory reasons, that they need to be as private as possible. Cloudflare is that preferred place to be that second hop in an OHTTP solution. So, I have been – I think we built this for some very specific and I would have thought relatively limited use cases. I am surprised how many different use cases this is now getting introduced into. And I think that as AI continues to develop, it's an area where a lot of people are rethinking the privacy of the Internet and thinking about how can they incorporate more modern standards. And to that extent, I think you will see that if there is continued growth in this space, it actually may be a lot of the AI companies that are leading in that direction.

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**Andrew James Nowinski**

*Analyst, Wells Fargo Securities LLC*

Q

Great. Thank you. That was really helpful. Maybe a question for Thomas as well. Just really impressive operating leverage in the model and a strong guide for the year. And I know you're not giving fiscal 2025 guidance yet. But given the substantial raise to your operating margin for this year, I was wondering if you could at least tell us how you're thinking about operating leverage next year and whether you'd expect operating margin expansion above the new guidance you gave for this year. Thanks.

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**Thomas Josef Seifert**

*Chief Financial Officer, Cloudflare, Inc.*

A

Yeah, nice try. But I'm not going to give guidance for next year. But I think over the years, we have been good stewards of investors capital and this will continue. Matthew and Michelle described how we – the philosophy, how we run the business really well. And as long as we see a market that is this large in terms of TAM that we can disrupt and deliver strong growth rates, investment into Cloudflare is the best return for the money that we earn. And keeping this balance in terms of how we think about the business of growth rate and operating leverage I think served us well. And we'll continue, we'll not deviate from this philosophy in next year. But I will shy away from giving you guidance.

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**Andrew James Nowinski**

*Analyst, Wells Fargo Securities LLC*

Q

Okay, thanks. Keep up the good work, guys.

Operation: Your next question comes from the line of Adam Borg of Stifel. Please go ahead.

**Adam C. Borg**

*Analyst, Stifel, Nicolaus & Co., Inc.*

Q

Awesome. And thanks for taking the question. Maybe just building off the last question a little bit and even tying it back to some of the wins you talked earlier on AI. How are you thinking about the inference opportunity overall? When you think about hyperscale cloud, obviously the edge network that you built as well as the edge device themselves, how do you think about how that relationship looks like today and how that evolves over time?

**Matthew Prince**

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

A

Yeah, Adam, my take is that inference is primarily going to happen in two places. The first is on devices themselves. And that you can already see what a number of handset manufacturers and others are doing to bring more powerful GPUs and TPUs directly to devices. In my [ph] rough hand way (00:45:30), the – I have no idea if it will be right. But just as a mental model is that maybe 50% of inference tasks get handled on your device. But there will always be either devices which are older and maybe don't have the latest chips on them, or models that are bigger and require more compute power than your handheld or device is able to deliver. And in those cases, you're going to have that inference task off to something else. One model of that is to send that back to Ashburn, Virginia, or some centralized sort of traditional public cloud. I think that especially, because of the concerns around privacy, because of the regulatory concerns where AI is getting just rapidly regulated, that you're going to want to keep that as close as possible and that also has the benefit of making it as performant as possible. And it also means that you can have the AI that's responding have regional differences more easily, so that if you're responding in the UK, then AI can spell color with U, whereas if it's in the US, it can spell it with no U.

I think all of those things then drive a lot of the other 50% of inference tasks to be running at a network like Cloudflare. And so we are trying to build that network out ahead, make sure that we can answer any inference path that can't get determined on your own device as close as possible to that device. And then make it very easy to get that inference task from us or from the device to us in a standard based API driven way so that it's seamless to that end user. There will still be some tasks that maybe will be even too big to run it off. Although that is becoming a smaller and smaller list of task and maybe there's some small percent that makes its way back to a traditional hyperscale public cloud. But I really think that inference is going to be between the end devices themselves and a network that is like Cloudflare that spans the globe and is incredibly close in every jurisdiction where end users might be.

**Adam C. Borg**

*Analyst, Stifel, Nicolaus & Co., Inc.*

Q

Awesome. Thanks so much.

**Operator:** Your next question comes from the line of Fatima Boolani of Citi. Please go ahead.

**Fatima Boolani**

*Analyst, Citigroup Global Markets, Inc.*

Q

Good afternoon. Thank you for taking my questions. Matthew and Thomas, this is for you both. I had a bigger picture question around the pricing strategy across the portfolio. So at a tactical level, you had some meaningful price increases that – your first ones ever. Thomas, wondering if you could just opine on how far deep those have pervaded the installed base and if you can kind of talk to where we are in terms of the innings, in terms of how

that unfurled in the base. And then, Matthew, the bigger picture question for you is, if I piece together a lot of what you shared in the prepared remarks as it relates to pool of fund deals, more pay as you go, more consumption, payment modalities, especially as the Workers portfolio scales, how should we generally think about the business impact and sort of revenue elasticity, if you will? Thank you.

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**Matthew Prince**

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

A

I'll start and then Thomas can add, and I think we might both have something to say on both pieces. So, we're about a year after a price increase across our pay as you go business. That is a – it's an important part of our business but it is a relatively small part of our business. I think we, for a long time, were very reluctant to raise prices on that part of the business. But we had added so much value that we just thought that it was the right thing to do. And we were really incredibly pleasantly surprised how many of the customers, the pay as you go customers, not only [indiscernible] (00:49:59) our churn rates were tiny due to that price increase, but really actually wrote to us and said, about time because there's so much more value that you've added. And that was good.

Price increases didn't apply across the rest of the platform. So, enterprise customers, all the customers we talk about on these calls, there wasn't any dramatic price increase there. I think we are always trying to find ways to have the highest ROI for our large customers and typically we can be a substantial savings over whatever the existing vendors are in the market. And because we have the efficiency in our business, we can do that while still maintaining 70%, 78%, 79% gross margins. Our long-term target gross margins are 75% to 77%. And we've been coming in ahead of that. And again, very healthy software like gross margins even for a business with the operational complexity and intensity that we have. And I think that's what allows us to deliver the returns that we can.

Generally, I think philosophically, what we want to do is be the network for all of our customers. And we want to solve all of the problems that a customer has around their network. And so we think of it as being their connectivity cloud. And that connectivity cloud works great with whatever devices and things they have on premise, works great with whatever they're running in a traditional hyperscale public cloud. But we're that connectivity layer that sits between those things, and that's a very, very, very substantial opportunity, and one that I think we have only just started to really, really penetrate.

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**Fatima Boolani**

*Analyst, Citigroup Global Markets, Inc.*

Q

Appreciate that.

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**Thomas Josef Seifert**

*Chief Financial Officer, Cloudflare, Inc.*

A

There's not much to add to what Matthew just said. Some of the impacts of this transition you've seen. We talked about how pool of funds deal impact the lumpiness or make our numbers a little bit more lumpy. We will also have an increasingly higher share of variable revenue in our numbers. While this number is still small today, it will grow meaningful over time. But this is less driven by price increases as Matthew said, but it's more driven by the structural changes that this transition implies. And with all the overall benefits of more stickiness, longer duration deals, platform [ph] deals (00:52:44) with better expansion capability and significantly higher total contract values.

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**Fatima Boolani**

*Analyst, Citigroup Global Markets, Inc.*

Q

Thanks for the color.

**Operator:** Your next question comes from the line of Hamza Fodderwala of Morgan Stanley. Please go ahead.

**Hamza Fodderwala**

*Equity Analyst, Morgan Stanley & Co. LLC*

Q

Hi. Good evening. Thank you for taking my questions. Matthew, I just had one question on public sector for you. We saw a lot of strong momentum in the public sector space and the federal space over the last year. I'm curious, as we head into the federal fiscal year close in September, what that momentum has been like, especially ahead of what's going to be an election in November? What are you hearing from the agency customers that you work with? Thank you.

**Matthew Prince**

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

A

Yeah. So federal has been a real point of strength for us ever since we started investing in it and ever since we achieved FedRAMP certification, which really unlocked a lot of US Federal business. But we've seen also strong government business around the world. I would say, first of all, the election is incredibly important. We couldn't have built Cloudflare without a stable, functioning democracy, and you can't have stable, functioning democracies unless you have elections that people can trust. And so since 2016, actually directly in response to the – a lot of mistrust and tampering in the 2016 election, we launched what we call the Athenian Project, where we provide our services at no cost to anyone who is helping administer an election around the world and – or excuse me, around the world, around the United States, although we've increasingly started doing it in select countries around the world as well.

And I'm incredibly proud of the work that we do on this to help support what our largely unsung heroes, and I don't care if it's a red state, or a blue state, or a purple state. Like if you're helping administer an election in some county around the United States, you're a real patriot and a real hero and you need all the help and protection that we can give. And I'm proud of the fact that our team on a pro bono basis provides the full suite of our services to the people who are administering elections, because I think it's fundamental for the success of our country, and our country is fundamental to the success of the company. So I'm not sure that the election itself drives significant upticks in spending, and I feel kind of a little gross if it did, because I think it's our duty to provide our services in these cases.

What I will say is that I think most of the people who are listening in on this call would say that it's not always the most rational thing to go work for government, certainly doesn't pay the best that's out there. But I think what government – the government officials that I've talked to, the public servants that I've talked to, again, across the political spectrum, what they all are is very mission driven. And they believe in the mission of – in the United States, of this country and the importance of that. And I think that they very much respect when they see companies like Cloudflare step up and say, it's not just all about how we collect the most revenue, but it's how we do the right thing to protect the underlying function of democracy. And so when you hear about us winning big deals that are big numbers and large revenue producing deals, I think a lot of that comes from the fact that we are thought of extremely well by those incredibly patriotic, very mission driven people who are public servants. And when they're thinking about when they have a hard problem that they are going to pick a vendor for, who they turn to, the work that we do on things like the Athenian Project and protecting elections is part of why we've had the momentum and the success that we've had with the Federal business. And I think that that will continue and only accelerate over the quarters and years to come.

**Hamza Fodderwala**

*Equity Analyst, Morgan Stanley & Co. LLC*



Thank you.

**Operator:** Your next question comes from the line of Trevor Walsh of JMP. Please go ahead.

**Trevor J. Walsh**

*Analyst, Citizens JMP Securities LLC*



Great. Hi, team. Thanks for taking my question. Maybe just one question for me within a couple of parts. Matthew, you had a good win story that you had in your prepared remarks. I think it was with the Australian tech company, a SASE deal, where they had also purchased Workers. Curious how much you're leaning into those SASE deals where [ph] an X3 (00:57:50) product such as Workers is kind of coming into the fold and how important of a differentiator you see that within that particular market. And then as a follow up, you had your Descaler campaign last year that kind of handle campaign against one particular competitor in that space. Just curious if you're seeing that overall competitive landscape shift at all kind of in the last 12 months. And if we might see a similar campaign against another competitor there. Just maybe just get your overall thoughts out who you're seeing in the deals if there is other players kind of coming up from different parts of the market that are not the standard ones that you have come up in the past. Thanks.

**Matthew Prince**

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



Yeah. I think that the thing that we can do that's very difficult for any point solution vendor to compete with is provide a comprehensive solution. And so, again, if the theme is pool of funds, platform deals, broad deals, Workers is a part of that. It is not as big of a part as our traditional application security. If you – it doesn't make any sense if you're going to do a SASE deal to not have the same vendor, also providing your DDoS mitigation, and we're really the only vendor in the space that can do both the traffic coming into your network and the traffic going out from your network. But it's just the network, like the networks would be smart and it should be – that you should provide one kind of holistic solution. I don't know yet of any real vendors where people have said, oh, I'm – or any real customers where people have said I'm going to choose your SASE solution because of Workers. There are places where people are using Workers and then they either use our SASE solution and those things go together. But I think you'll start to see more of that going forward.

The really powerful thing comes back to sort of the origin story of Workers itself. We didn't build Workers to sell it to the developer platform. We built it because we saw all of these opportunities and we needed a developer platform for our internal team, customer zero, to be able to build different solutions. What's powerful about that is that that then means that that same platform can be used to adapt, configure, customize any of the solutions that are built on Workers more so than you can with any other vendor that's out there because you're using that same developer platform. I don't think that that's – I don't think we're there yet in terms of customers. I think we're still in the kind of just get it up and running stage, and not just us. I think across the entire space, SASE is a new enough category. But over time, I think when people will go from saying, first of all, I want a secure network. Secondly, I want to make sure it's reliable. Third, I want to make sure that it is fast, it's performant. I think the next thing that people come to is I want to make sure it's programmable.

I think we are still kind of in the secure and reliable stage. I think customers are coming to us away from some of the first generation Zero Trust and SASE vendors because we are secure, reliable and fast. But over time, secure, reliable, fast and programmable is a pretty killer combination that I don't think there's any other vendor out there that's going to be able to match.

**Trevor J. Walsh**

*Analyst, Citizens JMP Securities LLC*



Great. I appreciate the perspective. Thanks.

**Operator:** That concludes our Q&A session. I will now turn the conference back over to Mr. Matthew Prince for closing remarks.

**Matthew Prince**

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

Just wanted to say thank you to the entire Cloudflare team. This quarter, really the theme was execution, and you guys executed incredibly well. Thank you to the team. Thank you to all of our customers. It continues to be a complicated world out there, but Cloudflare is helping better secure networks everywhere around the world. Thank you all. See you back here next quarter.

**Operator:** Ladies and gentlemen, that concludes today's call. Thank you all for joining. You may now disconnect.

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