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Fastly, Inc. (FSLY)

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MANAGEMENT DISCUSSION SECTION

Operator: Hello. Good afternoon. My name is Jeremy, and I'll be your conference operator today. At this time, I would like to welcome everyone to the Fastly Second Quarter 2023 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.

I'd now like to turn the conference over to Vernon Essi, Investor Relations at Fastly. Please go ahead.

Vernon P. Essi

Vice President-Investor Relations, Fastly, Inc.

Thank you, and welcome, everyone, to our second 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 second quarter 2023 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 third quarter, the KeyBanc Technology Leadership Forum in Vail, Colorado on August 7; and the Piper Sandler Growth Frontiers Conference in Nashville, Tennessee on September 13.

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 second quarter highlights, and then I will provide a brief update on the progress made in our product strategy and go-to-market motion before I hand the call over to Ron to discuss the second quarter financial results and guidance in detail.

We reported second quarter revenue of \$122.8 million, which grew 20% year-over-year and 4% quarter-over-quarter. This represents a significant increase in our year-over-year growth rate of 15% last quarter. I'm glad to see new enterprise customers drawn to Fastly's platform and a growing momentum within our go-to-market teams. I'm pleased that we exceeded our guidance range as we saw upside during the quarter from some of our larger customers and I expect to see that strength carry into the rest of 2023. I'd like to congratulate the Fastly team on pulling together new initiatives in our go-to-market strategy and delivering a strong Q2. I look forward to executing to and possibly exceeding plan for the remainder of 2023.

Our customer retention and growth engine remain strong. Our LTM NRR was 116% in the second quarter, flat from Q1 and slightly down from 117% in the year-ago quarter. Our DBNER was 123% in the second quarter, up from 121% in Q1 and also from 120% in Q2 of last year. Both of these metrics are indicative of healthy wallet share gains with existing customers. Thanks to our platform's expansion, we continue to cross-sell more functionality and more traffic to our existing customers.

Our total customer count in the second quarter was 3,072, which decreased by 28 customers compared to Q1 and increased 47 year-over-year. About a third of this quarter-over-quarter decline was due to customer consolidations. It's also worth noting that most of these customers were relatively small in ARR. We did see good momentum in enterprise customers totaling 551 in the quarter, an increase from 11 from Q1 and 52 year-over-year. Our average enterprise customer spend was \$818,000, representing a 3% quarter-over-quarter increase, as well as a 10% increase from Q2 of last year. We've seen continued wallet share expansion with customers as we've aligned our teams to be more focused on customer success and expansion.

Our portfolio expansion strategy continues to yield cross – strong cross-selling activity. We've seen strength in security, our growth product line, especially in Next-Gen WAF technology, augmenting our core network services offerings. This has been especially true as our Edge WAF has reached feature parity and is now easier than ever to enable for existing [ph] Fastly CDN (00:05:41) customers.

In WAF, we've seen both upsell success and new logo wins as stand-alone sales. We've also seen good momentum in our incubation businesses, compute, and observability. We saw success in the second quarter in selling existing customers computed edge and observability modules.

I'm excited to share some important new strategic wins and key expansion verticals for us. We saw our first win at Abercrombie & Fitch, a well-established brand with an innovative focus on omni-channel selling. I'm really proud of our team here, unseating an incumbent in a very competitive win and leveraging our new packaging model. You can refer to June's press release here for more information.

It's also worth noting that this is one of several new logo wins in the retail vertical. During the quarter, we closed nine new retail customers, many of them enhancing their digital experience closely tied to their brick-and-mortar presence. They include luxury brands like David Yurman and Diptyque; major European home improvement chain, Hornbach; and specialized woodworking supplier, Rockler. We also expanded our travel and leisure presence with the addition of Bally's Interactive.

We also saw great interest from high tech, closing nine new logos in the developer tooling and cybersecurity categories during the quarter including Bugcrowd, a crowd-sourced ML matching cybersecurity platform. Our media vertical continues to expand with the addition of Bonnier News, serving the Nordic region; as well Tango, a live-streaming social media platform. You can refer to our investor supplement for more information.

Our gross margin was 56.6% for the second quarter, representing a 100-basis-point expansion quarter-over-quarter and a 620-basis-point increase year-over-year. I'm incredibly pleased with this result as our continued efforts to work rigorously on our cost of revenue and fixed cost footprint are yielding real results. Our operating expenses were \$77 million in the quarter, coming in lower than anticipated by approximately \$6 million. While our rigorous cost controls drove about half of this decline, the other half was due to timing of marketing expenses and an increase in capitalization of internal-use software. Also, please recall that we took a \$3.4 million benefit in G&A due to a tax refund that won't occur in future quarters. Ron will explain in more detail, but as you can see from our guidance, 2023 spending is favorable, and we are now looking to improve on our prior 10% operating loss target for the year.

During the quarter, our durable innovation engine continued to deliver new developments to our feature set. There were several new technology releases you can see in our supplement such as, in the second quarter, we released support for Mutual TLS, bidirectional authentication for our customers' origin. This trusted digital certificate feature will save time and resources around mTLS setup and management for our customers.

Focusing on the automation power of the Fastly platform, we released Dynamic Backends, enabling customers create new back-end server definitions even more seamlessly. Our new Core Cache API allowed developers to extend their code on our Edge Compute platform with access to our powerful globally distributed cache network. We're excited about the [ph] feature (00:08:58) launches in our Next-Gen WAF solution like Advanced Rate Limiting and Site Flagging (sic) [Flagged] (00:09:02) IP signal. This caps off a migration of our WAF security technology to our native edge platform.

And lastly, we released into limited availability Certainly, which provides domain-validated TLS certificates that are fully automated in our Fastly-managed TLS services. This will enable trusted identification of websites to our customers, improving security and reliability. Expect to hear a lot more about this and website authentication with Fastly in the coming quarters.

Let me take a moment to discuss AI. We've got a lot of questions on this from the investor community, and I'd really like to share our thoughts. As we've indicated in the past, we'll be using our edge cloud to run inference for AI, and we'd expect the generative learning model to be mostly running in the central cloud. We have engagement from customers across many industries grappling of how AI is going to affect them, what the risks are and what advantages they might be able to gain from this technology.

In the case of e-commerce, we see very low latency and more personalized and more accurate recommendations coming from AI. For media and new media, we see sentiment, spam language detection, and toxicity analysis for user-generated content. Others might be interested more in computer vision AI to help identify the content of images uploaded by their users or even provide more friendly and smoother user experiences via speech recognition. We feel incredibly good about our position as a platform on which to build the next generation of user experiences via AI, experiences that are fast, safe, and engaging.

Moving on to our go-to-market development, so I'm excited to share with you that during the quarter, we introduced our new pricing and packages for Fastly's portfolio, including flat-rate pricing and tiered packages, making it easier for customers of all sizes to try, buy, and use Fastly's platform. The reception from our customers has been incredibly favorable so far.

Peter Alexander joined Fastly as our new CMO, bringing his expertise as CMO of Check Point and Harmonic, as well as marketing leadership roles at Cisco. Peter is a passionate, creative expert in demand generation and shaping the voice of technology companies. Marshall Erwin joined Fastly as our CISO, bringing his expertise from Mozilla as their CSO in addition to roles in the US intelligence community. And Karen Greenstein was promoted to General Counsel. She joined Fastly in 2019 and has been serving as our Interim GC.

I'm incredibly excited about the evolution of our senior leadership team. I believe Peter, Marshall, and Karen will bring enormous contributions to our business in driving durable innovation; a lower friction employee experience; and, most importantly, a huge focus on new logo acquisition revenue growth.

During the third quarter, I'm very excited to share with you that we'll be hosting our annual user conference, Altitude, in New York on September 26. We will invite the investor community to join our webcast as customers share their experiences using Fastly's platform.

On the financial front, we repurchased \$236 million in aggregate principal amount of our convertible debt for \$196 million, which reflected a 17% discount to par. This resulted in recording a \$37 million net gain in the second quarter. Our finance team is actively monitoring the capital markets for our liquidity needs while optimizing our cost of capital in an effort to give shareholders the best possible return.

And last but not least, we held our first-ever Investor Day in late June at the New York Stock Exchange. I want to thank the New York Stock Exchange and all of you who joined us. We greatly appreciate the level of engagement you brought, both in-person and virtually, to this milestone event. For those of you who may not have seen it, I encourage you to visit our IR website.

Now, let me take a moment to discuss the internal transformation taking place at Fastly. As I mentioned before, we've put in place structural changes to our processes and realigned our departmental teams into functional groups. We are seeing the positive outcomes this has brought to strategic initiatives and our financial results. 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 loss, 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.

Longer term, I believe following our vision of the best end user experience will guide us to where those market needs intersect with the edge cloud. And there is an enormous opportunity within that intersection.

As we simplify our offering and make it easier to deploy amazing Web technology around the world, we will find new customers. As we drive to reach a larger segment of the mid-market to acquire customers at a faster rate with a motivated, empowered channel to bring the best talent from across the cloud community to Fastly, we will be monetizing the edge cloud and providing favorable impact on returns to our shareholders. Our customers have a real passion for Fastly solutions, and our employees have a real enthusiasm for Fastly's mission to make the Internet a better place where all experiences are fast-paced and engaging.

Let me close by saying how excited I am about the road ahead. Of course, there is plenty of work to do, but I believe digital experiences will drive the mission and define the success of almost every organization around the world and Fastly will have a significant impact on the way digital experiences are built and delivered.

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

Ronald Wayne Kisling

Chief Financial Officer, Fastly, Inc.

Thank you, Todd, and thanks, everyone, for joining us today. I'll 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 second quarter increased 20% year-on-year to \$122.8 million, exceeding the top end of our guidance of \$117 million to \$120 million. Revenue from Signal Sciences products was 14% of revenue, a 32% year-over-year increase or 27% 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.

As Todd shared, in the second quarter, we saw traffic expansion in major customers as well as strong upsell and cross-selling activity. This led to a better than typical seasonal growth pattern in the second quarter relative to the first, which is usually relatively flat sequentially. We have a number of initiatives focused on increasing demand generation, motions to simplify our pricing and packaging, partnership programs and marketing activities that give us confidence in our 2023 revenue guidance. Our trailing 12-month net retention rate was 116%, flat with the prior quarter and slightly lower than the 117% in the year-ago quarter. We continue to experience very low churn and our customer retention dynamics remain strong.

As Todd shared, we had 3,072 customers at the end of Q2, of which 551 were classified as enterprise, an increase of 11 compared to an increase of 7 in the first quarter. Enterprise customers accounted for 92% of total revenue on an annualized basis, up from 91% in Q1. Our enterprise customer average spend was \$818,000, up 3% from \$795,000 in the previous quarter and up 10% to \$742,000 compared to Q2 of last year. Our top 10 customers comprise 37% of our total revenues in the second quarter, an increase from the 35% contribution in Q1 2023.

Let me take a moment to discuss our RPO, our remaining performance obligations. Our RPO reflects future committed revenue from current customer contracts and deferred revenue. As we augment our primarily consumption-based revenue model with predictable revenue packages, we anticipate our RPO will become more meaningful to the investor community. Also, our RPO will fluctuate on a quarter-to-quarter basis due to the timing

and the seasonality of customer contract renewals. So, looking at the year-over-year change is a meaningful way to evaluate the changes in our RPO. For the second quarter, our RPO was \$231 million, down 5% from \$242 million in the first quarter of 2023 and up 33% from \$173 million in the second quarter of 2022.

I will now turn to the rest of our financial results for the second quarter. Our gross margin was 56.6% for the second quarter compared to 55.6% in the first quarter of 2023. As Todd discussed, we are seeing the results from our continuing efforts to manage our cost of revenue and fixed cost footprint. Operating expenses were \$77.3 million in the second quarter, a 2% decline compared to Q2 2022 and down 3% sequentially from the first quarter.

This reflects the favorable impact of a \$3.4-million sales and use tax refund we discussed on our Q1 call, as well as approximately \$6 million in favorability in operating expenses relative to our expectations. About half of this was due to expense control measures, with the remainder due to the timing of marketing expenses where we see certain programs and related costs moving to the second half than the first half and an increase in the capitalization of internal-use software.

This favorability combined with revenue above the high end of our guidance and better than expected gross margins resulted in an operating loss of \$7.8 million, exceeding the high end of our operating loss guidance range of \$18 million to \$16 million. Our net loss in the second quarter was \$4.6 million or \$0.04 loss per basic and diluted share compared to a net loss of \$28 million and a \$0.23 loss per basic and diluted share in Q2 2022. I'm pleased to report that our adjusted EBITDA turned positive in the second quarter, coming in at \$5.2 million compared to negative \$16 million in Q2 2022.

Turning to the balance sheet, we ended the quarter with approximately \$475 million in cash, cash equivalents, marketable securities and investments, including those classified as long-term. During the quarter, we repurchased \$236 million in aggregate principal amount of convertible debt for \$196 million, which reflected a 17% discount to par value and resulted in our recording a \$37-million GAAP net gain. We will continue to monitor the capital market and are focused on improving our liquidity and cost of capital, and we'll continue to evaluate buybacks of our convertible debt at appropriate discount levels.

Our free cash flow for the second quarter was positive \$7.8 million, a \$33-million sequential increase from negative \$25.2 million in the first quarter. This improvement was primarily driven by an improvement in working capital and expanded operating margins. Our cash capital expenditures were approximately 9% of revenue in the second quarter, above the high end of our outlook of capital expenditures of 6% to 8% of revenue for 2023. We expect quarterly cash capital expenditures to decline in the second half of 2023 and to be in line with our outlook for the full year. As a reminder, our cash capital expenditures include capitalized internal-use software.

I will now turn to discuss our outlook for the third 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, and we undertake no obligation to update these forward-looking statements in the future, except as required by law.

Our third quarter and full-year 2023 outlook reflects our continued ability to deliver strong top line growth via improved customer acquisition and 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. We continue to expect expense growth for the year to lag year-over-year revenue growth and expect the meaningful improvement in our operating losses in 2023 over 2022.

As we stated last quarter, we are investing in our go-to-market efforts as part of our revenue growth initiatives to continue our expansion in our existing customers and to accelerate our new customer acquisition. We will continue our investments in product and R&D, and we see meaningful opportunities to drive greater efficiencies in our operation, especially across G&A, and expect to see meaningful leverage in our G&A costs in 2023 and for these costs to decrease as a percent of revenue.

Historically, third quarter revenue experiences sequential growth that accelerates into the fourth quarter. For the third quarter, we expect revenue in the range of \$125 million to \$128 million, representing 17% annual growth and 3% sequential growth at the midpoint.

As we have discussed, we are managing our capacity for higher traffic and revenue expected in the second half of 2023. While we continue to be very disciplined in our network investment and cost of revenues, which contributed to our second quarter gross margins being approximately 100 basis points better than we initially expected, we have on-boarded newer traffic patterns that have a modest adverse impact to our variable bandwidth cost. As a result, in the third quarter, we anticipate our gross margins will decline approximately 100 basis points relative to the second quarter, plus or minus 100 basis points. And we expect to see gross margin accretion in the fourth quarter of at least 150 basis points above Q2 levels.

As we shared on our first quarter call, we saw some increase in price declines in the second quarter as a result of winning additional delivery traffic from a major customer. We expect our pricing trajectory to return to its normal trajectory in the second half of 2023. Normal reductions in our bandwidth cost and ongoing network optimization, combined with increasing traffic into our fixed cost base in the second half, are expected to offset any pricing changes.

As we mentioned previously, our Q2 operating loss was approximately \$6 million better than our earlier projections, with half of this improvement due to the timing of marketing expenses and an increase in capitalization of internal-use software. Our Q2 operating loss also reflected the expected benefit of \$3.4 million from a sales and use tax refund.

For the third quarter, we will continue our cost control efforts. However, we will see a reversal in both the marketing expense benefit and the non-recurring sales and use tax benefit experienced in the second quarter. As a result, for third quarter, we expect our non-GAAP operating loss to increase by \$5 million to \$7 million to a loss of \$15 million to \$13 million and a non-GAAP loss of \$0.09 to \$0.07 per share. Given these results and our working capital expectations, we also expect our free cash flow to be negative for the third quarter.

For calendar year 2023, we are raising our revenue guidance from a range of \$495 million to \$505 million to a range of \$500 million to \$510 million. This increase represents 17% annual growth at the midpoint. We expect our non-GAAP operating loss to improve to a range of \$49 million to \$43 million, reflecting an operating margin of negative 9% at the midpoint compared to an operating margin of negative 18% in 2022. We expect our non-GAAP net loss per share to remain at \$0.27 to \$0.21 per basic and diluted share, reflecting the improvement in our operating loss expectations, offset by lower interest income in the second half, resulting from the \$196 million spent on our convertible debt repurchase in the second quarter.

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

QUESTION AND ANSWER SECTION

Operator: Thank you so much. [Operator Instructions] All right and we do have a couple already lined up. Our first question comes from the line of James Fish. James, please go ahead.

James E. Fish

Analyst, Piper Sandler & Co.

Q

Hey, guys. Congrats on the quarter. A couple of questions for you guys. Just first, if I look at your net retention rates, it's nice to see the trailing 12 months stabilize, but you're about to come off some high numbers kind of next quarter. I guess what's giving the confidence that we can see the number move higher? How should we think about net retention rates in the back half of the year especially given you could shed some customers, but you did sound like you landed some increased traffic at one of your larger customers? And, Ron, can you help us understand the gross number of new add this quarter? Just trying to – and quality underneath this as it looks like new business was quite good here.

Todd Nightingale

Chief Executive Officer & Director, Fastly, Inc.

A

Yeah, I can start. When we look at net retention rate, there is some organic growth in terms of usage on the platform that has a strong seasonal effect. But I think our biggest lever here and the reason we're seeing confidence from our teams in net retention rate is really about the cross-sell. We've made a lot of progress with platform unification and simplifying our sales motion. More and more of our largest deals are platform wins, even on the new logo side, meaning multi-portfolio wins. And our cross-sell motion is just getting really – I think gaining a lot of momentum. And so, that's I think really why we see confidence there on the net retention rate.

Ronald Wayne Kisling

Chief Financial Officer, Fastly, Inc.

A

And looking at total customers, I think, one, as you saw, our enterprise customers actually accelerate a little bit from plus 6 to plus 11. When we look at the aggregate number of customers, if you exclude customers at the low end, we actually did see a net add. If you take customers under [ph] \$1,000 (00:29:00) ARR, you would have seen some increase in the total customer number on a quarter-on-quarter basis. So, at the medium and high end, we're seeing good customer quality and adds.

James E. Fish

Analyst, Piper Sandler & Co.

Q

Got it. And, Todd, maybe for you. Sales incentives mainly have a line for kind of new use cases today, but at the Analyst Day we all talked about the big security opportunity, both as a spear for new logos and for expansion in the existing base. I guess what's going to be the differentiation and ability to replace your competitors at a lot of these overlapping and major customer accounts? And additionally, do you feel a need to potentially change sales incentives to align more with security cross-sell rather than new logos at all?

Todd Nightingale

Chief Executive Officer & Director, Fastly, Inc.

A

We are primarily focusing sales incentives around new logo growth. Of course, total revenue growth, but new logo growth especially when we look at [indiscernible] (00:30:07) or special incentives. The security cross-sell, I think

in a lot of ways, is – it's a natural extension of the sales motion, relationship – customers with whom we have a great relationship and really a best-in-class offering, especially in Next-Gen WAF.

I think the last piece to that puzzle is really completing the platform unification play. This past quarter we saw feature parity on our Edge WAF, our on Fastly platform Next-Gen WAF solution with the traditional SigSci solution, which is a big step in making that cross-sell smoother. And the platform unification for management claim, which we hope to have in the market by the end of the year, will really, I think, complete that story. I'm not really anticipating that we're going to need special sales incentives around the cross-sell. I would expect new customer acquisition primarily.

Operator: All right. Thank you. Our next question comes from the line of Frank Louthan. Frank, please go ahead. Frank, are you there? You might be on mute.

Frank G. Louthan

Analyst, Raymond James & Associates, Inc.

Q

Sorry about that. Okay. Hey. Thanks a lot. Can you walk us through the status of the chat channel program, kind of when does that began and where are you seeing that there? And then maybe a little more details on your cross-sell efforts here with Signal Science and delivery. Where are you on being able to roll that out with customers and what's the response? Thanks.

Todd Nightingale

Chief Executive Officer & Director, Fastly, Inc.

A

Yeah. The channel program was launched I think two quarters ago and we've had, I think, a pretty good uptick. We're seeing a significant increase in deal registration, which for me is kind of the leading indicator here in terms of a healthy channel launch. And deal registration also drives new logo acquisition, which obviously is a huge focus of ours across the board. We've seen some really creative partnerships as well, traditional systems integrators, especially on the security side, incredibly strong. But folks who actually embedded Fastly technology onto their platforms and have been able to resell it that way like A10, that's been incredibly successful so far, too.

So, right now, we're feeling pretty bullish about where the channel program lies. There's one interesting piece, which is the channel that we sort of had been incubating for the last year before the big channel launch started with the Signal Science business. And because of that, the Signal Science business had historically been primarily North American based. So, our channel has a little bit more maturity in North America. We're working hard to build out a comparable channel in the EU, but certainly it lags and we see that. We're investing there to make sure that we've got good channel coverage in at least both of those primary markets.

[indiscernible] (00:33:24)

Frank G. Louthan

Analyst, Raymond James & Associates, Inc.

Q

Great. And with that on the channel side, can you give us what sort of percentage of your sales came from channel in the quarter? Or where do you expect that to end up by year-end?

Ronald Wayne Kising

Chief Financial Officer, Fastly, Inc.

A

Yeah. So, yeah, the channel launch, particularly the security side coming from Signal Sciences has been a heavily channel-led business. And that business in the aggregate was 13% in the quarter, 14% of revenue in the

quarter. The big piece of that is channel-led. The channel delivery, which was launched two months ago, is we're starting to see some early traction. But in terms of a percentage, it's still a fairly nominal percentage at this point. We should start to see that ramp more in the second half and more of the business outside of Signal Sciences be sold through the channel partners.

Todd Nightingale

Chief Executive Officer & Director, Fastly, Inc.

A

I'll just try to highlight more of this, the channel deals and get the clearance to share more of that in the future. But it was nice to see, and I thought it matter, a handful of our biggest deals, some of the top five deals in the quarter went through the channel and were sourced there. And that to me actually makes a big difference. Internally, it signal to our sales team that you can find success through the channel and that helps us continue that momentum there.

Frank G. Louthan

Analyst, Raymond James & Associates, Inc.

Q

Okay. Great. Thank you very much.

Todd Nightingale

Chief Executive Officer & Director, Fastly, Inc.

A

Thanks.

Operator: All right. Our next question comes from the line of Sanjit Singh. Sanjit, please go ahead.

Sanjit K. Singh

Analyst, Morgan Stanley & Co. LLC

Q

Thank you for taking the questions and congrats on the quarter and regaining that 20% growth threshold. I want to get a sense of, Todd, from your perspective, as you guys sort of expand into new industries and you guys called out tech, how is the composition of traffic on the network changing? And does that have any sort of impact or mix effect on sort of your – the gross margins that you expect – that you still saw this current quarter and what you sort of expect going forward?

Todd Nightingale

Chief Executive Officer & Director, Fastly, Inc.

A

You know what, that is a really great question because we have some of that conversation internally. So, the mix shift by vertical, it matters actually a lot when it comes to time-of-day loading. Our infrastructure tend to be highest – under highest load in the evenings when people are streaming entertainment most commonly. And so, things like tech that tend to have a more balanced workload tend to be a good margin tailwind to us.

And you can imagine other types of verticals that have that shape will – that type of time-of-day mix is a margin tailwind for us for sure. It's also the case that tech, hospitality, people with large personalization requirements, e-commerce, retail, they tend to be pretty interested in the compute platform. And that, again, is the mix that will kind of be a tailwind to our margin. So, those things have been helpful. And I think we're going to start to see more of that effect in the coming 24 months.

Sanjit K. Singh

Analyst, Morgan Stanley & Co. LLC

Q

That's super helpful. And just sort of broader question sort of picking up on some of the themes from the Investor Day, the sort of one Fastly kind of unifying go-to-market, product engineering sort of customer advocacy, what inning do you think we're in? I mean, you sort of launched the channel program, which you talked about a couple of minutes ago. But what's more coming down the pipe over the next three to four quarters that we should be paying attention to?

Todd Nightingale

Chief Executive Officer & Director, Fastly, Inc.

A

When we think about one Fastly, the biggest piece that's coming is the full platform unification. And what that means is all of the product offerings can be managed from a single management suite, no swivel management, regardless of which type of Next-Gen WAF deployment you're using. If you're – if you have Next-Gen WAF and you add content delivery, if you expand the compute, if you deploy observability, there's one platform. Meaning one management plane, one API, and importantly, one set of infrastructure.

And what that means is a benefit for the user experience because they don't have that swivel chair. It's easier for them to operate and expand from one portfolio to the next. It makes our sales team's job in that land and expand easier for sure. And, of course, it drives a real simplicity in the operation. We don't have to run multiple different types of infrastructure. We don't have a completely different infrastructure for compute. We have one set of infrastructure where all of our services we run one management plan, one API, and I think there's benefits in ops and sales and certainly in the customer experience.

Sanjit K. Singh

Analyst, Morgan Stanley & Co. LLC

Q

Understood. Thank you very much.

Todd Nightingale

Chief Executive Officer & Director, Fastly, Inc.

A

Oh, you asked what inning. I'm saying we're in the fourth.

Operator: All right. Our next question comes from the line of [ph] Jonathan Ho. Jonathan (00:38:43), please go ahead.

Q

Hi there. Good afternoon and congrats on the strong results. Can you give us a little bit more color on sort of the AI opportunity that you described? And maybe what some of these specific use cases are, what the potential for revenue is, and how soon should we sort of expect this to become – or will it even become sort of a meaningful driver?

Todd Nightingale

Chief Executive Officer & Director, Fastly, Inc.

A

Yeah. I mean, I think it's a good question when it will become a meaningful driver. You should know we're not planning for it to be a meaningful driver for the remainder of this year. But the use cases are incredibly interesting. We see AI and especially inference-based algorithms that are being used for deep personalization, content recommendation, product recommendation, etcetera. And the sophistication of that algorithm truly matters directly

to the ROI of some of our customers, especially in e-commerce and media, etcetera. And I think those folks are experimenting with it right now.

But this is – it's a very interesting intersection for us where personalization matters and user experience matters. And where there's a strong ability for those two things in our stack, I feel like that's where we're going to see the AI at the edge. And this is a great example of the kind of multi-cloud strategy that we talked about at Investor Day. We know these models are going to be trained in central cloud, on AWS and GCP and then deployed to the edge in order to make those real-time decisions. And I think that's good. I think that's the way developers want to operate. And that puts the central cloud and the edge in a place where they can both shine.

Q

Excellent. And then just in terms of the new traffic patterns that you described that potentially impact gross margins, is there any additional detail that you can provide? And do you expect this to be a continued trend over time?

Todd Nightingale

Chief Executive Officer & Director, Fastly, Inc.

A

I do expect it to be a trend. I think any vertical – we are obviously focusing on vertical differentiation, the customer base, and new logo acquisition in non-media, non-publishing verticals. And that differentiation, it matters. It does matter because of the time of day, but also it does matter because of the type of workloads that they have. Compute and security workloads tend to be a tailwind to our gross margin. We'll have to give it some thought. I don't have any other data point that I could disclose right now there, but I definitely do expect it to be a tailwind as we continue to differentiate the customer base.

Q

Thank you.

Operator: All right. Our next question comes from the line of [ph] Madeline Brooks. Madeline (00:41:51), please go ahead.

Q

Hey, guys. Congrats on the strong quarter. Just two quick follow-ups from me. I guess first is the environment. From a guidance perspective, it looks like the – most of the raise is really coming from the [ph] beat (00:42:07) this quarter. So, how are you feeling about the environment going into the back half of the year? And then just one quick follow-up on AI after that. Thanks.

Todd Nightingale

Chief Executive Officer & Director, Fastly, Inc.

A

Sure. As far as the environment goes, I think we are actually pretty bullish. We've seen some of our – some other folks in the market be a little bit concerned about the growth in their user base. And I think maybe there are some of that down market, but we have very little exposure to it. Maybe some in service provider or banking. Again, we don't have a lot of exposure there. I like more [indiscernible] (00:42:48).

Look, I think as far as the guidance goes, and I think you make a good callout, like, we want to be very clear that we are being responsible about the guidance, that we have very high confidence in hitting those numbers. I was proud of the fact that the team was able to get real clarity and pull up the annual guide here. Yeah. I hope to do it again.

Q

Got it. Thanks for the clarification. And then on AI, understanding you're now training the models at the core and then really doing everything on the edge, from a SaaS perspective, do you see inferencing and doing storage on the edge the – as something that will require more CapEx than you're already planning for when it does become an opportunity? Or do you feel confident that the CapEx that you have spent so far is sufficient for that storage at the edge?

Todd Nightingale

Chief Executive Officer & Director, Fastly, Inc.

A

No. We have absolutely deployed for this, and you see it in the future releases over the last few quarters. We launched config store, as well as KV store, key-value pair store, which is – which can absolutely be used in order to deliver outcomes using an inference-based model. And you're going to see more storage features from us as we go forward. But this has been in the plan. And edge storage, as part of our Compute platform, is absolutely part of what we have already built out for. We're not expecting a significant change to our build plan because of that.

A

[ph] Thanks (00:44:26). Great. Thank you so much.

Operator: All right. Our next question comes from the line of Will Power. Will, please go ahead.

Q

Hi. It's [indiscernible] (00:44:38) here on for Will. Thanks for taking the question. Just on pricing and packaging, I think you mentioned that you started to introduce it this quarter. Kind of where would you say you are in that journey right now? And when do you expect to finish the transition? And when do you expect the bulk of the benefits to kind of kick in there? Any color would be great. Thanks.

Todd Nightingale

Chief Executive Officer & Director, Fastly, Inc.

A

I think it's going to be – it's going to be a relatively long transition in part because we're not trying to force it. We have lots of customers that want to run a true utility motion and especially customers in media entertainment. That's the motion they want to run. We have no intention of making any changes there. But there's a huge chunk of the enterprise market that wants an all-in-one package and especially they want reliable billing. And that's something that I think is good for us in that it makes our revenue a little bit more reliable, gives us strong sort of monthly renewing or monthly commit and revenue.

We're seeing the improvement in things like the RPO, which Ron added to the disclosure this time around. And, in part, I think so that you can track the progress here. I would say our sales motion, I hope to be kind of transitioned maybe in another 12 months, but I think the customer base will shift towards this maybe over the next two years until we hit kind of a steady state.

It was nice to see that, again, some of the big deals that we called out and named were using packages. And that new packaging system was a reason why some of them made the change from deeply entrenched incumbent, flat rate packaging, no overages, all-in-one feature set. That was nice to see.

Q

Awesome. Yeah. Thanks for the color there. And then just quickly on the competitive environment, what are you seeing in the core CDN, the business there? Any changes on the competitive environment? Thanks.

Todd Nightingale

Chief Executive Officer & Director, Fastly, Inc.

A

We have seen some consolidation in the market and some interest. But largely, the two big trends we see is there are large customers with a multi-CDN that are looking at vendor consolidation, and that tends to be good for us when we see that because they tend to choose the performance leader as one of their down selected vendors. And I think what we're seeing is that CDN more and more is being bought as part of an edge cloud solution. And so having the complete platform is an enormous tool. And we see some of our large competitors targeting that same kind of motion, and I think that's good. I think it's good for the industry that this is becoming much more of a platform play instead of a point solution.

Q

Great. Thanks a lot.

Todd Nightingale

Chief Executive Officer & Director, Fastly, Inc.

A

Sure.

Operator: All right. Our next question comes from the line of Rudy Kessinger. Rudy, please go ahead.

Q

Yeah. It's [indiscernible] (00:48:02) on for Rudy. I just had two quick ones for you. First off, I know you guys had said at the Analyst Day that revenue per server in Q2 was roughly – I'm sorry, in Q1 was roughly 12% below the peak. And I was just curious if you guys saw any further improvement in Q2.

Todd Nightingale

Chief Executive Officer & Director, Fastly, Inc.

A

It's a great question. We don't track revenue per server every quarter. I guess what I can tell you is, we did not have to deploy any significant additional hardware in this quarter, and the revenue went up. So, I feel like there's a good chance that the revenue per server increased. But to be honest, it's not a figure we track every single

quarter. It was disclosed during Investor Day because the trend was interesting and certainly in hindsight I think painted a picture. But it's really the cost of revenue that we are tracking most carefully. If I can optimize cost of revenue by adding a few servers and reducing other types of costs, we'll take that tradeoff all day long. I don't want my ops team chasing down a goal around revenue per server instead of just optimizing for gross margin overall.

Q

Got it. Yes. That makes sense. And then just second one, just any early feedback you've gotten from the bot mitigation beta? And then when will bot and DDoS products go GA? That's it for me. Thank you.

Todd Nightingale

Chief Executive Officer & Director, Fastly, Inc.

A

Oh, it's a great question. My security team will be so excited. No. We've had a very great response on the bot mitigation and we have a bunch of beta deployments out in the- in customers' hands right now. It's been going great, and we're really excited about that play.

On the DDoS side, obviously we've had lots of DDoS technology available from Fastly for years and years, but getting more DDoS visibility has been a win. The most interesting part of that has been an enormous amount of customer interest in the full managed security service, which includes the DDoS mitigation there. And that's been a nice tailwind and, to be honest, I think a really attractive service. It's something some of our competitors have had in the past. It gives a direct access to our security operations team, really in-depth threat mitigation. And those two, the security [ph] MSS (00:50:40) and the bot mitigation, we're incredibly confident in. And I think we're seeing really healthy pipeline growth right now.

Operator: All right. Thank you. [Operator Instructions] All right. Our next question comes from the line of Rishi Jaluria. Rishi, please go ahead.

Richard Poland

Analyst, RBC Capital Markets LLC

Q

Hey. This is Rich Poland on for Rishi. Thanks for taking my question. First one is just on the pricing and packaging, you mentioned it's good for some of those new industry wins and use cases. I think you called out retail and high tech in particular. Is there anything else besides the pricing and packaging that you've done over the past couple quarters to help be more suitable for those types of use cases? Just anything there that you could expand on a little bit.

Todd Nightingale

Chief Executive Officer & Director, Fastly, Inc.

A

Sure. I mean, we've pushed really hard on automation. You saw in the supplement, there's details on Dynamic Backends, which helps automate Fastly management. We pushed on the security side of the house with Mutual TLS. There's a bunch of work that we're doing to make the platform itself more powerful and, to be honest, easier to use and automate.

And I think there's a lot more work we have here on just simplifying our customer experience, making Fastly not just the most powerful edge cloud platform, but the easiest to use and the easiest to develop for; and we're working hard at that.

The strength of the platform has been, I think, really steadily increasing. We're very excited about – certainly, we're very excited about some of the security efficacy improvements we've seen. But if there was one thing that I could say that we've – that we're really pushing on hard where we've already seen benefits, and we hope to see a lot more, it's real platform unification because while the media vertical, I think, is very focused on direct content delivery, most other enterprise verticals really need a complete edge suite. They want a single platform, a single strategic vendor, and they want that to be as easy to onboard as possible. And so we've seen improvements in our – in account linking and UI consolidation. But as we get the full platform unification story, I think that's really going to help us knock down a lot of new logos in some of these expansion verticals.

Richard Poland

Analyst, RBC Capital Markets LLC

Q

Thank you. That's very helpful. And then just a follow-up on some of the security products that are rolling out, how should we think about just in terms of, like, monetization for some of those products? And how does that kind of flow into the model as we think about maybe just generally speaking, but then also as it applies to the pricing and packaging changes?

Todd Nightingale

Chief Executive Officer & Director, Fastly, Inc.

A

Sure. So, the security – the Web application security solution, we kind of try to sell that as one unified package, especially in our new modern packaging solutions, [ph] things like (00:54:09) DDoS, anti-bot mitigation, Next-Gen WAF. That, as one consistent package, I think that will be our primary motion, more and more. We obviously sell them à la carte, but you're going to see – I think we're going to see more and more of that. That is sold as a package, Web application security.

The TLS and the certificate solution usually gets sold kind of in conjunction with the CDN and certainly is really going to make that a lot easier, especially for a platform, what we call platform TLS, folks that [ph] need Web (00:54:46) support. A lot of URL. They have a lot of different Web presences and certainly is going to help us make that radically simpler for them. But I do think that will be sold separately. So, there's a little bit of a different motion there.

Yeah. I guess that's sort of how we see it. Largely, the core security solution being sold as a package, and things like TLS, certificate management, et cetera, being sold à la carte.

Richard Poland

Analyst, RBC Capital Markets LLC

Q

Got it. Thank you.

Todd Nightingale

Chief Executive Officer & Director, Fastly, Inc.

A

Sure.

Operator: All right. And that looks like all of our questions. I would now like to turn it back over to Todd and the team.

Todd Nightingale

Chief Executive Officer & Director, Fastly, Inc.

Thanks so much. Before we close the call, I want to thank our employees, our customers, our partners, and our investors. We remain as committed as ever to make the Internet a better place where all experiences are fast, safe, and engaging. Moving forward, we remain focused on execution and bringing lasting growth to our business and delivering value to all of our shareholders.

Thank you so much for your time today.

Operator: That concludes today's call. Have a pleasant day.

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