07-Aug-2024

Fastly, Inc. (FSLY)

Q2 2024 Earnings Call

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MANAGEMENT DISCUSSION SECTION

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

I would now like to turn the call over to Vern Essi, Investor Relations at Fastly. Vern, please go ahead.

Vernon P. Essi
Vice President-Investor Relations, Fastly, Inc.

Welcome, everyone, to our second quarter 2024 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

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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 filings with the SEC, including our most recent Annual Report filed on Form 10-K and quarterly reports filed on Form 10-Q filed with the SEC and our second quarter 2024 earnings release and supplement. For discussion of the factors that could cause our results to differ, please refer in particular to the section entitled Risk Factors. We encourage you to read these documents.

Also note that 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 during the third quarter, we will be attending the Piper Sandler Growth Frontiers Conference in Nashville on September 10.

Now, I'll turn the call over to Todd.

Todd Nightingale

Chief Executive Officer & Director, Fastly, Inc.

Thanks, Vern. Hi, everyone, and thank you so much for joining us. Today, I will cover our results and the dynamics facing our business and then discuss our recent technology developments, go-to-market initiatives, and the path forward. I will then hand the call over to Ron to discuss our second quarter financial results and our guidance in detail.

We reported revenue of $132.4 million for the second quarter, coming in above the midpoint of our guidance. Our operating loss of $12.6 million was also favorable to the guidance midpoint, thanks to strong gross margins and good cost control across the business. While I'm pleased with these results and execution in the second quarter, unfortunately, it does not offset the challenges we currently face with a small set of our largest customers. The industry has been challenged by the largest delivery customers as traffic projections have softened and focus has shifted to profitability. This has put increased pressure on vendors such as Fastly as our projected growth in those accounts has declined. We've taken initiatives to mitigate this impact. However, these customers constitute a material portion of Fastly's revenue, and we're seeing those effects in our projections for the rest of the year. Our top 10 customers, which is a fair proxy for these large delivery customers, has dropped from 38% of revenue in the first quarter to 34% in the second quarter.

Despite this drop in our top 10 customer revenue, we still managed to grow our top line revenue at 8% year-over-year. This was due to a 13% year-over-year growth in the rest of our customer base as a result of the actions we initiated a year ago in transforming Fastly's business. Specifically, it underscores the changes in our go-to-market strategy as we continue to drive customer acquisition and expand customer wallet share with our platform solution driving cross-sell and upsell. We've taken steps to bifurcate our business strategy to accommodate these large customers with more bespoke efforts that cater to their multi-vendor strategy.

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While we've been busy adjusting our sales and customer success teams to this dynamic, we haven't lost focus on driving customer acquisition and growth in the other two-thirds of our business to effectively outgrow this concentration risk over time. The success in this transformation will continue to drive top line revenue growth and become the foundation of our business. This is truly a moment of transition for Fastly. We must mitigate our legacy dependence on large multi-vendor customers primarily in the media vertical. By developing our channel and demand [indiscernible] (05:15) and by expanding our portfolio, we are reaching new verticals and building a more diverse customer base. This will drive more stability and higher growth for Fastly in the years to come.

On that note, our customer acquisition efforts showed strong improvement in the second quarter with our enterprise customer count at 601 compared to 577 in the first quarter, an increase of 4% sequentially. And on a year-over-year basis, we grew our enterprise customer count by 50.

Continued innovation is key to durable success in customer acquisition and wallet share growth. The Fastly platform is a software-driven edge network that offers best-in-class delivery, network services, security, compute, and observability. We continue to focus on investing in leading technology innovation that not only solidifies our platform, but also extends its features for the future of web application development. The functionality offer allows our customers to bring their applications to life around the world, and we believe that our unified platform approach will significantly enhance our customer retention and create efficiencies for Fastly in supporting our customer success.

Last quarter, we expanded our Security offering with the general release of our bot mitigation solution. We're excited to share that we have seen a strong response from customers, and that initial ramp has exceeded our expectations. As we shared last year, cross-sell will be a large part of our success in Security. Now that we have bot mitigation, in addition to WAF and DDoS prevention, we have a complete Security portfolio which will increase cross-sell and revenue growth from existing accounts. One example is a luxury retailer that was already a Fastly delivery and NextGen WAF customer. This retailer chose to replace an existing standalone bot solution with our technology, a truly demonstrating the power of Fastly's platform.

Edge compute is the next cornerstone of Fastly's platform, and we're seeing momentum in next-generation applications coming to that platform from existing customers. We've previously discussed how New Relic runs its observability workloads on our compute infrastructure, and there are other customer use cases as well. One great example of this is Yottaa, a SaaS platform designed to optimize enterprise online retail websites.

Recently, our partnership expanded to include edge compute technology that is complementary with their core service. This gave Yottaa engineers access to the Fastly API as well as the Fastly's cash management and data capture capabilities. After moving to Fastly, Yottaa saw a noticeable improvement in performance as brands experienced higher conversions and more engaged shoppers.

In June, we launched the beta version of our AI Accelerator, an AI proxy capable of delivering performance and cost savings to application builders, leveraging large language models. Fastly's AI Accelerator leverages the power of edge computing to deliver unparalleled performance worldwide. And importantly, developers can onboard this technology with a single line of code, allowing rapid adoption and a simple cost-effective developer experience. We announced the AI Accelerator at our developer event in New York and demoed it at our customer event, Xcelerate, in London. The interest and response here has been great. Beta testers have seen a dramatic speed improvement in cash results, and we plan to make this technology generally available in 2024. This is a key milestone for Fastly, our first truly AI product. And the activity here has been amazing. We are incredibly excited about the AI road map ahead.

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Turning to go-to-market, I'm delighted to share with you that we've brought on Scott Lovett as our new Chief Revenue Officer. Scott is an accomplished technology executive with decades of experience in cybersecurity and network services. His expertise includes all aspects of the go-to-market motion, driving multi-product line solution, and platform strategies, and delivering reliable growth in evolving markets. He's capable of both operating a global enterprise sales team at scale, and driving the transformation and evolution we will need over the next few years on our path to $1 billion in revenue. Scott joins us from Imperva, a cybersecurity company where he was the Chief Revenue Officer focusing on new customer acquisition and customer growth. Prior to Imperva, he led successful go-to-market teams at Akamai and Cisco. Scott is the ideal candidate for this role, and I'm thrilled to have him on board.

We continue to build upon the strong packaging foundation we launched last year. We recently launched our new self-service model with mix-and-match packages and evolved our free tier offerings. This marks the first time our recent PLG work is reaching the market, and you can expect more to come in future quarters. We also saw a material ramp in our initial Observability package, which hit its stride in the second quarter. As a result, our packaging motion is accelerating. And in the second quarter, our customer packaging purchases approximately doubled the first quarter's purchases.

Our channel partners continue to have strategic importance in our go-to-market efforts. In the second quarter, our deal registrations grew 33% compared to the first quarter, and our 2024 year-to-date revenue contribution from the channel is more than doubled compared to the second quarter of 2023. We anticipate more opportunity to leverage our channel and use it to help us drive top line growth.

Now, let me conclude with the discussion of our outlook and the path forward. The large customer headwinds we've seen have continued to impact our business. Unfortunately, our revenue outlook proved more dynamic as the quarter progressed than we expected. And as I discussed previously, this is a moment of transition, and we take this very seriously. We must continue to acquire new customers and grow accounts outside our large media cohort. This will diversify and strengthen our business, and this is exactly the path that we're on.

Our third quarter guidance of 3% year-over-year growth and modified 2024 guidance of 6% year-over-year growth are materially below our budgeted plans. We have to take appropriate action to align our costs with this level of revenue, while also positioning ourselves to invest in future growth. Over the past year, we've controlled expenses effectively through efficiencies in our infrastructure, measured head count management, and trimming overhead.

Now, we are intensely focused on growing our business through customer acquisition, portfolio expansion, and innovation at the edge that drives lasting differentiation for application and web development teams. In order to achieve this next level of focus and growth, we will be restructuring the company. This will include reduction in discretionary spend and a review of our workforce staffing levels. While this is an extremely difficult decision, we believe this step is critical to secure our position in maintaining a path toward operating profit and positive free cash flow. Furthermore, this additional financial rigor enables Fastly to continue to invest in top line growth and to maintain our differentiation and competitiveness in 2025 and beyond.

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

Ronald Wayne Kisling

Chief Financial Officer, Fastly, Inc.

Thank you, Todd, and thanks, everyone, for joining us today.

I'll discuss our financial results and business metrics before turning to our forward guidance.

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Note that unless otherwise stated, all financial results in my discussion are non-GAAP-based.

Revenue for the second quarter increased 8% year-over-year to $132.4 million, coming in slightly ahead of the midpoint of our guidance of $130 million to $134 million. Network Services revenue grew 6% year-over-year to $104.2 million, and Security revenue grew 13% year-over-year to $25.4 million.

In the second quarter, we continued to see sequential declines in revenue from some of our largest customers that partially offset growth in revenue from other areas, particularly social media, development platforms, and gaming. The sequential declines in revenue from our largest customers were driven by further impacts from the reversal and the consolidation of Network Services vendors last year that we discussed in Q1 and also a continuation of lower follow-on traffic than we have historically seen following typical customer rerate.

As a result, Network Services revenue per gigabit declined more year-over-year than the historical trend line we've typically experienced. We anticipate this dynamic will continue throughout Q3, and then begin to moderate in the fourth quarter. Our top 10 customers comprised 34% of our total revenues in the second quarter of 2024 compared to 38% in Q1 2024, reflecting the impact of the revenue declines from some of our largest customers. Also, no customer accounted for more than 10% of revenue in the second quarter. As Todd discussed, customers outside of our top 10 grew revenue 13% year-over-year. As we continue to transform our business towards a bifurcated customer strategy, we will continue to focus our customer acquisition strategy and direct more development and go-to-market investment towards the broader market opportunity outside our top 10 customers.

Our trailing 12-month net retention rate was 110%, down from 114% in the prior quarter, and down from 116% in the year- ago quarter. The decline is primarily due to the revenue declines in some of our largest customers. We anticipate this will continue to be a headwind to our LTM NRR and revenue growth throughout the remainder of 2024.

At the end of the second quarter, our RPO was $223 million, down 2% from $227 million in the first quarter of 2024, and down 3% from $231 million in the second quarter of 2023. This decline is primarily due to our largest customers working through their remaining obligations over their contract term, partially offset by customers increasing their adoption of our packaging products, which are sold on a subscription or SaaS basis, and add to our committed RPO.

We had 601 enterprise customers at the end of Q2, a net increase of 24 compared to a decrease of 1 in the first quarter. This represented a 4% sequential increase in enterprise customer growth quarter-over-quarter. We had 3,295 customers at the end of Q2, a net increase of 5 from the prior quarter. And enterprise customers accounted for 91% of total revenue on an annualized basis in Q2, consistent with Q1. Enterprise customer average spend was $804,000, down 5% from $846,000 in the prior quarter, and down 2% from $818,000 in Q2 of last year.

I will now turn to the rest of our financial results for the second quarter.

Our gross margin was 58.5% compared to 58.8% in the first quarter of 2024 and up 190 basis points from 56.6% in Q2 2023 as we continue to benefit from cost control efforts, in bandwidth transit costs, and related hosting and managed services costs, which were offset by higher maintenance and support costs. Operating expenses were [ph] $90.1 million (16:57) in the second quarter, slightly better than our expectations. We saw higher commissions and event-related costs for RSA and our Xcelerate customer event impacting sales and marketing. This was offset by lower R&D expenses, driven in part by an increase in capitalized internal use software-related expenses. This was a 17% increase compared to Q2 2023, and up 2% sequentially from the first quarter. Recall, we

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recorded a $3.4 million sales and use tax benefit that favorably impacted our G&A expense in the second quarter of 2023.

Adjusting for this benefit in 2023, operating expenses increased 12% year-over-year. This modest favorability in our operating expenses, combined with better than expected gross profit, resulted in an operating loss of $12.7 million in the second quarter, coming in at the lower end of our operating loss guidance range of $16 million to $12 million.

In the second quarter, we reported a net loss of $9.3 million, or a $0.07 loss per basic and diluted share compared to a net loss of $4.6 million, or a $0.04 loss per basic and diluted share, in Q2 2023. The one-time $3.4 million sales and use tax benefit in Q2 2023 adversely impact our year-over-year profit-related comparison. Our adjusted EBITDA was positive in the second quarter, coming in at $0.8 million compared to $5.2 million in Q2 2023.

Turning to the balance sheet. We ended the quarter with approximately $312 million in cash, cash equivalents, marketable securities and investments, including those classified as long term. Our free cash flow for the second quarter was negative $18.5 million, a $16.4 million sequential decrease from negative $2.2 million in the first quarter. This decrease was primarily driven by a decrease in our cash from operations to negative $4.9 million compared to $11.1 million in the first quarter as first quarter cash from operations benefited from year end 2023 receivables that were collected in the first quarter. Our cash capital expenditures were approximately 10% of revenue in the second quarter, coming in above the high end of our guidance of 6% to 8% of revenue we shared on our Q1 call. As a reminder, our cash capital expenditures include capitalized internal use software. For 2024, we anticipate our cash CapEx will increase to 9% to 10%. However, we continue to expect our medium to long-term cash CapEx to fall closer to our previous 6% to 8% of revenue expectation.

I will now discuss our outlook for the third quarter and full year 2024. I'd like to remind everyone again that the following statements are based on current expectations as of today and include forward-looking statements. Actual results may differ materially, and we undertake no obligation to update these forward-looking statements in the future, except as required by law.

As Todd shared in his remark, while we are seeing growth in new customer acquisition, which we believe will lead to further revenue expansion longer term, we are facing a challenging environment of revenue decline from some of our largest customers continuing throughout the course of 2024, which is adversely impacting our revenue growth. Our revenue guidance reflects these dynamics in our business and is based on the visibility that we have today. We expect somewhat flat to modest sequential growth in Q3 revenues compared to Q2 due to lower revenue at some of our largest customers. For the third quarter, we expect revenue in the range of $130 million to $134 million, representing 2% to 5% annual growth. 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. For the third quarter, we anticipate our gross margins will decrease approximately 150 basis points relative to the second quarter, plus or minus 50 basis points.

As Todd mentioned, we will be taking measures to align our cost structure to the challenging demand environment. This will enable Fastly to focus our investment on go-to-market and product innovation to capitalize on our new customer acquisition momentum while achieving our operating profit and cash flow goals. These measures include a review of discretionary spending, contract renewals, new hire requisitions, and overall staffing. As a result, we expect to generate approximately $14 million of operating expense reductions throughout the second half of 2024. These savings will be spread across R&D, sales and marketing, and G&A. We expect that roughly one-third of the savings will impact the third quarter, with the remainder impacting the fourth quarter.

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As a result, we anticipate recording a one-time GAAP restructuring charge in the mid-single-digit millions in the third quarter, excluding the impact of stock compensation.

Our third quarter operating results will reflect the impact of the decrease in gross margins and the beneficial impact of the operating expense reductions I just mentioned. As a result, for the third quarter, we expect our non-GAAP operating loss to decrease to $12 million to $8 million and our non-GAAP net loss of $0.08 to $0.03 per share.

For calendar year 2024, we expect revenue in the range of $530 million to $540 million, reflecting annual growth of 6% at the midpoint. This reflects continued weakness in some of our largest customers, offset by growth outside of our largest existing customers and newer enterprise customers. We expect to continue to see gross margin improvement in 2024 compared to 2023 as we leverage costs on the incremental yet lower revenue growth. Our incremental gross margin remains north of 75% on a trailing basis. And as a result, we anticipate our 2024 gross margins will improve by approximately plus or minus 100 basis points relative to 2023. As a result, we expect our non-GAAP operating loss to be in the range of $33 million to $27 million, reflecting an operating margin of negative 5.6% at the midpoint, an improvement of 23% over 2023 operating loss margin of 7.2%. We expect our non-GAAP net loss per share to improve to $0.16 to $0.11, reflecting the improvement in our operating loss expectations. And we expect free cash flow to be in the range of negative $20 million to negative $10 million in 2024 compared to negative $59 million in 2023.

As we look to 2025, we believe this cost realignment will enable us to focus investments in go-to-market and product development to continue to drive new customer acquisition and revenue growth while improving shareholder returns. This brings into focus the goal of achieving operating income and free cash flow breakeven in 2025.

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

Operator?

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QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] And our first question today comes from the line of Jonathan Ho with William Blair. Jonathan, please go ahead.

Jonathan Ho
Analyst, William Blair & Co. LLC

Q

Hi. Good afternoon. I just wanted to start out with a little bit more detail on what happened with regards to these large customers and maybe what caught you offguard with these sort of declines. Are they continuing or should we expect sort of stabilization at these levels?

Todd Nightingale
Chief Executive Officer & Director, Fastly, Inc.

A

Yeah. We mentioned there's definitely softness in the traffic with those large accounts, primarily media, large media accounts. And there's certainly a push to profitability from within those teams, and we're seeing that and trying to react to their needs and the business priorities of those customers. We've really transformed our customer success motion for these large multi-vendor customers. We're focusing on delivering the kind of differentiation and the kind of service that they're looking for in a very bespoke way. So, we have consumed, obviously, some headwinds here in terms of the revenue projection for the back half, which you see in our outlook. But, yeah, we believe we've stabilized those accounts at this point.

Jonathan Ho
Analyst, William Blair & Co. LLC

Q

Got it. Got it. And then, just in terms of the guidance, can you maybe help us understand how you sort of came up with these parameters? With the revised guidance, how de-risked you feel at this point? And are there any other large contract renewals that are coming up in the back half of the year? I think investors really want to understand the downside potential here or whether it's just been completely taken out. Thank you.

Todd Nightingale
Chief Executive Officer & Director, Fastly, Inc.

A

Sure. I should mention that the correction or the adjustments we made to our guidance largely weren't due to renewals, but they were due to softness in the traffic projections in the back half, and obviously pushes the profitability from those accounts. And you know what? We're taking a much more high touch, much more bespoke approach in these accounts. And that's given us more confidence in our projections now. This change in sort of the customer engagement motion and the internal analytics that we're using to make those projections are pretty, pretty significant and fundamental to how we're operating. And it's giving us a lot more insight into the dynamics in the top 10. And we believe we've got a pretty good view here for the back half of the year.

Ronald Wayne Kisling
Chief Financial Officer, Fastly, Inc.

A

I mean, the only thing I would add is I think, with our overall process, Todd mentioned we've kind of revised our engagement model. We've added regular senior engagement with these largest customers. We believe that's given us a lot better visibility into the dynamics of these customers than we had at the beginning of the year. And we have a much more reliable outlook in terms of what the dynamics are in those customers where patterns really changed a lot earlier this year.

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Operator: All right. Thank you for the question, Jonathan. Our next question comes from the line of Fatima Boolani with Citi. Fatima, please go ahead.

Fatima Boolani
Analyst, Citigroup Global Markets, Inc.

Q

Hi. Good afternoon, and thank you for taking my questions. I wanted to ask you about the restructuring efforts that are going to be underway and crystallized in the back half of this year. And I wanted to specifically zero in on your comment that, hey, this is going to be more of a broad-based retail operation in terms of resources. But why would sales and marketing be kind of lumped into that, specifically as the aspirations are for driving new customer acquisition? And so, why would it be more of a blanket [indiscernible] (29:04)? What kind of gave confidence that you're not potentially hollowing out your sales capacity and your sales organization that could prove kind of detrimental potentially to some of those other growth aspirations? And then I have a follow-up. Thanks.

Todd Nightingale
Chief Executive Officer & Director, Fastly, Inc.

A

Yeah, absolutely. And I think the question points at the real point for the restructuring. We need to adjust our spend to the top line. And we're always focused on delivering discipline on the bottom line regardless of volatility in the top line. But how we're doing this as a restructuring and very specifically not a sort of peanut buttering across the org is we're restructuring the company in order to allow ourselves to invest in the go-to-market and most importantly, the most efficient parts of our go-to-market that help us drive customer acquisition and wallet share growth in key accounts. And at the same time, in technology innovation that will help us drive revenue growth and sales efficiency in the long run. And specifically, that really means a focus on security, on compute and on AI. And the restructuring is really designed not just to align our spend to our top line to maintain that discipline, but also to give us room to continue to invest in customer acquisition and in these key areas of innovation.

Fatima Boolani
Analyst, Citigroup Global Markets, Inc.

Q

Got it. And then, just to follow up on Ron's commentary with regards to CapEx. I think you talked to 9% to 10%, longer-term model of 6% to 8%. But you just have come out of a pretty meaningful network rebuild, re-architect, and up-leveling. So I'm wondering why that envelope still remains high, particularly in the context of some of your large media delivery customers ratcheting back their traffic levels? So, why would that not alleviate some of the incremental CapEx pressures? Thank you. That's it for me.

Ronald Wayne Kisling
Chief Financial Officer, Fastly, Inc.

A

Yeah. I mean, there's a lot of dynamics beyond it. I think one of the things that we have seen this year has been a positive thing is, on a global basis, more traffic. And so, as we look at traffic levels geographically, a lot of this is the CapEx needed to support regions where we've seen expanding traffic levels, which ultimately in the long term play out well because as we see higher traffic levels at some of these historically low-volume areas, we're able to drive lower costs on bandwidth and other costs that, ultimately, in the long term, will drive efficiency. So, some of it is largely driven by some of just the changes in the geographic traffic mix. And why we believe in the medium to long term is that 6% to 8% of revenue is still the right medium to long term as we really adjust our geographic footprint.

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Operator: All right. Thanks for the question, Fatima. And our next question comes from the line of Frank Louthan with Raymond James. Frank, please go ahead.

Frank G. Louthan IV
Analyst, Raymond James & Associates, Inc.

Q

Great. Thank you. Has Scott changed sales metrics to revise any quota guidelines so far? And if not, when will that be completed? And then, where do you think quota-bearing – where is quota-bearing head count now? Where does that need to be to reach your goals? Thanks.

Todd Nightingale
Chief Executive Officer & Director, Fastly, Inc.

A

Scott has only been on for a couple of months, and it's amazing how much impact he's had already. You've got, I think, a pretty great sort of focus on both the customer acquisition side, but also driving revenue growth specifically through cross-sell. And he's been looking very carefully at that. And, look, I've been incredibly impressed with the way he has come up to speed on our business, which probably shouldn't be surprising given his background and how quickly he's been making changes already, including changes here in order to make that team more efficient and capable of growing and maturing really in the short term.

Frank G. Louthan IV
Analyst, Raymond James & Associates, Inc.

Q

Okay. And can you clarify what percentage of your sales come from the channel today?

Todd Nightingale
Chief Executive Officer & Director, Fastly, Inc.

A

We don't disclose the percent from the channel. We've had pretty good success growing that channel, and we'll continue to invest there. But it's not a number we disclose. I will say I think a part of this future success of this transformation is going to be in optimizing those channel investments, especially around leveraging that channel to drive deal registration and customer acquisition.

Operator: Okay. Thanks for the question, Frank. And our next question comes from the line of Sanjit Singh with Morgan Stanley. Sanjit, please go ahead. Sanjit, you there?

Sanjit K. Singh
Analyst, Morgan Stanley & Co. LLC

Q

Apologies, I was on mute. Thank you for taking the question. I just have a higher level question in terms of where Fastly is in its growth and sort of profitability curve. With overall top line growth coming down to the low-single digits, the company is still unprofitable and understanding the restructuring actions you're taking, still likely to be unprofitable. And with the sort of uncertain macro backdrop, I mean, is there a risk that you start to see weakness on sort of your non-media business? And does that sort of – I mean, I just want to get a sense of like how you guys are thinking about pushing further on the profitability side while the top line may seem still uncertain, at least for the next few quarters or maybe for a couple of years, as we go into more of a macro downturn.

Todd Nightingale
Chief Executive Officer & Director, Fastly, Inc.

A

No, I think it's an important question. Really, I mean, I think the way we see this is as a moment of transition. You can see the change in our customer concentration happening extremely rapidly here. And what we're doing is

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really building a foundation in those non-top 10 large media multi-CDN accounts. And that's the foundation upon which we'll really build the business and especially build that business around our complete edge platform, including not just delivery, but security, a compute, observability, AI, et cetera. And we really see this as a period of transition. It's why we're restructuring in order to be able to drive investments into those other areas and drive investments in the go-to-market that's needed to run a true platform play, a true multi-product line play to make that revenue base stronger, stickier, and higher growth through cross-sell. We are adjusting our spend to our top line to maintain bottom line discipline. Despite this volatility, we're doing it in a way to really transform the company and take this as an opportunity to drive growth in 2025, as well as profitability.

Sanjit K. Singh
Analyst, Morgan Stanley & Co. LLC

Q

Understood. And with the new Chief Revenue Officer being onboarded, how do you see the sort of go-to-market strategy execution in sort of year one of his tenure in terms of the magnitude of change that you expect him to bring to the organization?

Todd Nightingale
Chief Executive Officer & Director, Fastly, Inc.

A

Yeah, the restructuring is kind of accelerating that in a lot of ways. And a big chunk of the restructuring and the reconfiguration that Scott had begun planning for next year, I think we're able to do now instead, by taking this as an opportunity to drive urgency. And pulling that forward, I think, is great. I think it's also helping us prepare to really push hard on the cross-sell motion and upsell motion throughout that long, long tail of enterprise accounts.

Operator: All right. Thanks for the question, Sanjit. [Operator Instructions] And our next question comes from the line of James Fish with Piper Sandler. James, please go ahead.

Q

Hey, guys. This is [ph] Quinton (37:51), on for James Fish. Thanks for taking our questions. Maybe this is for Ron. As we think about the guide change here, when you guide in the prior quarter, it sounded like delivery expectations for these largest customers had been dropped down essentially just to minimum commitment levels. Was this not the case? And so, now, the updated guide is just embedding minimum commits or are you seeing those top 10 customers fall below prior kind of minimum commits and so the downside is just a little bit tougher to gauge?

Ronald Wayne Kisling
Chief Financial Officer, Fastly, Inc.

A

Yeah. So, we look at our largest customers, not all of them actually have a commit. And in many instances, their commit levels are well below or meaningfully below where their expected traffic levels are. So, the commit really isn't, if you will, a good guide. Think of these customers as really on a utility basis with variable traffic. And I think that's something we've spoken about in terms of kind of the dynamics on our forecasting process. And I think while – historically, we had a reliable model around this. I think the break in patterns that we saw with these largest customers really had a significant impact because they're our largest customers. And this impact was a lot greater and more sustained than we had anticipated last quarter. I do believe, with the increased engagement model that we put in place, the senior level engagement regularly with these customers is that we now have much better visibility into their own internal dynamics around their traffic expectations and traffic allocations. And that

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visibility translates into a much more reliable view of how their business will play out over the remainder of the year.

Q

Got it. That's helpful. And then, sticking with the top 10 customers, obviously, it sounds like the vast majority of pressure sits on the delivery side rather than security. Are there any sort of impacts from the customers taking down traffic that's impacting security, that's kind of driving some of deceleration? Or what do you need to kind of see re-acceleration? It sounds like packaging is going well and the incentives across kind of sales and marketing are in place. But we just haven't seen kind of stabilization across that segment. Thanks.

Todd Nightingale
Chief Executive Officer & Director, Fastly, Inc.

A

Yeah, those top 10 accounts tend to be very delivery-heavy, very media-heavy. And so, it does tend to be concentrated on the delivery side and, certainly, concentrated in the media vertical. And we see the momentum building outside those top 10 accounts, and very specifically outside of these large multi-vendor primarily media accounts. And it's about putting fuel on that fire. It's about investing in that enterprise motion while at the same time building bespoke customer engagement with those top accounts and returning them to growth and the growth we've been used to there. Our focus is really on trying to make sure that we stay on top of both of those initiatives at the same time.

Operator: All right. Thanks, [ph] Quinton (41:05). And our next question comes from the line of Will Power from Baird. Will, please go ahead.

William V. Power
Analyst, Robert W. Baird & Co., Inc.

Q

Great. Thanks. I was hoping just to drill down maybe just a little bit more on the top 10 pressure. I guess I'm just trying to understand, is this two or three customers, or is it really kind of broad-based across all the top 10? And anything else you could share just on industry traffic trends versus potential share loss to competitors?

Todd Nightingale
Chief Executive Officer & Director, Fastly, Inc.

A

Yeah, it really is a small number of accounts, but all of the top 10 is a small handful, less than a handful, I guess. But these are large accounts. And there is a lot of revenue in those accounts. And we take it very, very seriously. It's why we changed our motion in the way we engage, not just in those handful, but across that top tier of medium multi-CDN accounts. There really is strength in that rest of that business. And as we're bringing more technology to market, especially in the Security side, we're starting to see some real potential for the remainder of the business. And we've also seen a lot of stabilization in the top 10, just at a lower level than we expected. [indiscernible] (42:31).

[indiscernible] (42:34)

William V. Power
Analyst, Robert W. Baird & Co., Inc.

Q

Go ahead.

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Todd Nightingale
Chief Executive Officer & Director, Fastly, Inc.

A

No, go ahead.

William V. Power
Analyst, Robert W. Baird & Co., Inc.

Q

Well, no, I was just going to ask if there is any other color on, you know, just being, you know, more of an industry slowdown in traffic versus some of your top 10 customers just looking to diversify their vendors to reduce costs.

Todd Nightingale
Chief Executive Officer & Director, Fastly, Inc.

A

Yeah. I mean, we mentioned this in the call last time. There's certainly softness in the traffic projections that we are expecting. There are people who are, again, like, focused on that multi-vendor strategy and maybe adding a vendor here or there. We haven't, like, been removed from any of those accounts. We continue to have very strong partnerships in each of them. We just have drops in the revenue projection, which is affecting the guide.

Operator: All right. Thank you, Will. And our next question comes from the line of Jeff Van Rhee with Craig-Hallum. Jeff, please go ahead.

Jeff Van Rhee
Analyst, Craig-Hallum Capital Group LLC

Q

Great. Just two for me. Just to follow up on Will's question there. Can you just break it down roughly proportionally how much of the revenue reduction was share loss at media customers versus reduced spend expectations at those customers overall?

Todd Nightingale
Chief Executive Officer & Director, Fastly, Inc.

A

Yeah, it is a good question. It's just that we don't break down those numbers and disclose them, but there's a handful of those. There are areas where both of those are happening. We're seeing softness on the traffic side for sure, and we're seeing less revenue due to repricing in a handful of accounts. And both of those things are occurring. We do always expect to see some repricing, not just in our large accounts, but across the board. And with those repricings, we also expect to see increases in traffic as a natural part of our business. We just haven't seen that traffic increase as much as historically we've seen, as Ron mentioned. And because of that, we're just seeing this impact on the revenue guide.

Jeff Van Rhee
Analyst, Craig-Hallum Capital Group LLC

Q

Okay. And then, if I were to look at the revision to the guide, implicit in there outside of media, how did your outlook change on non-media revenue?

Todd Nightingale
Chief Executive Officer & Director, Fastly, Inc.

A

We don't disclose that exactly in media, non-media, but we do disclose the top 10 and outside of the top 10. And the number is outside of the top 10 or the momentum is building there. We feel pretty strong about it. And again, I really believe that is what's going to drive a more diversified revenue base for Fastly in the long run. It's going to

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drive a healthier and more accurate projection and broader growth really globally and across all the enterprise verticals, more predictable growth, and growth that will be tied more closely to the portfolio expansion in security and compute, et cetera. So, we feel pretty good about the projection outside those large top 10 accounts and outside the media accounts, especially in the back half.

Operator: All right. Thanks, Jeff. And our next question comes from the line of Madeline Brooks with Bank of America. Madeline, please go ahead.

Madeline Brooks
Analyst, BofA Securities, Inc.
Q

Hi. Thanks for taking my question. Just one for me. So, if I look at the implied guide for 4Q, that would suggest roughly 1% decline in revenues. If I then take that with the top 10 customers [indiscernible] (46:12), just projecting out similar growth trends, right, so 13% for not top 10 customers and continued decline with your top 10, my rough math would suggest that around 80% of the business by fourth quarter should be those non-top 10 customers. I just want to point to comments from last quarter's call where you did suggest that we should see healthy momentum from customers that were signed a year ago kick in in the back half of the year. So given those two trends, right, where we should see customers, you know, outside of top 10 being over 80% of the business, and we should see healthy contribution from customers that were added over the last couple of months. I guess, can you help me bridge the gap as to why that implied negative 1% guide is the correct guide? Because those two seem to be in contradiction of each other.

Ronald Wayne Kisling
Chief Financial Officer, Fastly, Inc.
A

Yeah. I mean, I think addressing kind of the question of top 10 concentration. While we expect to see some continued decline in the concentration in our top 10 customers, we do expect that decline to be slower or decline from what we really saw in the first half, where we saw the big flip from 38% to 34%. We'll see some continued decline, but not at the rate we saw in the first half. That does sort of imply, though, as that comes down, that we continue to see strength in the growth rates of the non-top 10, very healthy. And I think to your question, we really haven't seen any real change in our outlook outside of the top 10.

[indiscernible] (47:44)

Ronald Wayne Kisling
Chief Financial Officer, Fastly, Inc.
A

Sorry, Madeline. Can you clarify [indiscernible] (47:49) 1% number?

Madeline Brooks
Analyst, BofA Securities, Inc.
Q

If you just take the 3Q guide and then back out first quarter and second quarter and then implied – and then your 3Q guide, you would get the implied 4Q of roughly, if I'm rounding 1%, but I think it's at negative 0.6% decline. That's what I'm getting. The other two – sorry, Ron, just to reiterate that then. So, the 13% growth trajectory that you saw outside of top 10, you're expecting it to continue at that pace for the remainder of the year?

Ronald Wayne Kisling
Chief Financial Officer, Fastly, Inc.
A

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I think, implicit in the math, if you see some continued deceleration, although at a slower rate in the top 10, that non-top 10 growth rate, you should see that some nominal improvement in growth rates outside of the top 10 in the second half.

Todd Nightingale
Chief Executive Officer & Director, Fastly, Inc.

A

And I think that's really what's going to drive the diversification of our revenue. And in fact, the customer acquisition that you mentioned become more and more impactful, I expect our customer concentration to continue to come down. That drop from 38% to 34% in just one quarter, obviously, I think is an anomaly. But I do expect and I think it's healthy for that to slowly continue to decline as the growth of the rest of the accounts becomes more the predominant driving force there.

Operator: All right. Tthanks, Madeline. And our next question comes from the line of Rudy Kessinger with D.A. Davidson. Rudy, please go ahead.

Rudy Kessinger
Analyst, D.A. Davidson & Co.

Q

Hey. Thanks for taking my questions. So, your top 10 were about $45 million in revenue in Q2. What's the floor? Are all of those customers per utility? And could they all cut off 100% of traffic tomorrow or is there any floor? Is it $10 million, $20 million? I guess, just how much potential further downside could there be? I know you guys are saying you feel you have a good handle on it, but you also said that 90 days ago.

Ronald Wayne Kisling
Chief Financial Officer, Fastly, Inc.

A

Yeah. I mean, fair point. I think if you look at the top 10, there is a mix because generally not all of the customers do have a commitment, but some of the customers do have a commitment in their traffic levels. So, to that point, if they hold to their commitment, there is a meaningful amount of committed revenue across those top 10 in whole. Again, not all of those customers are in streaming. And Todd mentioned earlier, a small handful of these where we've seen the headwind. We've seen some positive momentum and some new customers come into the top 10 this year. So, you've got different dynamics moving there across each of the customers. So, to the point, these headwinds are not across all the top 10. There are commitments in there and there are customers where the dynamics are positive.

Todd Nightingale
Chief Executive Officer & Director, Fastly, Inc.

A

Just to add one point to that. Part of this new customer engagement motion that we have implemented in the last few months is about driving additional commitments into that space. Traditionally, that part of the market has relatively small commitments and a huge utility upside, and we've been working hard at improving that balance and getting a larger commitment in exchange for more traffic and rate changes.

Rudy Kessinger
Analyst, D.A. Davidson & Co.

Q

Okay. And then, Security slowed to 13% year-over-year, which is the slowest on record. What's the expectation for growth in Security implicit in your second half guide? Do you expect any acceleration with the top products out there?

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Todd Nightingale
Chief Executive Officer & Director, Fastly, Inc.

A

Yeah, we don't disclose projections by product line. But I can tell you, we're deeply focused on Security. I'm, certainly, not satisfied with the 13% number there. And that represents some softness in that product line that is regrettable. We're going to be deeply focused on bringing that Security growth rate back into the high-20s, if not higher.

Operator: All right. Thanks, Rudy. [Operator Instructions] And our next question comes from the line of Tom Blakey with KeyBanc Capital Markets. Tom, please go ahead.

Thomas Blakey
Analyst, KeyBanc Capital Markets, Inc.

Q

Hey, guys. Thanks for taking my question. I think what I'm trying to just understand what's kind of baked into 2025, I guess, a little bit with regard to these large media customers. I think you've given a lot of color there. Maybe shifting to pricing, I think pricing commentary in prior quarters was okay. There was no kind of like alarm there. But I think some of Ron's comments was maybe is the grading from a quarter-on-quarter perspective. But can you just give an update on pricing? And if you could, if you wanted to help us focus on the pricing dynamics of the non-media, what's going on just in the general health there? And I have a follow-up.

Todd Nightingale
Chief Executive Officer & Director, Fastly, Inc.

A

I think the point in Ron's statement is [indiscernible] (52:59). We have seen pricing pressure in those large media accounts. There's definitely a trend that those accounts are deeply focused on profitability. We're seeing that in their disclosures as well. And I'm sure your teams are tracking it. Outside of those media accounts, the pricing model has been pretty successful. We're seeing good momentum in packaging, I think, because that SaaS style model and the pricing environment is pretty healthy, and that's not just on the delivery side, but across Security and the surge we saw in the launch of the Observability packages. The pricing has been pretty good across that space. It's helping us keep our gross margins on target, which is great despite less top line revenue. And I feel pretty good, to be honest, about pricing outside of media, for sure.

Thomas Blakey
Analyst, KeyBanc Capital Markets, Inc.

Q

Great. Thanks, Todd. Yeah.

[indiscernible] (53:56)

<Q – [05QZPM-E]Tom Blakey – KeyBanc Capital Markets, Inc.> [indiscernible] (53:57) is a segue for the second question to Ron about the gross margin. You outperformed them. The second quarter seems to be taking a step down in the third quarter. Just walk us through maybe the dynamics there and helping us kind of like understand where we should exit and heading into 2025 around 50% kind of like targets that we were talking about in prior quarters should be helpful. Thanks, guys.

Ronald Wayne Kisling
Chief Financial Officer, Fastly, Inc.

A

Certainly. I think we've used one of the dynamics on the gross margin decline. You saw sequentially, although it was a fairly small decline, is we're seeing a little bit higher pricing adjustments than we've seen in the past. But

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those tend to fluctuate a little bit. You recall, we saw higher pricing declines in the first half of 2023 that sort of moderated in the second half. I think we're going to see the same dynamic this year where we saw higher pricing discounts in the first half. As you know, some of these largest customers focus on profitability. And we didn't see traffic, and so we raised it. It didn't bring additional traffic. We expect that to soften a little bit in the second half over the course of the year. And with this transition, that Todd spoke about, as these largest customers become smaller percentage and we see increasing growth in the non-top 10, that's going to drive some favorability in our gross margins moving forward as some of this pricing pressure starts to mitigate in the second half. And those largest customers where we're seeing this are a smaller concentration.

Operator: All right. Thanks, Tom. And that concludes our Q&A session today. So, I will now turn the call back over to Todd Nightingale for closing remarks. Todd?

Todd Nightingale

Chief Executive Officer & Director, Fastly, Inc.

Thanks. This time marks a moment of transition for Fastly. And I want to thank the team for their commitment and continued focus on our customers and on Fastly's growth. Restructuring the company is a necessary step, but this decision was not taken lightly as we care deeply for all of our employees and all of our teams. Everyone on the call today, I want to thank you for joining us and for your interest and support. Thank you so much.

Operator: Thanks, Todd. And ladies and gentlemen, that concludes today's call. Once again, thank you all for joining. And you may now disconnect.

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