



Fastly, Inc. (FSLY)
Q2 2020 Earnings Call
August 5, 2020

Corporate Participants

Maria Lukens

Vice President - Investor Relations, Fastly, Inc.

Adriel G. Lares

Chief Financial Officer, Fastly, Inc.

Joshua Bixby

Chief Executive Officer & Director, Fastly, Inc.

Artur Bergman

*Chief Architect and Executive Chairperson and
Chairperson of the Board of Directors, Fastly, Inc.*

Other Participants

Robert Majek

Raymond James & Associates, Inc.

Rishi N. Jaluria

D.A. Davidson & Co.

Brad Robert Reback

Stifel, Nicolaus & Co., Inc.

Timothy Horan

Oppenheimer

Will Power

RW Baird & Co., Inc.

Rudy Kessinger

Craig-Hallum Capital Group

Jonathon Ho

William Blair & Company

Tal Liani

Bank of America

Brad Zelnick

Credit Suisse Securities (USA) LLC

Walter Pritchard

Citigroup

Management Discussion Section

Operator

Operator

Good afternoon. My name is Josh, and I will be your conference operator today. At this time, I would like to welcome everyone to the Fastly Second Quarter 2020 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. If you would like to ask a question during this time, simply press star, followed by the number one on your telephone keypad. If you'd like to withdraw your question, press the pound key. Thank you.

I would now like to turn the conference over to Maria Lukens, Vice President of Investor Relations. Please go ahead.

Maria Salazar Lukens

Vice President - Investor Relations, Fastly, Inc.

Hi, everyone. Thank you for joining our Second Quarter 2020 Earnings call.

We have Fastly's CEO, Joshua Bixby; Chief Architect and Executive Chairperson, Artur Bergman; and CFO, Adriel Lares with us today.

I want to remind everyone about the format of our call. We published a Shareholder Letter on our Investor Relations website and with the SEC about an hour ago. We hope everyone had a chance to read it. Since the letter provides a lot of details, we will make some brief opening remarks and reserve the rest of the time for your questions.

During this call, we will be making forward-looking statements, including statements related to the expected performance of our business, future financial results, strategy, long-term growth and overall future prospects. These statements are subject to known and unknown risks, uncertainties and assumptions that could cause actual results to differ materially from those projected or implied during the call. Please take a look at our filings with the SEC, and in particular, the risk factors within those filings, and our Q2 2020 Shareholder Letter for a discussion of the factors that could cause our results to differ. Also note that the forward-looking statements on this call are based on information available to us as of today's date. We disclaim any obligation to update any forward-looking statements except as required by law.

Also, during this call, we will discuss certain non-GAAP financial measures. Reconciliations to the most directly comparable GAAP financial measures are provided in the Shareholder Letter on our Investor Relations website. These non-GAAP measures are not intended to be a substitute for our GAAP results.

Finally, this call is being webcast and will be archived on our website shortly afterwards.

With that, I'll turn the call over to Joshua.

Joshua Bixby

Chief Executive Officer & Director, Fastly, Inc.

Thanks, Maria. Hi, everyone, and welcome. Thank you for joining us today. We hope that you are all keeping healthy and safe.

Q2 was another exceptionally strong quarter for Fastly in a world that continues to change rapidly. The structural and societal changes resulting from this pandemic have continued to significantly accelerate the need for organizations to prioritize their digital transformation. We are in some of the most uncertain times in modern history, but we now see clearly that the major shift to digital will be long-lasting.

The need for a trustworthy and modern edge platform has never been greater. Developers and security operators are at the center of this transformation and they can only drive transformation effectively if they can build quickly and securely. We believe in developer and security operator empowerment. We partner with them to create simplified, frictionless, fast and secure solutions at scale to support the evolving needs of billions of users around the world. The strength of our Edge platform continues to show in our results. Fastly delivered another quarter of solid execution, thanks to the team's continued focus and performance. We delivered exceptional top line growth, generating \$75 million in revenue, which was up 62% year-over-year. Despite these turbulent times, we continue to see robust customer adoption of our Edge platform and security products by both new and existing customers across multiple verticals and geographies.

We grew our total customer count to 1,951 from 1,837 in the previous quarter, the largest quarterly increase since going public. Our enterprise customer count grew to 304, up from 297 last quarter. We are pleased with the number of new enterprise customers as well as customers who grew into the enterprise category. However, this strong growth was offset by some customers falling out of the category in COVID impacted industries.

In addition, ByteDance, the operator of TikTok was our largest customer in the quarter. Any ban of the TikTok app by the U.S. would create uncertainty around our ability to support this customer. While we believe we are in a position to backfill the majority of this traffic in case they are no longer able to operate in the U.S., the loss of this customer's traffic would have an impact on our business.

Our average enterprise customer spend increased to \$716,000 from \$642,000 in the previous quarter. Our existing customers are relying on us more and more as reflected in our increased net retention rate of 138%, up from 130% last quarter, and dollar based net expansion rate of 137%, up from 133% last quarter.

Looking ahead, developers now more than ever need to build differentiation at the edge and rapidly adopt new architectures. This is why we continue to invest in our network and offerings, specifically, Compute@Edge and security.

Many of our customers are further embracing Compute@Edge, our real-time serverless architecture, for high performance applications. This quarter we enhanced our offering with valuable new observability features, including logging, tracing and granular real-time metrics, bringing observability to the forefront of the serverless computing environment. We are on track for and expect to further expand the availability of Compute@Edge. We continue to learn from our customers and are inspired by the variety of innovative use cases we are enabling, including new ways they're thinking about security.

As transformation drives more code and applications to the edge, it's evolving into an increasingly critical place to secure websites and applications. This quarter, we delivered new key security features, including Fastly flow control. Security has always been a key focus for us and we will continue to invest significantly in this area.

We are also continuing to scale and build our network at a record pace to meet today's digital demand. We reached 100 terabits per second of global capacity, an important milestone for us, representing 35% growth since the beginning of the year.

Our results and guidance reflect that Fastly is uniquely positioned to empower our customers and we'll continue to drive growth during these uncertain times.

With that, I will turn it over to Adriel to walk through the financial details.

Adriel G. Lares

Chief Financial Officer, Fastly, Inc.

Thank you, Joshua, and thank you, everyone, for joining us today.

Fastly had a strong second quarter, as reflected in our results and raised 2020 guidance, which I will talk about in little more detail shortly.

First, I want to briefly touch upon some of the key financial results.

This quarter, we generated \$75 million in revenue, representing 52% year-over-year growth. We also continued to deliver a healthy gross margin as we continue to scale.

GAAP gross margin was 60.2% for the quarter, up from 55% in the same quarter last year. Non-GAAP gross margin was 61.7% for the quarter, demonstrating increased leverage of our

software-defined network, realizing over 600 basis points of operating leverage improvement year-over-year.

As we have said in previous quarters, our gross margin will continue to be impacted by the timing of personnel and infrastructure investments, along with the seasonal fluctuations of platform usage by our customers. Despite continuing economic uncertainty, we remain confident in our ability to deliver incremental annual gross margin expansion, as we continue to scale and deliver innovative security and edge computing solutions.

Finally, this quarter marked a significant shift towards profitability as we delivered our first quarter of positive EBITDA.

Turning to the balance sheet. We bolstered it with a successful follow-on offering and ended the quarter with \$454 million in cash, restricted cash and investments and marketable securities. We're pleased to have a strong balance sheet and liquidity as we navigate the current uncertain economic environment.

We remain optimistic about our strong fundamentals, the demand for our mission critical services and the underlying growth of our business into Q3 and future periods. That's why we're raising guidance again for the full year 2020.

For the third quarter, we expect revenue in the range of \$73.5 million to \$75.3 million. Non-GAAP operating income in the range of negative \$1 million to positive \$1 million. Non-GAAP net income per share in the range of negative \$0.01 per share to positive \$0.01 per share.

For the full year 2020, we increased our revenue guidance range to \$290 million to \$300 million from \$280 million to \$290 million. Non-GAAP operating loss range to minus \$12 million to minus \$2 million from minus \$20 million to minus \$10 million. Non-GAAP net loss per share range to minus \$0.06 to minus \$0.01 from minus \$0.15 to minus \$0.08.

In closing, we continue to believe we are well-positioned to execute and further our growth. Our Edge platform and product offering serve a diversified customer base that continues to acquire more from Fastly to fuel innovation. We have a strong balance sheet and we'll continue to strategically invest in our network and offerings, including Compute@Edge and security.

Finally, we believe the ongoing pandemic has permanently accelerated the need for businesses to focus on digital transformation. Fastly is focused on helping developers adapt their business and succeed in the world that emerges by providing a fast, secure and reliable edge platform that evolves with their needs.

With that, I'll turn it back to the Operator to take your questions.

Question and Answer Section

Operator

Operator

At this time, I would like to remind everyone in order to ask a question, please press star, then the number one on your telephone keypad. If you would like to withdraw your question, please press the pound key.

Your first question comes from Robert Majek with Raymond James. Please go ahead.

Robert Majek

Raymond James & Associates, Inc.

Thanks. My question's around the image delivery business. Part of what you're offering there is personalization at scale. Can you just elaborate on that driver? And then furthermore, I'm curious if your mix of business is shifting towards image delivery, and if so, what impact that might have on revenue growth given the higher average selling prices?

Joshua Bixby

Chief Executive Officer & Director, Fastly, Inc.

Hey Robert, it's Joshua. So, image optimization and the idea of doing personalization at the edge is obviously inherent in the underlying story of Fastly. We started out with edge programmability. It was key to us. In general, IO remains a very strong part of the business. It really is vertical dependent and some verticals absolutely rely on it. We're seeing some really innovative use cases around image when it comes to Compute@Edge, but we continue to see this—when you look at the growth for the quarter we continue to see it widespread across verticals, across geographies and strong. We are not seeing a significant shift in our business in any way. Actually, the business mix for this quarter was the same as last quarter. So this is just about broad, strong growth across all sectors and image optimization included.

Robert Majek

Raymond James & Associates, Inc.

And then perhaps just one more from me. I know it's early on for Compute@Edge, but curious to see if you could just highlight some of the interesting use cases that customers are exploring today.

Joshua Bixby

Chief Executive Officer & Director, Fastly, Inc.

Yes, absolutely. I'd turned to Artur who's deep in this. Artur, I know you have some interesting stories in this.

Artur Bergman

Chief Architect and Executive Chairperson and Chairperson of the Board of Directors, Fastly, Inc.

Yes. Hello everyone. Good to be talking to all of you again. Yes, we started to see more early our beta customers doing POCs and testing and we've seen a couple of use cases come up. One is a online retailer that wanted to migrate availability, stock-in pricing microservices to the edge so they can deliver live updates and faster updates to end users. We have another use case about—also an online retailer where they want to do much smarter waiting rooms, tokens to purchases so that they can be more responsive, simplify their own architecture and be more fair in how those tokens are handed out. We have other online retailers that want to cache way more data at the edge and personalize responses even when their origins are overloaded because of surges so they still deliver the best they can. We have examples of in the video of someone who wants to do significantly smarter health checking of their origins from each edge so that they can pick the best origin, the best live encoder so that there's less buffering and CABAC (phon) interruptions.

So it's kind of a little bit all over the place, but really some that we expected and some that I think are more advanced than I would have expected at this point in time.

Robert Majek

Raymond James & Associates, Inc.

Great.Thanks a lot.

Joshua Bixby

Chief Executive Officer & Director, Fastly, Inc.

Thanks Robert.

Operator

Operator

Your next question comes from Brad Reback with Stifel. Please go ahead.

Brad Reback

Stifel, Nicolaus & Co., Inc.

Great. Thanks very much. Joshua, maybe we could dig a little bit more into TikTok. Can you give us a sense of what percent of the traffic is U.S. versus rest of the world and maybe just high level what percent of revenue it represents for you?

Joshua Bixby

Chief Executive Officer & Director, Fastly, Inc.

Sure. So, over the last six months it represents just about 12% of revenue trailing six months ending June 30. Less than 50% of that is in the U.S. We continue to monitor the situation closely, obviously. What's unique about TikTok in this sector and other apps that are on us is that they are an innovator, and like historically with the innovators that we have we are working with them,

with the innovators in the high value areas of the business. So think about APIs and other areas, not just the delivery of video which is also something we help with when it's important.

So, we have looked at this risk. We obviously wanted to make sure everyone heard about it. As I stated in the prepared remarks, we are very confident because of our strategy on how we've looked at this side of traffic that there is a meaningful amount of traffic that we could pull on to the network and in case something didn't move in the right direction at short notice. But that's not what we're seeing today.

Brad Reback

Stifel, Nicolaus & Co., Inc.

Great. And then Adriel, just following up on this line of thought. As you look at the back half guidance have you assumed status quo with TikTok or have you made any changes in the assumptions? Thanks.

Adriel G. Lares

Chief Financial Officer, Fastly, Inc.

Hey Brad. Yes, nothing at this time. I mean, we're sort of assuming a little bit of status quo at this moment and again, as Josh has sort of mentioned, as you get to sort of the latter half of the year also will give us a lot more time to react. So that's sort of built into that.

Brad Reback

Stifel, Nicolaus & Co., Inc.

Perfect. Thanks very much.

Joshua Bixby

Chief Executive Officer & Director, Fastly, Inc.

Thanks Brad.

Operator

Operator

Your next question comes from Will Power with Baird. Please go ahead.

Will Power

Analyst, Credit Suisse Securities (USA) LLC

Great. Thanks so much, and congrats on the strong momentum and being there to power so many of the digital experiences we've become only more dependent on during the last couple of months. Joshua, maybe for you, just as we try to understand the demand and CapEx dynamics that we're seeing here in the numbers and that you've spoken to, were you at all constrained from a capacity perspective in Q1 as the pandemic hit in any region? And can you talk about where the average utilization of the network was in March maybe compared to prior months or even a year ago? And how has utilization been since then?

Joshua Bixby

Chief Executive Officer & Director, Fastly, Inc.

Sure. Let me answer at the high level and then Artur has been very deeply involved in some of this, so I'd love to get his perspective on this as well. I think what you see in the CapEx numbers, obviously, is that we recognized very early that there was something amiss in the numbers. One of the amazing things about being the platform for innovators is that you get a bit of an early warning sign of what innovative companies will do, and we saw them well before we closed our business in March. We saw them start adapting and so we adapted.

So what you're seeing in that CapEx number is us being proactive in pulling some of the CapEx that normally would have been in Q2 up into Q1 in order to deal with any particular capacity need. We've talked in the past about being such a high-growth business that we always have to have room on the network and thankfully we have that. I think Artur is probably in a good position to give you some more insight into the specifics. But, ultimately, we saw it early and we were very well prepared.

Artur, anything else to add to that?

Artur Bergman

Chief Architect and Executive Chairperson and Chairperson of the Board of Directors, Fastly, Inc.

Yeah. We have had significant growth in usage. We've had a couple of places that have had run harder than we kind of wanted, but we've had capacity nearby that has been able to handle that traffic without a problem. We did publish the blog post, Joshua mentioned earlier, couple of weeks ago that kind of has some of the countries in there that shows load.

But our general locality of how we want to grow the network and the kind of spare capacity we want to have because of our rapid growth certainly served us well when this hit because we used up some of that – or fair amount of that spare capacity, but that was – that supply was there and that's why we – how we forecast out into the future. So we have not been constrained on capacity to our customers. We have been able to deliver what they purchased in the past and what they're purchasing and asking for right now.

Joshua Bixby

Chief Executive Officer & Director, Fastly, Inc.

One thing, Brad, I think you know...

Brad Zelnick

Analyst, Credit Suisse Securities (USA) LLC

Thank you, guys. That's good...

Joshua Bixby

Chief Executive Officer & Director, Fastly, Inc.

...you're well familiar with, of course, is the sort of the efficiency of the network, and that certainly has been a strong part. Our software-defined modern network is very different obviously than our competitors' networks or the competitor – the entire subset of the competitive network and our ability to do the same with in the orders of magnitude less servers certainly played into this as well. And I think that efficiency just continues – or the gap in that efficiency just continues to build for us.

Brad Zelnick

Analyst, Credit Suisse Securities (USA) LLC

Makes perfect sense to me. Maybe if I can just follow up with a quick one for Adriel. Adriel, your guidance implies nice leverage in the business and appreciate your comments on gross margin leverage. But more broadly, how are you thinking about the path to profitability in your current capital position here? Has anything changed just given what's going on in the world?

Adriel G. Lares

Chief Financial Officer, Fastly, Inc.

Thanks, Brad. And, I mean, generally, we felt good about our path to profitability sort of pre-COVID. I think we feel just as good about it, if not maybe a little bit more confident about it, just based on the fact that we are seeing stronger demand which is reflected in our sort of annual top line revenue guidance. And so, from where we are from the cash position, where we are from the profitability position, I would say that nothing's changed other than [indiscernible] (00:27:04) incrementally more confident if and everything we're seeing at that time.

Brad Zelnick

Analyst, Credit Suisse Securities (USA) LLC

Awesome. Thank you so much, guys.

Joshua Bixby

Chief Executive Officer & Director, Fastly, Inc.

Thanks, Brad.

Operator

Operator

Your next question comes from the line of Will Power from Baird. Your line is open.

Will Power

RW Baird & Co., Inc.

Okay, great. Thanks. Yes, I guess maybe just following up on that a bit, Adriel. I wonder if you could just talk about more broadly the factors that are informing Q3 guidance. When I look historically normally you have a pretty good pickup sequentially from Q2 to Q3 and guidance assumes something that's flatter to maybe down slightly at the midpoint. So just trying to figure out how much of that is conservatism versus maybe any change in trend. And I guess along

those lines maybe I can kind of get your sense for what you have been seeing in traffic trends as you go from May, June into July.

Adriel G. Lares

Chief Financial Officer, Fastly, Inc.

Hey Will. Yes, so in general, we do see, we begin to see some pickup from sort of Q2 to Q3. I think the thing to keep in mind clearly is Q2 of this year relative to previous years, seasonally Q2 versus Q1 is actually relatively flat. Clearly that's not what we experienced this year, so I think you have a bit of a comparison challenge when you think about Q2 to Q3. The fact that we're still at the midpoint here getting some pretty strong year-over-year growth rate I think is worth noting. So from our standpoint, we had built in last quarter the idea that folks would be getting back to sort of a normal life from a shelter in place, the behavior from before, and we're beginning to see that sort of a mixed bag. It's mostly coming through but that's what's a little bit uncertain here is kind of the rest of the world and in some respects the rest of the United States is going to sort of play that out.

So, in some respects the normal seasonality being thought of in Q4 but with respect to Q3 it's somewhat perspective ameliorated a bit by the comparison to a very, very strong Q2.

Will Power

RW Baird & Co., Inc.

Okay. If I could just follow-up, sticking on the financial side. Gross margins were a good deal stronger. Maybe talk about some of the benefits to gross margin and how we think about the trajectory for that going forward from here.

Adriel G. Lares

Chief Financial Officer, Fastly, Inc.

Yes, we definitely, as you note, last quarter I did for the first time actually talk about the fact that I was going to be guiding gross margins sequentially upward. So I was pleased to see that we were able to deliver pretty meaningful growth quarter-over-quarter, let alone from year-over-year. I think given that we're normalizing Q3 over Q2, I'm going to give the mix of traffic. I think of the thing that always makes that challenging to project. I do believe that on an annual basis we're going to still contribute well over 100 basis points year-on-year. So I feel pretty confident about the leverage we're going to deliver this year. I think when we go into now the normalized Q3 versus Q2, I'm going to sort of hold before guiding a little bit where it grows, margins are going to grow from here.

Will Power

RW Baird & Co., Inc.

Okay, great. Thank you.

Joshua Bixby

Chief Executive Officer & Director, Fastly, Inc.

Thanks Will.

Operator

Operator

Your next question comes from Jonathan Ho with William Blair. Please go ahead.

Jonathan Ho

William Blair & Company

Hi, good afternoon. I just wanted to maybe start out with maybe if you could quantify for us—and I know this is challenging, but just a rough sense of how much COVID-19 and stay at home actually contributed to growth this quarter.

Joshua Bixby

Chief Executive Officer & Director, Fastly, Inc.

Yes, it's Joshua here. Jonathan, I mean, that is hard to assess in general. I mean, we are not projecting, as you see in our guidance, that this is sort of a one-time event and we are assuming and we are seeing that there's long-term sustained improvements here. I think Fastly is in this unique position to be a usage based model with the most innovative companies in the world. And so when you stack on the most—the largest innovators and you looked just at their results, whether it be Pinterest or Shopify or the list goes on and on, I think what you're seeing is just really strong strength, and if you look at the stories, those companies are telling sustained strength.

So, hard to parse out. I think this is a factor of the innovators are continuing to gain tremendous momentum and we think these are—this is a generational shift in some of these industries. But I think the other thing that is particularly exciting about this quarter from our perspective is looking at the new customer count. So this isn't just about the people on the platform, this is about the largest increase that we've seen in net new customers and the selling environment that has obviously changed. I think seeing the early success, which we talked about in the last earnings call, is we've seen a couple of weeks of this. I think this quarter demonstrates a much more sustained story arc which is strength going forward in that regard.

It's hard to parse out, but we are seeing that sustained strength going forward, unquestionably.

Jonathan Ho

William Blair & Company

Got it. And then just in terms of the wins that you highlighted on the quarter and sort of the digital transformation side of things, what were some of the main determining factors in terms of why companies (audio interference 21:33-21:38)

Jonathan, I heard you check out there.

Operator

Operator

This questioner has dropped. Your next question comes from...

Joshua Bixby

Chief Executive Officer & Director, Fastly, Inc.

I'll actually try to answer that question because I know where it was going in terms of sort of story arcs of why we're winning. I mean, Jonathan, I don't know if you can rejoin or at least hear this in the recording. I think that really strong thematic elements. One, the story arc of programmability continues to be strong with our enterprise customers. We serve—we are built by developers, for developers and that notion is as strong as ever in this world of digital transformation.

So, digital transformation is this great idea. You can write a book about it. You can see it in an article. But ultimately, our results are the output of digital transformation. We are the ones that are benefitting from those who have seen this world.

So the reality of what we're seeing is people are coming to us because of programmability stronger than ever because they're being forced to build and not buy differentiation and they're trusting their developers.

Another piece that's strong and we're continuing to invest in this is on the security side, which is customers are coming to us because our security offerings are strong, we're looking to continue to invest and make them stronger, but that is a strong signal as well. And one of the areas that we're investing very heavily in, as you know, is around Compute@Edge, which continues to very much separate us from the competitive set in the enterprise category, which is people want to continue to be able to do more.

So, lots of reasons and we're particularly proud of where we're in in that category. So, happy to take the next question.

Operator

Operator

Your next question comes from Brad Zelnick with Credit Suisse. Please go ahead.

Brad Zelnick

Analyst, Credit Suisse Securities (USA) LLC

Great. Thanks so much, and congrats guys on all the success. I've got a couple of questions. For starters, I think I've heard you emphasize the SecOps audience today more so than ever. You also highlighted investments in capabilities, like flow control. Can you just double click on the security use case a bit more? Because quite honestly, I think investors had always viewed that side of your business as less mature than others in the market and I'd just be curious for you to remind us of how you view the opportunity, where we are today and if you look back in three or five years what percentage of the mix might it be?

Joshua Bixby

Chief Executive Officer & Director, Fastly, Inc.

Yes, that's a great question. I do think that people don't understand our security DNA. I think people don't understand how heavily we invest and how deeply we invest in that area. So, I think stepping back, there are a number of things which make this unique. One, of course, which we talk a lot about, is one secure network, right, where we don't have a network for DDoS or a network for one application. That provides a tremendous amount of benefit to us, both efficiencies, but for customers' visibility and control. So customers are really coming to us when they don't want to have to call for professional services to deal with the real-time battle of security. I mean, these are adversaries who are in the middle of changing every second, every minute, and if you get, for example, data that's an hour old, that's pretty hard.

I think that one of the other areas and tenets for us is just our own culture. I mean, we drive data privacy, the customers we pick to put on our platform, all of that gets driven down into the culture and I think that's coming through and we're getting some really big wins. When we talked about some of those in the letter be it in education or e-commerce or financial services, all of those are coming because we are at our heart seen as a company that is really strong in that area.

We've talked about the portfolio in the past from WAF to denial of service protection, TLS, and in maybe of those categories we are leading. This is, however, an area that we continue to invest in pretty strongly and you see some of that investment coming through in Compute@Edge. The way that we've built Compute@Edge to isolate each of these requests and responses so that we don't reuse the environment allows us to really have an enterprise offering that customers would like. And one of the areas that I think is really interesting around Compute@Edge is how many use cases we're seeing that are security related.

But, we continue to look for investment opportunities, both organic and inorganic, and we are certainly looking to find both partners in some form of proximity to us that are proven leaders in their space, have revenue and really focus on this DevOps/Sec intersection where we believe the future is. So we are certainly out in the market looking to find ways to partner with those innovators.

But to your point, I do think it's a misunderstood part of our story and one that you'll hear a lot more from us about in the future.

Brad Zelnick

Analyst, Credit Suisse Securities (USA) LLC

Fantastic. Thank you Joshua. If I could just squeeze in one more.

Joshua Bixby

Chief Executive Officer & Director, Fastly, Inc.

Please.

Brad Zelnick

Analyst, Credit Suisse Securities (USA) LLC

It's nice to see the record customer adds in the quarter. What can you tell us about the size and wallet of the customers you're adding today? And as well, how would you characterize what you're seeing in the funnel in terms of propensity to spend?

Joshua Bixby

Chief Executive Officer & Director, Fastly, Inc.

Yes. So, I mean, I think you know, Brad, pretty well our strategy on the SMB market, which is to go to market with our partners. I think in the last few months we've really seen the strength and the wisdom of that approach, where instead of going and figuring out how we can monetize tens, hundreds, millions of individual domains by building a sales machine that does that. We have gone to the largest aggregators and the most sophisticated aggregators, the Shopifys and the Wixs and the Adobes and others. That's a strong play for us and it's something that we want to continue to do.

So, if you look at the customers that we have in that category, of new customers, they tend to be obviously the larger enterprise customers who really will benefit from a direct relationship with us. Most of the smaller customers we would work with our partners on, which we have done historically.

So, you're talking about large wallet sizes. I mean, to put our 300 enterprise customers into perspective, some of our largest competitors in the space have 6,000, 7,000 of these. So this is—we are in the early days of this market from our perspective and I think that only—that universe of 6,000 to 7,000 enterprise customers is very much limited by the lack of programmability and innovation in the traditional sector.

So, if you sort of cast your eyes wider to some of these other companies that have 30,000 or 100,000 enterprise customers, that's certainly where we're looking at. So we are humbled about where we are at in the journey. It is early but we're really stepping into it and seeing that acceleration and pretty excited about it right now.

Brad Zelnick

Analyst, Credit Suisse Securities (USA) LLC

Awesome. Thank you so much for taking the questions.

Joshua Bixby

Chief Executive Officer & Director, Fastly, Inc.

Thank you.

Operator

Operator

Your next question comes from Rishi Jaluria with D.A. Davidson. Please go ahead.

Rishi N. Jaluria

Analyst, D.A. Davidson & Co.

Hey guys, thanks so much for taking my questions. One for Joshua and one for Adriel. Joshua, in the shareholder letter you talk about some notable customer wins; one of those being in the education vertical which I thought was really interesting where you have a U.S. university using Fastly to help transition for online learning. Look, as more universities are going fully virtual or at least hybrid this semester or even the academic year, can you talk a little bit about how the education vertical is and how these customers are using Fastly to make that online learning experience better for the students? And then I've got a follow-up for Adriel.

Joshua Bixby

Chief Executive Officer & Director, Fastly, Inc.

Sure, Yes, absolutely. That's an exciting sector for us right now. And that particular win is particularly exciting just given the nature of who they are. But I think in general what we're seeing is a complete rethink of education. And when I think just through the eyes of my three boys, I walk upstairs and they're learning on Khan Academy, that's delivered through us. When I look at the educational institutions that they are a part of, those institutions are really struggling with how do they get content online? How do they do it quickly? What that means if they have content that isn't right. How can they make sure it's personalized? All these questions play beautifully into the story arc that developers are the new decision-makers. So at these schools you have some amazing developers that are innovating. That innovation is leading to personalized, frictionless experiences and I think if there's one thing that's underpinning the gold rush of digital innovation and digital transformation, it's frictionless, scalable, secure digital experiences and universities are at the forefront of that.

So it's a real growth vertical for us. Very excited about that win and others. And I don't think the underlying thesis is different. The gold that is coming out of the hills of the modern economy and the golden thread that leads through all of these is actually the same. Universities face digital—the need to accelerate digital transformation by years like everyone else does in order to survive.

Rishi N. Jaluria

Analyst, D.A. Davidson & Co.

Right, that's helpful. Adriel, nice to see some great margin expansion both on the gross margin side as well as just the bottom line. On the cash flow side though, maybe wanted to—looks like

there's a big increase in AR sequentially and that's the reason cash flow is still negative in the quarter. Can you talk a little bit about what is going on there? Is that just a customer and COVID dynamic and you wanted to be good partners to your customers or is there something else going on? And maybe looking beyond the quarter, how should we just be thinking about the translation of EBITDA or non-GAAP operating income to operating cash flow? Thanks.

Adriel G. Lares

Chief Financial Officer, Fastly, Inc.

Yes, good question, Rishi, and I think you sort of nailed it on the head. It was definitely one of the situations where we're certainly trying to partner with our customers. Especially early on in terms of the COVID-19 pandemic, a lot of customers faced a lot of uncertainty in terms of what's going to happen to them in the future, and I think as I've mentioned in the last call, most of those partnering and negotiations with customers is really much more on payment terms that (inaudible).

So from my standpoint, I was pleased to see that the majority of what really swung DSO in Q2 most of that was collected already, we collected here in the first month of the quarter. So I was pleased with that. I think in general you'll begin to still see some of that effect. Folks are trying to be really focused on cash, which I understand, and one of the primary reasons I went out and sought some additional cash ourselves just to sort of pad the balance sheet a little bit more so we feel comfortable move forward and I think we feel even more comfortable now.

Rishi N. Jaluria

Analyst, D.A. Davidson & Co.

All right, great. Thank you guys.

Joshua Bixby

Chief Executive Officer & Director, Fastly, Inc.

Thank you.

Operator

Operator

Your next question comes from Tim Horan with Oppenheimer. Please go ahead.

Timothy Horan

Oppenheimer

Thanks guys. Artur, can you talk a little bit more about Compute@Edge and maybe just compare and contrast a little bit to what AWS and Azure are doing? I know you talked to several (inaudible). How does that kind of compare and contrast at all to the (inaudible) product which I guess is the biggest and the most profit out there? And then maybe can you compare and contrast your competitors that are kind of more legacy CDN guys that say they have an edge product? Why is your product basically better than theirs at this point? Thank you.

Artur Bergman

Chief Architect and Executive Chairperson and Chairperson of the Board of Directors, Fastly, Inc.

Yes, of course. Hi. Yes, it is a frivolous product but one adopted to run at the edge and deliver the kind of functionality the customers need at the edge. So, Joshua alluded to this earlier, but one of the key things you really could do is how do you weigh the multitenancy and security requirements against the speed requirements and efficiency requirements that comes from operating in a more constrained environment. We're not massive data centers in the middle of nowhere. If we were we wouldn't be at the edge. So, first of all is the underlying technology that we chose to use, which is based on web assembly, and the core notion is that each request runs in its own isolated memory environment or sandbox. So kind of like using browser, it's one page—if one of your (inaudible) break, it doesn't take down the entire browser.

So same thing here applies. By making that really cheap from a start-up time, for memory, we can deliver that kind of guarantee, safety guarantee the enterprise is looking at, especially considering the different shared (inaudible) that we've seen in the CPU world or fake (phon) sharing attacks. We can deliver that at scale efficiently to our customers.

I think that's a key is the core technology differentiation. It also, because web assembly is written to support multiple languages, we can very efficiently support the languages that target web assembly and it's more environments and languages that target web assembly, that addressable market for people writing in those languages, it will automatically add to our offering.

So I think that is a huge difference and that's what I think will allow people to take a lot more what a normal (inaudible) could run in a central location and move out to the edge and then they will still have access to all the amazing features we have around logging and visibility and the cache storage, but you will have much more detailed programmatic access from the edge.

Timothy Horan

Oppenheimer

That is great color. And maybe just when do you think this is really going to start to take off and do you have a certain sense of the size of the market versus what your product suite looks like now? Thank you.

Joshua Bixby

Chief Executive Officer & Director, Fastly, Inc.

Yes, it's Joshua here.

Artur Bergman

Chief Architect and Executive Chairperson and Chairperson of the Board of Directors, Fastly, Inc.

Yes, I'll pass that one over to Joshua.

Joshua Bixby

Chief Executive Officer & Director, Fastly, Inc.

Yes. You know, we're still on track—we said that this would go through our normal cycle in '20 and hit in '21 and we're still on track for that. In fact, as I mentioned in the prepared remarks, we continue to add functionality to that and it continues to be successful. I think we've talked about this having some impact in '21. But like with many of our products we're going to see customers adopt this as a full package. So we'll definitely see an impact in '21, that's what we're driving towards.

Timothy Horan

Oppenheimer

Thank you.

Operator

Operator

Your next question comes from Jeff Van Rhee with Craig-Hallum Capital Group. Please go ahead.

Rudy Kessinger

Craig-Hallum Capital Group

Hi guys. This is Rudy on for Jeff. Thanks for taking my questions. Wanted to start out—I know Wolfgang had left, I think back in June (inaudible) to last quarter. For the time being you would be sort of stepping into his role and overseeing that. I guess just what are the plans at this point going forward, maybe hiring a new head of sales or what are your guys' thoughts there at this point?

Joshua Bixby

Chief Executive Officer & Director, Fastly, Inc.

Yes. Hi Rudy, it's Joshua. So that's me, I'm stepping in in that role currently. I think that we are looking for a new leader. Wolf continues to support us in that transition and I think importantly and I think the results speak this quarter to just an excellent group that has been established below Wolf. We have a seasoned group of sales executives who are running the business and I think if the results speak for themselves they have a lot of swagger and certainly deserve to have a lot of swagger given the results that they're putting up on the board.

So, not feeling a sense of urgency in the sense that that's an important role to fill, but we're going to fill it with the right person and we have ample time to do that.

Rudy Kessinger

Craig-Hallum Capital Group

Great. Got it. Yes, I meant you and Adriel. And then another one just as a follow-up. As you think about the—I'm not sure if you could quantify this, but I'm just curious on traffic trends as related to COVID. If you just think month to month, COVID emerges March, traffic probably peaked in April, just how traffic has trended towards now and if it is still growing now how has traffic growth, call it, May to June, June to July compare to typical seasonality you've seen in prior years?

Joshua Bixby

Chief Executive Officer & Director, Fastly, Inc.

Yes. Artur has been spending a lot of time in this area so I'll hand it off to him to give you some insight because he's done some really brilliant analysis on this.

Artur Bergman

Chief Architect and Executive Chairperson and Chairperson of the Board of Directors, Fastly, Inc.

Yes. Hi. You're right, the traffic growth in end of March and April was pretty dramatic. And then in May and I think June and July it's been less dramatic. The issue we have in trying to parse this out really is the lack of comparisons (inaudible) now being clearly traffic. It's grown more in Q2 than it historically has, any of the previous Q2s we've ever had. But one of the things that drove the biggest traffic increase was school closures. Of course, starting in June, schools weren't closed (inaudible) kids were home at school but the schools were just closed. It's really hard to answer exactly how the split is. The traffic growth went down is because people just started going outside as they usually do in June, July, and how much that compensated—how much of that was compensated by the still elevated COVID numbers.

So I'm afraid I don't really have a great answer and I'm sure when we have this call a year from now, and I can compare three years in a row with that, this year being the one we'll have the strongest effect, I'll be able to answer that better.

Artur Bergman

Chief Architect and Executive Chairperson and Chairperson of the Board of Directors, Fastly, Inc.

Got it. Great. Thanks, guys.

Joshua Bixby

Chief Executive Officer & Director, Fastly, Inc.

Thanks, Rudy.

Operator

Operator

As a reminder, if you would like to ask a question, please press star, then the number one on your telephone keypad.

And your next question comes from Tal Liani with Bank of America. Please go ahead.

Tal Liani

Bank of America

Hi, guys. I have two questions; one is just on the numbers. I'm trying to understand seasonality. I'm trying to understand what happened this quarter versus next quarter. On one hand, you're guiding for flat revenue growth for next quarter. While last year, you had about 8%, the year before similar, but on the other hand this quarter you grew way more than before. So it kind of evens out between the two. So, was there any project or anything that happened that pulled forward demand between 3Q and 2Q and this is why we see kind of very strong 2Q and flat 3Q? So that's my first question. Second question is more technical, so maybe we'll take one at a time.

Joshua Bixby

Chief Executive Officer & Director, Fastly, Inc.

Sure, yes. Adriel, why don't you take the first one, then we'll handle the next one. Thanks, Tal.

Adriel G. Lares

Chief Financial Officer, Fastly, Inc.

Sure thing, Joshua. Hello, Tal. Yes, I think as Joshua just—not Joshua but Artur just sort of alluded to earlier and I spoke a little bit as well, which is Q2 was definitely—I mean, it was 62% year-on-year. The traffic growth that we saw in terms of the trillions of bit that we were sort of piping through the network was in sort of an unprecedented pace and I think so you mix that with traditionally you—normally for you Q3 up over Q2 as you begin to sort of head into Q4, which is seasonally sort of our strongest quarter. So I think what you're seeing is sort of a comparison challenge here, which is really Q2 to Q3 and even then, if you take sort of the midpoint of our guidance, that basically implies about a 50% year-on-year growth.

So, it's still relatively strong growth I believe in Q3. So from that standpoint, I think that's probably the biggest thing and then there is just uncertainty as you know, just a bit with respect to one of our largest customers, as well as with respect to school closures, how those will be deployed and in some respect how there will be a Q2 originally, Q2 was unique in the sense that effectively the entire world was sort of working in lockstep with respect to shelter-in-place orders and school closures. And I think as we move beyond that period into Q3 and into Q4, it's a bit uncertain and uneven how it's all going to play out. And so you'll probably see a little bit of conservatism there as well.

Tal Liani

Bank of America

Got it. You said that TikTok was 12% of revenues this quarter, how much was it the same quarter last year?

Adriel G. Lares

Chief Financial Officer, Fastly, Inc.

Yes. So what we said was it's 12% of revenue for the last 6 months ending June 30, 2020. Yes, we have not talked about what it was previous to that.

Tal Liani

Bank of America

Got it. My second question is about your edge cloud, are there—so there are competitors in edge cloud, but you talked about your technical advantages. Are there any applications or any architecture of software that is more favorable to what you're (inaudible)? I'm trying to understand if there is any segmentation to the market where one type of applications is more likely to come to you, let's say, traditional applications ERP etc. versus more newer applications. So, I'm just trying to understand kind of the niche going after with your solution?

Joshua Bixby

Chief Executive Officer & Director, Fastly, Inc.

Sure. Artur, do you want to take first half of that?

Artur Bergman

Chief Architect and Executive Chairperson and Chairperson of the Board of Directors, Fastly, Inc.

Sure. I mean, I think in general when you think of the migrations of serverless, a lot of that is new development, a new kind of applications instead on something migrating. But the real way I look at it is if you're processing data that is targeted to one user, it makes sense to assemble that data and processes as close to that user as possible - the edge. If you're collecting data into a data warehouse and then running large models on it rather than along our central cloud. So even on the ERP application, I'd like the—the displays that I'm seeing at the end user pulls data from a whole bunch of different sources and pulling that data, first of all, authenticating and securing the client and making sure that someone has access and then after you've done the edge going out to different resources, maybe some of it is cash, maybe some of it has to go back to a central data center or two different ones.

Then you assemble that information at the edge. You still clear it for what you need, and then you hand it off to the client. And so I think even in that kind of application to me it makes tremendous amount of sense to leverage the edge. And so really if it's data that's assembled and personal life for the secured and authenticated, one of those things for one specific user it absolutely makes sense to move that logic as close to the user as possible.

Adriel G. Lares

Chief Financial Officer, Fastly, Inc.

Tal, I think one of the ways that I've thought about this, and I'm not as technical as Artur anyway, but edge does not replace the central cloud completely, right then that's not the story that we're telling. There are going to be compute jobs. One of the ways that I think about it is things like machine learning training, if you require enormous datasets, really long running training jobs,

specialized processes like GPUs like that type of learning and training is very well suited to the central cloud. However, once you've trained a model and you're ready to infer from it in the way that Artur is talking about, that's a great use case for the edge.

The other area that I think is worth calling out is when you need tremendous large amounts of large persistent data stores like a database like Oracle, for example, lots of information that's persisted a long period of time. Those are also really good candidates for the central cloud where it's easier to maintain that consistency. So I sort of think about it in the opposite sense, which is what isn't a good candidate. And that's really helped me think about where these use cases—where we flourish and it's sort of just a slightly different way to think about it.

Tal Liani

Bank of America

Got it. Thank you.

Joshua Bixby

Chief Executive Officer & Director, Fastly, Inc.

Thanks, Tal.

Operator

Operator

Your next question comes from Walter Pritchard with Citi. Please go ahead.

Walter Pritchard

Citigroup

Hi. Question for Adriel. On the revenue sources; can you talk about contracted—sort of contracted revenue that's coming in versus overage and how that trended this quarter versus what it's been historically?

Adriel G. Lares

Chief Financial Officer, Fastly, Inc.

Hi, Walter. Yes, it's still actually relatively the same. So we're still about 50%. So revenue is going to get committed and then about 50% usage of over the commit. I'd say that probably in Q2 it's a bit higher, but I think from a historical standpoint, we should sort of get back to that sort of level because every quarter you're coming up on two new renewals and commitments and what not and folks will sort of readjust their spend for what they sort of—where they normally want to be based on the run rates.

Walter Pritchard

Citigroup

And then, I guess for Joshua on just a new customer demand that's come in; how would you characterize the consumption of some of these customers that have come on in this current

environment in terms of services they're consuming from you versus what you've typically seen. Is it more of a kind of get online to get basic services or do they tend to take the full kind of the full offering of products as your installed base does?

Joshua Bixby

Chief Executive Officer & Director, Fastly, Inc.

Yes. I mean, it matches the installed base which is—it is vertical dependent, but for the majority of our customers, they coded the edge. They use our security features, they—I mean, this is all bundled together, possibly five years ago, you had somebody coming to you and say, hey, I want to deliver my content but not secure, that conversation doesn't exist anymore. This is always together, you can't think about one without the other. And honestly, you can think about doing this if you are an innovator without having the programmability visibility control into both security and delivery. And so it's very widespread and it mirrors exactly the core customer base and that's what we're seeing with this really strong net new add of customers, exactly the same thing as we've seen in the past.

Walter Pritchard

Citigroup

Okay, great. Thank you.

Joshua Bixby

Chief Executive Officer & Director, Fastly, Inc.

Thanks, Walter.

Operator

Operator

There are no further questions at this time, Mr. Bixby. I turn the call back over to you for closing remarks.

Joshua Bixby

Chief Executive Officer & Director, Fastly, Inc.

Before we sign off, I want to say thank you to our employees, customers, partners and investors. All of you contribute to our ongoing success and growth, and we're deeply grateful. We look forward to connecting with many of you in the near future, and hope to virtually see most of you at the upcoming Oppenheimer & KeyBanc conferences.

We are confident about our future and look forward to sharing more in the quarters to come. Thank you.

Operator

Operator

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



Fastly, Inc. (FSLY)
Q1 2020 Earnings Call
May 6, 2020

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