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Fastly, Inc. (FSLY)

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MANAGEMENT DISCUSSION SECTION

Operator: Ladies and gentlemen, good afternoon. My name is Abbie, and I will be your conference operator today. At this time, I would like to welcome everyone to the Fastly Third Quarter 2023 Earnings Conference Call. All lines have been placed on mute to prevent any background noise. After the speakers' remarks, there will be a question-and-answer session. [Operator Instructions] Thank you.

And I would now like to turn the conference over to Vern Essi, Investor Relations at Fastly. Please go ahead.

Vernon P. Essi

Vice President-Investor Relations, Fastly, Inc.

Thank you, and welcome everyone to our third quarter 2023 earnings conference call. We have Fastly 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 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, product sales, 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 Form 10-K and Form 10-Q filed with the SEC and our third quarter 2023 earnings release and supplement for discussion of the factors that would 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 three conferences in the fourth quarter; the RBC Capital Markets 2023 TIMT Conference in New York City on November 15th, the D.A. Davidson Technology Summit in New York City on November 16th, and the UBS Global Technology Conference in Scottsdale, Arizona, on November 29th.

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

Todd Nightingale

Chief Executive Officer & Director, Fastly, Inc.

Thanks, Vern. Hi, everyone, and thanks so much for joining us today. First, I will give a quick summary of our financial results and third quarter highlights, and then I will provide an update on our product strategy, go-to market and internal transformation before I hand the call off to Ron to discuss our third quarter financial results and guidance in detail.

We reported record third quarter revenue of \$127.8 million, which grew 18% year-over-year and 4% quarter-over-quarter. This came in at the very high-end of our guidance range, driven by strong international traffic. This demonstrates continued momentum in our enterprise customer motion as we continue to benefit from vendor consolidation and seasonal strength in streaming activity. Our customer retention efforts, a hallmark of our customer satisfaction, were favorable in the third quarter.

Our LTM NRR was 114%, down slightly from Q2. Our DBNER was 120% in the third quarter, down from 123% in Q2 and also slightly down from 122% in Q3 of last year. Our DBNER continues to demonstrate healthy wallet share gains in our customers, as we continue to cross-sell more functionality and grow with our customers' ongoing edge traffic requirements. We're starting to see some effects of budget tightening by our customers, but we continue to see strength in customer expansion, especially across product expansion across the board.

Our total customer count in the third quarter was 3,102, which increased by 30 customers compared to Q2 and 63 year-over-year. Enterprise customers totaled 547 in the quarter, a decrease of 4 from Q2 and an increase of 36 year-over-year. We have four new customers to make the enterprise \$25,000 threshold in the quarter. Number dropped to reflect a sequential decline. As we discussed during our Q1 earnings, our newer enterprise customer count methodology will be slightly more volatile.

Our average enterprise customer spend was \$858,000, up \$40,000 quarter-over-quarter, representing a 5% increase, as well as an 11% increase year-over-year. These results point to continued wallet share expansion as we've aligned our customer success teams to be more focused on cross-product adoption. Also, as we work towards platform unification, we've begun focusing on our goal of making customer cross-selling and onboarding as simple as a single click for existing customers. This will be a huge shift in the usability and the expandability of our platform and help drive customer retention, as well as expansion.

I'm excited to share with you that, in the third quarter, we acquired Domainr, a real-time DNS API provider. We brought on board a small team of highly respected DNS experts and paired with the general availability of Certainly, our certificate authority, we have the opportunity to greatly simplify onboarding to the Fastly platform with security and simplification.

In the third quarter, we landed key new logo wins and highly competitive deals. I'm personally very excited about Wendy's, a true lighthouse account and a new vertical for Fastly that opens up a major market opportunity. As our success in e-commerce grows to include more and more adjacent verticals, such as food delivery, travel and leisure and consumer brands, we see significant potential to accelerate customer acquisition.

Continuing our success in security and privacy proxy implementations, we are excited that Mozilla adopted Fastly's Oblivious HTTP Relay. Fastly now serves three of the top four Internet browsers worldwide. On thought leadership, we published our first threat intelligence report, featuring data and insights from Fastly's Network Learning Exchange, as well as continued post on Fastly's technical leadership in the constantly evolving world of DDoS exploits.

As some of you are aware, a couple of CDN providers are in the process of winding down their services and have sold the remaining customer contracts to our competition. This has created disruptive environment that Fastly is poised to capitalize on, especially as those contracts come up for renewal. Digital Turbine, a leading digital ad provider, is a great example and there are many others already engaged with Fastly to find higher levels of service and performance at competitive rates. We are committed to helping them find their next strategic partner. If anyone listening recently had their contracts filled, please feel free to reach out.

We're seeing this e-commerce expansion internationally as well, closing a top New Zealand grocer and an omni-channel retail fashion house in the UK. We saw continued customer acquisition in the travel and leisure segment and in the healthcare and life sciences. We anticipate continued momentum in these expansion verticals, as our sales team is now armed with more reference accounts and prebuilt use cases. This momentum significantly tilts the win probability to Fastly and gives us a considerable edge with new customers. As these new verticals ramp, a diversified traffic load will provide Fastly with smoother network and compute demand, providing better infrastructure utilization, leading to future margin improvements.

Our gross margin was 55.9% for the third quarter, representing a 70-basis-point decline quarter-over-quarter, but a 230-basis-point increase year-over-year. I am pleased with the team's efforts controlling our variable cost of revenue and continuing to get more from our infrastructure footprint. For the second quarter in a row, we saw outsized increases in international traffic, which did cause a short-term margin headwind. As with last quarter, these will open up opportunities for us to peer more and negotiate our bandwidth costs to lower our total cost of revenue for the future.

Our operating expenses were \$84 million in the quarter, coming in lower than anticipated. Financial discipline and rigor continue to have favorable results here. Note, this result also reflects heavy sales and marketing spend due to one-time events and fees. I'm also pleased that we posted another positive adjusted EBITDA quarter, making

this our second quarter in a row. Positive EBITDA should be a normal occurrence moving forward, but you'll excuse my enthusiasm just this one last time.

Ron will explain our outlook and guidance in more detail. But as you can tell from our OpEx spend, we are readying our model to leverage revenue growth and improve our cash flow for next year. During the quarter, we continued to drive our durable innovation engine strategy and have delivered several key pieces of functionality at the market. You can see these in our supplement, including KV Store shipping GA, which enables more powerful edge applications through very high performance reads and writes of key data at the edge.

GraphQL Inspection expands Fastly's API security offering. Certainly, [ph] going GA (00:09:52) establishes a Fastly's Certificate Authority to provide domain validated TLS certificates and improve the security and reliability of our customer sites. And our Go compiler SDK provides edge compute developers with a key capability for a highly requested language.

During the quarter, we hosted Altitude, our user conference in New York City, drawing hundreds of worldwide attendees. Most attendees were customers and prospects, but there were also industry and investor analysts in attendance. I was extremely pleased with the event. It was very well received. Some of the sessions have been viewed thousands of times online following our social media coverage.

One of the highlights was a demo of Simplified Service Creation, our new onboarding workflow and dashboard. This demo was so powerful because it showcased Fastly's new ability to provision a global website for best-in-class, low latency user experience worldwide all in 90 seconds. This combination of power and simplicity is near and dear to my heart, and I believe this is key to rapidly increasing customer acquisition of Fastly. Please give it a look if you have a chance. It's bookmarked in our Events page and in our supplement.

There's also been great progress with our packaging motion. We initiated this motion a little less than a year ago and closed our first handful of packaging customers in the first quarter of 2023. Since then, the growth has accelerated. In the third quarter, the number of customers that signed packaging deals more than doubled quarter-over-quarter. Almost half the packages sold to-date have been computing related, with almost a third of the customers buying a stand-alone compute-only package.

In terms of the overall number of packages sold, more than 25% of our package deals are platform wins, with multiple product lines included, demonstrating the ability for packaging to help us drive our platform strategy and expand our offerings beyond CDN. This data gives us great insight into where we can steer our efforts, and we plan to continue to drive a single platform cross-selling motion across our customer base. I'm very excited about this opportunity. As Ron will explain in just a moment, this is having a favorable impact on our RPO as well.

Moving on to our channel partner development, we are seeing great progress here. Our 2023 deal registration is already triple that of 2022. You'll recall that during our Investor Day in late June, Brett shared with you that we had 33 partners globally engaged. Today, that number totals 55. Our revenue contribution has grown more than 50% in 2023 year-to-date when compared to all of 2022 and we expect to see this trend continue into 2024.

So far, I'm pleased with the progress we're making in 2023 and this is reflected in our updated projections for the year. We raised our annual guidance for both revenue and operating margin, and we'll strive to find ways to outperform that guidance through strong innovation velocity, strategically lowering the friction of our go-to-market efforts, and streamlining our employee experience.

Fastly partners with our customers to deliver the best possible end user experience. This focus uniquely positions us where these market needs intersect the edge cloud, and there is an enormous opportunity in that intersection. The future user experience is fast, safe and engaging without compromise. Organizations spend too much time building best-in-class digital experiences, only to see the value of that effort lost by having to compromise between performance, safety and personalization. This represents a clear architectural opportunity for Fastly. The solution has to be built on the edge and it has to leverage all the benefits of our best-in-class edge cloud platform. Fast, safe and engaging without compromise. This is Fastly. Thank you so much.

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

Ronald Wayne Kisling

Chief Financial Officer, Fastly, Inc.

Thank you, Todd, and thanks to everyone for joining us today. I'll discuss our business metric 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 third quarter increased 18% year-over-year to \$127.8 million, coming in at the top-end of our guidance of \$125 million to \$128 million. Revenue from Signal Sciences' products was 14% of revenue, a 33% year-over-year increase or a 31% increase, excluding the impact of purchase price adjustments related to deferred revenue. Also, note that we calculate growth rates off of the actual results with the percentage of revenue rounded to the nearest whole percent.

In the third quarter, we saw traffic expansion at our major customers, as well as strong upsell and cross-sell activity. Our trailing 12-month net retention rate was 114%, down from 116% in the prior quarter and 118% in the year-ago quarter. We continue to experience very low churn and our customer retention dynamics remain strong.

Turning to RPO, as I discussed last quarter, our consumption-based revenue model is now being augmented with predictable revenue packages. For the third quarter, our RPO was \$248 million, up 7% from \$231 million in the second quarter of 2023 and up 43% from \$173 million in the third quarter of 2022. As Todd shared, we had 3,102 customers at the end of Q3, of which 547 were classified as enterprise, a net decrease of 4 compared to an increase of 11 in the second quarter.

As a reminder, we changed our calculation of enterprise customers this year to customers with an annualized revenue run rate of \$100,000 or \$25,000 in the current quarter, which results in more quarter-to-quarter volatility than the previous 12 months trailing \$100,000 definition. Using our prior methodology, enterprise customer count increased by 10 customers in the third quarter to 530, compared to an increase of 6 in the prior quarter.

Enterprise customers accounted for 92% of total revenue on an annualized basis in both Q3 and Q2, and enterprise customer average spend was \$858,000, up 5% from \$818,000 in the previous quarter and up 11% from \$771,000 in Q3 of last year. Our top 10 customers comprised 40% of our total revenues in the third quarter of 2023, an increase from the 37% contribution in Q2 2023, reflecting in part the impact of vendor consolidation and expansion of our traffic at some of our largest customers, which also drove one customer to account for 12% of revenue in the third quarter.

I'll now turn to the rest of our financial results for the third quarter. Our gross margin was 55.9% compared to 56.6% in the second quarter of 2023, slightly above our expectation of a 100-basis-point sequential decline. We saw increased bandwidth costs from higher-than-expected growth in traffic from customers outside the US and EU, which was partially offset by reductions in our other variable and fixed costs of revenue.

As we discussed, in 2022, we implemented new and more robust network capacity planning to better align network capacity investments with our expected traffic demand. These steps have driven significant reductions to our cash CapEx investment as a percentage of revenue, which declined from 14% in 2021 to a current range of 6% to 8%.

As part of this capacity planning, we identified approximately \$4.3 million of hardware, software and related commitments, primarily acquired or committed to in 2021 that are in excess of our requirements. We recorded an impairment charge for \$4.3 million in Q3 to reserve for this excess equipment and commitments. We excluded the impact of this charge in our non-GAAP results.

Operating expenses were \$84 million in the third quarter, an 8% increase compared to Q3 2022 and up 9% sequentially from the second quarter. A portion of this growth was a tax benefit of \$3.4 million recorded in the second quarter that did not recur in Q3 and one-time marketing expenses related to events and fees, in addition to our normal investments in R&D and sales and marketing.

The benefits from our continued focus on cost discipline and financial rigor offset these investments, resulting in OpEx coming in slightly below our expectations. This favorability, combined with revenue at the upper-end of our guidance range and gross margin slightly ahead of expectations, resulted in an operating loss of \$12.6 million, exceeding the high-end of our operating loss guidance range of \$15 million to \$13 million.

Our net loss in the third quarter was \$8 million or a \$0.06 loss per basic and diluted share, compared to a net loss of \$16.8 million and a \$0.14 loss per basic and diluted share in Q3 2022. I'm pleased to report that our adjusted EBITDA was positive in the third quarter, coming in at \$0.7 million, compared to negative \$9.1 million in Q3 2022.

Turning to the balance sheet, we ended the quarter with approximately \$461 million in cash, cash equivalents, marketable securities and investments, including those classified as long term. Our free cash flow for the third quarter was negative \$19.7 million, a \$27 million sequential decrease from positive \$7.8 million in the second quarter. This decrease was primarily driven by changes in working capital and lower operating margins as compared to Q2, which benefited from the aforementioned non-recurring sales and use tax refund of \$3.4 million.

Our cash capital expenditures were approximately 4% of revenue in the third quarter, below the low-end of our outlook of 6% to 8% of revenue for 2023. We expect to accelerate the purchase of certain hardware in the fourth quarter for deployment in 2024, which will drive our annual CapEx for 2023, as a percentage of revenue, to the high-end of our 6% to 8% range. As this demonstrates, we expect to continue to see quarterly fluctuations in the timing of our capital expenditures, but for them to align with our range on an annual basis. As a reminder, our cash capital expenditures include capitalized internal use software.

I will now discuss our outlook for the fourth quarter and 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. We undertake no obligation to update these forward-looking statements in the future, except as required by law. Our fourth quarter and full-year 2023 outlook reflect our continued ability to deliver strong top line growth via improved customer acquisition, upsell and cross-sell expansion in our existing customers, driven in part by new and enhanced products. Our revenue guidance is based on the visibility that we have today.

Historically, our revenue experienced a sequential growth in the second half that accelerates into the fourth quarter. For the fourth quarter, we expect revenue in the range of \$137 million to \$141 million, representing 16%

annual growth and 9% sequential growth at the midpoint. As we shared on our previous call, we saw some increase in price declines in the first half as a result of winning additional traffic from a major customer.

As we entered the second half of 2023, we experienced increased traffic in international markets where we saw favorable pricing. As a result, our pricing trajectory was more favorable than its normal course, and we expect that to continue for the remainder of 2023. And recall that normal reductions in our bandwidth costs and ongoing network optimization, combined with increasing traffic into our fixed cost base, typically offset our pricing decline.

Looking more closely into these dynamics on the cost side, in the second half of 2023, we saw a larger increase than previously expected in traffic from customers outside the US and EU markets. Within these markets, our bandwidth costs today are higher than those in the US and EU markets, and it had a modest adverse impact on our gross margins. While this increased traffic gives us the opportunity to renegotiate our bandwidth rates and increased peering, reducing costs for all customers in these regions, it will have a modest near-term impact on gross margins, while we complete these negotiations.

We continue to be very disciplined in our network investment and cost of revenues, which contributed to our third quarter gross margins being approximately 30 basis points better than we initially expected. For the fourth quarter, we now anticipate our gross margins will increase approximately 100 basis points relative to the third quarter plus or minus 50 basis points.

As we mentioned previously, our Q3 operating loss was moderately better than our earlier expectations, as our continued cost controls offset increased seasonal spending in marketing. For the fourth quarter, we will see the benefit of increased revenue as we continue our cost control efforts. As a result, for the fourth quarter, we expect our non-GAAP operating loss to decrease by approximately \$3 million to \$7 million to \$10 million to \$6 million, and our non-GAAP loss to be \$0.05 to \$0.01 per share. We reported nominally positive EBITDA in our third quarter and expect our adjusted EBITDA to remain positive and to improve materially in the fourth quarter.

For calendar year 2023, we are raising the midpoint of our revenue guidance from a range of \$500 million to \$510 million to a range of \$505 million to \$509 million. This increase represents 17% annual growth at the midpoint. We expect our non-GAAP operating loss to improve to a range of \$44 million to \$40 million, reflecting an operating margin at negative 8% at the midpoint, which compares favorably to our prior guide of negative 9% at the midpoint and our operating margin of negative 18% in 2022.

We expect our non-GAAP net loss per share to improve to \$0.23 to \$0.19, reflecting the improvement in our operating loss expectations, compared to our prior range of a net loss per share of \$0.27 to \$0.21. And we expect our adjusted EBITDA for calendar year 2023 to be positive, compared to negative \$32.9 million in 2022.

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 will take our first question from Frank Louthan with Raymond James. Your line is open.

Frank G. Louthan

Analyst, Raymond James & Associates, Inc.

Q

Great. Thank you. Just following up on the guidance, any change to the longer-term metrics you gave at the Analyst Day, particularly the free cash flow guide from 2024? And then to follow up on the OpEx declines, how much further can we see that decline, and what's sort of a good run rate for that going forward? Thanks.

Ronald Wayne Kising

Chief Financial Officer, Fastly, Inc.

A

Yeah. I think if you look at the sort of outlook, particularly with respect to cash flow that we gave back on the Investor Day, I think that is still intact. If we look toward 2024 on our cash flow basis, we would look to be breakeven-ish on a cash basis.

Todd Nightingale

Chief Executive Officer & Director, Fastly, Inc.

A

On the OpEx side, I'm pretty happy with the cost control across the company right now. But I'll tell you, we've got – we still have some significant benefits here. I mean, it takes a while to unravel long-term SaaS contracts and commitments. And we're still seeing that, we're still reaping the benefits there. And we've done, I think, a pretty good job of putting business model [ph] rubrics (00:27:38) in place to control the head count, to control the operating models for our teams, so that, going forward, we don't expect OpEx to grow nearly as fast at the top line, and I think that's going to be a key for us.

Frank G. Louthan

Analyst, Raymond James & Associates, Inc.

Q

All right. Great. All right. Thank you.

Operator: And we will take our next question from Jonathan Ho with William Blair. Your line is open.

Jonathan Ho

Analyst, William Blair & Co. LLC

Q

Hi. Good afternoon. Just wanted to get a little bit more color on what you're seeing in terms of the spending environment and some of the budget tightening? It's the first question.

Todd Nightingale

Chief Executive Officer & Director, Fastly, Inc.

A

Yeah. It's super interesting. We see budget tightening in some of our accounts that can lead to vendor consolidation. They don't want to manage many vendors. That tends to be good news for us. Because, as the performance leader in almost all of those deals, they tend to want Fastly to be part of their solution, even if they stick with a multi-vendor play.

There are some cases where we've seen deals taking a little longer to close, as more approvals are needed. I think that might be the nature of the current economic environment that we're in and we haven't seen those deals dissolve. We've seen them take a slightly longer than usual, but we're tracking that very carefully, kind of – I might have a little bit more interesting information next quarter on it, but we haven't really been too worried about it so far, but we're noticing something.

Jonathan Ho

Analyst, William Blair & Co. LLC

Q

Got it. And just as a follow-up, yeah, how should we think about where you're growing in terms of the international markets? Is there a way for you to maybe help us understand what markets these are? Is there a specific vertical that you're seeing traction internationally? And how long does it sort of take for some of these contract renegotiations to take? Thank you.

Todd Nightingale

Chief Executive Officer & Director, Fastly, Inc.

A

Sure. We see – we've been pushing on our international go-to-market for sure and that drives local business with local traffic in those expanding regions for us. But what is interesting and what is causing some of our model to shift a tiny bit is, we've got large multinationals who are successfully penetrating new regions themselves and they're using Fastly to partner to deliver that content. We see it in media largely.

And I think it's really good news. It's helping us grow into those markets and modernize our infrastructure and our – or I should say, mature our infrastructure. And that's what leads to those contract negotiations. Because with more traffic, we're able to negotiate and peer more effectively in those regions and that improves the margin for all of our traffic in that region, not just the multinationals, but the local traffic as well. It can take as little as a quarter, but more likely, probably six months. It doesn't take a full year, generally speaking, because those contracts have a much tighter timing on renegotiation.

Operator: We will take our next question from James Fish with Piper Sandler. Your line is open.

James E. Fish

Analyst, Piper Sandler & Co.

Q

Hey, guys, nice quarter here. Todd, maybe for you, channel partner deal registration up three times year-to-date. Can you just talk about what those channel partners are leading with between delivery that tends to be more self-serve versus security, understanding you gave some of those metrics there? And really, the crux is, is kind of what kind of economics you're seeing versus the traditional Fastly model? And then I've got a follow up for Ron.

Todd Nightingale

Chief Executive Officer & Director, Fastly, Inc.

A

Yeah. No worries. Our partner community is largely – it historically been around the security business, and we're starting to see that branch out from just security to them being able to operate across the portfolio, which is awesome. And that's been a big help, especially new partners that we're bringing on board. They're capable of operating and, in some cases, have much broader expertise. And that's why, for me, the jump of partners in the program up to 55 really matters. I think that is a broadening of the expertise of our partner community, and I think will also help customers who engage with those partners onboard faster, which is an important metric to our business.

And the other thing is just on the geographic side. We've got our traditional partner program, before the revamp, was really heavily focused in the US. We're seeing it start to ramp up outside of the US and that's helping quite a bit. And I should say, the partnership with the cloud providers helps that move a little faster. In some cases, it's easier for partners to onboard, because they're already operating through a cloud marketplace, and that is a nice synergy for them, and it's valuable for us as well. It lowers our operating costs.

James E. Fish

Analyst, Piper Sandler & Co.

Q

Got it. I'm not surprised to see the top 10 up. Just you guys own the relationships with those top 10 customers. And it's bit of a double-edged sword, especially as you think about the history of the space. So, I guess, how are you guys trying to mitigate some of that risk around those top 10 customers? Are you looking to sign those customers for longer contracts? And also, Ron, any puts and takes on 2024 to think about, understanding you're not going to guide here for it specifically, but especially as we start to think about how this packaging can kind of impact growth rates moving forward? Thanks.

Todd Nightingale

Chief Executive Officer & Director, Fastly, Inc.

A

Yeah. I'll say, I'm proud of the growth in the top 10 accounts, and we take that very seriously at Fastly. So, the largest, the most sophisticated users of this tech, they trust Fastly and they're leaning into the platform more and more strategically, which is a good thing. The only way that I look to combat that is through enterprise customer acquisition, especially large strategic customers.

I have – we love engaging with those large customers. I have no interest in doing anything, but growing those accounts as fast as we can, and adding more and more technology to those partnerships. But it's a long-term mitigation that has to come through customer acquisition, especially differentiated vertical customer acquisition. And that's why we're so focused on that. That's why we mentioned some of the expansion verticals, especially e-commerce expansion verticals that we're focused on.

Ronald Wayne Kisling

Chief Financial Officer, Fastly, Inc.

A

Yeah. And I think looking to 2024, and we haven't really shared our 2024 guidance. We talked a little bit about some of the cash flow expectations on our Investor Day. [ph] Yeah, we will share that as we've (00:34:28) historically done on our Q4 call in February. I think what I would say is, I think we're excited about the progress to-date. We continue to believe in our ability to outperform the market, continuing into 2024.

James E. Fish

Analyst, Piper Sandler & Co.

Q

Thanks, guys.

Todd Nightingale

Chief Executive Officer & Director, Fastly, Inc.

A

Thanks.

Operator: We will take our next question from Rishi Jaluria with RBC Capital Markets. Your line is open.

Richard Poland

Analyst, RBC Capital Markets LLC

Q

Hey. This is Richard Poland on for Rishi Jaluria. Thanks for taking my question. So, I guess, first one, just any sense for how much of that top 10 account expansion was on the traffic side versus a cross-sell of the broader portfolio, maybe getting more security products in there, just any color around kind of the breakdown of that?

Todd Nightingale

Chief Executive Officer & Director, Fastly, Inc.

A

It is a good question. We don't disclose it, although we do track it. The peak in international traffic that came from those large multinationals, that's largely traffic expansion. But there are new use cases being added with those folks all the time, because it's hard for us to disclose details on that. Maybe we will look and see if there's something that we can share in the longer term. Anything you'd add there?

Ronald Wayne Kisling

Chief Financial Officer, Fastly, Inc.

A

I mean, the only thing I'd add, I think, as you look at that growth, I mean, vendor consolidation that we saw at one of our largest customers clearly was a contributor in that concentration. I think, as Todd said earlier, I think as we look forward to the benefits from some of the sales and marketing, the packaging and the channel, as that accelerates new customer acquisition, that should be a countermotion to the expansion. We're going to continue to see, particularly our largest customers that you see in that top 10 number.

Richard Poland

Analyst, RBC Capital Markets LLC

Q

Thank you. That's very helpful. And then just a quick follow-up, on the security portfolio. I think, if I recall correctly, the bot management solution was still in beta as of last quarter. So any update there and just kind of how the progress of expansion of the security portfolio is going? Thanks.

Todd Nightingale

Chief Executive Officer & Director, Fastly, Inc.

A

Yeah. That's great. Our bot product is – we have like a very large number of folks on the beta. It's going limited availability this quarter. I hope to actually be able to close some deals on with this quarter, and then GA in the first half. We've had amazing success. I've been really happy with how many customers have leaned in to the beta and are helping us really co-develop that solution. And we got one more feature to check off and it'll become available to customers and to our sales team to start closing deals. So, I'm super excited about that.

We're also looking at a couple of other important areas on the security side, a productization of both – potential productization, I should say, of deeper DDoS analytics, visualization and services, as well as a deeper feature set in API security. It's become really clear to us that the buyer in this space that's looking for strategic edge partner in CDN, security, edge compute, et cetera, they're looking for a suite, a security suite that includes bot, DDoS, Next-Gen WAF and API security, and we plan on pushing hard on all of those components.

Richard Poland

Analyst, RBC Capital Markets LLC

Q

Awesome. Very helpful, Todd. Thank you.

Todd Nightingale

Chief Executive Officer & Director, Fastly, Inc.

Great.

A

Operator: We will take our next question from Will Power with Baird. Your line is open.

William V. Power

Analyst, Robert W. Baird & Co., Inc.

Okay, great. Thanks. Yeah, I guess, a couple. Maybe just starting on competition, I mean, you kind of noted and, I guess, we've seen a couple of smaller players selling off contracts and, I guess, exiting the business. I just wonder more broadly kind of what you're seeing from a pricing environment? At least in the US, it sounds like international pricing is helping probably overall. But any kind of color as to kind of how the competitive environment is looking today?

Q

Ronald Wayne Kisling

Chief Financial Officer, Fastly, Inc.

Yeah. I think, from a pricing perspective, as we said, the international mix, we do have slightly favorable pricing relative to kind of the major markets in the US and EU. And that really provided, if you will, some strength kind of in the quarter-to-quarter pricing. I think, generally in the US, the trend has been generally in line with our long-term trend. We did have some deceleration in the first half from some of the vendor consolidation. And I would say, outside of that international or if you look at it by market, it's generally been return to more of those long-term trends. We haven't seen any acceleration and we still see a good pricing environment, I think, discipline across the industry.

A

William V. Power

Analyst, Robert W. Baird & Co., Inc.

Okay. And then I guess, Ron, just on the gross margin comments, it sounds like there are some headwinds, just given the international traffic in Q4. But how would you kind of frame up how to think about gross margin progression next year? I mean, I know you've generally been expecting it to rise, but how quickly do you get kind of international kind of behind you and back kind of maybe on the targets where you were?

Q

Ronald Wayne Kisling

Chief Financial Officer, Fastly, Inc.

Yeah. I think if you look at kind of that timeline, I mean, I think the medium- to long-term gross margin dynamics are still intact. And I think the 80% gross margin that we had mentioned at the Investor Day in that medium to long term...

A

Todd Nightingale

Chief Executive Officer & Director, Fastly, Inc.

Incremental.

A

Ronald Wayne Kisling

Chief Financial Officer, Fastly, Inc.

...are intact. Incremental gross margins are intact. I think if you look at that incremental gross margins that we've seen, in the last four quarters, have been above 60% compared to the teens kind of in early 2020. I think, as we

A

go through that contract negotiations, that's probably a couple of quarters work. I think we generally, in 2024, address most of those headwinds and get back to that medium- to long-term gross margin targets that we've laid out previously.

William V. Power

Analyst, Robert W. Baird & Co., Inc.

Q

Okay. Thank you.

Operator: We will take our next question from Tim Horan with Oppenheimer. Your line is open.

Timothy Horan

Analyst, Oppenheimer & Co., Inc.

Q

Thanks, guys. Can you talk a little bit about the compute products? What customers are using it for and why are they using you? And any color when that kind of starts to move the revenue needle? Thanks.

Todd Nightingale

Chief Executive Officer & Director, Fastly, Inc.

A

Hey, Tim. We missed the first part of that. Could you repeat the question?

Timothy Horan

Analyst, Oppenheimer & Co., Inc.

Q

Yeah. I apologize. Can you talk about which compute products your customers are using? What are they using it for? And why are they [indiscernible] (00:41:18) needle? Thank you.

Todd Nightingale

Chief Executive Officer & Director, Fastly, Inc.

A

Yeah. Great question. The customers we track our compute business on customer acquisition, people tend to come to Fastly because we are really delivering freedom to developers, especially with the technology called Wasm that allows them to compile their own language and run it on the Fastly platform. You saw there's a release, I think it's in the supplement of our Go SDK, and I think that gives you a real sense of supporting languages that developers are – that are top of mind for developers, that give them the freedom to go and build serverless components at the edge.

Now, the second thing is, people come to Fastly to deliver use cases that are already proven out and that's a big deal, especially around personalization, shopping cart management, content recommendation, et cetera. That's been really a big push there. And from a vertical point of view, there's a very strong focus from high-tech companies who are – they tend to be the most sophisticated. They tend to be able to get a lot out of it very quickly, especially with pretty mature documentation and developer enablement from Fastly, in part thanks to the Glitch acquisition.

And I think that's what brings folks to the Fastly program. It's really an organic developer-first motion. I plan on tracking this business largely in customer acquisition through next year as it's still truly in incubation. But I think we're going to start to see it hit the – in some material way, hit the revenue line I hope by the tail-end of 2024 and 2025, but we'll see.

Timothy Horan

Analyst, Oppenheimer & Co., Inc.

Q

Great. And can you just give us some kind of revenue breakdown now, if possible, like on media delivery, your application delivery? Or any other color would be great.

Ronald Wayne Kisling

Chief Financial Officer, Fastly, Inc.

A

Yeah. We haven't provided that breakdown between media and other delivery across the verticals in our revenue breakdown. Sorry about that.

Timothy Horan

Analyst, Oppenheimer & Co., Inc.

Q

Okay. Thanks.

Operator: We will take our next question from Rudy Kessinger with D.A. Davidson. Your line is open.

Rudy Grayson Kessinger

Analyst, D. A. Davidson & Co.

Q

Hey, great. Thanks for taking my questions, guys. I guess, just with those smaller CDN players exiting the business in the quarter, did you pick up any material business from those smaller players that exited?

Todd Nightingale

Chief Executive Officer & Director, Fastly, Inc.

A

We do pick up – we've seen a few already move over and we've got quite a few additionally already in the pipeline. Those folks have contracts. And so, what really, I think – I think the real pattern here is that, as their contracts come due, they tend to stick their head out and make a new vendor selection. That's really a good news for us. We saw it with Digital Turbine. Those guys, pretty sophisticated group, they were able to move quickly. I'm hoping, now, we're going to see more of that really Q4 and Q1 on the new customer acquisition front.

Rudy Grayson Kessinger

Analyst, D. A. Davidson & Co.

Q

Got it. And then just general traffic growth trends across the board, anything to call out, any material changes, or just how's general traffic trend – traffic growth trending?

Todd Nightingale

Chief Executive Officer & Director, Fastly, Inc.

A

Yeah. The traffic trends pretty – have been sort of interesting. There have been a lot of interesting events. We're starting to see the seasonal sporting event trends. We even saw some peaks from content drops on some of the streaming platforms. I think it's fairly close to what we were expecting with the addition of some of the international – some additional volume on the international side.

Ronald Wayne Kisling

Chief Financial Officer, Fastly, Inc.

A

Yeah. And I think it's the...

Rudy Grayson Kessinger

Analyst, D. A. Davidson & Co.

Okay.

Q

Ronald Wayne Kisling

Chief Financial Officer, Fastly, Inc.

...normal seasonal uptick we start to see as we exit Q3, but we're continuing to see this year.

A

Rudy Grayson Kessinger

Analyst, D. A. Davidson & Co.

Got it. Great. Thanks for taking my questions and congrats on the numbers.

Q

Todd Nightingale

Chief Executive Officer & Director, Fastly, Inc.

Thanks.

A

Ronald Wayne Kisling

Chief Financial Officer, Fastly, Inc.

Thank you.

A

Operator: We will take our next question from Fatima Boolani with Citi. Your line is open.

Fatima Boolani

Analyst, Citigroup Global Markets, Inc.

Hi. Good afternoon. Thank you for taking my questions. Ron, maybe these are for you. First thing, over the course of this year, you all have been very intentional about managing your installed base and sort of pruning the less economical or lower LTV type customers in your base, and that's been pretty obvious. I'm curious if you can comment on, if you're sort of through the halfway point or towards the end of that process, such that we can start seeing somewhat robust growth in that metric? And then just a quick follow-up on some of the contract negotiations that you are foreshadowing for next year.

Q

Todd Nightingale

Chief Executive Officer & Director, Fastly, Inc.

Sorry, just to clarify, when you say pruning customers in the LTV space, what do you mean?

A

Fatima Boolani

Analyst, Citigroup Global Markets, Inc.

Just in terms of managing the installed base for higher quality customers. Just wanted to get a sense of how down the path are you that your current installed base is high value, high penetration opportunity versus some of the customers that you might have parted ways with over the course of the year. Just wanted to get a sense of where you are in that process. And is that mostly sort of done, are you done pruning?

Q

Todd Nightingale

Chief Executive Officer & Director, Fastly, Inc.

A

Got it. I'll just clarify that. We haven't pruned any customers intentionally. And largely, the way that our business runs and the way our infrastructure is built and is able to organically serve customers, I think it's pretty hard. I mean, it's very rare that we would find a customer that would be not a great fit. When we occasionally have a – or need to prune a customer, the only times I could think of that happening are on terms of use and community guidelines. The infrastructure at Fastly allows for us to have very efficient delivery, especially very efficient delivery of incremental traffic. And so, we don't – we haven't done any pruning. I absolutely don't intend to.

I do believe we have an opportunity to increase the margin by changing the traffic signature of our total customer base. But the only way that we're – the only thing we're pursuing to do that is focusing on differentiating the verticals that we serve, so that the traffic load will be more balanced across type of day, as well as the type of traffic load, and working hard to drive our customer acquisition motion into regions where we've got – where we have good infrastructure to be able to serve. And so, as far as improving the traffic mix on the platform, we certainly do that. We certainly have shifted our focus, but all of that focus is on the customer acquisition side, not on the pruning side.

Fatima Boolani

Analyst, Citigroup Global Markets, Inc.

Q

Understood. I appreciate that. And, Ron, I appreciate you're in the planning phases of 2024 right now. But some of the contract negotiations that you're, again, foreshadowing for 2024, that you're going to be addressing, can you give us a little bit of a flavor as to how big these body of contracts are going to be? Any high-level thoughts on, if these contracts may be concentrated with some of your largest customers, and any seasonality commentary at a high level you can share with us, that would be really great as we think about the next 12 months.

Ronald Wayne Kisling

Chief Financial Officer, Fastly, Inc.

A

Yeah. Yeah, I mean, I think starting with the seasonality, I think what we're certainly seeing this year is fairly consistent seasonal patterns. As we worked through Q3, we started to see an increase in traffic. We expect us to continue to see that accelerate in Q4, I think, as reflected in our guidance. I think, as you look to 2024 from seasonality, I think, again, we expect the typical seasonal patterns to continue. Q1 typically is flat to down a few percentage points. We would expect that to continue into 2024.

I think, as you look to kind of customer acquisition, I think, again, there's really two motions that we have that are driving that. There is the expansion and the cross-selling opportunity in our largest customers, and we continue to be really successful at that, particularly when we see vendor consolidation, and where there's multiple vendors, we – because of our performance gain share and are able to cross-sell additional products into those customers. And then our new customer acquisition engine with a lot of the work we're doing across packages, as well as the channel, we really expect that to sort of drive acceleration in new customers in 2024. So, I think you're going to see both of those motions driving the performance in 2024, both the expansion motion, which we've consistently done well, and the new activities really driving acceleration of new customer.

Operator: And we will take our next question from Tom Blakey with KeyBanc Capital Markets. Your line is open.

Thomas Blakey

Analyst, KeyBanc Capital Markets, Inc.

Q

Hey, guys. Thanks for squeezing me in here. Just perfect setup there, Ron, in terms of the channel, you discussed some highlights in your press release this afternoon. Any color, Todd, you want to provide for us, so we

can check the sustainability here? What are the biggest changes that you've implemented in terms of this dynamic growth you're seeing of late? And I have a follow-up for Ron.

Todd Nightingale

Chief Executive Officer & Director, Fastly, Inc.

A

Yeah. I think, look, it is still early days. I hope to have hundreds of partners driving business for Fastly and, more importantly, delivering services that allow our customers to move more quickly to adopt Fastly technology more rapidly. I'd say, from a trend point of view, I just think it's an underserved space. There's a lot of systems integrators with high software specialty. They're working very closely with teams that are building out digital experiences, and they haven't had the ability to partner closely with a edge cloud provider, especially a performance leader in CDN.

And so, we've had good reception to this new partner program. We'll be looking and reviewing it for next year to see ways to make it better. But so far, for me, the trends are what I want to see. This is moving in the right direction. But I would say for sure, partner acquisition and [indiscernible] (00:52:23) are trending in the right direction. But for sure, we're planning to ramp them hard in 2024.

Thomas Blakey

Analyst, KeyBanc Capital Markets, Inc.

Q

Does that include – just a quick follow-up before I ask Ron a question. Does that include like enterprise-caliber customers? And what are the – why is this kind of growth unique to Fastly, and what are the incentives? Sorry, just a lot of growth here and a big opportunity and typically...

Todd Nightingale

Chief Executive Officer & Director, Fastly, Inc.

A

Yeah.

Thomas Blakey

Analyst, KeyBanc Capital Markets, Inc.

Q

...doesn't really benefit from the channel.

Todd Nightingale

Chief Executive Officer & Director, Fastly, Inc.

A

Yeah. And I really think [indiscernible] (00:52:55) just the way the first few entrants into this product space have operated. I think looking at the market now, there's so much software spend that's already going through the cloud marketplaces. Systems integrators know how to operate that and operationalize deals big and small through those systems and direct to vendors. We offer both options. For me, there's one other twist, which is the ability – the flexibility in that channel program matters.

Our channel partners can operate in the traditional channel sales motion, but also in an agency model. That flexibility matters. And the way that we operationalize that, I think, is important. We're also engaging with partners who are really on the technology consulting side for the first time. And those engagements, although it's early days, I think, have a lot of potential upside as well. And those are like technology consultants largely. But, I guess, my point of view, and I think this will play out in the next 12 months, is that this is just an underserved part of the market. And by focusing here, we have an opportunity to gain the attention of the channel community.

Thomas Blakey

Analyst, KeyBanc Capital Markets, Inc.

Q

Very helpful. And then, Ron, on the 50% channel revenue growth, can you just – all the requisite questions there, over what period of time, what percentage of revenue here, even if it's a range, and where you kind of expect that to head in the coming year or two? That'd be helpful. Thanks, guys.

Ronald Wayne Kisling

Chief Financial Officer, Fastly, Inc.

A

The 50% channel growth that we said...

Thomas Blakey

Analyst, KeyBanc Capital Markets, Inc.

Q

Well, you talked about revenue channel growth. Just...

[indiscernible] (00:54:44)

Thomas Blakey

Analyst, KeyBanc Capital Markets, Inc.

Q

...over what period of time is that and...

Ronald Wayne Kisling

Chief Financial Officer, Fastly, Inc.

A

It's program to-date year-over-year.

Thomas Blakey

Analyst, KeyBanc Capital Markets, Inc.

Q

Okay. And where are we in terms of a percentage of revenue, and where do you expect that to go? Todd kind of spoke positively there that, obviously, it's going to increase. Just to give us something like level set here would be helpful.

Ronald Wayne Kisling

Chief Financial Officer, Fastly, Inc.

A

Yeah. So, I think what I would say is, we haven't given the specific percentage of revenue, but we do expect it to continue to grow as a percentage of revenue. I think in terms of really gaining traction and being a contributor, we see that really gaining traction in 2024. [indiscernible] (00:55:24) happen this year, we expect to see that grow as a contributor to our overall revenue in 2024.

Thomas Blakey

Analyst, KeyBanc Capital Markets, Inc.

Q

Great. Thank you.

Operator: And we'll take our final question from Madeline Brooks with Bank of America. Your line is open.

Madeline Brooks

Analyst, BofA Securities, Inc.

Q

Hey, team. Thanks so much for taking the question. Just a quick one for me here. Looks like from an edge compute standpoint, you've had a lot of positive signals with the packaging motion. So just want to marry that quickly to the budget comments, and the landscape you guys are seeing with the slight weakness. I mean, just want to know, and apologies if this has been asked [indiscernible] (00:56:00) few calls, but why do you think it's hitting Fastly now versus other companies earlier? And can you call out any specific areas it's impacted more versus less? Thanks so much.

Todd Nightingale

Chief Executive Officer & Director, Fastly, Inc.

A

Sure. On the compute side, I feel like the momentum is really good for us right now. I feel like you do need a critical amount of feature set and functionality before developers can really reach the kind of outcomes that they care about, running their services at higher cost, dramatically improving performance and user experience, being able to build sustainable solutions, and pull the appropriate workloads from their core into an edge serverless environment that will have the kind of performance, the kind of user experience improvement that they want.

And I think we're getting – we're starting to hit our stride, which is great. I think we have opportunity here on the product side as well, [indiscernible] (00:56:58), but I think we can simplify our offering and make it even easier for our customers to onboard and understand all the components there. So it's not to say that we've arrived. We're going to be on this journey for quite a while.

Your second question was around the belt tightening comment in the opening, is that correct?

Madeline Brooks

Analyst, BofA Securities, Inc.

Q

Yes, correct.

Todd Nightingale

Chief Executive Officer & Director, Fastly, Inc.

A

Yeah. I guess, we may have briefly mentioned it already. I think what we're seeing as our customers' budgets feel a little pinch to them, that certainly drives vendor consolidation. That tends to be a good thing for us. As the performance leader, we tend to fare well in those engagements. We do see a little bit of slowness in the deals as vendor changes.

When customers are leaving, some of our competitors are coming to Fastly. Changes in contracts are just getting more scrutiny, requiring more sign-ups, and that can delay some deals. So, we've seen a few deals that have taken a little longer to close than we'd like. But we'll see. I think I mentioned this earlier, like I think we might have a more of a complete perspective of that next quarter. Yeah.

Madeline Brooks

Analyst, BofA Securities, Inc.

Q

Got it. And sorry, just to quickly clarify that, Todd. So, is it fair to say that deals have elongated, but close rates have remained stable throughout the quarter?

Todd Nightingale

Chief Executive Officer & Director, Fastly, Inc.

A

Yeah. Well, we track a few – we track very carefully key deals in the quarter, and we saw a few of them slip a few weeks, nothing material. I mean, some of these are six-month engagements, and we saw them slip a few weeks.

And that – yeah, that slip is largely due additional approvals that are needed. I'd say, it's anecdotal, but we'll be tracking it closely. So, I might have better data for you next quarter.

Madeline Brooks

Analyst, BofA Securities, Inc.

Q

Got it. Thanks so much. Nice quarter.

Todd Nightingale

Chief Executive Officer & Director, Fastly, Inc.

A

Great and thank you.

Operator: And that concludes our question-and-answer session. I will now turn the call back to Mr. Todd Nightingale closing remarks.

Todd Nightingale

Chief Executive Officer & Director, Fastly, Inc.

Thank you so much. I do want to take a minute to thank our employees, our customers, partners and investors. Moving forward, we will continue to remain focused on execution, bringing lasting growth to our business and delivering value to our shareholders. I'd like to close by saying how excited I am about the road ahead.

Of course, there's plenty of work to do, but I believe digital experiences will drive the mission and define the success of almost every organization, everywhere in Fastly, while the significant impact on the way digital experiences are built and delivered around the world. Our customers have a real passion for Fastly solutions, and employees have a real enthusiasm for our mission to make the Internet a better place where all experiences are fast, safe and engaging.

Thank you so much for the time today.

Operator: And ladies and gentlemen, this concludes today's call, and we thank you for your participation. You may now disconnect.

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