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# Fastly, Inc. (FSLY)

Q4 2022 Earnings Call

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## MANAGEMENT DISCUSSION SECTION

**Operator:** Good afternoon. My name is David, and I'll be your conference operator today. At this time, I'd like to welcome everyone to the Fastly's Fourth Quarter 2022 Earnings Conference Call. All lines have been placed on mute to prevent any background noise. After the speakers' remarks, there'll be a question-and-answer session. [Operator Instructions] Thank you.

Vern Essi, Investor Relations at Fastly, please go ahead with your conference.

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**Vernon P. Essi**

*Vice President-Investor Relations, Fastly, Inc.*

Thank you. And welcome, everyone, to our fourth quarter and full-year 2022 earnings conference call. We have Fastly's CEO, Todd Nightingale; and CFO, Ron Kisling, with us today. The webcast of this call can be accessed through our website, fastly.com, and will be archived for one year. Also, a replay will be available by dialing 800-770-2030, and referencing conference ID number 7543239 shortly after the conclusion of today's call. A copy of today's earnings press release, related financial tables and investor supplement, all of which are furnished in our Form 8-K filing today, can be found in the Investor Relations portion of Fastly's website.

During this call, we will make 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.

For further information regarding risk factors for our business, please refer to our most recent Quarterly Report on Form 10-Q filed with the SEC, and our fourth quarter 2022 earnings release and supplement for a discussion of the factors that could cause our results to differ. Please refer, in particular, to the sections entitled Risk Factors. We encourage you to read these documents. Also note that the forward-looking statements on this call are based on information available to us as of today's date. We undertake no obligation to update any forward-looking statements, except as required by law.

Also during this call, we will discuss certain non-GAAP financial measures. Unless otherwise noted, all numbers we discuss today, other than revenue, will be on an adjusted non-GAAP basis. Reconciliations to the most directly comparable GAAP financial measures are provided in the earnings release and supplement on our Investor Relations website. These non-GAAP measures are not intended to be a substitute for our GAAP results.

Before we begin our prepared comments, please note that we will be attending two conferences in the first quarter, the Raymond James 44th Annual Institutional Investor Conference in Orlando on March 6, and the Morgan Stanley Technology, Media and Telecom Conference in San Francisco on March 8. And also mark your calendars for our Investor Day taking place on June 22 at the New York Stock Exchange.

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

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## Todd Nightingale

*Chief Executive Officer & Director, Fastly, Inc.*

Thanks, Vern. Hi, everyone, and thanks so much for joining us today. First, I'll give a quick summary of our financial results and fourth quarter highlights, and then provide a brief update on our product strategy and go-to-market motion. I will then hand the call over to Ron to discuss the fourth quarter and annual financial results and guidance in detail.

We reported record fourth quarter revenue of \$119.3 million, which grew 22% year-over-year, and 10% quarter-over-quarter. Included in this revenue is a \$3.3 million take-or-pay true-up payment materially above a similar \$973,000 true-up payment from Q4 of last year. Collecting for these non-recurring payments, our revenue would have been \$116.1 million, growing 20% year-over-year. We reported 2022 revenue of \$433 million, up 22% year-over-year. I'd like to congratulate the Fastly team on closing out a strong Q4. However, as I said last quarter, I still believe there remains an opportunity for us to outperform this level in 2023 and beyond.

Our customer retention and growth engine remained strong. Our LTM NRR was 119% in the fourth quarter, up from 118% in Q3, and our DBNER was 123% in the fourth quarter, up from 122% in Q3. Our average enterprise customer spend was \$782,000, representing a 3% quarter-over-quarter increase, and continues to demonstrate the success of Fastly's land and expand approach in strategic accounts.

In the fourth quarter, we saw continued momentum in our portfolio expansion strategy with strong cross-selling activity, just as we discussed last quarter, and had multiple follow-on sales for our Next-Gen WAF technology. In addition, we had multiple new logo wins for this product as standalone sale. We anticipate over time having the opportunity to sell these customers our network service delivery as well as our edge compute and observability features.

I'm also excited to share with you that we're gaining traction across multiple verticals. The fourth quarter marked six new logo wins in travel and leisure, a vertical that is more and more focused on the digital user experience. This is highlighted by one of the world's largest corporate travel management platforms moving to Fastly. We complemented this with four new logo wins in healthcare and life sciences highlighted by our first win at McKesson.

Our total customer count in the fourth quarter was 2,958, which increased by 33 customers compared to Q3. Enterprise customers totaled 493 in the quarter, an increase of 11 compared to Q3. Our gross margin was 57% for the fourth quarter, representing a 340-basis-point improvement quarter-over-quarter. I am very pleased with this outcome, and I believe it underscores our new cost control rigor and discipline. We found savings with continued increases in peering and improvements in network optimization coupled with improved hardware maintenance costs. We will continue to be focused on margin improvement through 2023.

In the quarter, we were also able to reduce our hardware purchase commitments by over \$10 million, reflecting our increased platform efficiency at a cost of \$2 million. This \$2 million cancellation charge impacted our cost of revenue this quarter, but we believe it will support our margin improvement trajectory moving forward and reduce our cash spend, excluding the impact of this \$2 million payment and the take-or-pay true-up payment I discussed earlier, our gross margin would have been 57.5% in Q4, increasing 390 basis points from 53.6% in Q3.

During the quarter, we continued to drive our durable innovation strategy and released powerful, important technology to our customer base in all of our product lines. A selection of them are listed in our investor supplement for your reference, and a few highlights include: one, we achieved PCI certification as a Level 1 Service Provider, expanding our e-commerce customer reach and making it easier for e-commerce customers to onboard Fastly; two, our Javascript SDK for Compute@Edge in GA offering unmatched initialization performance, further differentiating the ability for Fastly to provide among the fastest load times in the industry, we believe this is a big step forward for developer adoption; three, our Fastly Next-Gen WAF now supports automated provisioning and management via Terraform for our cloud-based deployment option; and four, as we continue to see advanced bot and DDoS expanded our Next-Gen WAF advanced rate limiting rules.

Security is top of mind for all of our customers. So, we are excited that for the fifth year in a row, Fastly's Next-Gen WAF has been recognized as a Customers' Choice in the Gartner Peer Insights Voice of the Customer Cloud Web Application API Protection Report. Fastly is the only vendor to receive this recognition for all five years. We're especially proud that customers gave Fastly an overall 5 out of 5 stars, the highest of any vendor, and 97% said they are willing to recommend it to others.

In keeping with our continued support of our developer community and strong user base, we were happy to bring back our Altitude User Conference live in New York City in November. We had 15 keynote speakers, including multiple customers at the conference. Videos of most of the conference are now publicly available. Also at Altitude, we relaunched our Open Source and Nonprofit Program, Fast Forward with a renewed focus on building community among the builders and maintainers of a faster, safer, and more inclusive Internet.

Our developer community continues to grow through our addition of Glitch. It has been less than a year since we acquired their team, but the results thus far have been impressive with over 2 million developers. That community is already starting to drive our compute roadmap and early adoption. And now, I'd like to share my thoughts on my first six months at Fastly. I remain incredibly impressed by this team, and its potential. Fastly has an amazing culture and a talented employee base. The team here is passionate about every customer, passionate about the technology we build, and most importantly, passionate about our mission to make the Internet a better place

where all experiences are fast, safe, and engaging. There is tremendous opportunity in Fastly as an edge cloud platform, delivering cutting-edge digital experiences for everyone, everywhere.

We believe we have an amazing opportunity to achieve our goal to become a more complete one-stop shop for the edge cloud, delivering a more complete experiences for our developers and for our users. We have a real opportunity to run a high-velocity, low-friction go-to-market motion at Fastly, reaching more customers and onboarding them more efficiently.

I'm excited with how the teams have realigned for FY 2023 to put the customer first, and run a more focused, more efficient sales motion. I've also been pleased that we're making progress to simplify our packaging as we ready our package offerings for the second quarter to streamline customer acquisition and success, and provide our edge cloud platform services with reliable billing, simple renewals, and a more complete simple offer. The progress driving gross margin correction has been amazing. I'm incredibly impressed by our team, and we remain committed to ongoing gross margin improvements, and continue our efforts to make progress in building a more financially stable Fastly.

When we look to 2023, we are guiding to 16% revenue growth. There are many uncertainties out there, but I believe Fastly is well-positioned to outpace the market. Gaining market share through customer acquisition and portfolio expansion is key to our strategy, and that is exactly where we are aligning our efforts. Additionally, I remain committed to meaningfully reducing our operating losses in 2023, both in percentage and dollar amounts.

Let me close by saying I'm very excited about the opportunity here. Our customers have a real passion for Fastly's solutions, and our employees have a real enthusiasm for Fastly's mission. Of course, there is plenty of work to come, and I'm excited about the road ahead. But most of all, I believe digital experiences will redefine the success, and drive the mission of almost every organization everywhere. And Fastly will have a significant impact on the way digital experiences are built and delivered around the world. I look forward to sharing more with you regarding our progress, our focus on fueling growth, our customer acquisition, and our velocity of innovation in the coming quarters and at our Investor Day in June.

And now, to discuss the financial details of the quarter and guidance, I'll turn the call over to Ron. Ron?

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## Ronald Wayne Kisling

*Chief Financial Officer, Fastly, Inc.*

Thank you, Todd. And thanks to everyone for joining us today. I will discuss our business metrics and financial results, and then review our forward guidance. Note that unless otherwise stated, all financial results in my discussion are non-GAAP based.

Total revenue for the fourth quarter increased 22% year-over-year to \$119.3 million, exceeding the top-end of our guidance of \$112 million to \$116 million. As Todd explained, included in this revenue amount is a \$3.3 million customer take-or-pay true-up payment. As Todd mentioned earlier, excluding this true-up, our revenue would have been \$116.1 million, representing 20% annual growth, and 7% sequentially. In the fourth quarter, revenue from Signal Sciences' products was 12% of revenue, a 37% year-over-year increase or 31% increase, excluding the impact of purchase price adjustments related to deferred revenue. We continue to see healthy traffic expansion from our enterprise customers. And given our relatively smaller market share, we've benefited from share gain in an otherwise challenging environment. These dynamics position us well for continued revenue growth into 2023 and beyond.

Our trailing 12-month net retention rate was 119%, up slightly from 118% in the prior quarter. We continue to experience very low churn of less than 1%, and our customer retention dynamics remained strong. As Todd stated, we had 2,958 customers at the end of Q4, of which 493 were classified as enterprise, those customers with an excess of \$100,000 of revenue over the trailing 12 month.

Enterprise customers accounted for 89% of total revenue on a trailing 12-month basis in line with their contribution in Q3. Our enterprise customer average spend grew to \$782,000 from \$759,000 in the previous quarter, representing 3% expansion in dollar spend. Our strong trailing 12-month net retention rate and growth in the average enterprise customer spend demonstrate our continued ability to expand within our largest customers by increasing our share of delivery traffic, and adoption of new products in security and in our emerging compute business.

Our top 10 customers comprise 37% of our total revenues in the fourth quarter of 2022, a slight increase to the 36% contribution in the prior quarter. As I discussed in our Q3 call, we've made a great deal of progress in our financial organization with efforts to closely align with Todd's new leadership. We are seeing benefits in our gross margin and capital deployment plan from engineering efforts that are increasing the efficiency of our platform and cross-functional efforts to simplify our operations and improve our forecasting and review processes. These efforts not only strengthen Fastly's financial position longer term and allow us to drive increased efficiency in our business, but also improve our competitive positioning and our transparency to the investor community.

I will now turn to the rest of our financial results for the fourth quarter. Our gross margin was 57% in the fourth quarter or 57.5%, excluding the \$3.3 million take-or-pay true-up and the \$2 million cancellation fee Todd discussed earlier, compared to 53.6% in the third quarter of 2022. This sequential improvement in gross margin reflects our prior expectations that it would lift in the second half of 2022, primarily due to the results of our efforts to improve our gross margins. As we shared on our Q3 call, we saw a reduction in our bandwidth rates at the end of Q3 that's favorably impacted all of the fourth quarter, and we continue to increase the percentage of our peering traffic which further reduces our bandwidth costs. We continue to see benefits from improvements in our network investment capacity planning from our closely matched capacity and investment that our traffic patterns and demand. Our efforts to further reduce our existing capital commitments through commitment cancellations Todd spoke about earlier reflect this work to align our capacity investments with expected traffic demands coupled with a meaningful increase in the efficiency of our platform.

We also benefited from the seasonal increase in revenue in the fourth quarter, which favorably impacts our utilization of platform overhead costs. Note that our seasonal revenue decline in the first quarter relative to the fourth quarter will have a modest gross margin headwind. I'll expand on this in a moment.

Operating expenses were \$80 million in the fourth quarter, up 21% over Q4 2021, and up 3% sequentially from the third quarter. This level of operating expenses, combined with the higher revenue and gross margin achievement, resulted in an operating loss of \$12 million exceeding the high-end of our operating loss guidance range of \$14 million to \$18 million. Our net loss in the fourth quarter was \$9.5 million or \$0.08 loss per basic and diluted share, compared to a net loss of \$11.7 million or a \$0.10 loss per basic and diluted share in Q4 2021. Our adjusted EBITDA for the fourth quarter was negative \$91,000, compared to negative \$3.5 million in Q4 2021.

Turning to the balance sheet, we ended the quarter with approximately \$683 million in cash, cash equivalents, marketable securities and investments, including those classified as long term. And our free cash flow of negative \$40 million has reduced sequentially from the third quarter's negative \$44 million. Our cash capital expenditures were approximately 14% of revenue in the fourth quarter, and 10% for fiscal year 2022, landing at the low-end of our revised outlook shared in Q3 of a range of 10% to 12% for the year. Our cash capital expenditures include

capitalized internal use software, and deployments of prepaid capital equipment. For 2023, we expect our cash capital expenditures to decline further to a range of 6% to 8% of revenue.

I will now turn to discuss our outlook for the first quarter and the full year 2023. I'd like to remind everyone again that the following statements are based on current expectations as of today, and include forward-looking statements. Actual results may differ materially. And we undertake no obligation to update these forward-looking statements in the future, except as required by law.

As we look to 2023, our first quarter and full-year 2023 outlook reflect our continued ability to deliver strong top line growth via improved customer acquisition and expansion within our enterprise customers, driven in part by new and enhanced products. Our revenue guidance is based on the visibility that we have today. We expect expense growth for the full year to lag revenue growth, and expect a meaningful improvement in our operating losses in 2023 over 2022. More specifically, we are investing in our go-to-market efforts as part of our revenue growth initiatives to continue our expansion in our existing customer and accelerate our new customer acquisition. We will continue our investments in product and R&D, and as we discussed on our last call, we see meaningful opportunities to drive greater efficiencies in our operations, especially across G&A. And we expect to see meaningful leverage in our G&A cost in 2023, and for these costs to decrease as a percentage of revenue.

Given the nature of network traffic drivers in the fourth quarter, including holiday shopping patterns and live sports streaming viewership, historically our first quarter sees flat to down revenue relative to the fourth quarter, and we expect to see a similar trajectory in 2023. In the first quarter of 2022, this seasonality was favorably impacted by the return of traffic after the Q2 2021 outage. I'd also like to remind you that excluding the onetime take-or-pay true-up in the fourth quarter of 2022, fourth quarter revenues were \$116.1 million. As a result, for the first quarter, we expect revenue in the range of \$114 million to \$117 million, representing 13% annual growth at the midpoint. As I mentioned earlier, given the seasonality in our business, we expect gross margins in our first quarter to be down 100 to 200 basis points from our Q4 gross margin of 57.5%, adjusted for the aforementioned true-ups.

For the full year, we expect to see continued gross margin accretion and to exit the year with gross margins within striking distance of 60%. We did not see any meaningful changes, positive or negative, to our pricing in the fourth quarter as compared to the prior quarter. We expect operating expenses will increase in Q1 relative to the fourth quarter of 2022 due to an increase in payroll taxes, which will extend into the second quarter, and the timing of sales events that impact the first quarter. However, as I mentioned above, we anticipate expense growth for the year to lag revenue growth with a meaningful improvement in our operating losses in 2023 over 2022. We expect a non-GAAP operating loss of \$18 million to \$16 million, and a non-GAAP loss per share of \$0.12 to \$0.08 per share.

For calendar year 2023, we expect revenue in a range of \$495 million to \$505 million, representing 16% annual growth at the midpoint. We expect a non-GAAP operating loss of \$53 million to \$47 million, reflecting an operating margin of negative 10% at the midpoint, compared to an operating margin of negative 18% in 2022. We expect a non-GAAP loss per share of \$0.27 to \$0.21. And I'd like to call out that the recent increase in interest rates is resulting in a meaningful increase in our interest income on our cash and investments, and we currently expect to earn approximately \$20 million in interest income in 2023.

Before we open the line for questions, we'd like to thank you for your interest and your support in Fastly. Operator?

## QUESTION AND ANSWER SECTION

**Operator:** Thank you. [Operator Instructions] We'll take our first question from Frank Louthan with Raymond James. Your line is now open.

**Frank G. Louthan**

*Analyst, Raymond James & Associates, Inc.*

Q

Great. Thank you. So, walk us through your path to getting more towards EBITDA positive. Do you think that's something that can happen this year or that's more next year? And then with that, what are some of the top things where you're finding, and you're taking cost down the business? Thank you.

**Ronald Wayne Kising**

*Chief Financial Officer, Fastly, Inc.*

A

Yeah. So quickly, I guess if you look at sort of adjusted EBITDA in Q4 of this year, we ended it at about \$91,000. So, I'd say that's fairly within striking distance to kind of breakeven. I think as we look to going forward, I think there's a couple of drivers around improving our operating margins. One, as we said, we expect to continue to see appreciated improvement in our gross margins. We expect that to continue beyond 2023. And our efforts to drive leverage and operating expenses, one, through just the efficiency things we've spoken about will continue to bring down OpEx as a percent of revenues. So, that's generally the trajectory that gives us high confidence in getting to that breakeven point.

In terms of kind of specific timing, we'll be sharing a lot more in terms of sort of further timelines and revenue levels where we achieve that metric at our Investor Day in June.

**Frank G. Louthan**

*Analyst, Raymond James & Associates, Inc.*

Q

All right. Great. And anything specifically you can point to, some of the major areas you'd find in the cost improvements? Thank you.

**Todd Nightingale**

*Chief Executive Officer & Director, Fastly, Inc.*

A

I can add a little bit there. We have efficiency in the cost of revenue that we're certainly finding in efficiencies on the infrastructure just due to the engineering improvements and also cost reductions on our networking cost because network optimization efforts as well as contract negotiations. So, for cost of revenue, we've got a few levers, and we've seen progress. We think we'll be able to continue in that trajectory. And then, as far as the OpEx goes, we're starting to see some success in removing duplicative systems that aren't needed across the board. And we're seeing that on the G&A line, but also to some degree in the go-to-market and the R&D side of the house, and really being thoughtful about our hiring and really focusing on customer-facing roles and durable innovation engineering roles primarily.

**Frank G. Louthan**

*Analyst, Raymond James & Associates, Inc.*

Q

All right. Great. That's very helpful. Thank you.

**Todd Nightingale**

*Chief Executive Officer & Director, Fastly, Inc.*

Thanks.

A

**Operator:** And next, we'll go to Fatima Boolani with Citi. Your line is now open.

**Fatima Boolani**

*Analyst, Citigroup Global Markets, Inc.*

Hi. Good afternoon. Thank you for taking my questions. Todd, I wanted to go back to something that you mentioned in your prepared remarks as it relates to the vertical diversification that you saw in the quarter. I wanted to get a better and more granular understanding of some of the drivers that are enabling you to more effectively compete in end markets that are maybe newer and not traditional to you, and what type of wallet capture you're seeing. I'm going to follow up from that, please.

Q

**Todd Nightingale**

*Chief Executive Officer & Director, Fastly, Inc.*

Yeah, for sure. And it's a great question, and it's something that we are thinking about quite a bit right now in terms of growing in a more balanced way across all verticals.

A

E-commerce, for example, is a place where we have focused in the past, we've seen lots of success. But there are a ton of verticals where a real focus on the digital experience, whether it be through website or through applications and apps, I think is driving interest in Fastly for sure on the content delivery side, which enable the lower latency, more engaging experience. But I think the edge compute side and the ease with which our security platform can be onboarded for the developer experience is making a difference there too. So, travel and leisure is a great example. Traditional retailer I think is another great target for us.

And starting to see it in healthcare to me is an incredibly positive signal. I think the healthcare industry pretty much across the board is looking at this more and more, and what that patient experience really looks like. And we have a real opportunity with our emerging edge compute portfolio coupled with our network service content delivery side of our house, I think has a huge impact there.

As far as the wallet share part of your question goes, to be honest, I think we're really scratching the surface right now. And we have a huge opportunity to deploy to take these customers that are just starting the ones we mentioned earlier, and expand broader and broader set of our portfolio there, land and expand motion. But also really, I think using these as lighthouse accounts to penetrate those verticals.

**Fatima Boolani**

*Analyst, Citigroup Global Markets, Inc.*

Yeah. I appreciate that detail, Todd. Ron, for you just on some of the onetime impacts in the quarter, so you really fleshed out for us the true-ups. But I'm curious from an event standpoint, if you can quantify what the World Cup might have done to the business and then the Super Bowl, and anything else we should be mindful of as it relates to the sequential compares from some of these onetime-y events. And then just as a related matter, I know customer concentration did tick up. So, with that, any particular vertical or end market that drove that, and do you expect that customer concentration level to increase as you continue to focus on penetrating the installed base? And that's it for me. Thank you.

Q

**Ronald Wayne Kisling**

*Chief Financial Officer, Fastly, Inc.*

A

Good question. So, we don't get into specific traffic levels around sort of specific event. I think the way to look at it is if you kind of look at the seasonality change between sort of Q3, Q4, and across the quarters, that'll give you some indication of some of the traffic increases. What we particularly see in Q4 is, as you note, a number of live sports events occur in the fourth quarter, as well as seasonal shopping patterns. And that's been a pattern that's been pretty consistent in the past couple of years.

I think as we look to the second part of your question on...

**Fatima Boolani**

*Analyst, Citigroup Global Markets, Inc.*

Q

Customer concentration...

**Ronald Wayne Kisling**

*Chief Financial Officer, Fastly, Inc.*

A

Could you repeat the second part of your question? I apologize.

**Fatima Boolani**

*Analyst, Citigroup Global Markets, Inc.*

Q

Oh, just the customer concentration where that should trend from here?

**Ronald Wayne Kisling**

*Chief Financial Officer, Fastly, Inc.*

A

Yeah. Yeah. I think we'll see some fluctuation in it. I think as we continue to accelerate new customer acquisition, I expect it to remain relatively stable. It's going to move around a few percentage points as we continue to see expansion within our largest customers. That expansion rate within enterprise customers is one of the motions that we do particularly well. But I would expect it to – it's going to move around a little bit, but I don't see any major either increase in it or decrease prospectively.

**Fatima Boolani**

*Analyst, Citigroup Global Markets, Inc.*

Q

Thank you.

**Operator:** And next, we'll go to Sanjit Singh with Morgan Stanley. Your line is now open.

**Sanjit K. Singh**

*Analyst, Morgan Stanley & Co. LLC*

Q

Yeah. Thank you for taking the questions. And I wanted to get the team's perspective on the factors that can ultimately drive gross margin. And in fact, I think you mentioned in your prepared remarks, Ron, that pricing was neither a tailwind nor a headwind. You guys took the tradeoff to reduce your purchase commitment. And so, I'm trying to get a sense of ultimately in getting a path to 60%, what sort of needs to happen? Is it a better pricing environment? Is a higher mix of WAF, does edge compute needs to come online as you sort of draw that picture for us getting to 60% and hopefully more through that over time? What are the sort of things that we're looking to execute upon?

## Todd Nightingale

*Chief Executive Officer & Director, Fastly, Inc.*

A

Yeah. That's a great question. So on the gross margin side, getting to 60%, I think is a good milestone and something we're looking at closely. I think you're right to mention ramping up the compute business faster would I think have a tendency to help in that area, and also a mix change that would shift towards security would help. But even under current – even with the current mix, we're targeting that goal of getting to within striking distance of 60%. And so, whether mix changes or not, we're going to drive towards that effectively through increased efficiency in the infrastructure.

That comes from building out the technology that delivers that, which is a big part of it. It comes from cost controls and managing our spend effectively. It also comes from better and more sophisticated demand planning. And our teams have really focused there so that we're not deploying equipment that we won't need. And that makes a big difference, which is exactly what motivated our focusing on getting rid of some of these purchase commitments to kind of lay the groundwork for better margins in the future.

## Sanjit K. Singh

*Analyst, Morgan Stanley & Co. LLC*

Q

That makes perfect sense, and it's encouraging to hear. Ron, one quick question on the guidance. So, I heard you loud and clear on like the seasonality in Q1, in particular, sort of taking account the true-up factors in Q4. But when I sort of look at the full-year guide, it does imply stronger growth generally in the back half of the year against compares that at least by my model look a little bit tougher. And so, just wanted to get your perspective on that potential stronger business in the second half against tougher compares.

## Ronald Wayne Kising

*Chief Financial Officer, Fastly, Inc.*

A

Yeah. It's a good question. And I think if you look at kind of the midpoint of Q1 guidance and the midpoint of the year, there is some acceleration that we anticipate as we move through the year despite some of the more challenging comparisons that we have in the second half. I think there's a couple of drivers. One, I think last year Q1, we saw a return of a lot of traffic coming back from the outage that we had in the year before. So, that makes Q1 a particularly challenging compare because we typically do see some seasonality down, and we didn't see that last year. And then I think as we move through this year, what we've seen is and building off of the really strong expansion motion that we saw across our customers as we continue to add new customers in the second half of this year, those as they ramp their traffic and we increase our expansion effort in those, those start to really take place as you move through the second, third, and fourth quarters of the year.

## Sanjit K. Singh

*Analyst, Morgan Stanley & Co. LLC*

Q

Understood. Thank you very much.

**Operator:** Next, we'll go to James Breen with William Blair. Your line is open.

## James Breen

*Analyst, William Blair & Co. LLC*

Q

Yeah. Thanks for taking the question. Can you just talk a little bit about the network and the CapEx side? It was 14%, you said, for the full year, and I think you said 6% to 8% for 2023. Just talking about where you are in terms

of the network evolution and spending on that over the next couple of years as you see increased revenue on the network. Thanks.

**Ronald Wayne Kisling**

*Chief Financial Officer, Fastly, Inc.*

A

Yeah. So, just to clarify on the CapEx, as a percent of revenue, while it's 14% in the fourth quarter, CapEx for the full year was 10% of revenue. It was down from what we had guided at the beginning of the year. As we move into next year, based on a lot of the efficiencies that Todd spoke about and some the platform efficiency, we see that capital intensity coming down further to where 2023 we would expect CapEx to be somewhere between 6% and 8% of revenue.

**James Breen**

*Analyst, William Blair & Co. LLC*

Q

And how are you able to do that in terms of taking some of those absolute dollars down?

**Ronald Wayne Kisling**

*Chief Financial Officer, Fastly, Inc.*

A

I think one of it is – there's probably two particular drivers around the efficiency. One is just the engineering work around the hardware that makes our hardware more efficient, and so we can manage more traffic through the same amount of hardware, which allows us to accommodate additional capacity without expanding our capital equipment. The other piece is engineering efforts to better manage the use of our bandwidth, being able to automatically route traffic to lower-cost bandwidth rates, increase our peering percentages. Those would be the biggest drivers that allow our platform to become more efficient, reduce the amount of CapEx that we have to add, and reduce our bandwidth costs as traffic increases.

**Todd Nightingale**

*Chief Executive Officer & Director, Fastly, Inc.*

A

And obviously, that scale helps. So as we grow, we have more opportunities to scale, and the engineering work needed to drive these types of platform efficiencies, the ROI on those become more and more attractive for us to deploy resources. And so, scale kind of helps us drive these efficiencies, which we're starting to see in that gross margin number.

**James Breen**

*Analyst, William Blair & Co. LLC*

Q

Great. Thanks.

**Operator:** Next, we'll go to Tim Horan with Oppenheimer. Your line is open.

**Timothy Horan**

*Analyst, Oppenheimer & Co., Inc.*

Q

Thanks, guys. And to clarify, the 6% to 8% CapEx, do you think that's more permanent kind of going forward or this is just another maybe a onetime true-up this year?

**Ronald Wayne Kisling**

*Chief Financial Officer, Fastly, Inc.*

A

So, I think just to I guess clarify, the 6% to 8% of revenue CapEx is kind of what we expect for next year, and this year it was about 10%. So, we do see capital intensity coming down in 2023 on the increased efficiency that we spoke about. I think as you look beyond that, I certainly don't expect it to increase. I think there's opportunities to maybe move towards the lower-end of that range. A lot of that's going to tie to how traffic ramps in the future. But we should continue to see increased efficiency in our use of CapEx. And I would say next year is a good guide to that trend. I think really over moving from sort of 21% to where we are today, we've gone from about 14% to around 6% to 8% next year. So, meaningful movement there.

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**Timothy Horan**

*Analyst, Oppenheimer & Co., Inc.*

Q

Got it. Thank you. And then Compute@Edge, can you just maybe talk a little bit more about customer interest and competitive differentiation? And how meaningful is it for customers in terms of both latency and cost, and how differentiated are you? And in the same vein, maybe just talk about the potential for AI to run on top of this infrastructure at a high level. Thanks.

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**Todd Nightingale**

*Chief Executive Officer & Director, Fastly, Inc.*

A

Sure. That's a great question. Something that's super top of mind for us here. Compute@Edge for us is – I think it's incredibly important because in addition to being I think super-interesting technology, it's really an extension of Fastly's core value proposition, delivering fastest, best, most engaging user experience. And that speed, that engaging application performance while the content delivery and network service portfolio helps deliver that in really significant ways, in a lot of ways the next step, the next natural evolution is Compute@Edge, and driving some of these processes all the way to the edge as close to the user as possible.

We've seen a lot of folks looking carefully around metrics tying to interactivity on websites and applications. And that I think super-interesting stat, some of our most sophisticated customers are focusing deeply on that, and so do we. And so content delivery helps deliver that, but edge compute can make a huge, huge difference, and it has been. We see it in both on the web side, and the app side for people who care deeply about that. And e-commerce is certainly an area where that's incredibly important. But we're seeing it in tech, we're seeing it in other verticals as well.

As far as sort of how we see a differentiation in that space, I'll tell you, I think this is an area we're being developer led is incredibly important, and you see that in some of the technology announcements in our supplement. And I think it's incredibly important because developers are moving workloads to the edge, they're driving towards these performance goals, and they are confident that Compute@Edge platform is going to be there for them to serve developers in the future. It's what motivated our Glitch acquisition. We're getting huge amount of feedback and input there. What's driving our roadmap for the platform support, language support I should say, which is like the Javascript launch we mentioned, and even the automation toolkits like Terraform support.

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**Timothy Horan**

*Analyst, Oppenheimer & Co., Inc.*

Q

And do you think the impact of AI is a major driver of growth potentially for this product?

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**Todd Nightingale**

*Chief Executive Officer & Director, Fastly, Inc.*

A

Yeah. Yeah, sorry I missed the part. Yeah. It's an interesting question. I would say sort of our growth trajectory isn't dependent on that. But it's an interesting idea. It might matter how much GPU you start deploying out of the edge instead of traditional CPUs, but for us right now we're focused on more traditional workloads.

**Timothy Horan**

*Analyst, Oppenheimer & Co., Inc.*

Q

Thank you.

**Operator:** Next, we'll go to James Fish with Piper Sandler. Your line is open.

**Quinton Gabrielli**

*Analyst, Piper Sandler & Co.*

Q

Hey, this is Quinton on for Jim Fish. Thanks for taking our question. Looking first at the security side of the business, this is a focus for a lot of investors. And the team really looked inorganically the last time it really tried to level up kind of the Fastly portfolio. Can you talk about how you're balancing organic and inorganic opportunities in the security platform, and maybe what opportunities are available for Fastly to take on from the security side?

**Todd Nightingale**

*Chief Executive Officer & Director, Fastly, Inc.*

A

Sure. Absolutely. When it comes to the security space, and it's an enormously diverse market, we're really focused on web application security. And so, the Signal Sciences acquisition represented in fact inorganic move to bring in an entire component and really operating business and partner motion around Next-Gen WAF. We're looking at now really bolstering that Signal Sciences portfolio with DDoS protection, and more advanced and more managed DDoS protection for our customers as well as bot protection. And that's really kind of fulfilling its vision of our deep focus on web application security.

Never say never. But at least in those areas, we're really looking at organic innovation from the Fastly team because the Fastly platform team has been doing advanced DDoS protection since practically inception. And it's an amazing opportunity for us to bring more insights, more management, more visibility to our customers in our security platform. And on the bot side, we see a ton of interest from customers. There, we've done interesting partnerships there. But again, I think we'll be looking at organic innovation in that space.

The Signal Sciences acquisition represented a really for a strategic product line acquisition for Fastly, I think. But right now, there's nothing like that on the horizon for us. We're really looking and focusing on organic innovation.

**Quinton Gabrielli**

*Analyst, Piper Sandler & Co.*

Q

Got it. Helpful. And then, Ron, maybe for you on the guide, what are you implying here from a macro standpoint to kind of get to the numbers you're laying out for 2023? Do we need to see any sort of improvement kind of in the back half of the year from an underlying macro or is this kind of baking in things are remaining the same from here? Thank you.

**Ronald Wayne Kising**

*Chief Financial Officer, Fastly, Inc.*

A

Yeah. It largely assumes that things moved the economies broadly the way it is now. Our growth is really predicated on market share gains and expansion within our existing customers. And given our relative market

share, well, we're not 100% immune from the macro economy. The key driver is going to be share gains. And we've assumed similar environment to what we have today, but that's not the biggest driver to our growth in 2023.

**Quinton Gabrielli**

*Analyst, Piper Sandler & Co.*

Q

Got it. Thank you.

**Operator:** Next, we'll go to Rich Hilliker with Credit Suisse. Your line is open.

**Richard Hilliker**

*Analyst, Credit Suisse Securities (USA) LLC*

Q

Hey, guys. Thanks for taking my questions. Todd, I was wondering if you can update us on your near-term intention to leverage peering and the path towards that. And then, Ron, maybe on that same topic, how should we think about peering playing into the 2023 versus 2024 margin story?

**Todd Nightingale**

*Chief Executive Officer & Director, Fastly, Inc.*

A

I'm so sorry, Rich, you broke up just a little bit. Could you ask that question again?

**Richard Hilliker**

*Analyst, Credit Suisse Securities (USA) LLC*

Q

Absolutely. Can you hear me better this time?

**Ronald Wayne Kislung**

*Chief Financial Officer, Fastly, Inc.*

A

Absolutely.

**Todd Nightingale**

*Chief Executive Officer & Director, Fastly, Inc.*

A

Much better. Yes. Thank you.

**Richard Hilliker**

*Analyst, Credit Suisse Securities (USA) LLC*

Q

Okay. Great. So, Todd, first for you, I was wondering if you can update us on the near-term intention and your really path towards leveraging peering. I know you've talked about that in the past. And then, Ron, on that same topic, I was wondering if you can give us a sense of how we should think about peering contributing to the margin progression in 2023 as opposed to 2024?

**Todd Nightingale**

*Chief Executive Officer & Director, Fastly, Inc.*

A

Yeah. Great question. Something our entire team thinks about a lot. Peering is an incredibly powerful tool for us because it actually has two positive impacts. First and foremost, it improves the user experience, drives lower latency performance for applications and websites, improves our kind of core value proposition by – in network distance, putting Fastly's POPs closer to the user, which is amazing.

It also drives lower networking costs in our cost of revenue. And so, for us, finding strategically the best places to add peering, it's really a win-win for us on both sides of the house. How often do you get to lower costs and improve the offering at the same time? So, yeah, something that we do focus on quite a bit.

**Ronald Wayne Kising**

*Chief Financial Officer, Fastly, Inc.*

A

Yeah. I think as you peering, I think one of the things that Todd said earlier is obviously as we scale, there's an opportunity to increase the amount of peering that we do, which brings down our bandwidth cost. We've said bandwidth is about a third of our cost. And so, the drivers there are going to be peering, and they're going to be more efficient use of overall bandwidth, which will drive, I believe, increased efficiency in our platform from bandwidth costs in 2024. So, as you look at where we exit, I think there's an opportunity to continue to see accretion in gross margins into 2024 driven from the cost structure side of things.

The other piece is capital intensity, and I think the efforts we've spoken about in terms of making our hardware more efficient, allowing us to run more traffic through the same amount of traffic, also is a tailwind that allows us to continue to show accretion in gross margins off of 2023 into 2024. But obviously bandwidth is a big one, it's the single biggest cost, colo and depreciation. Those three are probably two-thirds of our overall cost of revenues.

**Richard Hilliker**

*Analyst, Credit Suisse Securities (USA) LLC*

Q

Great. And so maybe the next question here, I'm changing gears, packaging has been a focus and, if I'm not mistaken, I think you mentioned you'd be ready for Q2 and some of the changes to drive simplification. I'm wondering, Todd, how does the sales playbook change relative to that packaging evolution? And how are you positioned to kind of leverage those, and all that hard work you've been doing to kind of mobilize those changes? Thanks.

**Todd Nightingale**

*Chief Executive Officer & Director, Fastly, Inc.*

A

Well, I love a packaging question. Yeah. So, I think there's just an incredible opportunity both sort of internal at Fastly, and externally. Internally, packaging helps us operate more quickly. It gives us offers for the market that are designed to be inclusive of everything that a typical customer would need, whether that's in network service, in security, in edge compute and observability, and those are the four areas that we're really looking to launch packaging in Q2.

But externally, I think it just provides a much easier motion, especially for mid-market customers to onboard, and that's something we'll be tracking very carefully. It also provides – as well as provides other benefits to customers like reliable billing, simple renewals, et cetera, it also importantly, it provides a more channel-friendly option of simple SKUs with straightforward pricing and discounting, et cetera, that can just move through not just our go-to-market, but our systems integration and MSP channel partners' go-to-market more efficiently.

**Richard Hilliker**

*Analyst, Credit Suisse Securities (USA) LLC*

Q

Thanks, guys.

**Operator:** Okay.

**Todd Nightingale**

*Chief Executive Officer & Director, Fastly, Inc.*

Thanks for the question.

A

**Operator:** Next, we'll go to Rishi Jaluria with RBC. Your line is open.

**Rishi Jaluria**

*Analyst, RBC Capital Markets LLC*

Oh, wonderful. Thanks so much for taking my questions, guys. Nice to see some good resilience and a path to better margins. Maybe two questions, if I may. First, as we talk about the developer ecosystem and I know like it's accelerated with the acquisition of Glitch, maybe I'd love to talk a little bit more about going down the PLG strategy, some of the efforts you want to make to maybe return to your roots as I may kind of think about it. And I guess what steps need to be taken to actually get that traction? And what sort of impacts do you think that could actually have on your margins and sales efficiency going forward? And then I've got a follow-up.

Q

**Todd Nightingale**

*Chief Executive Officer & Director, Fastly, Inc.*

Yeah. Great questions, also. I think we've been very thoughtful about PLG in these first couple of quarters that I've been here, specifically, really on building out product support for motions that allow our teams to move more efficiently and for customers and users to be able to self-serve more.

A

Specifically, we focused a lot on automating our free trial motion, and making it's about customers who are at Fastly can start that expand motion in a real product-led growth style, and that our go-to-market teams can help engage and help smooth the way as we go. So, I think there's a huge opportunity here, especially as we focus right now on free trials, and how the product support for fully automated free trials can help. And that's really just one example. The packages, I think, give us another opportunity to really lower the friction, be able to operationalize that sort of platform-wide free trials that have individual product or feature by feature free trials.

And maybe that's just a good example of sort of how we see product-led growth evolving at Fastly, not fighting against our sales and partner team, but really helping fuel and that drive enterprise sales motion. I think that we have maybe the biggest area where we expect to see real impact right away using that mid-market commercial account where having fully automated motion and having the ability to kind of bring in the right Fastly resources when needed to smooth the land and expand play can really make a difference. Yeah. As far as supporting margins, I always believe mid-market business is good for margins, good for customer retention. So, I like that.

**Rishi Jaluria**

*Analyst, RBC Capital Markets LLC*

All right. Wonderful. That's really helpful. And then just one financial question. So, nice to see improving margins. The guidance talking about margins improving more significantly from here. Yeah. But at the end of the day, right, cash flow is what's ultimately going to matter. I guess, two pieces. How should we be thinking about cash conversion for 2023? And maybe more importantly, what's kind of the glide path to get from here to being free cash flow breakeven or even starting to generate cash? Thanks.

Q

**Ronald Wayne Kisling**

*Chief Financial Officer, Fastly, Inc.*

A

Yeah. So, I think I'll leverage off of some of the comments we made about some of the opportunities and the business to improve from an operating margin and bringing that to sort of breakeven. As you look at 2023 and 2024, there's a couple of sort of significant tailwinds. During 2022, we spoke a lot about some of the prepayments we made toward capital equipment. So, a portion of that 6% to 8% of CapEx that we're going to deploy in 2023, we paid for in 2022. So, our cash deployments for equipment should be down materially. And then, I think as we continue to drive margins and efficiency in the business, we believe that there is a significant opportunity to improve the cash flows from working capital and bring that along with the improvements in our operating margin.

I think as we look to some of the specifics of you can look at kind of the progress we've made on kind of adjusted EBITDA. But in Investor Day, we'll provide a lot more granularity in terms of sort of the timelines, and again kind of revenue levels at which we get to kind of a cash flow breakeven. But in addition to the efficiency we see in the operating margins, there is efficiency in our cash going into 2023 that are meaningful tailwind to cash flow usage.

**Rishi Jaluria**

*Analyst, RBC Capital Markets LLC*

All right. Wonderful. Thank you.

Q

**Todd Nightingale**

*Chief Executive Officer & Director, Fastly, Inc.*

Thank you.

A

**Operator:** Next, we'll go to Jeff van Rhee with Craig-Hallum. Your line is open.

**Jeff van Rhee**

*Analyst, Craig-Hallum Capital Group LLC*

Yeah. Great. Just a couple for me. I think on the go-to-market improvements, it sounds like the packaging you see is a big catalyst, so maybe that's the answer. But when I look at the enterprise customer additions, relatively flat for a handful of quarters now, how do you think about that number in particular when we should think about an uptick?

Q

**Todd Nightingale**

*Chief Executive Officer & Director, Fastly, Inc.*

Yeah. That's a good question. Our enterprise customer count, it's been growing kind of slow and steadily. We measure that in arrears. So, \$100,000 revenue over the last four quarters. And so, it's a little bit of a trailing statistic for us. But I think this sort of slow and steady growth, that's what I'm expecting to kind of hope to accelerate slowly over time and not find a big, huge pop all at once.

A

Perhaps the driving force, I think packaging will be one, but maybe something else would be platform unification. By unifying our platform, I think we're making it a lot easier for our customers to start with one product line, expand into the next, into next, because it's all being built now on one unified user experience, unified developer experience. And that will by doing that help ease our expand motion, drive a more strategic relationship with our customers as they become sort of multi-portfolio users, and help them cross that threshold, that \$25,000 a quarter threshold.

But again, I think in terms of like are we going to see a big pop in that number, no, I hope to accelerate the growth in that number just as we accelerate the rest of our revenue line.

**Jeff van Rhee**

*Analyst, Craig-Hallum Capital Group LLC*

Q

Yeah. Got it. And you commented on taking share. In terms of the competitive landscape, if you want to clarify, who are you taking share from? And then, just in terms of that land, you commented on the platform unification. How has that initial use case or initial capability/pain point changed in terms of the reason you're landing in the first place?

**Todd Nightingale**

*Chief Executive Officer & Director, Fastly, Inc.*

A

Yeah. It's a great question. I don't really want to directly name competitors, but I'm sure you guess. But when we look at content delivery, we're picking up share, and I believe we have an opportunity to pick up share specifically by focusing on user experience. At Fastly, we're not a CDN company or a cloud security company or an edge compute company. We're focused on being a cloud platform company that delivers user experience outcome by bridging all of this together. And so, this idea of platform unification, this idea of building a more complete offering for our customers, that is the differentiation that we hope to use to deliver a better user experience for everyone. And that is the differentiation, I think, that's going to drive market share gains for us, a true focus on user experience, fast, safe and engaging digital experiencing.

**Jeff van Rhee**

*Analyst, Craig-Hallum Capital Group LLC*

Q

Okay. Got it. Thank you.

**Todd Nightingale**

*Chief Executive Officer & Director, Fastly, Inc.*

A

Thanks.

**Operator:** And we have time for one final question. We'll go to Rudy Kessinger with D.A. Davidson. Your line is open.

**Rudy Grayson Kessinger**

*Analyst, D. A. Davidson & Co.*

Q

Hey. Great. Thanks for squeezing me in here. Just want to clarify in the quarter, the \$3.3 million in true-up, did you have any – like any original guide you gave, is there any expectation that you would get any of that in the quarter or no?

**Ronald Wayne Kislring**

*Chief Financial Officer, Fastly, Inc.*

A

Yeah. I think going into the guide, I think there was an expectation that we would have some true-ups. I think what we saw in the quarter in terms of the level of overachievement was the magnitude of that as well as overall traffic pattern. We saw really good expansion with an existing customer over the course of the quarter as well that actually drove overachievement in the quarter.

**Rudy Grayson Kessinger**

*Analyst, D. A. Davidson & Co.*

Q

Okay. Got it. And then on the guide for 2023, just curious if you could give any more specifics with respect to the assumptions on growth for Signal Sciences or security versus CDN and compute, just any breakdown you can share there?

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**Ronald Wayne Kisling**

*Chief Financial Officer, Fastly, Inc.*

A

Yeah. I mean, we haven't broken out. I think what I would sort of generally speak to is, we have seen security or Signal Sciences reported being a faster-growing element, security is certainly important. I think the other piece is, compute is also a faster grower, although starting at fairly nascent levels. So, those are going to be the higher growth items, I would say security is probably the one of the magnitude that's a key contributor to the growth. But we're also seeing obviously growth in core traffic, both from new customers, but also we're seeing in some of our largest customers continuing to gain traffic share within some of those largest customers based on that user experience. And so, we see growth across that.

I think one way to frame it as Todd sort of framed it is, we have the core business, if you will, which is, growing nicely. We have really the growth engine, which is security. And we have sort of the incubation stuff, compute it's probably moving from that in the near term kind of into that growth engine, and continue to have new things in compute that will grow into part of the growth drivers.

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**Operator:** Anything further, Rudy?

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**Rudy Grayson Kessinger**

*Analyst, D. A. Davidson & Co.*

Q

No, that's it for me. Great. Thank you.

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**Operator:** Okay. I'll turn the call back over to Todd Nightingale for any additional or closing remarks.

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**Todd Nightingale**

*Chief Executive Officer & Director, Fastly, Inc.*

No. Thanks so much, everyone. Amazing questions today. Before we close the call, I want to thank our employees, customers, partners and investors. We remain as committed as ever to making the Internet a better place where all experiences are fast, safe and engaging. Moving forward, we remain focused on execution, bringing lasting growth to our business, and delivering value to our shareholders. Thank you so much for your time today.

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

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